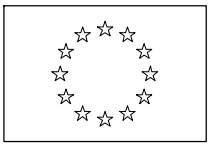

EUROPEAN COMMISSION

Brussels, XXX
[…](2012) XXX draft

COMMISSION STAFF WORKING DOCUMENT

EXECUTIVE SUMMARY OF THE IMPACT ASSESSMENT

Accompanying the document

Commission decision

amending Annex I to Regulation (EC) No 715/2009 of the European Parliament and of the Council on conditions for access to the natural gas transmission networks

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1. INTRODUCTION

Achieving a fully functioning and competitive European electricity and gas market can add an extra 0.6-0.8% to EU GDP by 2020, create employment and curtail inflation. The internal market for energy will ensure that energy is generated, transported and consumed as efficiently as possible, avoiding losses along the value chain.

The European Council Conclusions of 4 February 2011 call for the completion of the EU internal energy market by 2014. Improving competition in natural gas markets is based on opening infrastructure to all suppliers in a transparent and non-discriminatory way. Since gas transport infrastructure cannot usually be duplicated, rules for third-party access are a key factor for market functioning, in particular as far as transmission is concerned. Transmission capacity is a scarce resource which must be shared among market participants in a way that promotes competition and security of supply.

The existence of contractual congestion, due largely to long-term capacity reservations at Interconnection Points (IPs) between transmission networks, is inhibiting efficient capacity usage in the European gas network and consequently creating a barrier to gas shippers transporting gas from one Member State to another. This is a significant obstacle to cross-border trade within the EU and hinders the full development of the internal energy market that EU consumers should benefit from.

The capacity of EU gas networks therefore needs to be managed more effectively and efficiently and, as a part of that, congestion-management procedures (CMPs) need to be further improved.

2. BACKGROUND

This Impact Assessment has been prepared in the context of proposed amendments — via guidelines pursuant to Article 23 of Regulation 715/2009 ('the Gas Regulation') — to Chapters 2 and 3 of Annex I to the Gas Regulation. In order to find the most appropriate way to reduce contractual congestion at IPs, the Commission has engaged in a broad consultation.

The Third Energy Package calls for network codes and guidelines to eliminate the barriers to well-functioning markets. The network codes (NCs), to be developed by the Commission, ACER and ENTSOG, should lay the basis for harmonising the regulatory framework governing transmission networks. In addition, the Commission has the power to develop and propose guidelines on the same issues without formally involving ACER or ENTSOG. This may be called for when the full process of developing NCs is likely to take longer or where ENTSOG might be ill-suited to be entrusted with drafting, for example because of potential conflicts of interest. The CMP proposal falls into this category.

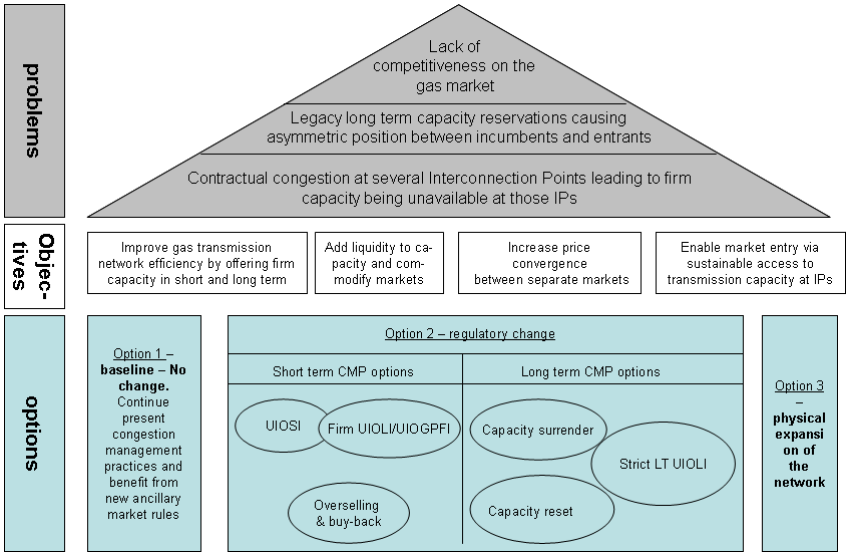
In order to be able to transport gas through the system to the consumers, shippers have to reserve capacity in the system and on the IPs. The capacity utilisation process is governed by a system of reservations (contracting of capacity in advance) and nominations/renominations (day-ahead and within-day reporting by the network user to the TSO of the planned capacity usage). Network users contract either *firm or interruptible* capacity. Firm capacity stands for the definite obligation of the TSO to ensure that the shipper's contract will not be interrupted in the event of physical congestion on the pipeline. Interruptible capacity, sold essentially when firm capacity bookings have reached the technical capacity, allows for the shipper's gas delivery to be interrupted when physical congestion occurs.

The current rules on gas congestion management are enshrined in Article 16(3)(a)-(b), Article 22 and Annex I, Chapter 2.2 of the Gas Regulation. They have remained unchanged since they were first introduced in Regulation (EC) No 1775/2005 and provide that in the event of contractual congestion: (i) the TSOs need to *market at least interruptible capacities*; and (ii) network users are entitled to re-sell or sublet their unused, contracted capacities. This rule essentially calls for a *secondary market* for capacities as the foremost congestion-management tool.

3. PROBLEM AND OBJECTIVE

The figure below illustrates the relationship between the problem, objectives and policy options in the context of contractual congestion.

Figure 1: Schematic representation of problems, objectives and policy options



Contractual congestion hinders the development of competition on the gas market by precluding new market players from accessing capacity and consequently entering the market. Contractual congestion may also send a signal that there is a need to invest in capacity expansion, which could be unnecessary if congestion was properly managed. As mentioned, contractual congestion occurs if the full transmission capacity is booked in advance. However, usually only part of the capacity is actually used for physical gas transportation. This is partly due to the willingness of shippers to hold excess capacities to ensure flexibility

since holding extra capacity is relatively inexpensive.[1] An additional possible reason may be that the incumbents book (and then hoard) more capacity than needed to foreclose competitors.

The Energy Sector Inquiry concluded in 2007 that European IPs suffer extensively from contractual congestion. This is also reiterated in the Gas Regulation. Both the ERGEG Monitoring report for 2010 and the data on long-term capacity reservations, provided by TSOs to the Commission under transparency rules in the context of the CMP public consultation (PC), confirmed that contractual congestion still poses a problem at several interconnection points. In other words, long-term capacity bookings fill up IPs, leaving market players that do not have such legacy contracts without access to firm capacity at those points.

4. POLICY OPTIONS

When considering the general policy options to tackle the problem of contractual congestion at IPs there are essentially three main choices: **Option 1**: *no further EU action*; **Option 2**: *implement new/amended EU rules on congestion management*; and **Option 3**: *implement capacity expansion at congested IPs.*

5. OPTION 1: NO FURTHER EU ACTION — DESCRIPTION AND IMPACTS

This policy option does not envisage any further rules on congestion management beyond what has already been enshrined in the Gas Regulation. Interruptible capacities are offered at IPs to a large extent when there is congestion. At the same time, the provision of firm capacity in the event of contractual congestion is marginal.

While interruptible capacity undoubtedly has a role for market players, in particular depending on their ability to cover the risk of interruption, the PC has highlighted stakeholders' preference for firm capacity. Therefore, continuing with interruptible capacity-based congestion management and calling for more and more effective secondary market trading will not solve the serious contractual congestion that certain IPs experience.

Furthermore, with the EU's dependence on imports of natural gas increasing and with cross-border trade being facilitated through different instruments, it is not inconceivable that trade at individual borders may increase substantially, depending on the price difference on both sides of the border. This may cause contractual congestion in pipelines that are currently not yet congested. Therefore other, more effective approaches are necessary to improve market functioning and stimulate competition.

The implementation of the Third Package will, in itself, not solve the problem of contractual congestion. The Third Package measures comprise a broad array of new rules for the gas sector, including on unbundling, regulatory oversight or downstream markets. However, they leave several other areas (such as congestion management in the event of contractual congestion) to be tackled by further subsidiary legislation such as network codes or guidelines. The legislator explicitly stipulated in the Third Package that the rules had to be fleshed out by more technical market design and network operation rules to be developed under the comitology procedure. The proposed measure sets out such rules.

[1] The capacity price amounts to 5-10 % of the commodity price.

6. OPTION 2: IMPLEMENT NEW/AMENDED RULES ON CONGESTION MANAGEMENT — DESCRIPTION AND IMPACTS

The second option is to implement new/amended EU rules on congestion management. The possible short-term measures include (i) use-it-or-sell-it (UIOSI), (ii) firm day-ahead use-it-or-lose-it (UIOLI)/use-it-or-get-paid-for-it (UIOGPFI) and (iii) oversubscription and buy-back. The list of possible long-term capacity releasing measures includes (i) capacity surrender, (ii) strict long-term UIOLI and (iii) capacity release/reset.

6.1 SHORT-TERM CMPS

Capacity oversubscription mechanisms have worked well in the Member States where they have been applied. Depending on the network topology and the level of capacity reservations, the system can be relatively sophisticated. It gives TSOs an incentive to provide capacity beyond their technical capacity, on the basis of capacity usage assessments. The TSOs need to take a controlled risk in this scheme, by oversubscribing just the right amount of capacity to still avoid physical congestion, which would make them have to buy back some capacity. Similarly, NRAs also need to closely monitor both the calculation of the baseline capacity and the calibration of the incentive system to ensure that maximum capacity is given to the market.

The system is thus effective both in freeing up firm capacity to market players and in providing a mechanism to solve contractual congestion that does not constrain the rights of shippers, although it does require strong coordination between TSOs and NRAs. This coordination is, nevertheless, in the spirit of the Third Energy Package and the completion of the internal market and thus a necessary step forward.

The real costs of the system include the risk premium/incentive payment to the TSO, which again can be said to be fairly insignificant in the light of the possible benefits from more competitive commodity offers. Finally, and importantly, this is the only mechanism that provides a direct link between short- and long-term CMP as it can be effective for both.

Firm day-ahead UIOLI, essentially a restriction (to any given degree) of the renomination rights of capacity holders, is a very effective short-term CMP instrument as it immediately frees up capacity on the day ahead by restricting renominations. However, its drawback is that it reduces the flexibility of shippers.

That said, the Commission departments take the view that market players are able very accurately to predict their gas demand for the day ahead. Nevertheless, market players pointed in the course of the PC to several issues that may lead to precise predictions on the day ahead being overridden by unforeseen events. The PC has shown that one of the largest handicaps of such a system would be the as yet undeveloped and illiquid nature of within-day markets and platforms (both for commodity and in particular for capacity) that would be supposed to provide flexibility for market players. At the same time it seems evident that the development of those markets would also benefit from the significant 'jump-start' which could indeed come from introducing such a system.

As regards the most appropriate band for allowed renominations, care needs to be given also to not penalising new entrants, who may have a much smaller flexibility portfolio than established players.

UIOSI is a congestion management mechanism that requires primary capacity holders to offer all unused capacity to the market, but it depends on possible ex-post intervention by the national regulatory authorities (NRAs) to assess whether capacity holders have indeed done

so. In the light of the very severe contractual congestion at certain IPs, UIOSI is too indirect a mechanism, albeit with the threat of fines, to significantly improve the availability of firm capacity.

6.2 LONG-TERM CMPS

According to the responses to the PC, a system of *capacity surrender* could provide benefits, in particular as long as capacity markets are not yet liquid or platforms are not established. In any event, the concept of capacity surrender is based on free choice, so it is a mechanism that can potentially bring benefits at a low implementation cost and without capacity holders being forced to give up rights. It is considered that the mandatory application of a system of capacity surrender would make a major contribution to reducing long-term contractual congestion by enabling primary capacity holders to market their available capacity via the TSO. This would allow new entrants to obtain longer-term capacity.

Strict *long-term UIOLI* is essentially a 'back-stop' mechanism to be activated in clear cases of capacity hoarding. It is not easy to apply in practice because of the criteria that need to be considered when assessing whether capacity has indeed been hoarded. However, capacity hoarding has very significant social costs in that it enables markets to be foreclosed, eliminating competition and, ultimately, increasing prices and thereby harming consumers. In such a context, the possible loss of rights of any individual capacity holder engaging in capacity hoarding can be contrasted with the overall benefit to the market and society in eliminating such behaviour. It is thus considered that the mandatory application of strict long-term UIOLI would be a key tool to convince capacity holders that capacity hoarding does not pay.

While the *release* of certain amounts of capacity held by primary users does not go so far as a full *capacity reset*, both solutions are quite far-reaching. Capacity release has been implemented in the context of remedies in competition cases and has been quite effective. While capacity reset may indeed be the most effective solution to the legacy-driven, asymmetric competitive situation on the EU gas market, it is also the most controversial one. As internal market legislation in the EU in the past 15 years has not involved any such steps, resistance to it from stakeholders would be high and legal challenges very likely. Therefore, it is considered that neither of the two variants of this option should be pursued.

7. OPTION 3: IMPLEMENT MANDATORY CAPACITY EXPANSION PROJECTS AT CONGESTED IPS — DESCRIPTION AND IMPACTS

The EU gas transmission infrastructure is to a large extent a regulated, natural monopoly. Investment in this system, as also mentioned in the Commission's proposal for a Regulation on guidelines for trans-European energy infrastructure, is necessary in areas where as yet no infrastructure exists, e.g. to connect isolated markets or where the existing system faces a physical bottleneck. The situation is different, however, if the existing infrastructure is ready to handle additional flows but such flows are inhibited by contractual congestion at a certain point. In that case capacity expansion is unlikely to be the most efficient solution.

This mechanism would essentially take levels of contractual congestion as a proxy and solve the problem via investment. The Commission departments take the view that as long as contractual congestion is not coupled with physical congestion, the building of new capacity (or the expansion of existing capacity) seems disproportionate in economic terms. It may, however, still be justified on other general interest considerations such as security of supply.

8. CONCLUSION

Contractual congestion and the lack of available firm transmission capacity at some IPs remains a problem that hinders the development of cross-border competition and with it market integration in the EU gas sector. Current CMPs have not been able to provide an effective solution. This in turn harms consumers by not facilitating efficient price discovery and may ultimately result in higher gas prices. Therefore, a better, yet proportionate solution to this problem needs to be found.

The Commission departments take the view that *Option 2, amended CMP rules*, should be pursued, together with the following sub-options, to solve the long-running problems of contractual congestion in the EU gas transmission network.

In the short term, the most effective solution would be to apply:

- a mandatory oversubscription and buy-back mechanism at all IPs; and
- a mandatory firm day-ahead UIOLI mechanism as a fallback to be applied if contractual congestion is still occurring after 2015, that is after some years of application of the oversubscription and buy-back mechanism; and
- an optional firm day-ahead UIOLI mechanism to be applied by NRAs.

The oversubscription and buy-back system would thus constitute a general rule for CMPs across the EU. Firm day-ahead UIOLI could in addition be applied — if deemed necessary — at the most congested IPs. Furthermore, firm day-ahead UIOLI would have to be applied after some years at all IPs where oversubscription and buy-back were unable to alleviate contractual congestion. Such a combination of tools would provide an effective CMP regime for both the short and the long term.

In addition, further specific measures to be applied in the long term should be:

- mandatory application of a capacity surrender mechanism; and
- mandatory strict long-term UIOLI.

Both measures can be considered as important ancillary measures that should ultimately lead to the crucially important long-term solution to contractual congestion.