

# CEER consultation on Market-based investment procedures for gas infrastructure

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A EURELECTRIC response paper



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# EURELECTRIC response to CEER consultation on Market-based investment procedures for gas infrastructure

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WG Gas to Power

Stephen ROSE (GB), Chair

Pablo ARGUELLES (ES), Gábor BRIGLOVICS (HU), Konstantinos CHRONIS (GR), Cécile DAVID (FR), Beat DEUBER (CH), Sam EMMERECITS (BE), Gerry HOGGAN (GB), Peter G. KRUSAA (DK), Ari LAINE (FI), Carlos MATA (PT), Zvonko PETAN (SI), Thomas PFLANZL (AT), Elisa RONDELLA (IT), Derek RUSSELL (IE), Hein-Bert SCHURINK (NL), Jan SIERIG (DE), Aurimas STIKLIUNAS (LT), Alican TAKUNYACI (TR), David VIDUNA (CZ), Ion ZARNESCU (RO)

Sébastien DOLIGE, Anne-Malorie GERON, Giuseppe LORUBIO and Susanne NIES (EURELECTRIC Secretariat)

Contact:

Sébastien DOLIGE – [sdolige@eurelectric.org](mailto:sdolige@eurelectric.org)

## **EURELECTRIC response to CEER consultation on Market-based investment procedures for gas infrastructure**

EURELECTRIC believes that there currently is a lot of confusion in debates on the CAM Network Code and the CEER public consultation paper on the notions of incremental capacity and new capacity. Often it is not clear whether discussions relate to new technical capacity that will be built at new interconnection points, or new technical capacity that will be built in addition to technical capacity at existing interconnection points, whether as a result of increased compression or downstream network reinforcement. The discussion between ACER and ENTSOG on whether or not parts of the CAM Network Code should apply to new technical capacity are illustrative in this regard. We think that there is merit in finding a common understanding amongst European stakeholders on the scope and semantics of investment procedures. The definition of incremental capacity should at least be identical between the CAM Network Code and the CEER public consultation paper.

- 1. Have you participated in an Open Season process for cross-border capacity? If so, what are your views on the process?*

As a trade association EURELECTRIC does not participate in Open Seasons and members will provide their own views on such processes. However, a number of our members have previously expressed concern about the transparency, cost reflectivity and uncertainty associated with Open Seasons they have been involved in, as further referred to in question 3.

- 2. In light of your experience, do you consider that current methodologies (for example, Open Seasons) to decide on investments are an appropriate way to identify and integrate new cross-border capacity, or is there a need to move away from them? If so, what would be your preferred alternative and why?*

Open Seasons have been used extensively across Europe to market test investment in incremental capacity, with varying degrees of success. Where TSOs and NRAs either side of an interconnection point cooperate effectively and coordinate their approach to assessing efficient investment costs, and cost recovery, in a transparent way, Open Seasons can prove to be effective tools for market testing and allocating incremental capacity. However, where this is not the case, problems inevitably arise and investment in incremental capacity can be delayed, restricted or permanently stalled.

An alternative method of allocating incremental capacity through integrated entry capacity auctions has also been used in the GB gas market for over ten years and has successfully demonstrated its ability to deliver incremental capacity at new and existing entry points.

At this stage, we think there is merit in retaining Open Seasons for market testing incremental investment at new cross border interconnection points<sup>1</sup>, or complex

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<sup>1</sup> Including interconnection between different market areas within the same Member State.

interconnection capacity spanning more than just one cross border point<sup>2</sup>. This would allow greater time and flexibility for different route options, pipe sizes and lead times to be properly considered and for the multiple NRAs involved to coordinate their approach to tariff setting, assessing investment cost efficiency and the economic test. It is also worth noting that this type of investment is more likely to apply for an exemption from regulated third party access requirements.

However, at existing cross border interconnection points, we think that market testing for incremental investment could be achieved through the long term capacity auction mechanisms specified in the CAM NC. Incremental investment at existing interconnection points is more likely to take the form of increased compression, or downstream reinforcement, than new pipelines, and so should have more predictable investment lead times and be less burdensome as regards consenting. TSOs should also be able to regularly evaluate the efficient cost of such investment relatively easily, and convert this into a series of incremental price steps that network users can bid against in the annual capacity auctions.

To the extent that these auctions do reveal a demand for incremental investment greater than that which the TSOs have provided for in the incremental price bid steps, the binding bids from these auctions could be carried forward into a standalone Open Season held, say, within three months of the auction closing. This would allow the TSOs time ex-post to investigate more complex investment options and to properly assess the enhanced lead time, and consenting burden, that are likely to result, rather than having to anticipate these ex-ante.

To conclude, we believe that both Open Seasons and long term capacity auctions have merit if designed well. We see no good reason why one method should be used exclusively across Europe. It is essential to recognise that both approaches address the same issues but in different ways, and therefore should not be seen as incompatible. Hence EURELECTRIC is not in favour of adopting new EU legislation which makes one option mandatory in all EU member states.

However, this does not mean that the existing options cannot be improved. Effective cooperation between TSOs and NRAs either side of an interconnection points is probably one of the most significant elements which will contribute to enhancing the European wholesale market.

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<sup>2</sup> An example of such complex capacity could be capacity connecting Spain to Northern France.

3. *Do you think the paper addresses the right questions? What (if any) are the additional questions that should be addressed? What in your view are the main problems that need to be resolved?*

We think the paper does a good job in addressing the key issues and asking the relevant questions.

One issue which ACER may wish to give further consideration to is the extent to which consenting regimes in different Member States may hamper the ability of TSOs to offer bundled capacity in a consistent and timely manner, and the impact any consenting delays will have on the contractual rights of network users who have been allocated incremental capacity in an auction, or Open Season.

One additional question which the paper might have asked directly is how parties view the inter relationship between the allocation of incremental investment through an Open Season, or auction, and the TSO's Ten Year Network Development Plan. In our opinion, TSOs should only be able to invest in incremental capacity that has been allocated through an Open Season, or auction<sup>3</sup>, except where it is obligated under other regulations such as Regulation 994/2010<sup>4</sup>. The Ten Year Network Development Plan could be used simply to reflect the investment resulting from the Open Season, or auction, but must not become a vehicle for centrally planned investment sanctioned by NRAs or governments.

In our opinion, the main problems that need to be resolved relate to the lack of transparency and cost reflectiveness of TSOs' investment costs, the visibility of regulated tariffs for Open Seasons and the uncertainty and inconsistency of the economic test.

- Lack of transparency and cost reflectiveness of TSO investment costs

TSOs should be required to publish their investment costs and the assumptions on which these are based prior to an Open Season, or auction, along with the methodology for determining any resulting tariffs, reserve prices or incremental bid prices. This will enable NRAs and network users to compare the efficiency of TSOs' unit investment costs either side of the border and challenge any significant differential, which may indicate undue discrimination. Also, in this respect, ACER may have a role to play in benchmarking TSOs' unit investment costs as part of its role in facilitating a single European gas market.

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<sup>3</sup> Incremental Capacity which is exempt from regulated third party access requirements is likely to have to demonstrate it has undergone some form of market test before it can gain an exemption.

<sup>4</sup> Even here, fulfilment of the Infrastructure Standard is not necessary if it can be demonstrated that the investment is not required by the market.

- Visibility of tariffs

NRAs either side of the border should also give more defined guidance about the level of the regulated tariffs that will apply for Open Seasons. A significant disadvantage of an Open Season is that shippers must commit to finance incremental capacity without knowing the cost for it. Indeed, contrary to the UK long term auction mechanism whereby shippers make commitments on the basis of predefined price steps, shippers under OS mechanisms do not know the tariffs that will apply in the future. As a minimum requirement therefore, network users should have full visibility of the methodology for setting regulated tariffs. If these cannot be determined prior to the investment being made, network users should then at least have reasonable predictability about what they are likely to be.

- Uncertainty and inconsistency of economic test

NRAs either side of the border should also be required to clarify in advance of the Open Season, or auction, the basis on which incremental capacity will be allocated and any resulting investment will be triggered. The level of commitment required from network users to trigger incremental investment shall reflect any positive externalities, social funding or congestion rent previously agreed to be carried forward from previous auctions.

4. *What should be the scope of this paper? Should our proposals apply to cross-border points only, or should they also apply to entry points to LNG terminals and entry/exit points to and from storage? Why or why not?*

We believe the proposals should, and can, only apply to cross border points.<sup>5</sup> This is consistent with the CAM Network Code, which may form the part of the mechanism for allocating incremental capacity.

Nevertheless, TSOs should use their reasonable endeavours to ensure that the method for releasing incremental capacity at other entry points (e.g. storage, LNG, indigenous production) are consistent with the principles applying at cross border points, or, at least, are not unduly favourable, or detrimental, by comparison.

5. *What in your view needs to be harmonised on a European level, what can be done at other levels?*

In our view the process for allocating incremental capacity cross border and the structure of the economic test that triggers allocation and investment need to be harmonised.

Harmonisation is also needed as regards the transparency TSOs are required to provide over their investment costs and the assumptions on which these are based, along with the methodology for determining any resulting tariffs, reserve prices or incremental bid prices.

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<sup>5</sup> Article 8.7 of Gas Regulation 715/2009 makes it clear that network codes and guidelines, including those relating to capacity allocation shall relate to cross-border network issues and market integration issues.

6. *Do you agree with the proposals to allocate incremental cross-border capacity via an auction? Why or why not? What are the advantages/disadvantages of using auctions vs. Open Seasons (in cases where Open Seasons do not include an auction in the allocation phase)?*

We believe that the long term capacity auctions should form the basis for allocating and triggering investment in incremental capacity at existing cross border interconnection points. This will ensure network users are able to routinely assess their requirements for capacity at existing points and collectively signal any requirement for incremental capacity within an established non discriminatory allocation mechanism.

The principles of well designed Open Seasons and auctions for incremental capacity should not be significantly different in principle. Open Seasons may have the advantage of providing greater flexibility to accommodate different combinations of lead time, technical design or pipe routes than can be achieved through the CAM auction process. As such they are likely to be more time consuming and possibly less transparent than an auction. TSOs may adopt tailor made procedures for Open Seasons making them less harmonised than an auction and network users will be heavily dependent on the timing of a TSO's decision to hold an Open Season in order to signal their requirements for incremental capacity.

Auctions may have the advantage of providing network users with greater transparency over the process and certainty that their requirements for incremental capacity will be met, via an established non discriminatory mechanism applicable on a harmonised basis throughout the EU. However, auctions have the potential disadvantage of requiring TSOs to routinely assess the costs of investing in incremental capacity, regardless of whether network users require this or not. Because of their harmonised nature they are also less able to address some of the complicated issues surrounding investment lead times and consenting regime applicable to new infrastructure investment, or to allow efficient coordination of investment with other TSOs and infrastructure providers.

7. *What in your view should be the key considerations for the economic test? How could it be designed? How should risks/costs be allocated?*

Transparency and cost reflectivity of TSOs investment costs aside, the key considerations for an economic test should be:

- the extent to which network users are required to underpin TSOs incremental investment costs in order to trigger investment, through their binding bids in an Open Season or auction;
- the method for determining an appropriate level of commitment from network users that triggers investment;
- how positive externalities and/or past congestion rents can be properly reflected in the economic test;
- how the costs of any investment necessary in downstream capacity are allocated in relation to incremental cross border capacity; and
- how the prices network users pay for incremental capacity that are set via an Open Season, or auction, vary over time and the impact this may have on under, or over, recovery of TSOs committed investment costs.



At this stage we do not have a firm view about how exactly the economic test should be designed. This will somewhat depend on the policy options which are chosen in relation to the Framework Guideline and Network Code on tariff harmonisation. However, we see some merit in the approach used in GB entry capacity auctions, whereby binding bids are converted into a discounted revenue stream which is assessed against the discounted cost of the TSOs investment.

A harmonised investment trigger could then apply<sup>6</sup> across the EU, above which TSOs would be required to invest if the discounted revenue stream exceeded the discounted investment cost. However, NRAs either side of a border could agree to apply a lower investment trigger reflecting positive externalities and/or previous congestion rents<sup>7</sup> at specific interconnection points, and in specific Open Seasons, or auctions, following consultation with stakeholders and approval by ACER.

8. *Would a fully harmonised economic test across Europe be appropriate, or would it be sufficient to harmonise only the general principle to investments? Why or why not?*

We do not think a fully harmonised economic test that applies across all of Europe is necessary, or achievable. This is because it is inherently related to the wider regulatory framework agreed between the relevant TSO and NRA. Indeed, the economic test should be consistent with the level of risk that TSOs face and the associated rate of return they are allowed to earn in their Member State. Where capacity is being made available at a cross border point (i.e. involving two different regulators) NRAs and TSOs should agree a common approach to the economic test to ensure a successful outcome for the Open Season or long term capacity auction.

However, the principle of how the test is applied and a common maximum threshold of user commitment necessary for triggering investment would be beneficial and is, we believe, realistically achievable.

Such levels of harmonisation ex-ante will provide network users with reassurance that their bids for incremental capacity will be interpreted consistently by TSOs and NRAs across Europe, thereby helping to facilitate the single European gas market. Network users will have certainty that provided they meet the pre-determined threshold of user commitment at an interconnection point, TSOs will make the necessary investments to allocate them the incremental capacity they have made binding commitments for. This avoids any TSO/NRA uncertainty or procrastination and forces NRAs and TSOs to cooperate and agree conditions for investment in advance. It also removes incentives on network users with existing capacity from trying to hoard it, as other network users will know that providing their bids are sufficient to achieve the necessary level of user commitment incremental capacity will be built and allocated to them.

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<sup>6</sup> For example, [85%]

<sup>7</sup> And any other relevant factor, for example the extent of the risk to which TSOs are exposed under their price control or tariff regime

9. *How often should market testing be conducted?*

- a) *when potential demand is identified in the annual TYNPD process;*
- b) *annually; or*
- c) *every two years (when potential demand is identified in the community-wide TYNDP)?*

Market testing at existing interconnection points should be conducted annually through the long term CAM auctions. We concur with ENTSOG's view that the multi-round ascending clock algorithm applicable in such auctions is consistent with market testing at existing interconnection points.

Any more substantial or complex investment which is beyond the scope of that provided for in the CAM auctions should be subject to a separate Open Season. The timing and frequency of when TSOs hold Open Seasons should be driven by the results of the long term auctions,<sup>8</sup> or through a TSO's engagement in regular dialogue with its network users and interconnected peers. Such dialogue and any supply, demand and investment projections resulting from it may feature in the TSO's Ten Year Network Development Plan. However, we think the Ten Year Network Development Plan itself should principally reflect only investments which the TSO is committed to making following conclusion of the CAM auctions or Open Seasons.

10. *If auctions used to allocate existing capacity result in a congestion premium over the reserve price, at what instance (if at all) should TSOs consider a future enhancement? Please refer to the frequency of occurrence of a premium as well as the size of the premium.*

If the allocation of incremental capacity at existing interconnection points is integrated into the long term CAM auctions, as we propose, any congestion premium over the reserve price will occur as a consequence of incremental investment having been triggered, subject to the economic test being met. If investment is not triggered, because the congestion premium reflects a demand for capacity higher than that being made available by the TSO, this could prompt the TSO to hold an Open Season a few months later. Unfulfilled bids from the auction could then be carried forward as binding bids in the Open Season.

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<sup>8</sup> Where the auction indicates a demand for incremental capacity at an existing interconnection point in excess of that provided for in the TSO's incremental price steps. Such circumstances are expected to occur where incremental capacity cannot be met by a TSO increasing compression or reinforcing its downstream network.

*11. What other criteria could be used to identify a need for investment (e.g. frequency of interruptions of interruptible capacity)?*

We do not think it necessary to define specific criteria by which TSOs identify a need for investment. Integrating incremental capacity allocation within the long term CAM auctions will ensure TSOs test the market's requirement for new investment at exiting interconnection points at least annually. Frequency of interruption may be a possible indicator of the need for investment, but it will not always be a reliable indicator because of its inter relationship with weather and congestion management measures, such as over selling and buy-back.

*12. How could the allocation process be organised? Should existing and incremental capacity be allocated jointly (integrated auction) or as part of a separate process? How could an integrated auction work? (Please take into account different tariff regimes, i.e. fixed and floating when answering.)*

See our response to the questions above.

The extent to which an Open Season's, or auction's, clearing prices remain fixed, or are allowed to float, throughout the duration of the capacity will be relevant to the design of, and level of user commitment under, the economic test.

Fixed clearing prices may favour designing the economic test based on a comparison of the discounted revenue stream arising from shipper's bids with the discounted costs of TSOs investment. Any discounted revenue stream will always equate to a known sum of money and so provides an element certainty to the revenue that will be recovered to fund the incremental investment.

In contrast, when clearing prices are allowed to float the discounted revenue stream arising from shippers bids is not known at the outset. This may favour an approach whereby the economic test is based on a threshold of user commitment equivalent a percentage level of capacity booking.

Also, the certainty resulting from fixed clearing prices may in turn justify adopting a lower threshold of user commitment than might apply based on an economic test where clearing prices are allowed to float. Under a floating price scenario, whilst NRAs might be expected to address any under recovery in the TSO's incremental investment costs through subsequent increases in the floating price, this could be a rather imprecise process, as it may not be disaggregated on an investment by investment basis.

*13. Should shippers' bids into the market test for incremental capacity be binding? If so, how should this best be achieved?*

Ideally yes.

In the long term CAM auctions, shippers' bids become binding on conclusion of each round of the ascending clock auction algorithm.<sup>9</sup>

In an Open Season, TSO's may be able to avoid the initial step of formally seeking indicative bids from shippers, which experience suggests are likely to be overly optimistic and time consuming. This could be done by engaging in regular and detailed dialogue with stakeholders who specifically express an interest in using incremental capacity, or developing infrastructure projects which rely on this being available.

As mentioned above, we also envisage a situation where Open Seasons for incremental capacity at existing interconnection points could be prompted by a level of demand in excess of that made available by TSOs in the long term CAM auctions. In such circumstances, unfulfilled bids from the auction could then be carried forward as binding bids in the subsequent Open Season

*14. What in your view should be the approach to regulatory approval?*

- a) automatic if the economic test has been met and bidding process run correctly;*
- b) subject to separate regulatory approval processes?*

We believe regulatory approval should be automatic if the economic test has been met and the bidding process has been run correctly. This will force the relevant TSOs and NRAs to adopt the discipline of cooperating and coordinating their activities in a timely manner ex-ante. It will also provide network users with confidence that by making the necessary level of commitment in the bidding process incremental capacity will actually be allocated to them within a defined lead time.

This is not to say that NRAs should automatically allow the actual costs TSOs incur providing incremental capacity to be fully recovered, or added to the regulatory asset base. NRAs should continue to ensure that these costs have been efficiently incurred<sup>10</sup> and make any necessary adjustments to reflect out-performance or inefficiency within the confines of the TSO's price control regime.

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<sup>9</sup> With the exception of where small price steps are applied to minimise unallocated capacity.

<sup>10</sup> The costs on which the regulated, reserve or incremental bid prices used in the auction, or Open Season, can only be based on a TSO's estimates or pre-defined cost factors.



Union of the Electricity Industry - EURELECTRIC aisbl  
Boulevard de l'Impératrice, 66 - bte 2  
B - 1000 Brussels • Belgium  
Tel: + 32 2 515 10 00 • Fax: + 32 2 515 10 10  
VAT: BE 0462 679 112 • [www.eurelectric.org](http://www.eurelectric.org)