Prime Movers' vision on intermediate results of ENTSOG "Incremental Proposal"

(why justified concerns of long-term shippers / promoters of new capacity are not yet taken into account?)

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Creating new capacity in unbundled gas market: how to minimize investment risks & uncertainties to tolerable level for all parties in gas supply chain

	Bundled gas market	Unbundled gas market
Pricing mechanism	Cost-plus	(1) Net back replacement value (price indexation), (2) Spot/futures pricing
Who takes investment risk	End-users	Shippers & TSOs
Who manage capacity & commodity markets	VIC = in one face producer & supplier (commodity) & TSO (capacity)	Producers & traders (commodity) & TSO (capacity) => different parties in term commodity & capacity contracts
Comparative value of investment risks	Bundling minimizes invest. risks in creating new capacity (no contractual mismatch)	Unbundling objectively (by definition) increases invest. risks due to potential mismanagement of two markets (risk of contractual mismatch)

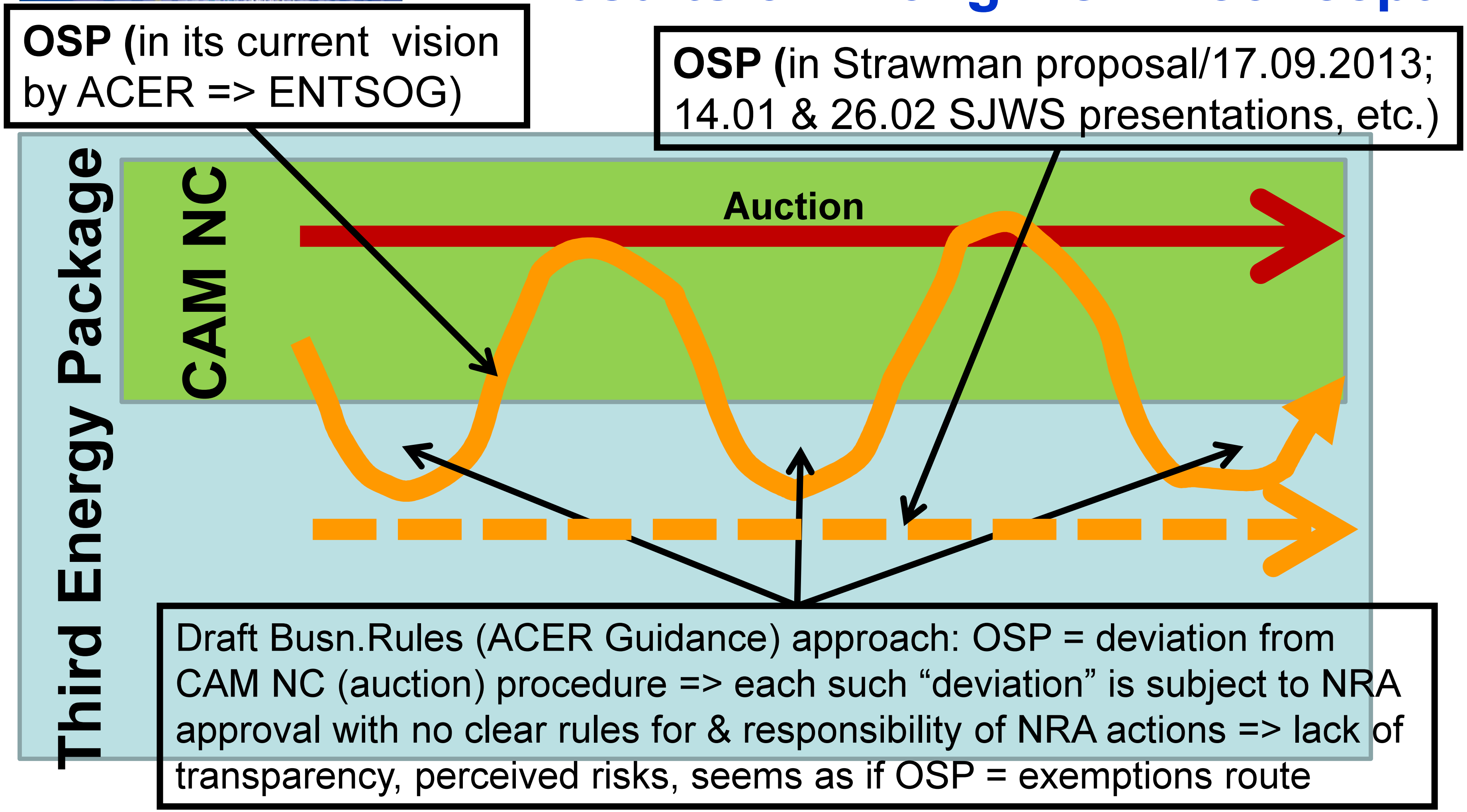
Economic background of our position & proposal

Demand for TSO coordination / cooperation /JV (between & within IPs) to provide for financeability of creation of new capacity

What is fundamental fault of current “default mechanism” in draft Busn. Rules for creation of new capacity

- “Auctions are the default mechanism for the allocation of incremental/new capacity” (Business Rules, art.III.1.5), but:
  - Incremental/new capacity = yet non-existing capacity,
  - To allocate non-existing capacity you should first create it, but CAM NC deals with existing capacity only => implementation of CAM NC rules to new capacity is economically incorrect in principle
  - To allocate (**trade**) existing capacity and to create (**invest** in development of) not yet existing capacity is not the same => **trade** & **investment** are NOT synonyms, but different types of economic activity => their mixture seems to be a systemic long-term default in EU (energy) legislation (the reason for Art.21/36 in 2^{nd}/3^{rd} Directives)
  - ACER intention to put “investment” into Procrustean bed of “trade” is counterproductive since considers the first just as occasional (from time to time) deviation from the latter => procedural faults in ACER Guidance reproduced in ENTSOG Busn.Rules, at least for new cap.

Procedural risks & uncertainties of OSP in current draft Busn.Rules – results of wrong ACER concept



Strawman "project-based" proposal for OSP – yet not considered

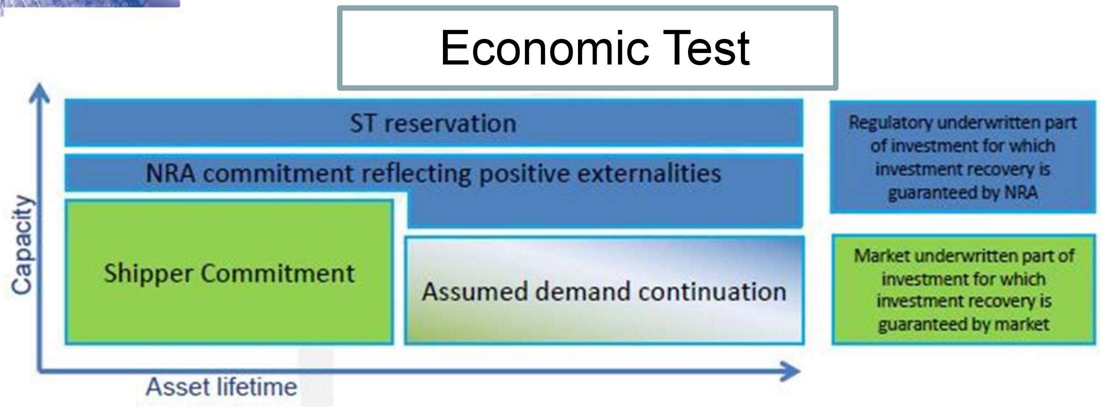
New cross-border capacity project life-cycle

Invest.+pay-back period → **Post-pay-back**

OSP (Strawman-based proposal)	CAM NC + draft NC HTTS
-Project-based approach through pay-back -Tariff as swing parameter in economic test -NPV as criteria for economic test -Fixed tariff through pay-back period -F-factor =100% (90% - shippers demand, 10% -NRA guarantees, securitized by EU fin. Inst.) -No cost socialization -Cross-border unitization, ITSO for unitized project, coordination within single project -Costs/revenues reallocation within project -No contractual mismatch…	-System-based approach -Volume as swing parameter -WTP as criteria -Floating tariff -F-factor established by NRA, flexible, less 100% -Huge cost socialization (1-F) -Cross-border coordination for existing & not yet existing cap. -…between diff. market areas -Risk contractual mismatch…

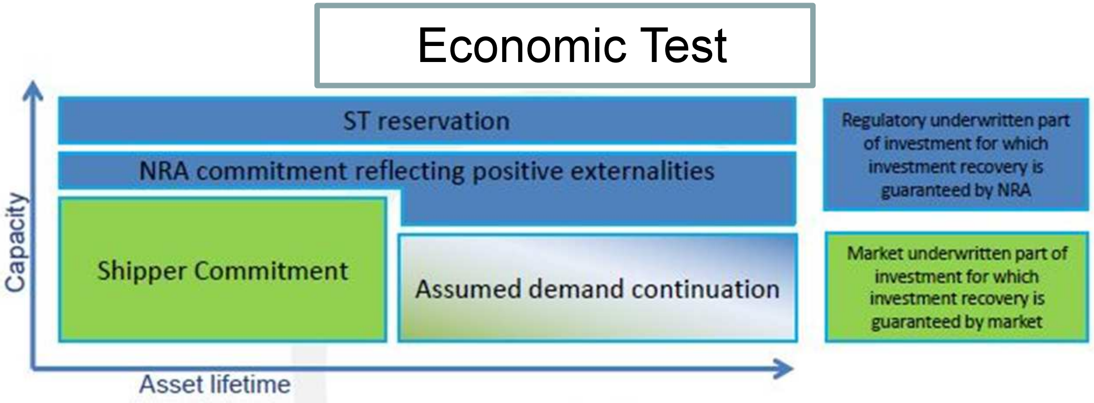
Cross-border ("transportation route") new capacity principle: until capacity is built & paid-back – OSP procedure based on project-based (not system-based) approach

Floating Tariff Problems for Incremental / New capacity



- Economic Test depends on shipper commitment which is function of years of capacity booked and commitment to pay reference price prevailing at time of economic test
- But price paid at time of use will be different to reference price at time of economic test because of the floating tariff
- This means the Economic Test is no longer directly linked to the financeability of the incremental/new capacity nor a true test of shippers' willingness to pay/market requirement for incremental/new capacity
- It makes it unlikely that shippers will be prepared to book sufficient years of capacity to meet the Economic Test as they will be required to sign an open ended financial commitment for a fixed quantity of capacity
- Result will be incremental/new capacity will either not occur due to failure of economic test OR will go ahead as part of central planning type process (10YNDP) which raises risk of stranded assets

Potential Solutions to Floating Tariff Problems



- Shippers need a degree of certainty or predictability to commit to several years of capacity required to pass economic test
- The following approaches, or a combination of them could be used to provide this certainty:
  - Fixed tariffs – the tariff used at time of economic test is the payable tariff at time of use
  - Fixed tariffs with indexation - tariffs indexed to inflation (Retail Price Index, Producer Price Index etc. depending on structure of TSO Price Control)
  - Fixed tariffs with agreed level of variation – e.g. Increases allowed up to a certain level to allow for increase in construction costs. This will need to be linked to level of risk undertaken by TSO as part of its Price Control e.g. Allowed rate of return for new investments
  - Separating tariffs associated with new investment from tariffs for the rest of the TSO network so that users of new investment pay only for under-recovery associated with that project.

Why willingness to pay (NPV) does NOT equal pay as bid (CAM NC)

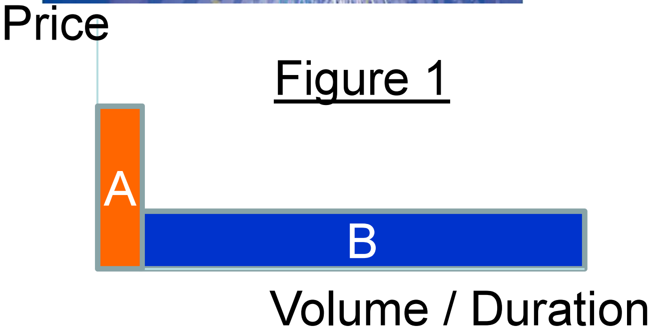


Figure 1

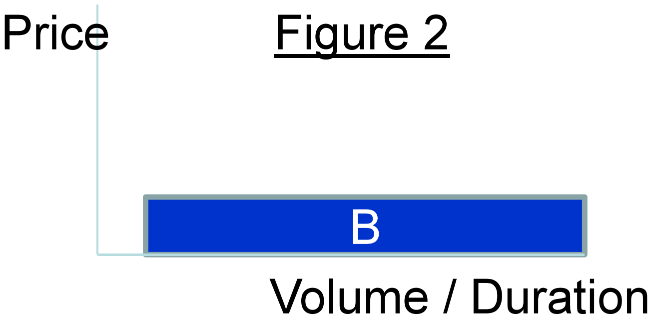


Figure 2

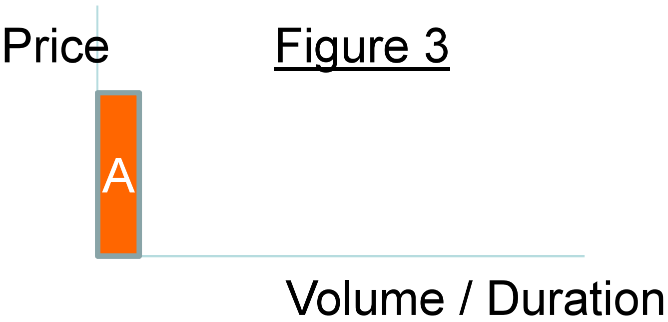


Figure 3

Figures represent the economic test

Figure 1 shows the result if allocation is based on highest bid for an annual strip of capacity

A is allocated Year 1, B is allocated the remaining years

Economic Test is met overall

BUT

B contributes more to passing the economic test but will not want to accept capacity as he receives no capacity in Year 1

AND

Although A has paid more for capacity than B, A's bid is not sufficient on its own to meet the economic test

Use of CAM algorithm does NOT take account of need for shippers to book contiguous strips of capacity => NPV-based approach suits best for this

Willingness to pay measured by NPV is consistent with Third Package Principles

- "**Each TSO** *(1)* ***shall*** **build sufficient** *(2)* ***cross border capacity*** **to integrate European transmission infrastructure accommodating** *(3)* ***all*** *(4)* ***economically reasonable*** **and** *(5)* ***technical feasible*** *(6)* ***demands for capacity***" (Directive 2009/73/EC, Art.13.2) by matching supply of new capacity to demand for it in (the only possible economic) way that maximises financeable (paid-back) investment to the level fully covering demand for capacity (*mark-up & numbers by AB/AK*):
    - Use of simple pay as bid approach would therefore **NOT** be compatible with Directive as it would **NOT** accommodate economically reasonable demand (see previous slide)
    - Directive takes precedence over ACER Guidance since the latter is **NOT** legally binding as guidance is **NOT** a legal term in either Gas Directive or Gas Regulation or the ACER Regulation and Framework Guidelines are "**NON** binding" (Regulation EC/715/2009, Article 6 (2))
- This is why NPV approach being fully compatible with Directive is compatible also with ACER Guidance:
    - NPV approach is market based and is consistent with standard ways of determining viability of investments (NPV / discounted cash flows). "Capacity demand . . .can be satisfied in a **market based manner**, if the necessary investments are **efficient** and **financially viable**". (Para 1(a)).
    - NPV gives more weight to bookings in the near future compared to those farther out; this favours those preferring to book more in the short term compared to the long term.
    - NPV measures willingness to pay as it is a function of capacity booked and price. This is consistent with ACER Guidance which requires "an allocation rule based on willingness-to-pay should be used as priority."

Way forward

- To take a cross-border new capacity project structure from AK/AB presentation at 2nd SJWS and to test step-by-step applicability of both OSP procedures (business game/case study):
  – From current draft Business rules
  – From Strawman proposal (17.09.2013, 14.01 & 26.02.2014)
- ENTSOG team with Prime Movers to organize such case study/business game for next (?) Incremental proposal meeting
- To develop draft Business Rules for OSP for cross-border new capacity based on project-based approach

Thank you for your attention

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