Prime Movers' comments on draft CAM amendment for Incremental Capacity

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Objectives of the CAM Amendment

- To create a market based mechanism for the release of incremental and new capacity that is subject to regulated Third Party Access (i.e. Not exempt under Art. 36 of Gas Directive)
- CAM Amendment needs to enable different potential projects for incremental / new capacity, e.g.:
  - "Simple" reinforcements of cross border capacity
  - "Large, complex" additions of new capacity across several market zones
  - . . . And all variations in between
- ENTSOG, ACER, NRAs and EUC need to create framework that enables different projects

Key issues: Enabling the Economic Test to work

- The Test is the lynch pin of the mechanism as it enables investment to go ahead if it is economic and efficient
  - Assurance to NRAs / TSOs that project will not lead to undue risk of stranded assets
  - Assurance to shippers that project will go ahead if test is met
- Therefore Economic Test must “mimic” commercial reality as if in a competitive market because shippers act in a commercial way
- Two key elements that impact this:
  - Tariffs – predictability to enable shippers to commit
  - Capacity Allocation – knowing what shippers will get if they do commit

Tariff issues

- Economic Test requires shippers to book for several years to pass test . . .
- . . But floating tariffs / system wide recovery of allowed revenues mean low predictability of tariffs over booking period . . .
- So shippers will not know the scale of their financial commitment
- Two potential solutions:
  - Separate regulatory account for new projects (could be linked to size of investment relative to existing capacity)
  - More predictable tariffs (transparency, fixed, fixed plus indexation etc.)

Allocation issues

- Link between shippers' decisions to book capacity and need for sufficient bookings to meet Economic Test
- Shippers' decisions based on need for capacity – risk in open season that if not all capacity allocated, shipper will book none
- Allocation procedure should reflect contribution that shippers make to meeting economic test
- Capacity should be provided at regulated cost – auction premium approach creates cross subsidy risk as TSO only able to recover Allowed Revenue

Conclusions (1)

- Welcome possibility of fixed / indexed tariffs in ENTSOG draft Tariff NC . . .
- . . But more transparency and clarity of how TSOs calculate tariffs is essential
- Welcome recognition that default auction allocation mechanism may lead to unnecessary negative Economic Test result and consideration of alternative . . .
- . . . ACER and NRAs need to be open to use of such an alternative if they want market based mechanisms to work.

For detailed explanations see slides from 5th SJWS (Reserve slides).

Conclusions (2): Coordinated Open Season (COS) & its place in CAM NC

Third EU Energy Package – CAM NC rules

- Open Season procedure – two types of OSP (one, *area-based* – in existing draft; another, *project-based*, – proposed)
  - Auction as default mechanism (existing draft, area-based)
    - Existing capacity
    - Incremental capacity
    - New capacity – simple cases
  - Project-based COS as special procedure (to add to current draft based on Strawman proposal)
    - New capacity – extreme cases (cross-border mega-projects)

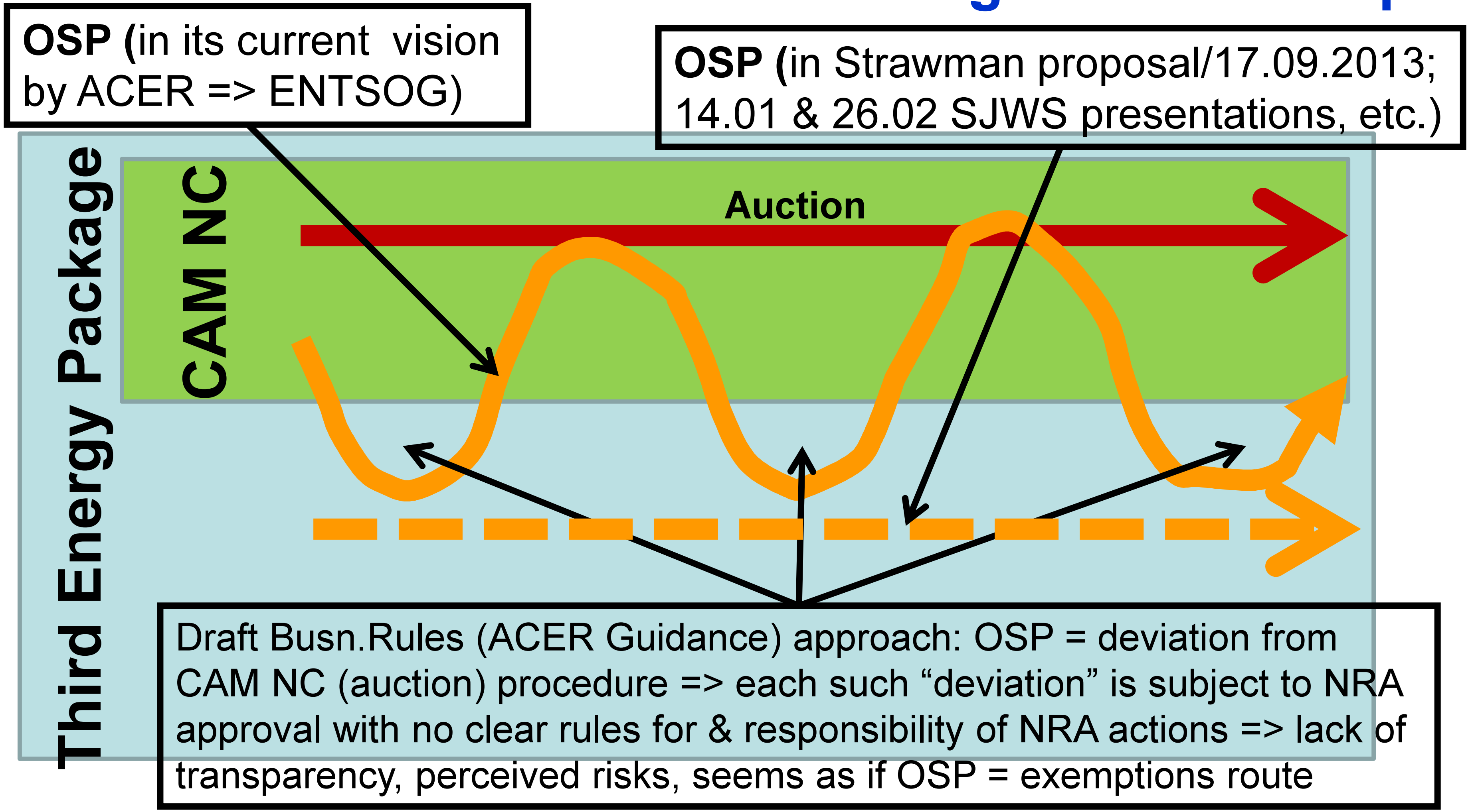
Slides from 5th SJWS 8th April 2014

(Reserve slides)

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 2nd/3rd 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

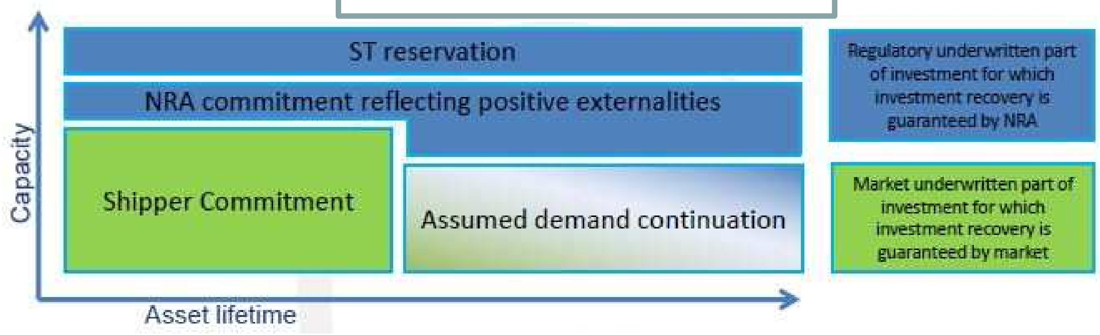
Invest.+pay-back period → **Post-pay-back**

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

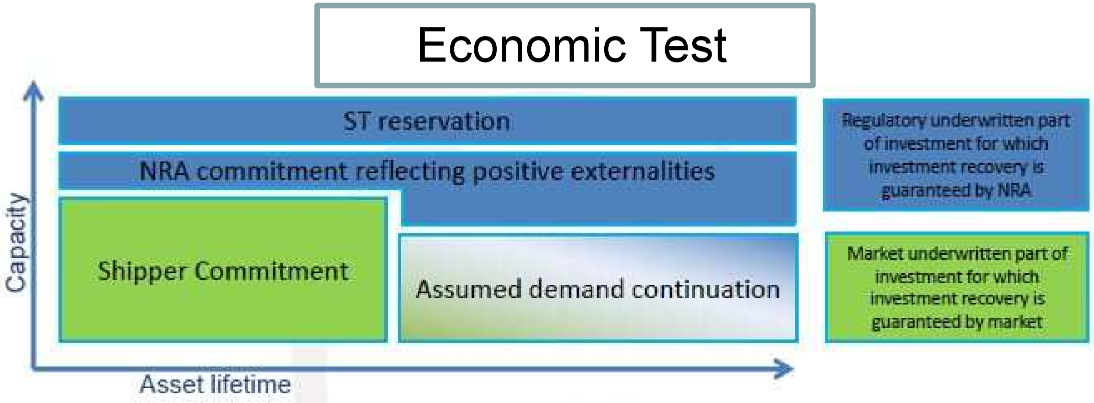
Floating Tariff Problems for Incremental / New capacity

Economic Test



- 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

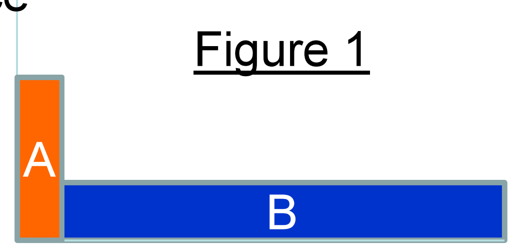


- Shippers need a degree of certainty or predictability to commit to several years of capacity required to pass economic test
- The following approaches, or a combination of them could be used to provide this certainty:
  - Fixed tariffs – the tariff used at time of economic test is the payable tariff 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)

Price

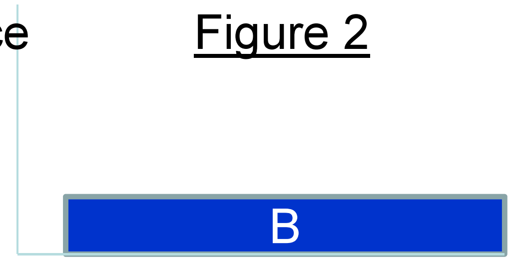
Figure 1



Volume / Duration

Price

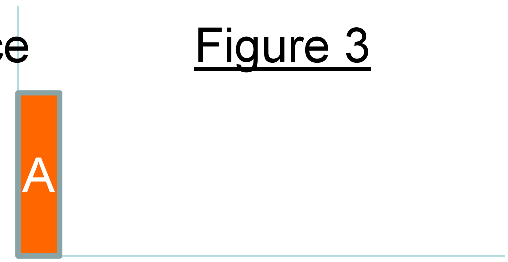
Figure 2



Volume / Duration

Price

Figure 3



Volume / Duration

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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