

Decisions Pending on EU Gas Capacity Trading

The industry is awaiting a decision in September on whether a pilot day-ahead auction can be put in place by the end of the year. According to Dr Colin Lyle¹, chairman on the EFET Gas Committee, even if the deadline is not met, the process would be worthwhile, if there can be agreement to remove all barriers to trade.

Setting the scene

The Gas Committee of the European Federation of Energy Traders² has long recognised that restricted access to cross-border capacity is distorting the development of the EU gas market. How do we reach a situation in which capacity is available to all on an equal and non-discriminatory basis? Well, as a wise Irishman is known to have said when asked for directions "I wouldn't start from here!" But 'here' is where we are, with most cross-border gas capacity in Continental Europe assigned to a small number of historical players. Furthermore the EU Gas Directive, and to some extent the Gas Transmission Regulation, assume that capacity is in the hands of the Regulated TSOs!

Putting a market value on capacity

Within EFET we have debated whether or not a Nord Pool-like approach could be undertaken for the gas market, involving all the capacity, by some means, first returning to (independent) TSOs. Whilst this had theoretical attractions, the majority felt that it did not offer a workable way forward for the gas market in the short or medium term. Instead, EFET formed a strong,

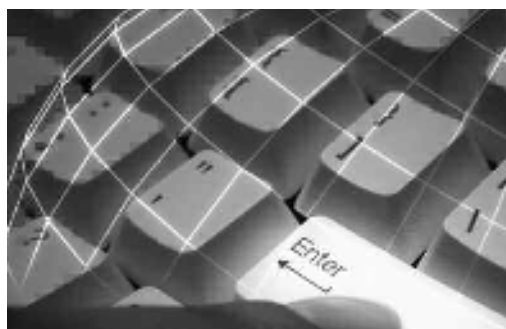
united view that capacity must become a tradable right, and to help achieve this EFET has been urging better information transparency, improvements in TSO services and processes (for example) to speed up registering capacity transfers, and harmonisation of the approach to selling primary capacity.

Primary capacity allocation

At the two Madrid Fora in 2006, EFET set out how primary capacity should be allocated, in particular the importance of TSOs maximising the capacity that is offered to the market and an incentive scheme that rewards successful TSOs for maximising the use of capacity. EFET also supported ERGEG's view that **regulated** infrastructure operators do not generally need binding long-term transport contracts to enable investment. Indeed the starting point for Gas Transmission investment should be that the TSO ought to put in place sufficient capacity to meet all reasonable demands for the agreed forecast use of their infrastructure, and the costs will be covered through regulated tariffs. ▶

¹Statements of EFET positions in this article refer to documents published on www.EFET.org. Other statements are the author's independent observations and are not necessarily EFET policy.

²Established in 1999, the European Federation of Energy Traders (EFET) is an industry association representing over 80 trading companies operating in more than 20 countries. The EFET mission involves improving conditions for energy trading in Europe and fostering the development of an open, liquid and transparent European wholesale energy market.



Is congestion physical or contractual?

Perhaps the first difficulty in the gas market is the lack of information transparency, so that it is sometimes impossible for a third party, even the regulator, to distinguish whether the congestion is physical or just contractual. Physical congestion cannot be resolved without operational changes (e.g. reconfiguration of compressor plant) or investment to increase pipeline capacities.

Contractual Congestion at the time of Capacity Allocation might occur if parties are unable to obtain the capacity they seek to flow their gas because one or more parties are not using all the capacity that has already been allocated to them. Alternatively contractual congestion at the time of allocation might simply arise because the value placed on capacity by market participants is higher than the regulated price for capacity, resulting in a higher demand for available capacity than has been offered for sale. Regulatory, contractual or market remedies can solve contractual congestion without physical changes to the infrastructure.

How can capacity allocation be improved?

The key steps that EFET set out to improve Primary Capacity Allocation and resolve Congestion Management were as follows:

- There must be a clear obligation or incentive for the TSO to invest in sufficient capacity to meet agreed forecast use of regulated infrastructure.
- Full information transparency on the aggregate historical use of the pipelines and their future availability (in terms of the technical capacity, aggregate booked capacity etc...) is essential so that the right valuations and investment decisions can be made.

- Regulators must have checked to ensure that any scheme put in place includes all capacity and is not distorted by historical arrangements.
- Capacity is a right that should be tradable. This means that new and historical capacity rights must be established on an equal basis and if there are significant anomalies due to historical arrangement then these need to be addressed.
- In particular it is essential that the way primary capacity has been and is sold in the future allows that capacity to be traded on a secondary market.
- On a regular basis (perhaps only once per annum if there is an effective secondary market) the maximum available capacity (technical minus booked) should be offered on an annual and multi-annual basis.
- The sale should be based on an auction, which will clear at the regulated price when the demand for capacity can be satisfied by the available capacity. This should be the normal outcome.
- Auctions at cross-border points should be organised in a co-ordinated way so that capacity allocated by one TSO is recognised by the other. ▶



- If demand (for capacity) cannot be met by available capacity then there is either contractual congestion or physical congestion.
- A well-designed auction will result in a fair allocation of this scarce capacity cleared at a market price that is higher than the regulated price when congestion occurs.
- Consistent approaches to the shorter-term sale of any remaining primary capacity will be necessary during the year and can be managed on-line by the TSO.

EFET went on to point out that the use of auction revenues needed careful consideration, as a TSO should not benefit from allowing physical (or indeed contractual) congestion to occur. The unbundling of the TSO also needs to be sufficient to ensure that recycling auction revenues to users does not result in undue benefits to an affiliate. Auction revenues above the regulated price could be used to improve the firmness of future capacity that can be used by market participants.

The day-ahead capacity pilot

In October 2006, EFET made a new practical suggestion: the Day-ahead x-border capacity pilot. The proposal was specifically designed for the gas market but it followed certain mechanisms of the daily auctions that were already being successfully implemented for cross border electricity transmission capacity.

In the current situation, a shipper needs to contract exit capacity out of one grid and entry into the other. The new proposal implied auctioning firm capacity from one hub to the other, so entry and exit combined. Only where the capacity implied a counterflow, (i.e. where physically no flow in the required direction is possible) would the capacity be interruptible.

The auction required the TSOs to obtain, free up or reserve capacity for the auctions and also required them to jointly organize the auction, since the auctioned capacity was to be sold as a combination of entry and exit capacity.

The proposed model also fostered secondary trading of capacity by encouraging shippers to make unused capacity available for resale; they would be reimbursed the value of the auction. When the shipper had only offered entry or only exit capacity, they would receive 50% of the auction outcome.

Implementation of the day-ahead pilot

The target start date for the pilot was 1 April 2007. Auctions were to have been held via secured internet websites run by one dedicated auction office with one common platform or technology. This was to avoid each TSO developing its own IT system for the auction; a situation that exists in the power market and which requires significant additional resources from the participants.

The proposal was intended as a test or trial after which the process would be reviewed and improved leading to potentially more capacity being auctioned, as well as additional delivery periods (e.g. front month, front quarter etc) and additional locations (EGT-GRT, Fluxys-EGT, EGT-Transgas etc).

The main goal was to break down the artificial contractual and procedural barriers that stop liquidity developing at traded hubs in North and North West Europe. The capacity scheme would have supported initiatives of liquidity providers in these markets, such as the daily choice market as introduced by E-on Ruhrgas in the EGT North grid.

So EFET's proposed pilot for auctioning primary gas capacity and stimulating cross-border gas capacity trading in NW Europe should have touched down by now, but ►

as we continue to circle around the runway enthusiasm is beginning to decrease. What has caused the delay? Adam Cooper, who leads the Capacity Market Project Group in the EFET Gas Committee summarises the problem as “Legal and regulatory barriers preventing rather than encouraging TSOs to facilitate the necessary products.” There is now a risk that the initial idea is taking so long to land that traders’ attention will focus elsewhere.

Criteria for success

To help get better understanding among all players, the EFET Gas Committee published a guide to secondary capacity trading, including the requirements on TSOs to facilitate day-ahead secondary trades. The TSOs involved in the pilot have responded positively to this and have committed to being able to register capacity transfers within 3 hours, rather than the 10 days that has been the norm until now.

For the platform to be successful, however, Regulators and TSOs will need to:

- Resolve, on a final basis and before a scheme is put in place, any legal issues that would prevent the implementation of secondary capacity trading.
- Actually implement the necessary system changes, to allow the transfer of capacity between eligible shippers within the day.
- Ensure that full aggregate information on capacity and flows is made available to all market participants on an equal basis.

Unfortunately it seems that significant additional work remains on product definition, changes to network access arrangements, and clarification of national legislation. Although a general framework can be put in place fairly quickly, the detailed contractual arrangements for

capacity trading are fundamentally different between the networks – some are still changing – and the negotiation and conclusion of individual agreements for all relevant systems will take time. Additionally, the success of the market will depend on capacity being made available to waiting buyers by existing capacity holders and by TSOs.

Decisions pending

With cooperation, these difficulties will eventually be surmounted. In the meantime, developments in network access terms elsewhere in Europe mean that primary capacity auctioning and secondary capacity trading at other cross-border points, albeit not yet as x-border products, are being established more quickly elsewhere. The industry is working towards a decision date on 15 September 2007 for whether a pilot can be in place in December 2007. Whether or not this is achieved, the process will have been worthwhile if there is a clear plan for the removal of the remaining legal, contractual and operational barriers that currently prevent auctioning primary capacity and cross-border capacity trading at crucial interconnection points in the European pipeline grid. ■

