

Position Paper

ERGEG Pilot Framework Guideline on capacity allocation

General Remarks

The German Association of Energy and Water Industries (BDEW) represents 1,800 members of the electricity, gas and water industry. In the energy sector, we represent companies active in generation, trading, transmission, distribution and retail.

We welcome the opportunity to comment on the ERGEG Consultation Paper.

General

What are your main views of the proposed measures? Do you think Network codes-based on these guidelines can achieve non-discriminatory and transparent capacity allocation and the fulfilment of the capacity allocation principles set out in the Third Package of Energy legislation?

Essentially, the draft framework guideline is aiming at the right direction and can achieve non-discriminatory and transparent capacity allocation and fulfil the capacity allocation principles set out in the Third Package of Energy legislation. However, the focus should lay on capacity allocation mechanisms. Interference with other areas for network codes as set out in the 3rd package should be avoided. Additionally it should be pointed out, that reasonable implementation period as well as full cost recovery for TSOs is irrevocable.

BDEW supports the harmonization of market designs through EU-wide binding rules instead of a large variety of instruments which NRAs can select.

We welcome the coordination between TSO in offering products and harmonizing processes.

Traders welcome improvements, facilitating trading at cross border interconnection points. However, an obligatory bundling of capacities would not be in the interest of the market. It is further noteworthy that there should be an adequate time for the implementation of the final network code.

The framework guideline needs to be clear and detailed on auction rules to avoid adverse market impact and to ensure consistency across Europe.

The target model of 'coupled' gas markets in conjunction with implicit capacity auctions has our particular interest and we will stay actively engaged in further steps towards this model.

We are concerned about the potential implications of the proposed measures on existing transport contracts as well as on cross-border purchase and sales contracts. Sanctity of contracts is essential for continued investment and long-term security of supply. In particular, compulsory bundling of entry and exit bookings are therefore not adequate.

BDEW will comment in detail on the proposed measures.

What are your views of the implications of each for the measures for sector in which you operate? In particular, we are interested to understand the nature of the implications in a qualitative way (and, if available, any quantitative evidence on costs and benefits would be extremely welcome).

BDEW believes that implementing the framework guideline in conjunction with congestion management procedures will facilitate increased trading liquidity at market hubs as the capacity interconnecting such hubs will be allocated more efficiently. Greater opportunities to purchase capacity and increased trading liquidity will encourage new entrants and more sophisticated traded products which will further competition in the supply of gas.

Allocating firm capacity by auction will also create market signals showing where incremental capacity is required and the congestion rents and user commitment resulting from auctions can be relied upon to underpin TSOs investment decisions in such incremental capacity.

The implementation of these mechanisms will require an alignment of the existing processes and IT-systems by all market participants. The adaptation of IT-systems will require an interim period and will temporarily increase costs. A general implementation deadline of six months, as stated in the guideline, is not adequate in this context. An implementation period of 12 month with an adequate lead time before the beginning of the next gas year (e.g. April of the relevant calendar year), is more appropriate. Since the implementation of each topic will bind a considerable amount of resources, it is sensible to implement the single provisions stepwise to prevent frictional losses.

The proposed procedures for long-term allocation and the allocation of new capacity might be inconsistent with the Guideline of Good Practice on Open Season Procedures (GGPOS). Therefore, we recommend clarification of the relationship of both, particularly if new capacities of a new pipeline are allocated.

Scope of the Arrangements

Do you support the scope of the draft framework guidelines proposed?

We support ERGEG's focus on all booking points between EU Member States resp. between market areas within Member States. Exempted by ERGEG's proposals are (and indeed should be) exit points to end consumers and distribution networks, entry points from supply-only / upstream networks, entry points from gas production facilities, entry points from LNG-terminals, entry/exit points to or from storage facilities. This follows inter alia from recital 16 of Gas Regulation 715/2009: "The network codes ... are not intended to replace the necessary national network codes for non cross-border issues".

Existing contracts

We are concerned about the implications of the guideline on amending existing contracts. The scope of possible amendments should be clarified.

The requirement to adapt existing contracts should not affect the commercial value of existing contracts. Sanctity of contract is an important principle in the gas industry to ensure a sound investment climate that is in particular pivotal to long term security of supply in the gas industry.

However, as from the entry into force these guidelines TSO should forcefully ensure that:

- Any new primary capacity be allocated according to the new rules;
- Contracted but unused capacity be surrendered (according to the Use it or lose it principle) and tendered in market-based auctions

What are in your views of the challenges that existing contractual arrangements create with regard to capacity allocation? What would be the possible ways to overcome those challenges?

Instead of a potential re-allocation of existing contracts, additional capacity should be offered to the market by TSOs (e.g. via capacity buy-back) on the basis of achievable incentives for TSOs in order to hedge the financial risks. Furthermore adequate (positive) incentives should be designed to make shippers voluntarily sell capacity they do not fully need (in addition e.g. to a stricter and effective long-term and short-term UIOLI freeing up unused capacity to the market).

- Time scale of 6 months to amend existing contracts will not be sufficient
- If amendments of existing contracts are desired clearly legal and/or regulatory rules are irrevocable; specification of “relevant clauses” that need to be amended is necessary
- Long term capacity bookings are irrevocable for investment decisions of TSOs (as well as the reliability in concluded contracts)

Should relevant clauses in existing contracts be amended if they contradict the new legally binding set of rules (which will be based on the framework guideline) in order to create a level playing field for all shippers?

Generally, all shippers and TSOs need to be able to rely on their existing contracts and the intended measures should not affect existing capacity contracts as such. Amending these contracts, which may become necessary in implementing a new CAM regime, should be done in close cooperation with current capacity contract holders.

The continued ability to conclude long-term capacity contracts is important in order to guarantee security of supply via long-term import contracts. This market need has to be acknowledged and addressed in implementing any market-based CAM measures.

We support ERGEG's proposals that contracts coming to term must not be automatically prolonged – the capacity out of these contracts must be allocated through the new CAM framework.

Experts have discussed if existing / legacy contracts should be questioned if certain conditions are met, in order to free up capacity, which would then be reallocated. Do you consider such a proposal appropriate?

Evergreen clauses in existing contracts must not be allowed to be maintained. However, we expect that commercial rights of "normal" existing contracts are respected.

The focus of ERGEG's CAM & CMP proposals should be the allocation of available capacities; reallocation of booked capacities should not be taken into consideration. It would inter alia cause substantial risks for TSOs (as existing contracts are a.o. the basis for investment decisions of TSOs).

TSO cooperation

Is the scope of the identified areas for TSO cooperation appropriate to ensure efficient allocation of cross-border capacity in order to foster cross-border trade and efficient network access?

We fully support further cooperation of TSOs as to exchange of relevant data, harmonization of capacity products and both capacity calculation and allocation procedures. The cooperation of adjacent TSOs must be accompanied by closer cooperation of the relevant NRAs and the abolishment of inconsistent national regulation. Furthermore, tariff regulation must set the right incentives for closer cooperation of TSOs but with regard to the areas for framework guidelines/network codes as laid down in the 3rd package tariffing should be subject to a separate framework guideline. The solution for cross-border trade and efficient network access must be consulted with all relevant stakeholders to ensure a cost efficient and harmonised result.

Contracts, codes and communication procedures

Should a European network code on capacity allocation define a harmonised content of transportation contracts and conditions of access to capacity?

A harmonised European solution is absolutely necessary in particular with regard to standardization of capacity products, the allocation mechanism and timeline and procedures (i.e. auction design).

Should a European network code on capacity allocation standardise communication procedures that are applied by transmission system operators to exchange information between themselves and with their users?

Standardised communication procedures are crucial to harmonise exchange of information between TSOs and their users but should be subject to a separate framework guideline. These procedures should be limited to interconnection points, though.

This applies inter alia to nomination procedures. However, since the implementation of new formats and procedures is always time-consuming and cost-intensive, only a strict standardization would allow for economies of scale. A broader approach and less stringent implementation would potentially lead to a negative cost-benefit-analysis.

It is important that there will be a very close cooperation with the network users because the IT systems which have to be implemented must be compatible with the shippers systems.

Capacity products

What are your views of our proposals regarding capacity products?

We welcome the target to bring more available firm capacity to the market and support new products as part of the solution.

A small range of standardized capacity products should be introduced to avoid splitting of capacity markets. We propose the following products and recommend including them explicitly in the framework guideline:

- Intraday capacity (allocation of unused capacity)
- Day ahead
- Month ahead
- Quarter ahead
- Year ahead

Yearly and quarterly products shall be available in a yearly long term capacity auction at least 15 years/ 60 quarters ahead (see UK QSEC example). We suggest a maximum contract length of 1 year but with the ability to bid for up to 15 annual contracts at the same time at an interconnection point.

Example: In August 2010 TSO X will hold a 'Long Term' auction for Entry capacity at IP Y. Shippers can bid for yearly contracts for the calendar years (or gas years – one standard year should be defined) 2011, 2012, ... 2025. Each shipper can bid for one/all of these years, for the first and/or last 5 years, for the year 2011, 2012 and 2015, etc. The auction design should then take into account the best combination of all bids (in terms of aggregated maximum of available capacity allocated throughout the 15 years).

We believe the scope of the framework guideline should be limited to the allocation of available capacity that is firm, in accordance with Article 2 (20) and 2 (18) of the Gas Regulation 715/2009. Interruptible capacity is an instrument that should be covered under congestion-management rules.

Do you agree with the idea of defining a small set of standardised capacity products that do not overlap?

We agree with the idea of defining a small set of standardised capacity products (see above). We would propose a European-wide adoption of a uniform gas-day - this means that operational consequences and cost must be accounted for. It is important that the products are able to fulfil the requirements of the balancing systems and the framework guidelines and codes are flexible enough to add new products in a short time if the market asked for.

With regard to the standardised capacity products it is important that these products can cope with the shippers needs evolving from the commodity market. The standardisation of capacity products should be limited to firm capacity products so that the market requirements can be fulfilled.

Should TSOs offer day-ahead and within-day capacity products?

BDEW agrees that there will be a need for multiple capacity products with different terms ranging from intra-day, daily, weekly, monthly to multi-annual specifications. In particular, long-term capacity bookings are necessary for ensuring security of supply and for hedging market risks in trading. We agree that the demand of market parties should develop the actual capacity products. With regard to short-term capacity, such as day-ahead and intra-day, the development of new products (e.g. hourly or blocks of hours) should be considered. The source of day-ahead and intraday capacity could be an additional intraday maximization of capacities by the TSO via a re-calculation of capacities as well as not used capacity. BDEW supports the reservation of parts of the capacity to be allocated in the short-term (maximum 1 year).

Such development however depends on corresponding commodity products at the commodity markets and in particular gas exchanges. The NRA's approval for the capacity products should therefore not deviate from the market based approach. The NRAs do however have the responsibility that the product design allows bundled products and efficient use of cross-border capacities.

Should European TSOs offer the same capacity products at every interconnection point across Europe?

We demand an EU-wide harmonization of market design through EU-wide binding rules. Those EU-wide binding rules are a prerequisite for EU-wide harmonisation. Any cross-border rules should be identical at least throughout large regions. We therefore propose the implementation of the same mechanisms and products for all cross-border entry and exit points, which are binding throughout the EU. Therefore we prefer the same set of products at every interconnection point.

Should TSOs offer interruptible capacity also in cases where sufficient firm capacity is available?

No, in this case the TSO should offer only firm capacity. Generally, interruptible products are only helpful to shippers in a limited amount of cases, in particular where demand is flexible (e.g. dual fuel production/ generation).

The main aim must remain offering the maximum amount of firm capacity. This should be achieved by TSOs offering products according to the market needs in a consistent method for all points.

A prerequisite for interruptible capacities is a harmonization of those products at interconnection points.

If all firm capacity is sold the system operator is allowed to offer interruptible capacity.

Breakdown and offer of capacity products

Should a reasonable percentage of the available capacity be set aside for firm short term capacity products?

Basically we agree with the idea of setting aside a share of the available capacity for short term use but we would like to point out that in our view it should be used with extreme caution.

We see some merit in phasing the amount of capacity that is offered under an auction process for (multi-)year contracts, so that potential users know there will still be some capacity left that can be acquired through monthly auctions. This would allow users to better tune capacity bookings with their actual requirements.

On this topic the framework guideline is too unspecific and introduces additional NRA approval procedures that should be avoided. Furthermore we believe that there are more effective and efficient ways to optimize network utilization that should also be considered, such as implicit auctions of short term available capacity.

Cross-border products

Recital 19 of Regulation (EC) 715/2009 states that gas shall be traded independently of its location in the system. Do you think that cross-border products will facilitate the exchange of gas between virtual hubs of adjacent markets?

Combination of exit capacity from one zone and entry capacity into the adjacent zone to create a hub-to-hub service is supported. However, this should not lead to a limitation of the possibility to trade natural gas at the border. Existing import/export contracts generally specify that gas is delivered at the border where the custody transfer facilities are located. Forced changes to these contracts, such as moving the delivery point to a hub, could have significant commercial consequences and must be avoided.

Also, delivery of gas at the border allows parties to do cross-border trades without the need to have legal presence in both countries, whereas hub-to-hub services introduce economic activity in both countries.

Moreover, we believe that a limitation of trade at the border would clearly be outside the scope of the framework guideline, and even be in conflict with inter alia recital 19 of the Gas Regulation 715/2009: "... to give network users the freedom to book entry and exit capacity independently..." and its Article 13.1: "Tariffs for network users shall be non-discriminatory and set separately for every entry point into or exit point out of the transmission system".

Finally, we also believe that such a limitation of trade at the border would be executed without proper legal basis within European Energy Law (esp. Regulation (EC) No 715/2009 on conditions for access to natural gas transmission networks) and that such a limitation would arguably lead to a disproportionate intervention into contractual freedom.

Do you support full bundling of cross-border capacity into one single capacity product, including a limitation of the possibility to trade at the border so that gas is traded at virtual hubs only in order to boost their liquidity?

Compulsory bundling would unnecessarily limit the possibilities to trade. The market should decide – combined products should therefore be offered as an option. The UK example shows that trading at the beach is indeed an accepted alternative in a developed market.

Furthermore, limiting flange trading by compulsory booking of combined/bundled products would require the adaptation of all cross-border supply contracts with delivery at a flange. This would not just be a matter of substituting a flange for a hub in the contract. It would rather lead to the renegotiation of the entire contract, since the delivery point has always strong implications on the management and distribution of risk between the involved parties. This is in particular true for import contracts with non-EU producers.

Finally it is noteworthy that – even without interfering with existing contracts – producers can already today reach the virtual points with the help of released capacities and additional capacities (e.g. via overbooking), interruptible contracts or the Rucksack principle.

We nevertheless welcome the establishment of combined products as an option, which are an important step for more liquidity on the gas markets as they allow easier trading from hub to hub.

The implementation of combined products however is a very complex matter and relies on:

- National regulatory regimes allow closer cooperation of TSOs and make capacity allocation for shippers independent of single TSOs (physical points belonging to different TSOs can become one single “virtual” border point). Incentives should be introduced by NRA for fostering TSO cooperation and for establishing independent capacity allocation.
- TSOs have a common understanding of capacity calculation and strongly cooperate to calculate capacities relative to the situation in adjacent systems
- TSOs are willing to offer a one-stop-shop to shippers
- A new tariff regime offers lower transactional costs than for current flange trading – flange trading currently is an additional flexibility to manage the portfolio without bearing the costs of both the entry and exit capacity
- It is clear what happens with capacities (either a physical entry or an exit capacity) held by market participants at only one side of the border

Therefore, TSOs must allow and implement combined products at all booking points. This means that it will not be necessary to procure entry and exit capacities to a single booking point separately if the network user does not wish this. As set out above, besides the need of enhanced cooperation of TSOs, the offer of combined products has to be supported by the respective regulators and consistent regulatory frameworks in the states concerned. In cases, where additional investments are necessary for offering combined products, the question how these investments are reimbursed in the tariff regulation framework also needs to be solved in advance.

Do you consider combined products to be an appropriate interim step towards bundled products?

Combined products (where required by network users) are an alternative to bundled products. Still, we are concerned that the Guideline does not specify a clear approach but leaves it to the discretion of the NRAs to define terms and conditions of combined products (in comparison to bundled products) and to decide how to handle combined products. We would welcome a consistent and harmonized approach applicable to all interconnection points.

Should capacity at two or more points connecting the two same adjacent entry-exit systems be integrated into one single capacity product representing one single contractual interconnection point?

In general we support the formation of entry resp. exit zones (in contrast to a bundling of entry and exit capacities).. The process should however not reduce available capacity, hence each individual network must be analysed individually.

As this may require constant flow based capacity re-calculation and alignment between adjacent TSOs we are sceptic about its cost-benefit ratio – particularly since there is mostly only one IP between two adjacent entry/exit systems. Moreover, through the combination of several points which are geographically further apart, a considerable amount of capacity could be lost, if TSOs use worst case calculation scenarios.

Capacity allocation

Should auctions be the standard mechanism to allocate firm capacity products?

We support the idea that TSOs offer capacity on a regular basis for all firm products, and agree that – in general – an auction is the preferred mechanism to allocate scarce capacity (existing and future). We also welcome that ERGEG has addressed the potential allocation by means of implicit auctions. However, attention must be paid when designing auction terms to avoid unintended adverse effects. Lessons should be drawn from the experience with auctions in the UK Gas market. We do not believe that detailed auction terms rather than the principle design should be specified in the framework guideline, but recommend that ENT-SOG designs detailed auction terms in consultation with stakeholders.

In general auctions should be clearly designed. The goal should be to establish coordinated auctions of the TSOs concerned for all capacity durations (excluding intra-day). Fostering cooperation between adjacent TSOs also requires further cooperation between the involved regulatory authorities. The auction dates should be fixed and the auction deadlines have to be in line with gate closure times of the relevant gas exchanges. TSOs also have to publish in advance which capacity products are available at the respective auction. Lot sizes must be aligned with current market practises.

We propose auctioning with a market clearing price, which means that all shippers of the auction pay the same marginal price. All participants in the auctions have to be treated equally. The reserve price for physical flow should be the cost-based regulated tariff.

The additional revenues from capacity auctions shall exclusively be employed to remove the congestion at the respective IP (or further downstream) or to guarantee firmness of the allo-

cated capacities. All processes need to be harmonized with existing national regulations (e.g. in Germany Anreizregulierung) – or national network tariff regulation needs to be adopted. A prerequisite for a fair price finding in auctions is effective CMP to ensure that unused capacities become available to the market in different time-frames but the capacity products should not overlap.

The development of the specific mechanism for implicit auctions must be consulted with all market parties.

We would further welcome the use of a single platform for both secondary and primary capacity products to ensure liquidity and cost efficiency. The details of how to integrate secondary capacities best into such a common TSO platform still have to be analysed.

What would be the implications of using auctions for capacity allocation in the markets in which you operate? Is there any way in which auctions can be designed to overcome potential issues resulting from their introduction in those markets?

As noted earlier, auctions present a simple, transparent and stable, market-based system. Nevertheless, the auction results might lead to increasing or strongly volatile prices for some points. TSO must be obliged to spend excess revenues (= congestion rents) on de-bottlenecking the respective IP. Fair prices can only be achieved if effective CMP measures are in places that guarantee all unused capacities being available to the market.

In this context it is important that the auctionplatforms are able to provide a clearing service. Also relevant information of OTC trades should be published on these platforms.

Do you support pro rata allocation as an interim step? If yes, should pro rata allocation only be used in given situations or market conditions?

We do not support pro rata allocation as an interim step or as any other part of the solution. Pro rata allocation has the disadvantage that in general none of the participating shippers receives capacity according to his needs – thus also resulting in strategic bidding behavior. Additionally, it is not a market-based method as required by European legislation.

Re-Marketing Booked Capacity

Should the network code define harmonized firm secondary capacity products and anonymous procedures for offer and allocation of secondary capacity products in line with those on the underlying primary capacity market?

We fully support the creation of a liquid market for capacity products including primary and secondary capacity. Therefore, we support harmonized capacity products and anonymous procedures. However, the price of secondary capacity should not be linked at all to the price of primary capacity. Otherwise a seller would not be able to offer his capacity below the price

of primary to sell at least parts of it, if demand is low. Sellers should also be able to “slice and dice” their capacity into bits according to the set of standard capacity products.

We would welcome more clarity on how the facilitation of a secondary capacity market can be part of the framework guideline and the network codes. We generally support product types and durations consistent with primary products and which can be sliced and diced by capacity holders according to their needs, standard operational procedures and a platform, operated by TSOs, that facilitates this secondary market.

Booking platforms

Do you think that all capacity connecting systems of two adjacent transmission system operators should be allocated via a joint, anonymous, web-based platform?

We welcome initiatives to create joint booking platforms for allocation of primary capacity and trading of secondary capacity. However, this should not restrict shippers to trade secondary capacity without using the booking platform. We do not believe that OTC-transactions should be banned. In the long run, a common auction platform would be highly desirable. Such a common auction platform could make best use of already existing platforms, e.g. in Germany trac-x. We also think that implicit auctions should be considered for short-term allocation at a later stage. In implicit auctions, capacity and commodity is sold together. We would welcome a harmonised treatment of all capacity trading aiming for a common auction platform mechanism.

Do you agree that joint allocation of primary and secondary capacity products on these platforms would strengthen capacity markets?

Yes, we agree. However, there should be no restrictions or discrimination for holders of capacities to market them separately in a secondary market before a nomination gate closure. Market participants have to be able to adapt their capacity holdings to changes in their underlying production, purchase, sale and consumption decisions over time.

An active secondary market of capacity rights is therefore essential to realign capacity rights between users over time and to ensure the optimal use of the transmission network. To trade capacity freely in secondary markets, shippers must have the possibility to divide capacity into its constituent parts, to be able to sell an individual month, day or even hour taken from e.g. an annual capacity booking. The original shipper shall have the choice either to transfer only the right to use the capacity or - with the consent of the TSO - to transfer the complete contract including all rights and obligations. The whole process must be facilitated by TSOs' platform by ensuring that contractual rights to capacity can be transferred freely between market participants in the secondary market.

As mentioned above it is important that the platforms are able to provide a clearing service. Also relevant information of OTC trades should be published on the platform.

However, as the implementation of such complex system is very cost-intensive and time consuming, full cost-recovery and adequate implementation periods are irrevocable.

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