

**POSITION PAPER ON THE DEVELOPMENT OF A MARKET IN GAS TRANSMISSION
CAPACITY RIGHTS: IMPROVING ALLOCATION AND CONGESTION MANAGEMENT**

Executive Summary

Delivering the benefits of competition to European gas consumers requires effective competition in the supply, trading and retailing of gas, for which objective liquid capacity markets are vital. In recent years there have been a number of improvements in capacity markets, but more needs to be done. Eurogas welcomes the focus on improving capacity allocation and congestion management and recommends that the following design features are taken as a starting point to reach a harmonized system, that maximizes use of existing capacity and sends efficient signals for future investment.

- More firm capacity is made available to the market
- Existing capacity rights must be respected in the transition to new capacity markets
- Capacity rights are defined efficiently
- Capacity rights are sold efficiently to market participants
- Market participants use their rights efficiently
- The transmission system is managed and used efficiently.

A main objective should be a capacity allocation process that improves the availability for shippers on a non-discriminatory basis. Regulators should encourage TSOs to consider a dynamic approach to capacity calculation but there should be no risk arising from the capacity allocation system that any shipper is unable to honour firm delivery contracts.

Also, there should be an understanding that capacity hoarding is not permitted. Incentives to resell capacity on fast efficient terms should be introduced. It would be premature, however, to consider an approach involving any restrictions of existing renomination rights on a Europe wide basis, while long-term UIOLI should only be considered as a last resort.

In the transition to new capacity markets, existing capacity rights must be respected, although solutions may need to be found by agreement, if historic rules and procedures are inconsistent with the desired future model.

Capacity should be understood as the right to deliver to - or take delivery from – a single hub or interconnection point, and cross-border capacity to the neighbouring countries or regional hubs should be sold either as a combined product or a separate entry/exit capacity.

Capacity needs to be sold efficiently by TSOs over appropriate timescales and system operations should align capacity booking windows at the interconnection points between neighbouring countries. Primary capacity should be sold at its market value, preferably via auction although alternative approaches may be appropriate in some markets. Capacity also needs to be used efficiently, and an efficient secondary market is key to this. Therefore system operators must provide a fast platform for capacity trading. The market must be underpinned by a robust transparency. Efficient system regulation, with appropriate incentives for TSOs, is necessary.

Eurogas supports the need for an eventual convergence of solutions, but recognizes that in the transition period to a fully liquid capacity market, this may not be possible. In this case, it is necessary to ensure maximum co-operation between the TSOs and NRAs in bordering Member States and regionally to avoid distortions that could arise from continuing different approaches.

Introduction

Delivering the benefits of competition to European gas consumers requires effective competition in the supply, trading and retailing of gas. A key component in delivering this vision will be the need to ensure that transmission networks are built, operated and used to their maximum capacity thereby maximising the scope for the market to work in delivering more efficient gas supplies with due attention to security of supply. The creation of a market in transmission capacity rights is crucial to the delivery of this objective and it is possible to set out several key design features of these capacity markets which will ensure that:

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In recent years there have been a number of improvements in the capacity market, but more needs to be done. Eurogas welcomes the focus on improving capacity allocation and congestion management and recommends that the above principles are taken as a starting point to reach a harmonized system.

1. Increasing Firm Capacity

1. Maximising availability of firm capacity

The greater availability of firm capacity will enhance the robustness of the market and deliver more efficient investment signals on necessary system expansion. Firm transmission capacity is essential for market participants to be able hedge their portfolio of gas purchases and sales efficiently. While interruptible short-term use-it-or-lose-it (UIOLI) is a partial solution to freeing up capacity, it does not address the requirements of network users to have access to firm capacity in the shorter and longer term.

2. Capacity calculation should optimize firm capacity availability

Although transmission capacity over time may depend on the pattern of inputs and outputs to the network, system operators are in a unique position to optimise the construction, maintenance and operation of the transmission network to optimise the availability of firm capacity against the likely pattern of deliveries. Regulators should encourage TSOs seriously to consider a dynamic approach to capacity calculation, taking into account the IT resources that will be required.

3. Existing firm delivery contracts should be guaranteed

There should be no risk in the capacity allocation system that shippers are not able to honour their firm delivery contracts. Any over-subscription and capacity buy-back managed by the TSOs has to guarantee no disruption to shippers' business. Such an approach should not be a European level obligation, and if a TSO opts for it after consultation with stakeholders, there should be back-up arrangements including a clear compensation system for any possible negative effects on shippers' business. At no point should shippers be under any obligation to give-back capacity to the TSO, unless there is a particular prior agreement for each occasion. It is no use if a shipper is locked into a fixed price for gas purchases and sales if there is any risk of non-delivery.

4. Capacity hoarding is not permitted

Incentives to resell capacity on fast, efficient platforms should be introduced, with a diminishing compensation scheme, the longer unused capacity is held. There should be a collective market emphasis on use-it-or-sell-it (UIOSI) in preference to use-it-or-lose-it (UIOLI).

To improve the availability of short-term firm capacity, procedures that involve some restrictions of existing renomination rights could develop in a fully liquid market but today when the flexibility to renominate is essential, any such solutions can only be envisaged at a limited number of interconnection points on a case by case basis, in a regional context, and therefore it would be premature to consider it as a Europe-wide approach.

Long-term UIOLI could be an instrument for consideration but it is a complex and delicate issue, as it touches on matters in the domain of competition law. It should only be considered as a last resort, modelled on best practice existing approaches.

2. Existing capacity rights must be respected in the transition to new capacity markets

1. A shared understanding is necessary on the likely impact of a new capacity market on existing access terms and conditions

The introduction of efficient markets in gas transmission capacity rights must not abrogate or undermine existing contractual rights to use the network. Maintaining existing contractual rights contributes to a stable framework for investment. In the event that historic rules and procedures are inconsistent with the desired future model, system operators should work with shippers and Regulators to ensure an appropriate and acceptable path for reflecting the economic rights enjoyed under the historic contracts in the new arrangements.

2. Rethinking on "evergreen" contracts is needed

Unless provided for in the respective contracts, the holding of existing rights should not, however, generate any implicit right to future capacity rights. The need to respect existing rights in order to provide regulatory stability, moreover, would also clearly not override any changes to existing contractual rights resulting from agreements struck with competition or energy regulators in the course of their investigations and actions.

3. Defining Capacity Efficiently

1. Capacity should be defined as the right to deliver to – or take delivery from – a single market hub or interconnection point

As "point-to-point" definitions of capacity will never deliver sufficient liquidity, the creation of a single, national or regional hub is essential. This hub can either be a physical point on the network or "virtual" hub implied by the terms for nominating deliveries. Capacity rights should then be defined as either "entry capacity" – the right to deliver gas to the hub/interconnection point - or "exit capacity – the right to take delivery of gas from the hub/interconnection point. (It may nevertheless also be necessary to adopt different hubs and delivery point for different qualities of gas, i.e., an H-gas hub and Lgas hub.)

2. Cross-border capacity to the neighbouring countries or regional hubs should be sold either as a combined product or a separate entry/exit capacity

On any interconnected network, the capacity at any one point on the network is in part

dependent on the capacities made available elsewhere on the same network (so called "network externalities"). This makes it essential that neighbouring system operators coordinate and agree on the specification and volume of the capacities made available in capacity services at the interfaces between their respective markets and the possible enlargements of connected networks. Capacity concerned can be firm or interruptible, bundled or unbundled. Additional products allowing trade at the hubs should be introduced.

3. Capacity should grant physical scheduling rights

Capacity rights should remain – as now – physical rights to take delivery from, make deliveries to and to move gas between respective market hubs/interconnection points. This can be contrasted with the potential use of "financial transmission rights", i.e., contracts for difference between the locational spot prices at different nodes/zones on the integrated network.¹ Financial rights can only realistically be applied in highly developed markets where there is a high degree of explicit operational coordination and high spot market liquidity, conditions are highly unlikely to exist for the foreseeable future in the EU gas market and hence the focus should be on developing the existing specification and usage of physical transmission rights², including trading of short-term products. A better functioning secondary market supported by improved definition of products as mentioned above is essential.

4. The Efficient Sale of Capacity

1. System operators should sell transmission capacity forward over appropriate timescales

System operators must adopt a flexible approach to capacity sales. In selling capacity, TSOs have to be responsive to customers' evolving needs and market dynamics, accepting that needs will change overtime and they should pay due attention to security of supply needs.

In striking an appropriate balance between long-term and short-term sales, system operators should aim to provide sufficient liquidity to the forward transmission markets to facilitate efficient hedging of transmission risks and their volume and price risks in forward markets and to facilitate effective competition within and between market hubs. System operators should weight sales to avoid unduly constraining the secondary market in rights.

System operators should align capacity booking windows at the interconnection points between neighbouring countries.

2. Primary capacity should be sold at its market value

Primary capacity should be sold at its market value and the best, most transparent, non-discriminatory way to establish this value will typically be via capacity auctions if there is sufficient available capacity to avoid speculative prices. In the interim period, however, alternative approaches may be appropriate in markets that have not reached an adequate level of maturity and liquidity, or where the legal framework has still to be adapted. Auction variations, e.g., open seasons for capacity, might be appropriate in the case of new large infrastructure.

¹ The contracts for difference listed on the Nordpool electricity exchange and the Financial Transmission Rights used in the Pennsylvania- New Jersey-Maryland (PJM) electricity market provide good examples of this.

² One common misconception is that in these conditions the market can be left to its own devices to naturally provide and trade these "financial capacity rights" as swaps on locational price differences. This ignores the fact – explained in Principle 4 – that the system operator is the only party that is "long" transmission and hence the only conceivable seller of efficient transmission hedges. This has been borne out in practice in the Nordic market, where despite locational swap products being offered on the exchange, they are highly illiquid and rarely traded in the absence of the Nordic system operators stepping in as sellers of the required capacity.

3. System operators should offer incremental capacity at reserve prices linked to the economic cost of expanding the network

Capacity markets will not only play an important role in maximising the use of the existing transmission network, they should also provide valuable signals on the future need to expand network capacity. System operators – in consultation with regulators – can facilitate this by establishing the economic cost of expanding network capacity at specific entry and exit points (i.e., the “long-run marginal cost” of capacity) and offering to sell long-term capacity at this “reserve price”. This approach – coupled with the firmness of the capacity sold - has the additional benefit of ensuring that any subsequent construction decision is optimal.

5. The Efficient Use of Capacity

1. Capacity rights should be freely tradable in a secondary market

The efficient management of market risk means that market participants’ capacity holdings need to adapt to changes in their underlying production, purchase, sale and consumption decisions over time. An active secondary market in capacity rights is therefore essential to realign capacity rights between users over time and to ensure the optimal use of the transmission network. System operators must facilitate this market-driven process by ensuring that capacity usage contractual rights to capacity can be transferred freely between market participants in the secondary market. System operators may only ask for limited fees for such operations.

2. System operators must provide a platform for capacity trading

In line with the ability to transfer easily usage rights between users, the system operator must provide a central platform to trade rights which allows market participants to notify changes in the holdings of those rights to the respective TSO.

3. Forward capacity sales (where applicable) must be freely divisible into daily/hourly rights as required

To trade capacity freely in secondary markets, market participants must be free to divide capacity into its constituent parts, i.e., be able to sell an individual season, month, day or even hour out of an annual capacity purchase.

4. System operators shall publish all relevant historic and prospective capacity booking and usage information

The efficient sale and usage of transmission capacity requires system users (and operators) to have good information on the capacities available now and into the future – including any capacity expansions - and the likely constraints on that capacity. This helps users to establish the likely value (and price) of capacity into the future to optimise their capacity bookings alongside the efficient management of their wider portfolio of gas purchases and sales. At a minimum, but taking due account of the applicable legislation on confidentiality of commercial information, this will require system operators to release information relating to:

- Projected capacity – including planned increments – and likely availability, given projected maintenance;
- Aggregate capacity bookings over relevant timescales;
- Real-time capacity availability and utilisation; and
- As an initial one off, historic records for the last 5 years for the above categories of information to assist in building informed projections for the future.

6. Efficient system regulation and management

1. Regulators should give system operators incentives to make efficient decisions

The system operator has a direct interest in optimising the construction, maintenance, operation and use of the transmission network and makes appropriate economic trade offs with their duties to operate a secure system. It is essential that regulators provide strong incentives to the system operators to provide a commercial transmission service by offering additional returns for exceeding relevant performance targets (e.g., building new capacity, selling capacity forward, increasing network utilisation, reducing congestion etc).

2. The recovery of residual revenues should not distort the capacity rights market or use of the network

The sale of ancillary operating services at commercial rates in future may, in some circumstances, fail to recover sufficient revenues to provide a sufficient regulated return on the existing asset base. This will typically require charges/tariffs in addition to the market-based capacity payments. It is important to ensure that the economic signals to use the transmission network are not undermined.

Conclusions

Eurogas considers that there is scope for making progress on both Capacity Allocation and Congestion Management. In particular, measures should ensure more compatible procedures and products between TSOs. Also TSOs should facilitate improved trading platforms, that will enhance the transparency of secondary market opportunities and incentivize shippers to resell unused capacity.

Eurogas can also support consideration of how other market-led mechanisms might contribute to the availability of firm capacity, without harming suppliers' interest. Any mechanisms should respect the principles outlined above.

Eurogas supports the need for an eventual convergence of solutions, but recognizes that in the transition period to a fully liquid capacity market, this may not be possible. In this case, it is necessary to ensure maximum co-operation between the TSOs and NRAs in bordering Member States and regionally to avoid distortions that could arise from continuing different approaches.