

Market-Based Investment Procedures for Gas Infrastructure: Issues and Approaches

A CEER Public Consultation Paper

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Abstract

This CEER document (C12-GWG-87-03) addresses market-based investment procedures for gas infrastructure and stems from CEER's commitment in its 2012 work programme to develop proposals on how to identify and integrate new capacity, based on market demand and coordinated market procedures, in consultation with stakeholders. The need to develop such proposals has been identified in various contexts.

The aim of this paper is to consult on options for an investment regime which builds on the advantages of the merchant approach without the need for exemptions and which are fully fit for purpose for cross-border projects.

Following the consultation, CEER will elaborate a conclusions document incorporating stakeholders' input and an evaluation of responses paper. The results of this consultation will be used to support the further development of the European gas target model and the European framework guidelines and network codes.

Target Audience

Energy suppliers, traders, gas/electricity customers, gas/electricity industry, consumer representative groups, network operators, Member States, academics and other interested parties.

How to respond to this consultation

Deadline: **14 September 2012**

This public consultation is carried out through a dedicated online questionnaire on the European energy regulators' website. To participate in the consultation please go to:

http://www.energy-regulators.eu/portal/page/portal/EER_HOME/EER_CONSULT/OPEN%20PUBLIC%20CONSULTATIONS/Investment%20Procedures%20for%20Gas%20Infrastructure/BG

and fill in the login request form. You will be provided with a login and technical instructions for the questionnaire.

If you have any queries relating to this paper please contact:

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All responses except confidential material will be published on the website <http://www.energy-regulators.eu>.

Treatment of confidential responses

In the interest of transparency, CEER

- i) will list the names of all respondents (whether confidential or not) or, alternatively, make public the number (but not the names) of confidential responses received;
- ii) requests that any respondent requesting confidentiality submit those confidential aspects of their response in a “confidential appendix”. CEER will publish all parts of responses that are not marked confidential.

For further information on CEER’s rules, see CEER Guidelines on Consultation Practices¹.

Related Documents

CEER documents:

- “CEER Vision for a European Gas Target Model. Conclusions Paper”, Ref. C11-GWG-82-03, 1 December 2011, http://www.energy-regulators.eu/portal/page/portal/EER_HOME/EER_PUBLICATIONS/CEER_PAPERS/Gas/Tab/C11-GWG-82-03_GTM%20vision_Final.pdf
- “Draft Vision for a European Gas Target Model: A CEER Public Consultation Paper“, CEER, Ref. C12-GWG-77-03, July 2011, http://www.energy-regulators.eu/portal/page/portal/EER_HOME/EER_CONSULT/CLOSED%20PUBLIC%20CONSULTATIONS/GAS/Gas_Target_Model/CD/C11-GWG-77-03%20GTM%20PC_5-July-2011.pdf

ACER documents:

- “Framework Guidelines on Capacity Allocation Mechanisms for the European Gas Transmission Network”, ACER, Ref. FG-2011-G-001, August 2011, [http://acernet.acer.europa.eu/portal/page/portal/ACER_HOME/Communication/News/FG-2011-G-001%20\(final\).pdf](http://acernet.acer.europa.eu/portal/page/portal/ACER_HOME/Communication/News/FG-2011-G-001%20(final).pdf)

¹http://www.energy-regulators.eu/portal/page/portal/EER_HOME/EER_MEMBERS/Rules_Templates/Admin_GL/C07-EP-16-03_PC-Guidelines_CEER.pdf

Other documents:

- Directive 2009/73/EC of the European Parliament and of the Council of 13 July 2009 concerning common rules for the internal market in natural gas and repealing Directive 2003/55/EC, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:211:0094:0136:EN:PDF>
- Regulation (EC) No 715/2009 of the European Parliament and of the Council of 13 July 2009 on conditions for access to the natural gas transmission networks and repealing Regulation (EC) No 1775/2005, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:211:0036:0054:EN:PDF>
- Proposal for a Regulation of the European Parliament and of the Council on guidelines for trans-European energy infrastructure and repealing Decision No 1364/2006/EC, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2011:0658:FIN:EN:PDF>
- Regulation (EU) No 994/2010 concerning measures to safeguard security of gas supply and repealing Council Directive 2004/67/EC, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2010:295:0001:0022:EN:PDF>

EXECUTIVE SUMMARY

The 20th Madrid Forum invited CEER, together with stakeholders, to elaborate concepts on the allocation of incremental capacity so that “new build” capacity at existing interconnection points can be integrated into a market-based approach. Being aware of the importance of this issue in general and also the interlinkages with other work streams, CEER developed an integrated proposal considering the work on the network code for capacity allocation, Energy Infrastructure Regulation discussions, the gas Ten Year Network Development Plan (TYNDP) as well as CEER’s past work on Open Seasons.

The purpose of this paper is to consult on options for incremental capacity auctions as well as on possible interactions between incremental capacity auctions and European and national TYNDPs that would support efficient investment in cross-border gas infrastructure and facilitate the development of the single European gas market. The consultation paper considers options for an investment regime, which build on the advantages of the merchant approach (mainly, that it is demand driven) without the need for exemptions and which is fully fit for purpose for cross-border projects. Also, the regime we seek to develop is one where non-commercial positive externalities such as security of supply and market integration could also be taken into account (alongside user demand) if deemed appropriate. This would mean that the new regime could also cater, for example, for investments that are made by one country for the benefit of an adjacent market.

In order to clarify the scope of the paper, some essential definitions are needed:

- “Incremental capacity” means capacity that is provided on top of technical capacity available at an existing interconnection point².
- “New capacity” means capacity provided at a new interconnection point.

Although the paper uses the term “incremental capacity” throughout, its intention is to cover both “incremental capacity” and “new capacity” (as defined above). The proposals we are seeking to develop could equally apply to both.

The results of this consultation will be used to support the further development of the European gas target model and the European framework guidelines and network codes.

² “Interconnection point” means a cross-border interconnection point, whether it is physical or virtual, between two or more Member States as well as interconnection between adjacent entry-exit-systems within the same Member State, in so far as these points are subject to booking procedures by Registered Network Users.

1. Background

This paper stems from CEER's commitment in its 2012 work programme to develop proposals on how to identify and integrate new capacity, based on market demand and coordinated market procedures, in consultation with stakeholders. The need to develop such proposals has been identified in various contexts:

- The monitoring of compliance with the Guidelines of Good Practice on Open Season Procedures (GGPOS) in 2009 and 2010 highlighted the need for further guidance on the coordination of cross-border market-based investments.
- The identification and integration of new capacity, based on market demand established through coordinated market-based procedures, has been identified in the framework of the Gas Target Model (GTM) discussions as being one central element to be developed.
- The Capacity Allocation Mechanisms (CAM) Framework Guideline and Network Code deal with how to allocate existing capacity at cross-border interconnection points, but do not apply to new capacity (aside from capacity which remains unsold once it has been initially offered to the market via an open season procedure).

2. Introduction

Infrastructure development is of key importance to achieve the EU's energy policy objectives, namely competitiveness, security of supply and sustainability. Much emphasis has been put on investment by the European Commission over the past few years, both in its communications and in its legislative initiatives such as the Connecting Europe Facility package currently under discussion. The draft Energy Infrastructure Regulation³ in this package is aimed at setting the framework for selecting and potentially financing projects of "common interest". These are projects that promote security of supply and market integration, but which might otherwise not materialise due to issues in the regulatory regime, the permit granting process, public acceptance or financing.

Another of the objectives of the European internal market for gas is to ensure competitiveness and the efficient use of network assets and existing infrastructure; this has been the focus of the 3rd Package of energy market legislation (the 3rd Package). This establishes the need for increased cooperation and coordination between transmission system operators (TSOs) to provide and manage effective and transparent access to the transmission networks across borders. The 3rd Package also acknowledges the importance

³ Proposal for a Regulation of the European Parliament and of the Council on guidelines for trans-European energy infrastructure and repealing Decision No 1364/2006/EC, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2011:0658:FIN:EN:PDF>

of infrastructure development by requiring ENTSOG⁴ to prepare every two years a ten-year network development plan (TYNDP)⁵. This approach is also applied at a national level where TSOs organised as an Independent Transmission Operator (ITO)⁶ are required to submit every year a national TYNDP. This plan, which is binding for the upcoming three years at least⁷, has to be consistent with the non-binding Community-wide TYNDP. In addition, the Regulation on Security of Gas Supplies⁸ requires the implementation of infrastructure standards in order to achieve a proper level of system resilience in case of a supply crisis.

Ensuring the development of competitive markets and security of supply relies on there being sufficient transmission capacity across Europe (the same reasoning is also true for storage or regasification). It is important to ensure that the investments made are efficient (such that the benefits outweigh the costs) and that they promote competition, cross-border trade and security of supply whilst minimising the risk of assets becoming stranded. Furthermore, it is important that once capacity is constructed, it is used efficiently, such that any unused capacity is freed up and offered back to the market. In their work on investment⁹, European Energy Regulators have underlined the importance of maximising the use of existing infrastructure.

The current and future approach to investment is that infrastructures should be built only if needed. Building new infrastructure when existing infrastructure is physically underutilised may be inefficient from an overall economic welfare point of view. Many different reasons can drive investment needs but the challenge remains, in any case, that investment decisions have to be based on sound and objective criteria. In the draft Infrastructure Regulation, the concept of an EU-system wide cost-benefit analysis has been proposed to enable the allocation of infrastructure costs to the beneficiaries (which might be in other Member States), and to allow TSOs to invest across borders. The objective is to place an economic value on positive externalities such as security of supply and market integration whilst maintaining a demand driven approach.

The concept of demand driven investment procedures has been addressed in open season procedures; the British gas market has included capacity development in the regular capacity allocation mechanism. As a general principle, investments are made when, among other

⁴ European Network of Transmission System Operators for Gas (ENTSOG)

⁵ Art. 8 (3) (b), (4) and (10) Reg. (EC) 715/2009

⁶ Art. 17 Dir. 2009/73/EC

⁷ Art. 22 Dir. 2009/73/EC

⁸ Regulation (EU) No 994/2010 concerning measures to safeguard security of gas supply and repealing Council Directive 2004/67/EC, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2010:295:0001:0022:EN:PDF>

⁹ ERGEG Guidelines of Good Practice on Open Season Procedures (GGPOS), C06-GWG-29-05c, May 2007, http://www.iern.net/portal/page/portal/IERN_HOME/ICER_HOME/ABOUT_ICER/Regulatory%20Research%20Database/2007-05/-%20ERGEG%20Guidelines%20for%20Good%20Practice%20on%20Open%20Season%20Procedur

factors to be considered, market players' demand for capacity shows a clear need and provides a sufficient financial security through subscriptions¹⁰. In any case, three key questions can be identified:

- When and how to decide to offer some new transmission capacity to the market, taking into account market (e.g. user demand) and non-market based objectives (e.g. security of supply or market integration)?
- When and how to decide to invest?
- Who pays for the investments and takes on the risk and/or benefits?

One crucial requirement is to make available new capacity to all market participants on a non-discriminatory basis. Fair and transparent rules are therefore needed. Having a consistent approach for existing and future transmission capacity has been an important request from stakeholders during the preparation of the CAM Network Code. The need to further develop proposals on this issue has also been confirmed by the results from the consultation on the GTM¹¹ and has been included in the recommendations. Stakeholders expressed a preference for regular market testing and for more transparency in the decision making process. In a recent position paper, EFET¹² has also proposed different steps for market-based investment procedures which do not however request a systematic offer of incremental capacity¹³.

3. Scope and definition of essential terms

The purpose of this paper is to consult on options for an incremental capacity auction, as well as on possible interactions between incremental capacity auctions and European and national TYNDPs, that would support efficient investment in cross-border infrastructure and facilitate the development of the single European gas market. The results of this consultation will be used to support the further development of the European GTM and the European framework guidelines and network codes.

This paper seeks to develop workable options. This requires looking carefully at the conditions in which capacity is to be developed in terms of capacity allocation mechanisms,

¹⁰ It should be noted that in GB, the requirement is on the TSO to release incremental capacity (over and above the baseline level) if there is a market signal for it and the results of the auction are such that the "economic test" is passed. However, it is up to the TSO to choose how it wants to meet this obligation, e.g. by investing or by managing network flows more efficiently.

¹¹ CEER Public Consultation on Gas Target Model, http://www.energy-regulators.eu/portal/page/portal/EER_HOME/EER_CONSULT/CLOSED%20PUBLIC%20CONSULTATIONS/GAS/Gas_Target_Model/CD

¹² European Federation of Energy Traders (EFET)

¹³ EFET Paper on Incremental Capacity: Regulated Pipeline Investment in Response to Market Needs, January 2012

tariff structures as well as project design and technical complexity. As far as cross-border investment is concerned, coordination between the different operators and regulators is a key factor for success. The cross-border dimension can bring a high complexity that can advocate for the adoption of specific “tailor-made” approaches.

One potential framework for securing cross-border investment is a merchant model whereby the risks of the investment are borne in their entirety by the project developers. Under this scenario, for the investment to go ahead National Regulatory Authorities (NRAs) have to exempt the infrastructure from regulatory requirements such as third party access. One advantage of this model is that investments are fully demand-driven. Although the exemption regime is not about guaranteeing against the risk of stranded assets, a merchant developer will not undertake an investment unless it considers it will be able to recover its costs. Hence, it is likely there will be market demand for that asset once it is built. However, this is not the default regime, and exemptions should only be seen as an exception to the norm. Another potential framework is a regulated model whereby TSOs put together a business case for an investment and the NRA adjusts their allowed revenues to account for those costs. Intermediate approaches have also been developed, whereby the project remains within a regulated framework but the investment is triggered when the market has expressed a clear need for capacity, which can take the form of long-term subscriptions.

Therefore, the aim of this paper is to consult on options for an investment regime, which builds on the advantages of the merchant approach (mainly, that it is demand driven) without the need for exemptions and which is fully fit for purpose for cross-border projects. Also, the regime we seek to develop is one where non-commercial positive externalities such as security of supply and market integration could also be taken into account (alongside user demand) if deemed appropriate. This would mean that the new regime could also cater, for example, for investments that are made by one country for the benefit of an adjacent market.

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However, there is the question of whether new pipeline projects spanning over several countries should be within the scope of this work. We note that the CAM Network Code

¹⁴ “Interconnection point” means a cross-border interconnection point, whether it is physical or virtual, between two or more Member States as well as interconnection between adjacent entry-exit-systems within the same Member State, in so far as these points are subject to booking procedures by Registered Network Users.

discussed the option of holding auctions over a “route of interconnection points”, but that this option was dismissed as being too complicated to implement for the time being, as well as for being problematic in terms of the non-discriminatory evaluation of different transport needs between two countries only or over a route of countries. However, although these “multi-country” projects will be more complicated, their importance is crucial to the development of the internal market for gas and should be acknowledged. Although the focus of this work is on increasing capacity to better connect adjacent entry-exit systems, in line with the GTM, its purpose is not to preclude investments spanning across several countries.

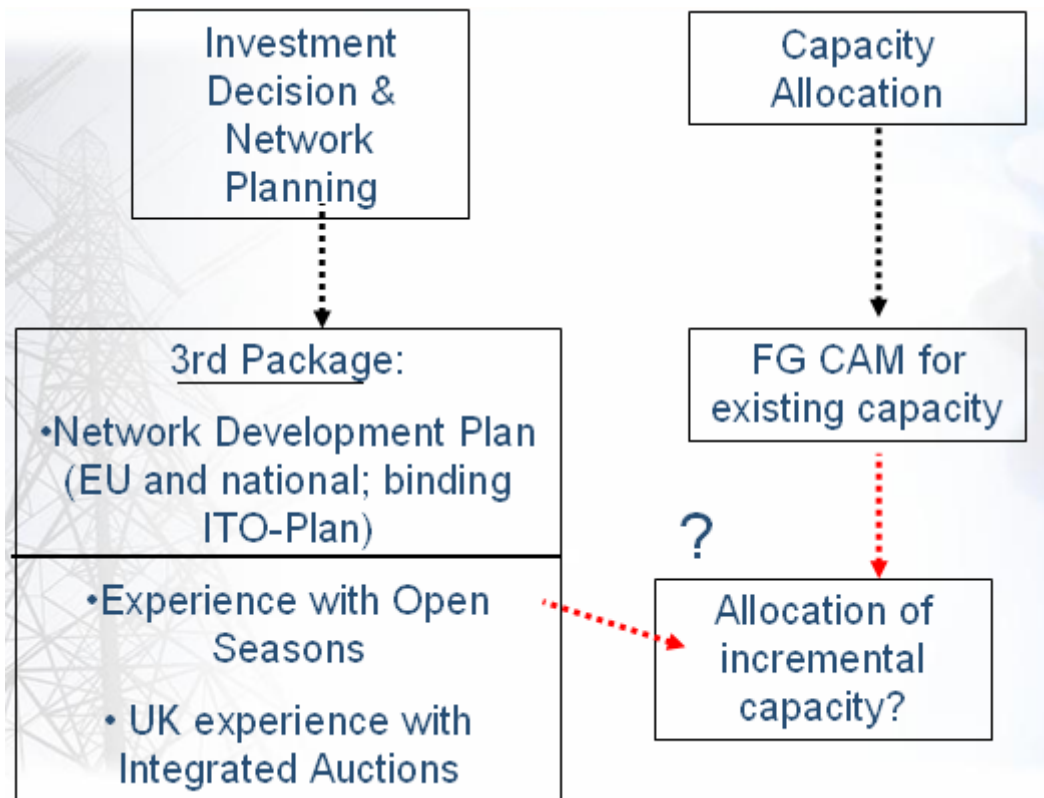
National decisions that affect the level of capacity that gas TSOs are able to provide at interconnection points are outside the scope of this work. Infrastructure exempted according to Art. 36 of the Gas Directive¹⁵, is not in the scope of this work, but only for the part that is exempted from third party access. Possible future enhancements are covered as they are not exempted.

We would also welcome stakeholders’ views on our “*minded-to*” position not to include within the scope of this work entry points from LNG terminals and entry/exit points to or from storage facilities. We note these were also not the focus of the Commission’s Congestion Management Guidelines or the CAM Network Code and there are reasons why it might be more appropriate for our proposals to apply to cross-border interconnection points only i.e., where barriers to trade may arise as a result of cross-border differences. Also, we consider that including storage and LNG points within the scope of this work might raise questions as to why other points are not included, for example entry points from production sites or exit points to end consumers – clearly this is a level of harmonisation that is not needed.

4. Current legal framework: interaction between investment/network development and capacity allocation

The current legal framework defines rules on network planning as well as on capacity allocation of existing capacity. Art. 13(2) of the Gas Directive also sets out the principle obligation that TSOs “shall build sufficient cross-border capacity to integrate European transmission infrastructure accommodating all economically reasonable and technically feasible demands for capacity and taking into account security of gas supply”. However, the interaction between investment decisions/network development and capacity allocation is not sufficiently clear.

¹⁵ Directive 2009/73/EC of the European Parliament and of the Council of 13 July 2009 concerning common rules for the internal market in natural gas and repealing Directive 2003/55/EC, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:211:0094:0136:EN:PDF>



Network development: This is governed by new European rules under the 3rd Package for different levels: a non-binding Community-wide network development plan¹⁶, non-binding regional investment plans¹⁷ and national network development plans. National investment plans have already been implemented for several years in many Member States in order to assess investment needs. European law generally leaves it up to national discretion to introduce binding or non-binding national plans. However, in the case of an ITO those plans have to be binding at least for the upcoming three years¹⁸ and they have to be consistent with the non-binding Community-wide TYNDP. Furthermore, they are subject to complex requirements with respect to the assessment of market demand, market consultation, the final decision by NRAs and the possibility to introduce investment obligations on the TSO¹⁹. Under the ISO model, the TSO has also to comply with a TYNDP²⁰. The NRA has the duty of

¹⁶ Art. 8 (3) (b), (4) and (10) Reg. (EC) 715/2009

¹⁷ Art. 12 Reg. (EC) 715/2009

¹⁸ Art. 22, Dir. 2009/73/EC

¹⁹ Art. 22 (7)(a) Dir. 2009/73/EC

²⁰ Art. 14(2)(c), Dir. 2009/73/EC

monitoring the plan and may include recommendations to amend it²¹. In contrast to the ITO model, there is no explicit possibility to require the TSO to execute an investment. In both cases, the need for investment has to be assessed within these planning procedures.

Capacity Allocation: This is governed by Art. 16 of Regulation (EC) 715/2009²², which describes the principles for capacity allocation which shall, inter alia, facilitate investment in new infrastructure and be compatible with market mechanisms and with the network access systems of the Member States. Additionally, there is the possibility to introduce Framework Guidelines and Network Codes²³ on capacity allocation. Based on the CAM Framework Guideline, the corresponding CAM Network Code introduces auctions for existing capacity, but does not deal with the allocation of new or incremental capacity, “apart from capacity which remains unsold after it has been initially offered via an Open Season procedure”. Furthermore, it is recommended that the processes for determining incremental capacity, i.e. capacity to be made available above the level of existing technical capacity, are consistent with the provisions of these Framework Guidelines.

Hence, the legal framework for both, the allocation of existing capacity as determined in the CAM Network Code as well as the network development plans, which can be binding at the national level, have to be taken into account²⁴.

Tariffs: Provisions on tariffs are currently under discussion in the context of developing guidelines on harmonised transmission tariff structures. One of the key issues being discussed is, for instance, the appropriate reserve price for the short and long-term capacity products to be auctioned at cross-border interconnection points. There is also a debate as to whether auction premiums should be used. Although there is a close interaction between tariff structures and the provision of new and incremental capacity, tariff structures will be kept outside the scope of this work.

Capacity calculation: The need for investment is also linked to, and affected by, the methodology used by TSOs to calculate capacity across their networks. Whilst this linkage should be recognised, capacity calculation and interconnection agreements are not the subject of this work and are currently being dealt with in the context of the Framework Guidelines on “interoperability rules”²⁵.

²¹ Art. 41 1(g) Dir. 2009/73/EC

²² Regulation (EC) No 715/2009 of the European Parliament and of the Council of 13 July 2009 on conditions for access to the natural gas transmission networks and repealing Regulation (EC) No 1775/2005, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:211:0036:0054:EN:PDF>

²³ Art. 8 (6)(g) Reg. (EC) 715/2009

²⁴ The Community-wide TYNDP shall include a supply adequacy outlook (Art. 8(3)(b) Reg. (EC) 715/2009)

²⁵ Art. 8 (6)(e) Reg. (EC) 715/2009

5. Problem identification: our experience with market-based investment procedures and why a new approach may be needed

5.1 Defining demand driven investment

As far as transmission is concerned, in most European countries investment decisions are made by TSOs following regulators' approval (or governments in some cases). In some countries, the regulator does not approve investment decisions or the TSOs' allowed revenues and does not fix tariffs or tariff methodologies. Instead, the regulatory framework leaves investment decisions up to the TSO, often applying some kind of efficiency benchmarking to ensure they are efficient. However, in some European countries, other options that are not "market based" have been used, for example, the Governmental Central Planning of infrastructures. The 3rd Package will require NRAs that do not yet do so to fix or approve tariffs, or methodologies used to derive tariffs. NRA approval of tariffs or methodologies is important to ensure they are non-discriminatory and cost-reflective, and to enable NRAs to set out an appropriate regulatory framework for investment.

Demand-driven investment procedures develop additional transmission services based on the needs of market players. This can consist of either building new infrastructures or reinforcing existing ones. In general, the role of "the market" is to:

- help **evaluate** the value of a project; and
- **secure its financing** through secured revenues for a certain duration.

There are two ways of testing shippers' commitment to an investment: (1) Open Seasons and (2) integrated auctions for existing and incremental capacity.

5.2 Experience with Open Seasons

With the objective of achieving sound investment decisions, one approach across Europe has been to survey the interest for the investment project and then invite market players to translate their needs into long-term commitments, through an Open Season procedure.

The Guidelines of Good Practice for Open Seasons (GGPOS) published in 2007 foresee a two-step process. Once the infrastructure operators involved have agreed on capacity development steps, corresponding costs and their translation into tariffs, a first non-binding phase is organised. The bids submitted during this first phase allow for an estimation of the actual interest in capacity and help to identify under what terms the capacity sale would best fit the needs of the market. The offer of capacity is then settled and the economic test is agreed. This determines the level of cost-coverage the subscriptions need to reach to trigger the investment decision. Finally, a second – binding – phase is organised; market-players are invited to make binding long-term subscriptions and if these generate sufficient revenue to cover the agreed level of costs, the final investment decision is taken.

After the publication of the GGPOS in 2007, European Energy Regulators conducted monitoring exercises in 2009 and 2010 which showed that the practice of Open Seasons was sometimes not in line with the target process defined in the GGPOS, in terms of transparency and cross-border coordination in particular. The need for improvement was highlighted in the following areas:

- Exchange of information between involved parties;
- Compatibility of capacity products sold on either side of a border;
- Transparency regarding tariffs and the investment decision making process; and
- Reliability of the “non-binding phase” which often led to an overestimation of capacity needs.

An important requirement of the GGPOS is also that part of the new capacity is set aside for short-term bookings. Experience has indeed shown that selling all of the capacity on a transmission system or a particular interconnection point on long-term contracts leads to capacity holders hoarding and not offering unused capacity to the market. Not only is this an inefficient use of capacity but it leads to the market being foreclosed to new entrants. However, in some of the Open Seasons organised in the past, this requirement has not been fully met and investors have sometimes built only as much capacity as shippers were willing to buy under long-term contracts. In some cases, shippers’ commitments (10 to 20 years) are shorter than the assets’ depreciation period (40 to 55 years) but often cover all of the interconnector capacity being constructed for that period of time. Whilst this has the advantage of underwriting the investment, one of the challenges is whether such an approach provides the correct incentives for investment in cross-border capacity going forward.

The level of transparency in the process can vary. In some cases, binding commitments may have been the outcome of a private negotiation between the investor and the individual shippers on the volume and price of capacity in the contract and the process is neither transparent nor compliant with the GGPOS.

However, in other instances, an open process has been used to obtain commitments and coordination efforts led to successful outcomes. For example, a survey conducted in 2009 and 2010 in the South Gas Regional Initiative (GRI) following the experience gained during the Open Seasons to develop cross-border capacity between France and Spain showed a general satisfaction from stakeholders with the results of the past Open Seasons. The positive features of the South Region approach is that, after the joint allocation of available capacity showed great market interest, coordinated capacity allocation has been done through an Open Season along several entry-exit zones (4), providing shippers with the same amount of capacity along the corridor for the long-term (10 years) but keeping a percentage of capacity for the short term (10%). The economic test design is the key aspect to agreement among the different TSOs and NRAs involved. Similarly, valuable experience has been gained in the North-West region, in particular with the coordinated Open Seasons carried out in 2010 and 2011 for the development of the interconnection capacity between Belgium and France. However, some of the downsides identified in the GGPOS monitoring report also became apparent in these processes. For example, the survey in the South GRI identified potential improvements such as greater cost reflectivity and greater transparency of the tariff methodology and pointed out the need for complex analyses to include security of supply criteria in the procedure.

In summary, recent experiences clearly indicate that coordination efforts are of the utmost importance to ensure an open, transparent and non-discriminatory investment decision process. The complexity of the Open Season process may be increased with an allocation through auctions and this is why a more extensive elaborated procedure and stronger coordination requirements need to be explored.

5.3 Experience with integrated auctions for existing and incremental capacity

Integrated auctions for existing and incremental capacity, as organised in the UK, allow shippers' commitments to buying incremental long-term capacity to be determined through a transparent bidding process. Shippers are given information about the cost of providing a particular volume of incremental capacity; shippers then make price bids for that capacity. If a certain value of those costs is covered by the bidding process, the TSO will be obliged to provide that level of incremental capacity, this can be done by either investing in physical infrastructure or - instead of building - by managing flows more efficiently, by shifting demand between different points or applying a buy-back if needed in the end, for example. As such, this process is open, transparent and non-discriminatory. It also allows for some capacity to be set aside for other shippers in future auctions.

One of the positive features of the GB approach is that shippers' bids are binding which reduces the risk of shippers overestimating the volume of capacity that they require at a given point. The reason for this is that, in advance of the auction, shippers are informed of what percentage of the total costs of the investment must be recovered from the revenues generated by long-term subscriptions in order for the investment to be approved by the NRA. That is, in the auction invitation, shippers are informed of the value of the economic test such that, if the test is passed, the investment goes ahead. This means that when shippers bid into the long-term (integrated) auction, they bid in the knowledge that, if the revenues generated from long-term subscriptions cover a certain proportion of the total investment costs, such that the economic test is passed, they will be committed to buying the capacity they have bid for. This approach of holding incremental capacity auctions has proved successful in delivering investment in transmission assets since auctions were introduced into GB in 2002. Through the use of incremental capacity auctions, GB's capability has risen from 3,537 GWh/day to 7,449 GWh/day. Examples of investments include the investment signal in 2004 given to National Grid to build pipelines to connect two new LNG import terminals (Dragon and South Hook) to the national gas transmission system, and to reinforce the existing national gas transmission system. Another example of successful investment following an auction signal was the expansion of the Easington transmission entry point in 2007 and reinforcement of the national gas transmission system. This was in order to facilitate the connection of the Langeled pipeline to the existing national gas transmission system (connecting Norwegian gas fields to GB).

5.4 Interactions between CAM Network Code and investment

The CAM Network Code provides for a yearly auction process for the allocation of existing capacity for up to the 15 coming years. Existing capacity can therefore be allocated beyond the lead time for investment to increase capacity, which is often from 3 to 5 years. In this context, there is a chance that users flag the need for capacity by paying a significant premium, but then see the anticipated constraint being relieved and incremental capacity for the same gas years (i.e., years 6 to 15) being allocated at a lower premium. When considering investment in incremental capacity, one crucial challenge is thus to ensure that there is no discrimination either between users of existing capacity and users of incremental capacity. In particular, if proposed following high auction prices on existing capacity, incremental capacity should be sold at a "fair price". In other words, users of existing capacity

should not be discriminated against compared to users of incremental capacity (i.e. they should not pay a higher price) once the capacity is built. The main role of a high auction price should be to signal congestion²⁶, not to increase TSOs' revenues. One way to approach this problem may be through floating tariffs but others may include having an integrated auction for existing and incremental capacity. The CAM Network Code does not prescribe the usage of the premium, which is dealt with according to national rules. This point will be addressed in the guidelines on harmonised transmission tariff structures, as explained in the next section.

The CAM Network Code also requires bundled products at interconnection points and currently foresees that at least 10% of the technical capacity has to be dedicated to short term bookings. It implies that capacity levels on both sides of the interconnection point are aligned when designing the investment project. However, depending on the connected systems the required investments to provide the market with incremental capacity may vary quite substantially on each side of the interconnection point. The objective is to provide bundled capacity, which may be achieved by investment at one side of the interconnection point only. This means that, when designing the investment project, capacity to be bundled may be provided on one side of the border without a need for investment. Therefore, NRAs will need to take into account the rules in CAM Network Code when agreeing the economic test for new and incremental capacity. The main challenge with incremental capacity auctions is that these have only been held within national jurisdictions and will need to be adapted to apply to cross-border capacity. The section below discusses some of the key issues for cross-border cooperation.

5.5 Interactions between guidelines on harmonised transmission tariff structures and investment

As mentioned above, the CAM Network Code does not prescribe the usage of any auction premiums; this is being debated in the context of developing guidelines on harmonised transmission tariff structures. One option being considered is for the premium to be used to reduce costs of the future investment, thereby resulting in lower or at least less increasing tariffs for all network users due to the investment or for directly lowering tariffs. The debate on tariffs covers the issue of from which users any under- or over- recovery should be collected. Regarding incremental capacity, one option is to recover the costs of incremental capacity only from those using the capacity at that point where incremental was triggered (project-specific approach). This may be seen as more cost-reflective but in a meshed network where additional capacity is built through more compressors or pipelines, users at other points may also benefit, making this difficult to disaggregate. Another option is that the under- or over- recovery is recovered from all users (socialised approach). The guidelines on tariffs are also considering two options on the relation between (i) the price capacity is allocated at in the auction and (ii) the actual price paid for capacity when that capacity is

²⁶ Congestion in this sense refers to contractual congestion as the physical capacity available may still not be sufficiently be utilised.

used (up to 15 years later). One option is fixed tariffs whereby the price paid is the price capacity is allocated at in the auction. This would mean that those buying capacity in the long-term are likely to pay a lower price than those in the short term. The other option is to have floating tariffs whereby the price paid for the capacity is the reserve price in operation in the year of use plus any premium above the reserve price at which the capacity was allocated. The premium is fixed.

5.6 The need for coordination in cross-border investment projects

Interconnection development includes investment decisions by two or more²⁷ TSOs. It often requires important reinforcements of the national infrastructures to allow dispatching the additional gas flows towards consumers. The cost of domestic infrastructures associated to a new or increased interconnection can therefore be much more important than the interconnection itself. Evaluating precisely the specific domestic investments associated to cross-border developments may be difficult especially taking into account the way infrastructure investment is translated into capacity levels in an entry-exit system. Hence, these developments can have an impact on the capacity which can be offered to the market.

The need for coordination is important for technical and economic aspects. On technical aspects, TSOs have to agree on the design of projects and, in particular on the different steps of capacity development. As a general principle, unless the services offered on the two sides are not the same, coordinated market-based investment procedures are driven by “the short side” of the project. Applying the concept of bundled products exacerbates this characteristic. Additionally, it is important to take into account the way capacity is calculated in entry-exit systems. Although physically the infrastructure at a cross-border point provides for the same level of gas that can be transported, the amount of firm capacity offered may be different due to the size or congestion in the connected zone. On economic aspects, the need for coordination concerns cost evaluations and associated elements used potentially to assess whether the investment is acceptable or not. The way cost elements are translated into tariffs is also very important for the outcome of the market-based procedure.

More precisely, investment decisions on interconnections, taken under different regulatory schemes require some coordination relating to:

- The compatibility of tariffs applied on both sides of the border to ensure that the total capacity charge may not deter capacity bookings;
- Guaranteeing that cost evaluations are based on fair and competitive methods for all infrastructures. Covering the risks of delays from one of the investors that would result in delaying the overall commissioning of the interconnection;
- Assessing the collective value of the new asset for each market as well as for the

²⁷ Even if the focus is on one individual interconnection point, investments by more than two TSOs may be required, depending on the structure of the entry-exit zone.

- Community in order to establish the minimal conditions under which the investment has to be agreed; and
- Identifying the long-term economic risks, for instance, to the future rate of use of the infrastructure.

To be efficient, they have to follow sound methodologies providing both enough visibility to market players, notably on tariffs to be applied in the future, and a proper investment decision making method, based for instance on an “economic test” estimating whether shippers’ commitments provide secure enough investment conditions.

6. Options for incremental capacity auctions and interactions with TYNDPs

This section presents different steps for cross-border investment procedures. For each of these steps, several possible approaches are specified in order to meet different local circumstances.

The intention is to draw on the lessons learned from previous Open Seasons while ensuring consistency with the regulatory framework deriving from the 3rd Package, including the elaboration of network development plans and the introduction of auctions for existing capacity.

6.1 When to launch the incremental capacity auction

To ensure that market players are offered sufficient capacity to satisfy their needs, investment in incremental capacity needs to be considered in a timely manner.

Option 1: Regular integrated capacity auction for incremental and existing capacity

One first approach consists of automatically triggering the investment procedure and offering incremental capacity on a regular basis, along with the yearly auction on existing long-term capacity for instance. This way, the market is invited to flag its incremental capacity needs every year. Under this approach, the TSOs at each interconnection point would have to jointly assess the options for expanding the capacity. The TSOs will identify the costs associated with their options which will be assessed and approved by the NRAs to ensure that they are reasonable. The NRAs would have to agree how much of the value of the investment needs to be sold in the long-term incremental capacity auction for the investment to be approved before the annual auction was held. However, ex-ante approval by the NRA may not be possible in each legislation. This option may also be possible where TSOs have already identified the need for investment.

Shippers are then provided with, at the same time as the long-term capacity auction, information on how much particular volumes of incremental capacity may cost. For example, they may be told that 5 units of incremental capacity would cost X euros, 10 units would cost Y euros, etc. Shippers would then bid into the auction for particular volumes of capacity at a particular price. If the value of the bids amounted to a certain value of the investment (as agreed by NRAs) the investment would then be approved. The advantage of an integrated

auction is that it would allow shippers to bid simultaneously for existing and incremental capacity and signal their need for future investment. This helps to promote price discovery and to ensure that shippers' bids for existing capacity are not skewed. The disadvantage is that it would require considerable coordination from TSOs and NRAs at interconnection points to agree costs for new investment, where there may not be any demand for new investment. In addition, there are also issues around the practicability of holding simultaneous integrated auctions across all interconnection points across Europe. One aspect to consider, for example, is whether the ascending clock auction algorithm proposed by ENTSOG in the CAM Network Code would allow for integrated auctions to be held.

Option 2: Incremental capacity auction if demand is identified in a regular process

A second approach is to collect evidence of scarcity on existing capacity before initiating the incremental capacity auction. The 2007 GGPOS already refer to access refusals, direct notification from shippers, forecasts and also TSOs' and NRAs' assessment of long-term congestion as signals to enhance the system. Actual interruptions of interruptible capacity also provide a signal of physical congestion. In addition, the implementation of the 3rd Package and network codes provide for new tools to identify capacity needs:

- The CAM Network Code provides for a yearly auctioning of long-term capacity products for up to the next 15 years. The outcome of this auction process, i.e. the price or premiums over the reserve price will give valuable information on the market's perception of congestion on the long term. Monitoring the evolution of the auctions' results year on year will allow for a clear identification of future scarcity of capacity and therefore the need to offer incremental capacity.
- In addition, the 3rd Package also places an obligation on TSOs organised as ISOs and ITOs to develop each year a TYNDP which is - in the case of an ITO - binding, for the next 3 years at least. Investment projects are identified yearly within the TYNDPs, based on the auctions' results, supply/demand forecasts, production and flow forecasts, and consultation with all actual or potential system users.

This option would not necessarily require holding an existing capacity auction first, if it is already known by the NRAs and the TSOs that there is demand for new capacity and if feasibility studies have already been undertaken. The point is that, in contrast with the first option, this option would limit the launch of an incremental capacity auction to those interconnection points where there is a known need for further capacity.

Hence, the provision of incremental capacity would take into account market evaluation of existing capacity shown by auctions as well as to assess the longer-term need for infrastructure based on a regular assessment as part of the national and community wide development plans, thereby reducing the risk of stranded assets due to the long rate of depreciation.

Where the potential need for additional capacity is identified, the TSOs would then need to jointly assess the options for expanding the capacity. The auction would be held on a similar basis to that outlined above but the difference is that the incremental auction would be held separately to the long-term capacity auction. There is a risk that prices in the existing capacity auction rise further as shippers will not know whether an incremental auction will be

held. However, this could be managed on the one hand through commitments to hold an incremental auction if it is shown, for example, in the network development plan that there is a need to expand the network and, on the other hand floating tariffs result in the same price being paid by all capacity holders irrespective at what point in time they bought the capacity. The advantage of this approach is that the design of the project and following steps would be undertaken less frequently and thus require less organisational costs, especially for the TSOs which have to design the investment project, which can be particularly important when cross-border investment is at stake. At the same time, it ensures a coherent approach and provides the market with information on future expansion of the network by annually updating the network development plan, where a plan is to be provided.

Option 3: One time integrated auctions

An intermediate approach can consist of organising first the yearly long-term auction on existing capacity and, if it has resulted in high prices revealing congestion, organising an ad-hoc integrated auction which would allocate incremental capacity and apply the outcome price to both incremental capacity and the existing capacity previously allocated. This approach would allow for the organisation of one shot allocation processes for incremental capacity and thus lower the organisational costs, while providing for a coherent price treatment of both existing and incremental capacity. However, in order to implement such ad-hoc auctions, the TSOs would need to be able to design the investment project within a short timeframe after the results of the long-term existing capacity auction are known. If not possible, the investment project would need to be systematically designed in advance, which can imply high organisational costs.

6.2 Decision on the investment

A key question in any investment decision is who pays for the investment and who takes on the risk. In many of the decisions that have been taken so far, new investment only goes ahead if TSOs are able to sell one hundred per cent of capacity ahead of time on a long-term basis (10 to 20 years out). In the future, however, rules sourcing from the CAM Network Code will require TSOs to set aside a set percentage of interconnection capacity for shorter-term bookings. Although, in itself, this requirement does not mean that TSOs will not be able to allocate incremental capacity 100% on a long-term basis (as the requirement could still be met if, e.g., more than the required percentage of existing capacity was set aside for the short-term), it does mean that in the future it will be important for NRAs to agree at cross-border points how much of the cost of the investment needs to be covered by long-term bookings (user commitment) and how much of the cost will need to be covered by TSOs (and hence, underwritten by consumers).

This so-called economic test (such that if the test is met, the investment goes ahead) needs to be pre-agreed by the relevant NRAs at cross-border points, once the investment costs are identified by TSOs and approved by the relevant NRAs. The economic test needs to strike the right balance between promoting investment on the one hand (which would suggest a lower investment trigger is appropriate), and reducing the risk of stranded capacity on the other (for which a higher trigger would be best). Depending on where they set the threshold, NRAs can design the economic test in such a way that it takes more or less account of non-commercial positive externalities such as security of supply and market integration. For

example, if the threshold is set at 100% (meaning that, unless revenues generated from shippers' long-term bids cover 100% of the costs of the investment, the investment does not go ahead), this means that positive externalities will not be taken into account but also that there will be no stranded capacity in the market. More importantly, this would also mean that long-term subscriptions over 10 or 15 years would cover all the costs related to assets with a depreciation period of usually 40-50 years. On the other hand, if the test is set at 0% (meaning that all costs are covered by TSOs/underwritten by consumers) this means that the investment will go ahead irrespective of user demand. This might be in the interest of promoting security of supply for instance, but on the downside, might lead to capacity being built that the market does not need. The appropriate trade-off will be determined by the size and riskiness of the investment project at hand, and by the desire to take into account those non-commercial positive externalities.

Hence, this raises the question of whether an EU-wide economic test would be appropriate, or whether this should be agreed by the relevant NRAs on a cross-border point by cross-border point level. However, there are reasons why such a degree of harmonisation may not be appropriate, as setting the investment threshold requires taking a judgement as to how much of the costs of the investment should be underwritten by consumers, and how much should be covered by shipper bookings. This judgement will obviously depend on the specifics of the case at hand, and should be at the discretion of NRAs (in line with the Gas Regulation requiring NRAs to approve investments taking into account efficiency, but also security of supply and market integration). Hence, there is the question as to whether it is necessary to also harmonise the economic test, or whether it is sufficient to harmonise the regulatory approach and leave the specific threshold to be agreed at interconnection point by interconnection point level. Also, NRAs will need to take into account a number of considerations when determining the appropriate value for the economic test; including (but not limited to) the costs of the actual investment, any associated costs which TSOs will need to incur at national level, the expected life of the asset and an appropriate depreciation period, the appropriate level of cost-sharing between TSOs, and the duration of long-term commitments which shippers are willing to become party to. A benchmarking of costs of the various investment projects across Europe might also be useful in helping NRAs pre-agree on the value of the economic test.

6.2.1 Criteria to fulfil the economic test

The decision to invest needs to be based on the results of the market test. Adjacent TSOs can use specific criteria to assess the results of the market test. TSOs shall cooperate to establish these criteria, so that the capacity development is made consistent. In addition, stakeholders need to be informed of how the investment can be fulfilled before submitting their bids during the market test. Two types of criteria can be used:

I. Investment trigger based on subscription levels

One first option is to determine which percentage of the offered capacity should be booked during the market test on a binding long-term basis. This will need to be set at a level that takes account of the CAM Network Code, which will require at least 10% of the technical capacity to be set aside for short-term allocation.

II. Investment trigger based on revenues generated by the subscriptions

A second option is to consider the revenues generated by the long-term subscriptions and assess whether they cover a sufficient part of the project costs. It must be noted that, in general, full financial security cannot be guaranteed due to long depreciation periods compared to shippers' commitments. Risk management is thus an important element of these procedures; investors' remuneration and the cost of projects are indeed highly dependent on the level of risks and who is responsible for their coverage. A case by case analysis based on objective criteria and taking the specific investment project into account will therefore be necessary.

6.2.2 Approval of the investment

Where the market test does not reveal a sustained need for long-term bookings, the investment will be rejected by the NRA. However, where the market testing shows sustained shipper commitment in the form of long-term bookings, it is important to consider how the decision on whether to proceed with the investment is taken. In a market-based investment procedure, as much information as possible should be given to the market in order to help stakeholders bidding in best conditions. There are two possible approaches under NRA supervision, which might be combined:

I. NRA approval based on economic test being met

Under this approach, if the market test has been conducted in such a way that meets the agreed criteria (non-discriminatory, fair and transparent) and the economic test is met, the relevant NRAs will approve the investment. Reliable information on the various criteria of the project (including technical design, cost of particular volumes of new capacity and tariffs) is a pre-requisite for such an approach. As such, the relevant TSOs have certainty that if the economic test is met, they will be allowed to recover the efficiently incurred costs for the construction of additional capacity. It provides shippers with certainty that the additional capacity will be made available and reinforces the fact their bids are binding. This reduces the likelihood of speculative bidding (when shippers overestimate their needs) as if a shipper bids for additional capacity and the economic test is met, they will be required to pay for it. In order to protect consumers, who may be exposed to the efficiently incurred costs by the relevant TSOs, if a shipper does not honour its commitments, it may be necessary to ensure that shippers comply with certain credit conditions. Furthermore, NRAs will also have to cooperate to ensure that TSOs recover only efficiently (as opposed to inefficiently) incurred costs.

II. NRA approval based on wider criteria

Under this approach, the economic test is indicative and may not be communicated to the market so if the test is met, the results are referred back to the relevant NRAs for regulatory

decision. The TSO is not automatically committed to invest. The NRAs will cooperate to reach an agreed position using the market test as an input but ultimately retain discretion to reject or to allow some or all of the investment based on other criteria. This may be part of the national development plan process. In general, if projects are identified as a result of the network development plan process²⁸ they will be deemed to be a necessary investment, approval of the project itself is not needed as the plan as a whole is approved by the NRA. However, estimated costs of the project will be checked against actually incurred costs. Testing market demand may help with prioritising identified projects, especially those in the non-binding phase of the plan and may provide a basis to require TSOs to execute the investment in question²⁹. Such an approach is not be substantially different to that outlined above, if the regulatory decision is reached in a timely manner, there is transparency in the decision-making process and NRAs allow investments that meet the economic test. However, it may create a certain amount of regulatory uncertainty for shippers, yet reduce the likelihood of inefficient investment.

²⁸ Art. 22 (1), Dir. 2009/73/EC

²⁹ Art. 22 (7), Dir. 2009/73/EC

7. Questions for public consultation

CEER invites all interested stakeholders to respond to this public consultation. The deadline for responses is **14 September 2012**.

CEER welcomes responses setting out any issues considered relevant. In particular, stakeholders are invited to reply to and provide comments on the following non-exhaustive list of questions:

Public consultation questions

1. Have you participated in an Open Season process for cross-border capacity? If so, what are your views on the process?
2. In light of your experience, do you consider that current methodologies (for example, Open Seasons) to decide on investments are an appropriate way to identify and integrate new cross-border capacity, or is there a need to move away from them? If so, what would be your preferred alternative and why?
3. Do you think the paper addresses the right questions? What (if any) are the additional questions that should be addressed? What in your view are the main problems that need to be resolved?
4. What should be the scope of this paper? Should our proposals apply to cross-border points only, or should they also apply to entry points to LNG terminals and entry/exit points to and from storage? Why or why not?
5. What in your view needs to be harmonised on a European level, what can be done at other levels?
6. Do you agree with the proposals to allocate incremental cross-border capacity via an auction? Why or why not? What are the advantages/disadvantages of using auctions vs. Open Seasons (in cases where Open Seasons do not include an auction in the allocation phase)?
7. What in your view should be the key considerations for the economic test? How could it be designed? How should risks/costs be allocated?
8. Would a fully harmonised economic test across Europe be appropriate, or would it be sufficient to harmonise only the general principle to investments? Why or why not?
9. How often should market testing be conducted?
 - a) when potential demand is identified in the annual TYNPD process;
 - b) annually; or
 - c) every two years (when potential demand is identified in the community-wide TYNDP)?

10. If auctions used to allocate existing capacity result in a congestion premium over the reserve price, at what instance (if at all) should TSOs consider a future enhancement? Please refer to the frequency of occurrence of a premium as well as the size of the premium.
11. What other criteria could be used to identify a need for investment (e.g. frequency of interruptions of interruptible capacity)?
12. How could the allocation process be organised? Should existing and incremental capacity be allocated jointly (integrated auction) or as part of a separate process? How could an integrated auction work? (Please take into account different tariff regimes, i.e. fixed and floating when answering.)
13. Should shippers' bids into the market test for incremental capacity be binding? If so, how should this best be achieved?
14. What in your view should be the approach to regulatory approval?
 - a) automatic if the economic test has been met and bidding process run correctly;
 - b) subject to separate regulatory approval processes?

8. Next steps

All interested stakeholders are invited to respond to this public consultation, in particular to the concrete questions listed above. Following the consultation European Energy Regulators will evaluate the responses and incorporate them into a conclusions document planned to be published at the end of 2012.

The results of this consultation will be used to support the further development of the European gas target model and the European framework guidelines and network codes. Based on the results of the consultation, further work will be undertaken in 2013 if and where necessary.

Annex 1 – CEER

The Council of European Energy Regulators (CEER) is the voice of Europe's national regulators of electricity and gas at EU and international level. Through CEER, a not-for-profit association, the national regulators cooperate and exchange best practice. A key objective of CEER is to facilitate the creation of a single, competitive, efficient and sustainable EU internal energy market that works in the public interest.

CEER works closely with (and supports) the [Agency for the Cooperation of Energy Regulators \(ACER\)](#). ACER, which has its seat in Ljubljana, is an EU Agency with its own staff and resources. CEER, based in Brussels, deals with many complementary (and not overlapping) issues to ACER's work such as international issues, smart grids, sustainability and customer issues.

The work of CEER is structured according to a number of working groups and task forces, composed of staff members of the national energy regulatory authorities, and supported by the CEER Secretariat.

This report was prepared by the Gas Incremental Capacity Task Force of CEER's Gas Working Group.

Annex 2 – List of abbreviations

Term	Definition
CAM	Capacity Allocation Mechanisms
CEER	Council of European Energy Regulators
EFET	European Federation of Energy Traders
ENTSOG	European Network of Transmission System Operators for Gas
GGP	Guidelines of Good Practice
GGPOS	Guidelines of Good Practice for Open Seasons
GRI	Gas Regional Initiatives
GTM	Gas Target Model
GWG	Gas Working Group
ISO	Independent System Operator
ITO	Independent Transmission Operator
NRA	National Regulatory Authority
TSO	Transmission System Operator
TYNDP	Ten-Year Network Development plan

Table 1 List of abbreviations