



Response to the questions posed in ‘ERGEG Principles: Capacity Allocation Mechanisms and Congestion Management Procedures’

EFET¹ welcomes the opportunity to respond to the above consultation. We consider that congestion management and capacity allocation is a difficult but essential area of work where good policy will provide immediate improvements to market developments.

Congestion management and capacity allocation needs to make sure that:

1. Capacity is calculated efficiently;
2. Capacity is sold efficiently to market participants;
3. Market participants use their capacity rights efficiently;
4. There is the necessary level of coordination between TSOs and between regulatory authorities;
5. Market participants have the potential to align (or split) their bookings across multiple transmission networks; and
6. All market participants have the information they need for the efficient operation of these processes.

The challenge for European Regulators is clearly to provide system operators and users with the correct incentives to manage and use the transmission system in a way that the above-mentioned principles are met. With this response to the consultation questions, EFET offers its views on the principles proposed by ERGEG.

EFET welcomes the majority of the conclusions in the consultation and considers that Guidelines would be an appropriate tool to improve current processes.

1. Do you agree with the problems that ERGEG has identified with capacity allocation and congestion management? Are there other aspects that should be taken into account?

EFET welcomes the recognition that in some parts of Europe problems do exist for capacity allocation. Action is necessary to improve primary capacity allocation, especially in the case of congested and potentially congested system entry points and to encourage the development of secondary capacity markets across certain key interconnections.

We are unsure whether a policy approach differentiating between congested and potentially congested points (especially within a particular market) is workable. We recognise that market participants who, as a result of their historical position, dominate capacity booking at certain locations, should bear some particular responsibility to help make the market work. Different treatment at different points however, which could presumably alter over time, could add significant complexity and possible confusion.

¹ Established in 1999, the European Federation of Energy Traders (EFET) is an industry association representing over 90 trading companies operating in more than 20 countries. The EFET mission involves improving conditions for energy trading in Europe and fostering the development of an open, liquid and transparent European wholesale energy market. More information about EFET views and activities is available on www.efet.org.



An alternative if there are specific serious concerns relating to a dominant capacity position at a certain location is for the contract and behaviours involved at that one location to be investigated and remedied using competition law procedures.

2. The scope of ERGEG's principles and of the derived proposals covers bringing capacity to the market where there is currently contractual congestion. Do you agree with this approach?

EFET expects that the solution proposed by ERGEG would bring some capacity to the market where there is currently contractual congestion, but the overall goal must be to improve the traded market throughout Europe. It is not clear that the ERGEG proposal would be the best solution where contractual congestion occurs.

It is EFET's position that contractual congestion issues are more specific to particular markets because they are the result of previous (often pre-liberalization) allocation approaches, and therefore should have more focused policies. On the other hand, capacity allocation issues are better suited to broader application as they represent the ongoing provision of capacity where harmonization of thinking at a regional or European level would bring the greatest benefits.

EFET also has concerns that policy on contractual congestion could be too target driven (i.e. provide day ahead firm capacity) without due consideration of the broader implications for all existing shippers.

As a more enduring long-term solution, **EFET would advocate stronger incentives and/or obligations being placed on TSOs to efficiently manage capacity on their networks**, including updating the calculation of available capacity. This will encourage them to develop new capacity products that reflect the characteristics of their networks and respond to the needs of all network users (both actual and potential holders of capacity). This would be more effective and efficient than a solution imposed by regulators.

For example, even where there is contractual congestion it is unlikely that all capacity will be nominated and as such there will always be unused capacity – which represents a deadweight loss. TSOs should be able to anticipate and react to this outcome by initially selling more than 100% of the capacity that is actually available. In the unlikely event that more than 100% capacity is nominated TSOs can opt to 'buy-back' capacity from market participants. In this way, all capacity is utilized and those market participants that have been constrained will be paid a market price in compensation.

EFET recognizes that TSOs are likely to be exposed to higher risks in operating the networks in this way and as such they should be rewarded (if they are successful) with a commensurately higher rate of return. The level of risk TSOs are potentially exposed to needs careful consideration as a balance needs to be struck between ensuring capacity is managed efficiently and the costs TSOs incur in operating their networks.



EFET urges regulators to review the incentive framework provided to each TSO to manage capacity and to see what measures need to be put in place to encourage them to take more efficient and effective decisions. EFET is ready to contribute to this work.

Discussions within our membership have resulted in a variety of views including some supportive of targeted restrictions at particular points. In the main, however, our members identified a number of risks that could emerge with restrictions to renomination rights. These risks include:

- Creating artificial barriers between markets that prevent the economic flow of gas;
- Higher performance risks for shippers under existing contracts which are often structured around existing nomination regimes.
- Lower secondary market value of capacity as it is sold with embedded restrictions, compared with the new day ahead firm capacity that can be renominated without restriction.
- A higher reliance on flexibility services within a country to manage shipper positions where sellers know that the competitive threat of cross border flexibility is reduced.
- A threat to market integration in order to solve issues by cross border restrictions rather than action within a particular market.
- The economics of some cross border investment, such as in storage, could be undermined by restrictive ingress or egress.
- It could introduce strategic behavior for capacity management.

3. In principle, European regulators consider FCFS allocation potentially discriminatory. Do you share this view? What do you think about the proposed mechanisms (OSP with subsequent pro-rata allocation or auctioning)?

EFET agrees that FCFS is not an appropriate approach in the liberalizing gas markets and that it is potentially discriminatory, particularly where it applies to congested points. We welcome this position from ERGEG.

EFET also has concerns about the underlying approach of FCFS being used for congestion management. For example, the principle of CMP described as Last Committed First Interrupted (LCFI) in the ERGEG paper is potentially discriminatory for the same reasons as FCFS is for capacity allocation whenever congestions are to be managed.

The primary allocation of existing capacity needs to be re-thought so that there is a market-based allocation method wherever congestion needs to be managed.

Furthermore the investment decision for additional capacity should be based on a pre-agreed economic test that has been agreed between the regulators, TSOs and market participants². OSP, auctioning and open seasons can all be appropriate mechanisms for capacity allocation when they are properly structured.

² Available on the EFET website at <http://www.efet.org/default.asp?Menu=283>



4. In your view, what is the future importance of the proposed capacity products (firm, interruptible, and bundled) and of the proposed contract duration (intra-day up to multi-annual)?

Traders need a variety of capacity products to be available. The EFET papers on primary and secondary capacity set out our preferred approach.³ EFET agrees with the longer-term goal of at least some allocation of capacity from one trading hub to another as a firm bundled product that could be ‘unbundled’ and traded by the capacity holder if they wish to do so. The first step must be to ensure that there is more consistency in the capacity allocation and products offered by connected TSOs.

EFET considers that flexibility in terms of product choice and duration at the primary allocation stage (including being able to hold capacity on just one side of the border) not only provides a better opportunity to get a shipper’s capacity portfolio right, but importantly reduces the reliance on second best measure to deal with contractual congestion.

5. What is the role of secondary capacity trading?

Secondary capacity trading is a tool for optimizing shippers’ trading portfolios. Shippers have no desire to miss market opportunities, carry imbalance positions or not deliver on contracts, nor do they wish to pay for capacity they have no intention to use.

A properly functioning secondary market discovers the value of congestion. For points with no congestion, the secondary market would compete with primary capacity prices (both firm and interruptible). For congested points the value represents the economic costs of alternative optimization solutions, so can offer a mechanism for efficient allocation.

The incentives on TSOs are also important for the delivery of an efficient secondary market solution. It could be argued that in some markets, TSOs have little incentive to encourage more efficient allocation of capacity, which would lead to higher utilization rates. Better incentives, such as a revenue driver based on throughput, could further encourage TSOs to develop platforms and better processes to facilitate secondary trading.

6. How do you assess the proposed measures to enhance the availability of firm capacity and to improve short-term and long-term congestion management?

In gas, production and import flexibility is a key source of downstream market flexibility. Broad access to such flexibility is a crucial element in the creation of liquid energy markets as it allows responses to changing market conditions. Re-nomination rights are widely acknowledged as essential for an efficient gas market to be able to respond to volatile demand or market signals in general.

The proposal to limit re-nomination rights would restrict the ability of market participants to supply flexible products (including physical and virtual storage and production and import flexibility). Restriction of re-nomination rights would be especially problematic for

³Available on the EFET website at <http://www.efet.org/default.asp?Menu=283>



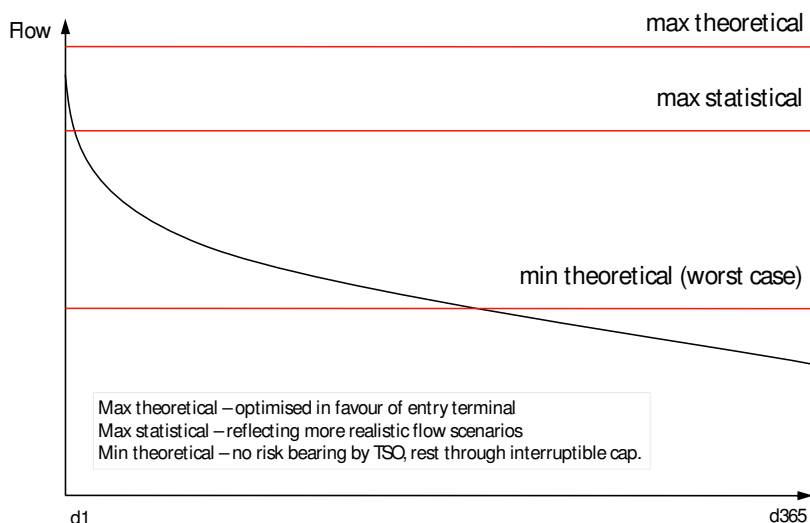
markets that continue to have hourly balancing requirements. Practical examples of the application of ERGEG's particular approach to curtail re-nomination rights should therefore be worked through and compared with alternative approaches such as the one mentioned above for increased TSO incentives.

7. What are your views on the proposals? Do they address the problems? Will they lead to more effective capacity allocation methods being developed?

The improvements to the allocation mechanisms are welcomed. Better allocation reduces the need for second best solutions for congestion management as shippers are better able to build efficient capacity portfolios through primary sales.

In our view ERGEG seems to focus more on enhancing the availability of short term firm capacity rather than long term provision. EFET believes that the integration of European markets requires the release of additional – short and long term – transmission capacity, EFET also believes that **there is huge potential to maximize available capacity through improved methods of capacity calculation**, in particular the implementation of dynamic modeling by TSOs.

When calculating technical system capacity TSOs currently use a scenario approach that ensures smooth operation of nominated flows even under hostile circumstances, e.g. sudden drop in temperature, unplanned outage of production field or storage. It is basically because of this approach that interruptible capacity still plays a major role in continental gas transport: it releases – probably – unused capacity to the market without putting TSOs at risk of having to compensate capacity holders in the unlikely – although possible – case of usage. But as this “probability” can be statistically calculated by TSOs there is a realistic possibility to allocate this risk fairly and maximizing the available technical (i.e. firm) capacity to the market.



Therefore, TSOs should move to a **maximum technical capacity** approach that takes into account a certain risk of not being able to deliver all the sold capacity. TSOs should



be entitled and obliged to buy back capacity at a market price in the –unlikely– event, that they cannot fulfill their obligations (capacity buy back mechanism). Certainly, this approach requires that revenue regulation of TSOs is adjusted accordingly in order to allow for symmetric risks and chances,

Regulators should ensure that TSOs have appropriate compensation and incentives to improve their modeling capabilities as an immediate priority.

8. Are the needs of shippers performing supply activities properly taken into account?

EFET is not sure what this question is asking. However, we do not believe that it is necessary to distinguish between different types of shippers when it comes to the efficient allocation and management of capacity. Regulators should avoid second guessing motivations and requirements of different market players as there is no clear or meaningful divide between Transmission System users.

9. Are the proposed measures suitable to facilitate development of liquid gas markets?

Overall, the improvements suggested by ERGEG would help in some markets, but some proposals, in particular the unilateral restriction of re-nomination rights, are probably not the best approach for the reasons that we have already explained. A further point is that several markets are a crucial formative stage in the development of balancing markets, and the restriction on re-nomination could make the development of an intra-day gas market more difficult. We also think it is necessary to think about markets in a regional or European sense. While policies directed at particular markets may look potentially positive, consideration should also be given to the impacts on investment and activity in neighboring markets.

EFET would like to reiterate that without greater transparency none of the proposals will be effective. In this respect we strongly welcome that ERGEG's proposals seek to reinforce the provision of useful information on the availability and use of gas infrastructure.

10. In your view, how important are compatible booking and operational procedures between adjacent systems?

Essential if there is to be a fully efficient market, but this is just one element of TSO co-ordination that should be addressed. Far more fundamental is the operation of the EU pipeline system (or at least consistent planning and operation of some parts of the regional systems) to optimize the availability of capacity that is offered to the market on a consistent basis.

11. Do the proposed measures increase the efficient use of the system? What aspects would you support and like to see further developed?

There might be an increase in efficiency in parts of the system in some areas, and a decrease in liquidity in other parts. The ideas may warrant a trial in part of the market where a real problem has been identified and where the downstream market (in particular an intra-day market) has not been established. In any case, it would be useful



to have a view from ERGEG on what constitutes efficiency, and also a view on whether alternative approaches would be more efficient and effective.

EFET would like to see measures to ensure the coordination of regulatory decisions across borders in the area of CAM and CMP. The current proposals could be developed to address this.

Conclusions

EFET is very supportive of the ERGEG consultation and is keen to improve capacity policy especially in the area of allocation. For congestion management, we support improvements that bring more firm capacity back to the market, but have concerns about the preferred solution. We consider that other approaches could be less complex and less risky for liquidity development in specific markets and in the European markets as a whole.

Importantly, for congestion management, **we believe that it is simpler to encourage TSOs to sell more firm capacity where there is enduring high levels of underutilization of specific pipelines.** This is easier to implement contractually, provide impetus for the secondary market to gather the rents otherwise accruing to the TSO, can be implemented quickly and importantly does not distort economic flows of gas.

EFET would be pleased to continue working with ERGEG and other stakeholders on improved solutions to deliver improvements to market liquidity.