

GTE comments on ERGEG CBT report

ERGEG consultation on transmission pricing (for Transit) and interaction with Entry-Exit Systems (Ref: E06-GFG-18-03), 28 June 2006

Ref. 06GTE210-final

A. Introduction

(1) The 10th Madrid Forum took note of the GTE report on Transit and invited CEER to “present a report to the next Forum [...] on how transit and regulated entry-exit systems could encourage competition and support a competitive market for natural gas.”

(2) ERGEG invites stakeholders to comment on issues raised in the first part of its report, dated June 29, 2006, “on the transmission pricing (for Transit) and how it interacts with Entry-Exit Systems”.

(3) GTE welcomes the opportunity to give its views on this report. GTE has noted that “ERGEG will ensure in its work that appropriate arrangements are in place for dealing with cross border trade” and appreciates this position from ERGEG. However, the report is not complete, since part 2 of the document with recommendations is not included.

(4) This response covers the main points of the consultation document (part 1) on a chapter by chapter basis.

(5) This GTE response contains main comments only. The absence of more detailed comments should not be interpreted as consent to the content of the ERGEG Report.

(6) In any case GTE offers ERGEG further cooperation in contributing to the recommendations, in association with all the stakeholders.

(7) The ERGEG CBT report refers to existing legislation, e.g. Directive 2003/55/EC and Regulation 1775/2005/EC as well as to the draft explanatory notes on tariff (DEN on tariff) as published by DG TREN. GTE would like to point out that the DEN on tariff do not represent the opinion of the European legislator and are not legally binding in any way.

(8) The report seems over-restrictive in its views whereas Directive 2003/55/EC and Regulation 1775/2005/EC leave room for practical application of its provisions. For example, paragraph 10, 11 and 47 of the report seem to restrict unduly the application of the benchmarking of tariffs whereas recital 7 of the Regulation 1775/2005/EC explicitly leaves room for other cases.

(9) GTE supports the development of entry-exit models that facilitate the development of the national market and hub trading. However GTE aims to develop solutions for transit, e.g. with respect to possible cross-subsidisation and balancing. Solutions should not hamper competition and should if possible be sought within entry-exit models, however the specific situation in some countries might require other solutions.



B. Preface and introduction

(10) GTE welcomes the fact that the ERGEG report acknowledges the crucial link between the market functioning and the ability of the system to transport gas through Member States.

(11) GTE notices that since EU gas liberalization, the main infrastructure projects under development are predominantly “direct links” from the gas fields such as LNG plants or offshore pipelines and interconnectors. GTE thinks this can be explained by the fact it has become increasingly more difficult to realize investments into projects where the infrastructure crosses several Member States with different regulatory regimes.

(12) GTE warns that bearing in mind the huge investments as i.e. outlined in the TEN-ENERGY–Invest report¹ and the Commission’s Green Paper² there is a pressing need to address this issue in order to ensure that this type of investment is brought forward. This problem is particularly acute taking into consideration the long lead times for infrastructure investments (which is typically of five years). Finding a solution for this very complex issue will require the involvement of all stakeholders, i.e. shippers, operators, Member States and RNRA.

(13) The report often refers to “cross border trade” or “cross-border infrastructure”, but gas trade must not be confused with electricity cross-border trade (since less than 10% of electricity crosses borders) as gas is transported through long distances from production areas to consumption markets as more than 60% of natural gas crosses at least one border. Solutions developed to facilitate electricity cross-border trade don’t fit the gas transit issue.

(14) To differentiate between these types of infrastructure investment, GTE proposes to use the term Non-Domestic Investment (NDI) to underline that in many Member States the natural gas system, or a significant part of the natural gas system is not dedicated to the local domestic market, but to foreign markets, which implies a situation which is so different from electricity.

(15) Where there is competition between different pipelines and LNG terminals and where the risk that investors face is higher, as is often the case with NDI, this justifies a different regulatory and tariff treatment.

(16) Non-domestic investments are essential to provide transmission through Europe from producers to customers for the completion of the internal gas market and GTE therefore sees a need for appropriate arrangements being put in place dealing with NDI decisions.

C. Section 1 – Classification and definition

¹ Ten-ENERGY-Invest (Energy Infrastructure Costs between 1996 and 2013 (medium term) and further (long term) on the trans European Energy network and its Connection to Neighbouring Regions with emphasis on investments on renewable energy sources and their integration into the Trans-European energy networks, including an inventory of the Technical Status of the European Energy-network for the Year 2003; Contract n. TREN/04/ADM/S07.38533/ETU/B2-CESI, dated October 2005)

² GREEN PAPER: “A European Strategy for Sustainable, Competitive and Secure Energy”, COM(2006)105 final, 8.3.2006

(17) The report starts from the legal definition of the term “transmission” included in the Directive 2003/55/EC, which encompasses both transit flows and national transports; then it examines whether there is a reason which might justify a different treatment of transit flows.

(18) This ERGEG report identifies a few areas which could lead to a different treatment:

- New infrastructure exempted from TPA under Art. 22 of the Directive 2003/55/EC
- In the case of unidirectional pipelines crossing Member States, if they are only used for carrying transit gas without any connection to the gas supply system of the transit country, distance can be considered as a factor for tariff setting.
- In the case where networks are not sufficiently meshed, distance related tariffs may be used.
- Where effective pipe-pipe competition exists (for which criteria have to be developed), it does justify a different treatment of tariff; this tariff will have to be set/approved by the relevant national regulatory authority.

(19) With respect to the last bullet point GTE would like to note that according to Directive 2003/55/EC Member States may opt either for an approval of tariffs or their underlying methodologies.

(20) This type of flow as described in Section 1 number 9, page 7: (“from one boundary of the network and/or entry/exit zone to another boundary”) crossing at least one TSO should also be considered as relevant in the framework of this ERGEG CBT report.

(21) According to ERGEG even the contracts concluded under the previous transit Directive 91/296/EEC, whose existing prices can be different from the regulated tariffs, should be reviewed, “wherever possible”, and the price made consistent with the regulated tariffs. GTE would like to point out that Directive 2003/55/EC explicitly acknowledges the validity of historical contracts. This rule provides for confidence that existing investments will not be undermined and provides confidence in the sanctity of contracts according to which future investors’ interests will be protected.

(22) GTE is of the opinion that the situation regarding transits, and more specifically, new investments for transit purposes, varies significantly from country to country, also with respect to regulatory regime, and therefore it is not possible to have a “one size fits all” approach. GTE therefore believes that – as set out in its Transit report of June 2005 – that the definition of NDI is better dealt with at Member States level, taking into account the specific characteristics of the various energy markets. In some cases, this means that transit can be defined based on the physical characteristics of the network used, and, in other cases, on the type of service that is delivered. GTE does, however, encourage regulatory co-ordination with respect to NDI in order to allow a harmonised treatment of NDI risks. This would benefit TSOs and shippers alike.

(23) Most GTE Members have implemented an entry-exit system. But these entry exit models are a compromise between appropriate cost allocation and market facilitation and may therefore, if the respective regulation framework is not consistent with this market setup, result in significant cross subsidies. The objective of enlarging the entry/exit zones to facilitate the market opening is justified for the sake of simplicity, but it increases the difficulty of an appropriate treatment of long



distance transmission when the respective regulation framework does not allow for flexibility in charging methodologies as far as costs and market based prices are concerned.

(24) In order to avoid significant cross subsidies, it may be appropriate, for new investments and in cases where the respective regulation framework does not allow for the tariffs to be determined by the incurred costs or market prices, to implement a treatment of point-to-point transits in an entry-exit system. A point-to-point treatment is not necessarily contradictory with the entry-exit system. It can be a specific case which is met when the gas flow is firm and permanent over a long period from one given point to another one. This situation implies a technical and economical specific design, as far as an optimum is sought.

(25) This option should be open within the EU regulatory framework and then discussed between the TSOs concerned and their relevant national regulation authority(ies), when a new project is occurring.

(26) In general, NDI as a result of competition and the lesser predictability of usage have a higher risk profile than other types of investments. In the past, NDI were largely financed by the companies of the importing countries. Under the new environment, the framework for NDI is not defined and this situation, in the absence of clarification, entails the risk of under-investment in transmission grids.

(27) GTE is of the opinion that this larger risk for NDI should be incorporated into the respective regulation framework and that such regulation framework should allow for risk returns within the regulated framework to the extent that it is the TSO that has the risk.

(28) GTE is of the opinion that there are different cases, which should be distinguished. The important factors distinguishing the situation in various countries are:

- a) all transmission is physically and administratively done in one entry-exit system
- b) transit is administratively separated from other transmission

Nevertheless, in many cases the same physical infrastructure is used for transit and other transmission.

Under a) and b) the investment risk can be treated differently:

- o investment risk is taken by TSOs (e.g. in tariff regulation systems)
In this situation it is crucial that market prices for transmission can be charged, as the investment is competing with other transmission and LNG. The TSO can take on as much risk as he sees fit. The TSO determines in this setting if/how much additional capacity is built.
- o investment risk is socialised by including investments in a regulatory asset base (e.g. in cost based regulatory framework)
In this situation the regulatory framework socialises the investment risk of investments, which are added to the RAB. If an investment is stranded, all or part of the users will face higher tariffs to recover the costs.

(29) NDI is a combined service and part of the domestic transportation asset base. In such case the TSO should receive sufficient signals from shippers active in an open season or



alternatively shippers entering into binding long-term commitments. It should be recognised in this situation that initial open season and initial long term binding commitments may only cover part of the initial investments and therefore, depending on the regulatory framework, the end users or the TSO(s) in the country might be bearing the remaining risk.

D. Section 2 – Requirements on gas transits

(30) The ERGEG CBT report states that “TSOs could be required to cooperate on long term planning at a European level to determine the necessary investments.” (No 10, page 10 ERGEG CBT report).

(31) GTE agrees that there is a need for increased cooperation amongst the TSOs but also would like to stress the need for increased co-ordination between regulators, particularly as concerns NDIs, not only to identify the relevant infrastructure but also to define how these infrastructures can be funded through TSOs return on risk or on long-term commitments and, if additional capacities are required, through other mechanisms.

(32) With view to the necessary investments for new supply routes, solutions have to be found in order to properly allocate risks. Open seasons leading to long-term capacity contracts are one way for TSOs to cover investment risks, but they need to define a stable tariff or a stable and predictable methodology, as soon as the process is going on. Shippers usually claim for predictable tariffs in long term commitments.

(33) For getting financially binding signals open seasons provide an appropriate way but they should be designed carefully and depend on the degree of the market opening in the respective market.

(34) Should there be a need for developing further capacity for short and medium term needs, e.g. for new market entrants and small market players, a clear framework for covering the financial risks for such capacities will have to be introduced,

(35) In general Art. 22 Directive 2003/55/EC does not fit with transit of gas because transit infrastructures cannot be completely separated technically and juridically as underlined above. Depending on national circumstances standard entry-exit models may not fit because gas transit constitutes a service characterised by point-to-point transmission. Therefore GTE suggests for specific NDI considering the following approach:

- a) Prices and capacity allocations could be point-to-point distance based.
- b) Long term commitments should be granted, that means that prices should be fixed for a long period.
- c) Open seasons should be systematically organised before decisions.
- d) Additional capacity for short term commitments could be added if the risk question described above is solved.

- e) or grants that the TSOs take their own risk, with transmission tariffs set at appropriate levels and possibly with additional incentives to be determined on a case by case basis.

(36) The report stresses the need for avoiding pancaking of transaction costs associated with booking in multiple systems; according to the report this would be best achieved through a single contract between the network users and a single European operator/TSO and a European wide entry/exit system, with corresponding inter TSO compensation schemes.

- o Such a TSO compensation scheme (“system of inter-TSO payments”, paragraph 20 ERGEG CBT report) might be appropriate for electricity, where production is fairly spread across the whole EU territory, resulting in limited physical cross-border flows. On the contrary, a significant proportion of natural gas is produced outside the EU, and transit gas flows reach very high levels in many countries, up to more than 90% of total flows. A mere “compensation mechanism” is unlikely to be sufficient to address such physical and contractual flows.
- o Our main concern with any such scheme is whether or not it would be able to properly remunerate existing investments and provide the market signals for new investments. Such a compensation scheme for gas would lead to a complete change of the current gas transport paradigm, making many TSOs almost completely dependant on the mechanism, and not able to manage their own business by commercial contracts.
- o Finally, we foresee that a TSO compensation scheme would be very complex and bureaucratic to implement and maintain.
- o GTE considers that a further development of the internal gas market could be much better achieved through strong involvement and co-operation of infrastructure operators supported by regulators - both in terms of new policy development and investment planning.

E. Section 3 – Increasing the efficiency in the usage of the pipeline

(37) As to increase the efficiency in the usage of the pipeline, the report indicates that capacity planning at the regional level is a prerequisite.

- o GTE understands that this could be one of the issues which might be discussed in the Gas Regional Initiatives. Referring to the comment in the previous paragraph, GTE considers strong involvement and co-operation of infrastructure operators supported by regulators as essential for the investments needed (see also comment (36) above).

Cross subsidies between network users

(38) GTE considers that entry-exit tariffs taking distance into account are capable to avoid cross-subsidies to a large degree. The report indicates that backhaul and short haul tariffs may be appropriate to avoid cross subsidies; GTE agrees with this, but would like to discuss the possibility of, where necessary, also introducing point-to-point tariffs, to meet the objective of avoiding cross subsidies.

- As for postage stamp tariffs, the report indicates that they may be acceptable “for small systems or where calculated entry and exit tariffs are geographically uniform across the transmission system.”
- In GTE’s opinion, the design of the tariff system should take into account not only the size of the transmission system, but also the structure of the network. For instance, if the gas supply comes from various entry points scattered on the network, the postage stamp could be applied even in a large transmission system (in this case, the distance factor is outweighed by the security of supply obligation, which imposes the duty to deliver gas from any point of the network).
- The distinction between “meshed networks” and “not sufficient meshed networks” deserves further explanation, as the document seems to contain some contradictions. The document states in paragraph 31 that virtually all networks are meshed if looked at from a European perspective (at the European level, if there is competition, there must be a meshed network – i.e. multiple routes- and hence “the distance based tariffs have been abandoned by a large majority of TSOs”.)
- But then the report admits the potential existence of a “not sufficiently meshed natural gas grid with unidirectional flows” (see paragraph 51), which, in this case, leaves room for a different treatment in tariff setting.
- The same applies to paragraph 52 mentioning “linear long distance transit not interconnected with other domestic transportation”, since it is said earlier in the report that “this type of gas transit is rare in practice”.

Trading of unused capacities

(39) GTE agrees that mechanisms which allow freeing unused capacities are a consistent counterpart for the possibility of long-term commitments. GTE has released on this specific issue a report focusing UIOLI mechanisms (Ref. 04CA136-FINAL).

(40) With respect to the statement that existing contracts using distance as a factor for tariff calculation should be transformed into “product units” (whichever these may be), GTE refers to the comments made in section (18) regarding the sanctity of existing contracts.