



Remarks on ENTSOG Preliminary View on Incremental Proposal as of 14.01.2014 within the framework of Acer Guidance to ENTSOG as of 29.11.2013

**Andrey A.Konoplyanik – Alex Barnes,
WS2 GAC & Russia-EU Informal Consultations
on EU Regulatory Topics (3rd EU Energy Package)**

**19th round of Informal Russia-EU Consultations on EU Regulatory
Topics & 12th meeting of the EU-Russia Gas Advisory Council's Work
Stream on Internal Market Issues (WS2 GAC) *combined with* ENTSOG
Workshop on "Incremental Proposal" (CAM NC amendment),
Vienna, E-Control, 31 January 2014**



GAC 19.11.2013 agreed on further RF-EU joint actions on New Capacity / Incremental Proposal

- GAC (19.11.2013) agreed with WS2 Co-Chairs working proposal for further actions: to concentrate on Case Study/CAM NC amendment (COS/New Capacity still open issues) => Case Study Task Force to be continued:
 - Workshop on **financeability** (NPV-test, WTP vs RTP, F-factor, system-based vs project-based tariffs, non-discriminatory booking of existing vs new capacity, etc.)
 - Workshop on **TSO cross-border coordination** (ITSO, ring-fencing of cross-border ITSO, ITSO vs project promoters/shippers, prevention of 2 types contractual mismatches, etc.)
- WS2 & ENTSOG agreed to organise joint workshop(s) on above-mentioned open issues of NEW capacity to listen to voice of producers-suppliers to EU (incl. from non-EU) within each step of NCs drafting process



ENTSOE Incremental Proposal: RUS/GG level of participation

- Level of participation RUS/GG Consult./WS2 participants:
 - Alex Barnes: “Prime Mover” on Incremental Proposal as a whole (EFET)
 - Andrey Konoplyanik: “Prime Mover” (only regarding “New Capacity” section) and “Active SJWS Participant” for the rest of Incremental Proposal (RUS/GG part of WS2/Informal Consultations)
- Seems to be first time that non-EU representatives actively participate in consultation process on drafting internal EU rules 😊



Potential aims of 31.01.2014 meeting as follow-up of 14.01.2014 ENTSOG Kick-off meeting

- ENTSOG aim at SJWS 1 (10.02.2014):
 - Content of Incremental Proposal: Do we have the right topics covered? Is the schedule for covering the projects adequate given the strict timeline?
 - Initial discussion on structure of the Incremental Proposal
- Two important statements/comments at ENTSOG Kick-off meeting, 14.01.2014:
 - M.Wiekens (ENTSOG): “Revision not amendment of CAM NC. It’s not just an amendment – it’s quite a new topic which is quite big. CEC & ACER considered so as well”
 - K.Kovacs (CEC): “Additions to CAM NC might not always be fully in line with CAM NC provisions. Slight adjustments of CAM NC are possible if/when necessary, but not renegotiation/redrafting of CAM NC”.
- What value can we add today (31.01.2014) for SJWS 1 (10.02.2014)?
 - To justify new topics (re NEW capacity) and/or topics that were undervalued/missed by the drafters of CEER Blueprint/ACER Guidance
 - “Devil’s advocate” for ENTSOG Preliminary Views on Incremental Proposal



Scope of POW

- Next 3 slides present de facto our joint proposed/agreed POW (Programme of Work on New Capacity within RF-EU Consultations/WS2 together with ENTSOG on Incremental Proposal) => presented here just to refresh the memories/for convenience of the audience



Some key issues for New Capacity

(as identified by CSTF through June-Nov'2013)

- 1 CAM NC auction for incremental vs. open season for new capacity
- 2 Shipper's NPV and/or other criteria in economic test
- 3 Up/down-sizing of project design – producer limitations
- 4 Capacity mismatch of two types (at individual IPs & between IPs through the route) & TSO's cross-border coordination
- 5 F-factor (cost coverage, socialization of costs, who decide, financeability)
- 6 10% quota regarding new capacity for future short-term trade (acc. to CAM NC approach) & its influence of financeability
- 7 Project promoter participation in financing & project management support (implementation of ownership unbundling principle); possibility for newly established (incl. cross-border) ITSO & its relations with companies affiliated with shippers prior to start of operation of new built capacity
- 8 Cross-border issues (coordination between corresponding TSOs at IPs through the route from zone to zone)/Coordinated Open Seasons
- 9 Tariff issues for new capacity & financeability (floating tariffs vs their predictability, possibility for tariff ring-fencing through pay-back period)



ACER Guidance for ENTSOG: Key points raised by RF side which are not yet clarified (as presented at ENTSOG Kick-off meeting) (1)

- 1) Distinction: market test vs economic test (p.2) => **NOT YET**
- 2) “Predefined level of binding network user commitments necessary to justify investment from financial perspective” (p.2, also N6 below): who to decide on financeability: market players or regulators? => **NOT YET**
- 3) Economic viability vs efficiency of execution of investment within regulatory regime (p.2) => **NOT YET**
- 4) Identification by ENTSOG of “physical capacity gap in... a reasonable peak demand scenario” in TYNDP (p.3) => **NOT YET**
- 5) “A failure to test market demand for incremental or new *capacity* (BCM = volume) ...is deemed to be in breach of TSO’s obligation to assess market demand for *investment* (CAPEX = value)” (p.4) => **NOT YET**
- 6) Approval by the NRA - *before an offer of IC or NC for binding commitment* - of the level of network users commitment that should be necessary to enable investment from economic perspective (p.5) (*F-factor: decision by NRA or by market participants: TSOs, shippers & financiers?*) => **NOT YET**



ACER Guidance for ENTSOG: Key points raised by RF side which are not yet clarified (2)

7) Reference to applicable tariffs & methodology published by TSO (p.5,6) (*but financeability at risk if economic difference is not considered: system-based vs project-based tariffs, see above*) => **NOT YET**

8) “ENTSOG is requested to develop... amendment to CAM NC ...keeping the integrity of the ascending clock algorithm” both for incremental & new capacity (p.5) (*but: non-financeable for new capacity, contradicts to COS*) => **NOT YET**

9) Willingness-to-pay (p.5 + twice on p.6) (*vs readiness-to-pay: RTP = WTP X regulatory-created risk*) => **NOT YET**

10) Decision to use OS is subject to NRA approval (p.6 – twice: on criteria & on terms & design) (*means: market participants takes investment risk vs NRA takes decision?*) => **NOT YET**

11) “Capacity set aside for short term allocation” (p.7) (*short-term quota discriminates project promoters & destipulates financeability*) => **NOT YET**

12) (*To add section (g) on financeability requirements ?*) => **NOT YET**



1. CAM NC auction for incremental vs. open season for new capacity



Auction & Open Season are *two different* economic models, but...

Incremental vs New Capacity

Criteria: 1IP, size...

Incremental Capacity

Auction

Incremental Capacity offered by TSO to market participants (potential shippers) – top bottom approach

Criteria; 2IP+, size...

New Capacity

Coordinated Open Season (COS)

New Capacity requested by market participants (potential shippers) from TSO – bottom up approach

SHOULD BE A CHINESE WALL BETWEEN TWO PROCEDURES

At least until economic test on COS will give negative result (see next second slide)



**... but ACER de facto requested that
ENTSOG base COS on auction
mechanism (“auction-based COS ?)**

1. ACER Guidance to ENTSOG, 29.11.2013, p.5:

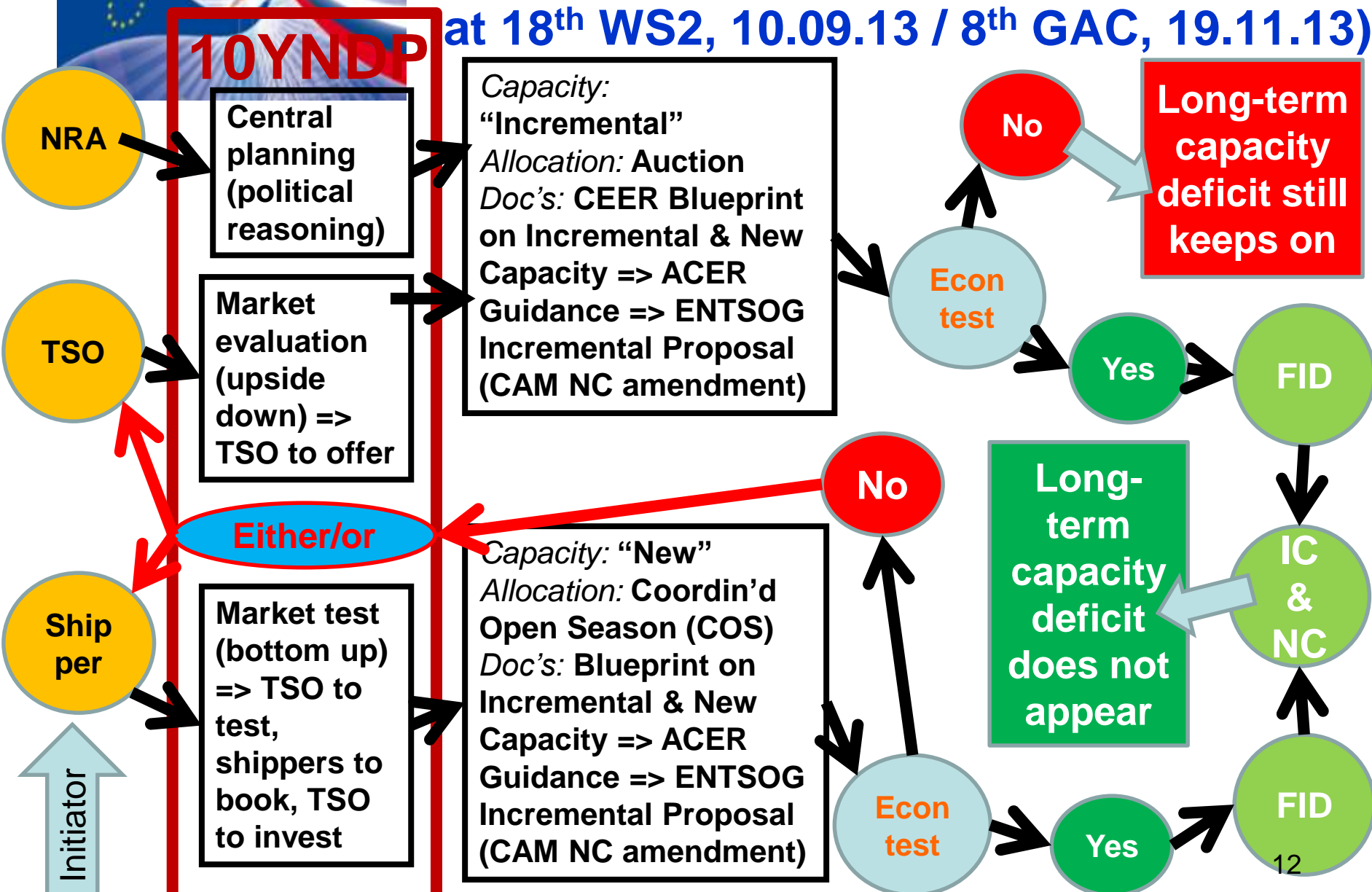
- **“ENTSOG is requested to develop... amendment to CAM NC ... keeping the integrity of the ascending clock algorithm” both for incremental & new capacity**

2. ACER on Incremental Capacity, 14.01.2013, ENTSOG Kick-off meeting, slide 31:

- **“Key content issues: Consistency with CAM: how to “make fit” the auction algorithm?”**

Q: Whether COS should be integrated into CAM NC Auction procedure (“auction-based COS” ?) or COS and Auction should be developed by their individual (economically motivated & best effective) rules? => see next slide

How CAM NC & COS procedure can finally come together (based on joint presentations at 18th WS2, 10.09.13 / 8th GAC, 19.11.13)





ACER Guidance wording reflect ‘mental models’ of drafters & intended procedures requested from ENTSOG

- (14.01.2014, slide 32): ACER Guidance, content, (b): “**When to offer incremental and new capacity**” => “to offer” capacity:
 - Potential risks of such approach have been indicated to EU colleagues since/related to TAG auction (Dec’2005),
 - This issue has been regularly raised during Case Study Task Force meetings & within debates on CEER Blueprint through 2013,
 - Standard terminology of J.Heidelberger (Co-chair, ACER WG on IC) et al, but terminology from auction-based procedure reflects corresponding way of thinking (each economic term has its specific economic substance/meaning),
 - Can be used for auction-based allocation of Incremental Capacity not for open season-based development of New Capacity
 - Under Open Season capacity is not “offered” (upside-down process) but accumulated by the regular “market test” (differs from “economic test”) in a “bottom-up” manner



Open Season: who decides, flexibility vs handy regulation ?

- 14.01.2014, ACER Guidance, content 3 (slide 34):
 - **“Open Season Procedures:** NC CAM long-term allocation procedures might not yield satisfactory result due to size and complexity of projects, therefore, **more flexible open seasons (? - AK) are admissible, with respect to process timeline, allocation procedure and duration”**
 - However, no deviation from principles: bundling, short term quota, market based, non-discriminatory, transparent” (see next slide) +
- J.Heidelberger (14.01.2014, while presenting ACER view):
 - “Do not expect from ENTSOG very detailed cook book – just to reconfirm general principles” (as mentioned above) +
- ACER Guidance to ENTSOG (29.11.2013):
 - Decision to use OS is subject to NRA approval (p.6 – stated twice: (i) on criteria & (ii) on terms & design)
- => Whether such model being developed intentionally: not to draft detailed OS procedure thus providing NRAs to decide on OS in a handy manner? Risk of lacking procedural clarity for shippers/TSOs



ACER Guidance, Content 3 (f): Open Season Procedures (cont'd from previous slide)

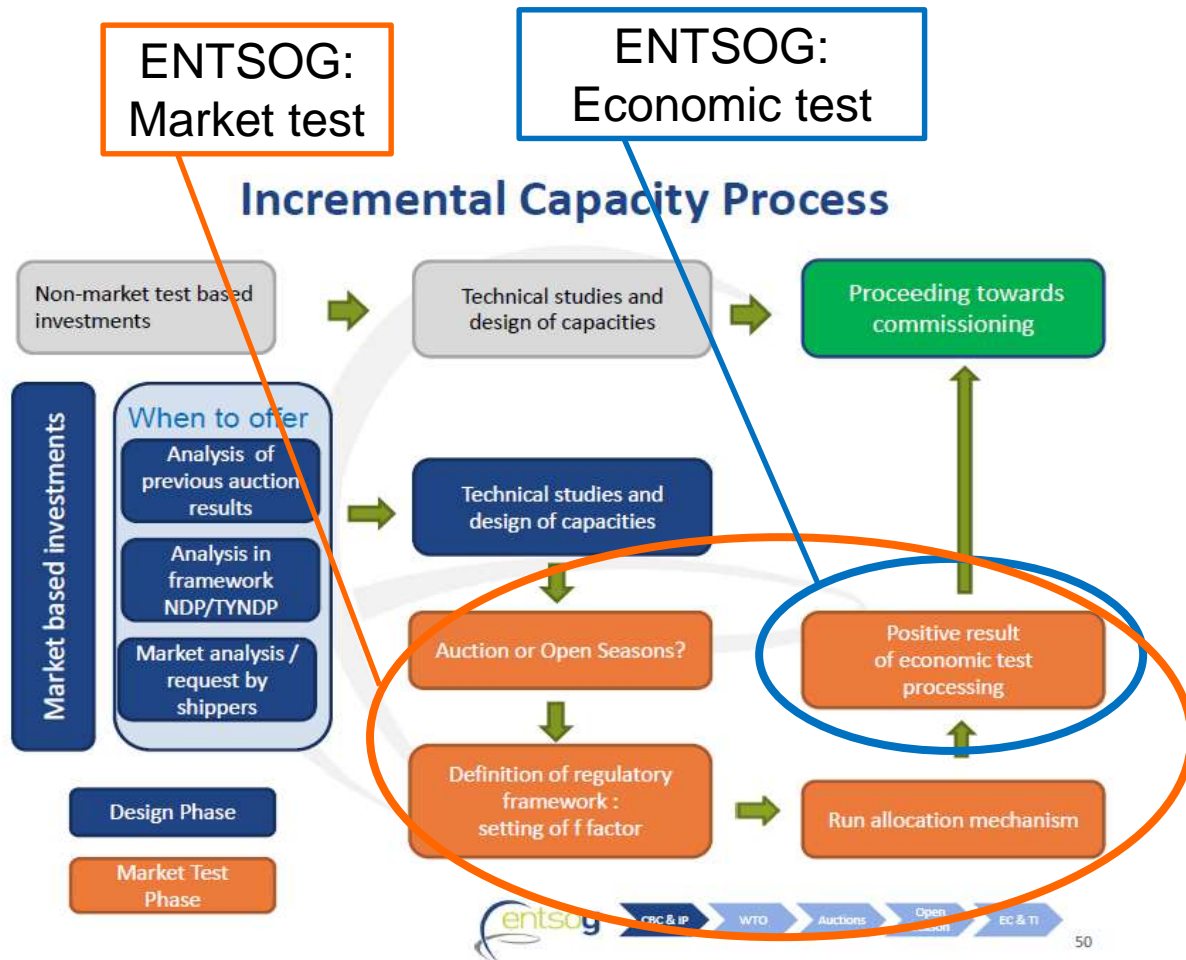
Principles	Solution under Open Season
Bundling	No problem at individual IP if coordinated with other IPs at the route. If so, will diminish risk of mismatches between IPs on the route. Delivery point at final destination is not at the border (either at VTP or at delivery point within final destination zone) – no deviation from “bundling” principle
Short term quota	Who will pay for this? If other shippers – this is discriminatory; the institutions who request such provision should pay for (guarantee) it to TSO and be paid back if this quota would be in demand
Market based	OS is based on regular “market test” (though diff. understanding of “market test” – see next slide)
Non-discriminatory	Under OS every market participant can book needed amounts of capacity if ready to pay for his booking
Transparent	This is why is “ <i>more flexible open seasons are admissible, with respect to process timeline, allocation procedure and duration</i> ”, it will diminish transparency due to special design of OS by ACER



'Market test' vs 'economic test' in ENTSOG proposal vs in 'COS-Strawman' paper

In the given ENTSOG proposal (14.01.2014), economic test is an integral part of market test. From our view, those are two separate stages of Open Season procedure. 'COS-Strawman' Paper (17.09.2013) describes five COS phases until final investment decision:

- Phase 1: identification of need for new capacity (**market test**);
- Phase 2: preliminary open season phase (**market test**)
- Phase 3: initial project scoping phase (**economic test**)
- Phase 4: final open season phase (**economic test**)
- Phase 5: final investment decision



Source: Topic Identification: ENTSOG's preliminary view on the Incremental Proposal, slide 50. – ENTSOG Kick-off meeting, 14.01.2014



ENTSOG triggers for OS: what else on top of this five options is practical?

When to choose OSP instead of auctions

ENTSOG should analyse and specify circumstances or situations where OSP are more suitable than auctions

Examples of situations where OSP could be more suitable than auctions:

- Setting up a gas route with many interconnections points (IP)
- Highly interconnected networks where the incremental projects involve more than one IP
- The range of potential projects is too wide to come to an efficient outcome in an auction
- When the horizon of user commitments that is necessary to pass the economic test is expected to be higher than the 15 years ahead provided in the auctions
- When the number of prospective customers is expected to be very low and non-standard flexibility is strongly improving the likelihood of securing requested level of commitment

Source: Topic Identification: ENTSOG's preliminary view on the Incremental Proposal, slide 57. – ENTSOG Kick-off meeting, 14.01.2014



6. When potential shipper (project initiator & promoter) provides such volumes of firm capacity bookings that they guarantee construction of new pipeline even without other shippers/additional capacity booking (minimum threshold is passed)
7. Why not to provide freedom to choose between OS & auction procedure to the shipper? In such case clear & transparent OS procedure (the same as CAM NC auction) should be available
8. ...



Qs on OSP terms & conditions

Terms and conditions for an OSP

- Decision to test via auction or Open season is subject to NRA approval and the terms of OSP should be approved by all the NRAs
- According to the Guidance, an OSP should comply with the following principles:
 - ➔ It should "offer non-discriminatory opportunities to make commitments for capacity products."
 - ➔ The capacity expansion should aim at "satisfying all commitments as far as this is overall efficient and economically feasible."
 - ➔ "Prorating should be the only other fall-back allocation rule that should be allowed to arrive at an efficient investment size that maximises the degree to which user requests are fulfilled"

Source: Topic Identification: ENTSOG's preliminary view on the Incremental Proposal, slide 58. – ENTSOG Kick-off meeting, 14.01.2014

1. What means "non-discriminatory"?
 - a. Equal treatment for different actors = discrimination,
 - b. Different treatment for equal actors = discrimination,
 - c. Equal treatment for equal actors = non-discrimination,
 - d. Different treatment for different actors = non-discrimination => Shippers booking long-term based on their upstream production profile (investment-related booking) and shippers booking short-term based on their trade portfolio (trade-related booking) are different => deserve different treatment

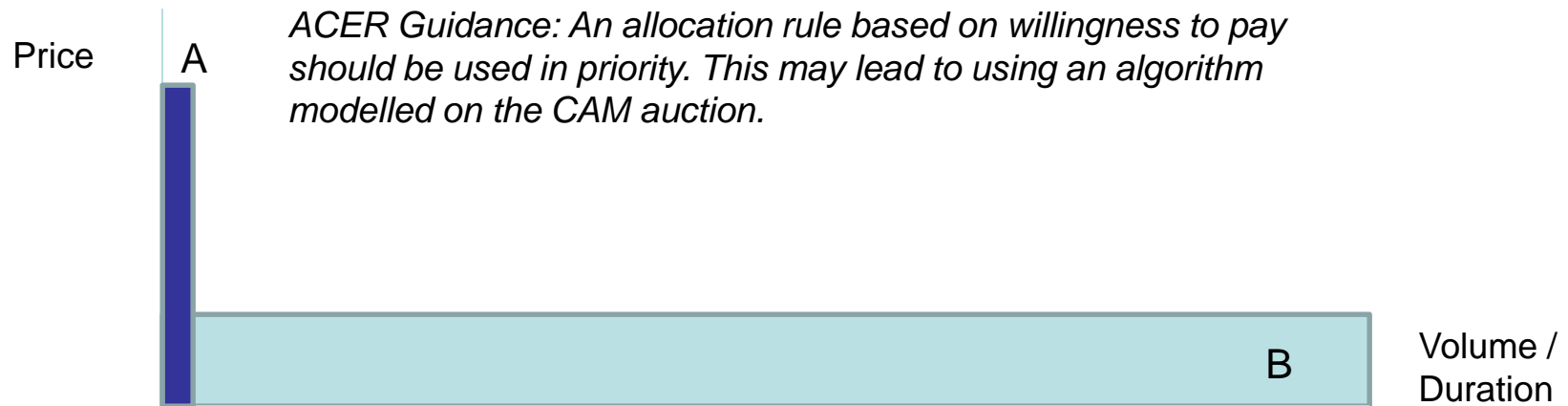
2. "satisfying all commitments": whether producers & traders are the same? Today in EU intention for "positive discrimination" of shippers with long-term commitments
3. Pro-rating: based on volume of booking or on NPV analysis? (see section 3 below)



2. Shipper's NPV and/or other criteria in economic test



Capacity Allocation / Willingness to Pay



Which shipper provides the greater financial commitment to underpin an investment in new capacity?

- CAM allocates to shipper who pays highest price for the period being sold e.g. one annual strip of capacity
- Each period is allocated separately i.e. it takes no account of total quantity of capacity booked and favours those who only book for limited periods
- NPV test would take account of overall commitment towards an investment
- If floating tariffs are used shippers who book for longer duration are providing an even greater commitment – reducing chance of under-recovery associated with new capacity and liable to reduce under-recovery from other points



“Willingness to Pay” (WTP) vs “Readiness to Pay” (RTP)

- WTP = “trade” world, RTP = “investment” world
- WTP – appropriate for auction & for short-term (competition of financial capacities / money bags), no major risk related to cost of capital within time frame
- $RTP = WTP \times [\text{non-commercial risk}]$, also considers risk of potential non-payment of long-term CAPEX due to regulatory & related uncertainties (f.i. OPAL case)
- Using WTP term regarding COS is misleading => clarification needed

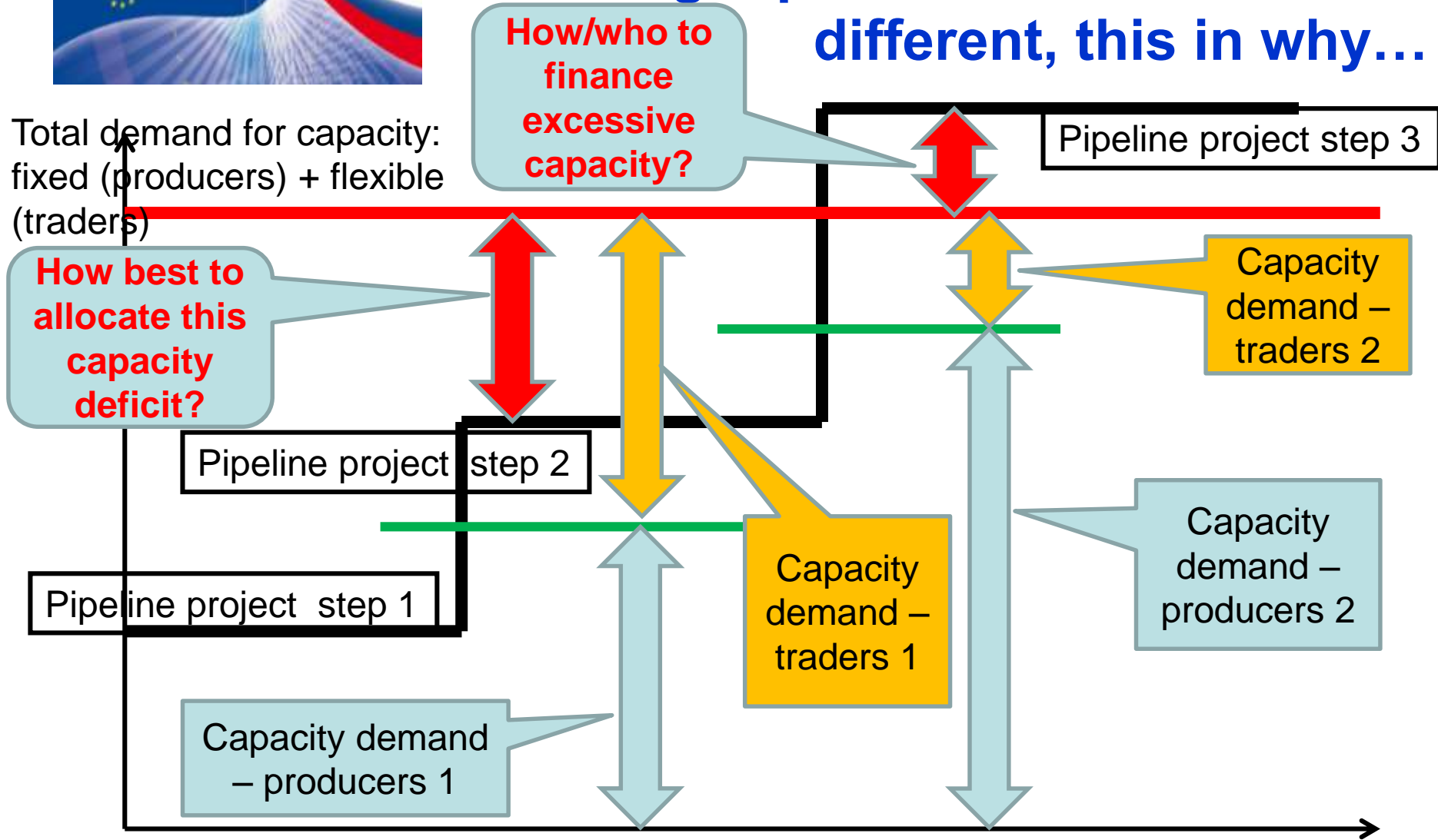


3. Up/down-sizing of project design – producer vs trader limitations



Upper-down sizing of project design: producers & traders are different, this in why...

Total demand for capacity:
fixed (producers) + flexible
(traders)





...pro-rating vs non-discrimination should be addressed

- This is why “pro-rating” (as presented in ACER Guidance as the only allowed fallback solution) will discriminate those shippers who take the most of financial burden of the project - if “pro-rating” is understood as proportional diminishment of booked capacity by short-term (traders) & long-term (producers) shippers



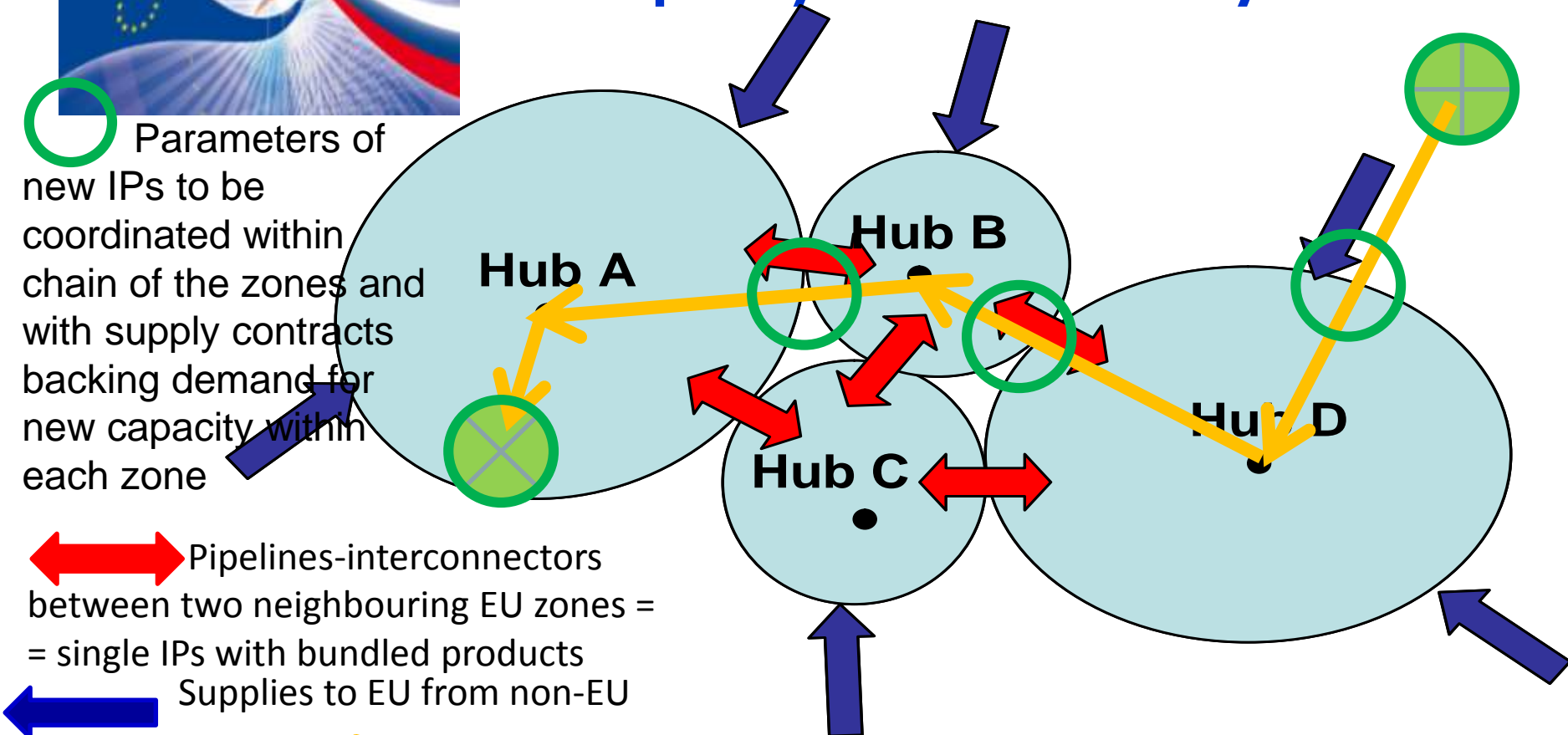
4. Capacity mismatch of two types (at individual IPs & between IPs through the route) & TSO's cross-border coordination

8. Cross-border issues (coordination between corresponding TSOs at IPs through the route from zone to zone)/Coordinated Open Seasons

Risk of Contractual Mismatches for New Capacity within EU Entry-Exit zones



Parameters of new IPs to be coordinated within chain of the zones and with supply contracts backing demand for new capacity within each zone



↔ Pipelines-interconnectors between two neighbouring EU zones = = single IPs with bundled products

← Supplies to EU from non-EU

⊕ Non-EU producer

⊗ Its EU customer

← **New Capacity** = multiple IPs with bundled products to be balanced, cross-border coordination of TSOs needed to avoid two types of contractual mismatches:

- (1) at each IP: between term supply & transportation contract, and
- (2) At all IPs on the route: between bundled products at each IP



TSO cross-border coordination: ITSO & project ring-fencing as draft solution

- “New Capacity” project could be ring-fenced since it has its physical enter point into EU & physical delivery point within EU (as finally agreed at GAC 19.11.2013 – issue “delivery points” closed)
- Ring-fenced project should have its individual operator => ITSO
- To move from few individual TSOs in MSs on the route of the project - to one ITSO uniting all parts of the ring-fenced cross-border project (since New Capacity = 2IPs+) => this settle the issue of cross-border coordination since it thus being converted into project coordination
- Ring-fencing will also settle the issue of tariffs (see corr.section of presentation below)
- Options for ITSO (to be further discussed):
 - ITSO among existing certified TSOs => selection procedure,
 - Newly established ITSO specifically for the project - to be certified:
 - by EU entities only,
 - by/with participation of non-EU entities, incl.existing non-EU TSOs (Art.11)



5. F-factor (cost coverage, socialization of costs, who decide, financeability)

6. 10% quota regarding new capacity for future short-term trade (acc. to CAM NC approach) & its influence of financeability



Market & non-market commitments leading to F-factor < 1

Market commitments leading to F-factor < 1 (collected by TSO => bottom-up)(+slide 33) **Non-market commitments leading to F-factor < 1 (ordered to TSO => top-bottom)(+slide 33)**

- Not enough bookings collected within OSP “open window” time frame? => but this can happen only due to a lot of short term bookings collected which can discriminate project promoter(s) (who book long term)
- 10% quota for short term bookings
- 15Y obligatory booking limitation (now rule more flexible)
- “Centrally planned” volumes (NRAs decision based on SOS considerations)

BUT: J.Heidelberger (14/01/2014): “no part of 1-F will stay uncovered” => this is positive statement, but next Q: who will/can cover 1-F (it size can be big – see Frontier Economics report) in its both parts ???



Two ways of understanding “10% quota”: in financeable & counter-financeable way

Financeable way (10% quota additive)

- 100% long-term booked capacity PLUS 10% quota for short-term potential bookings
- Non-discriminatory for shippers (they book 100%, pay for 100% & receive 100%) but question for TSO/NRA how to finance/guarantee financing of 10% quota as add.capacity not yet booked => options (see next slide)

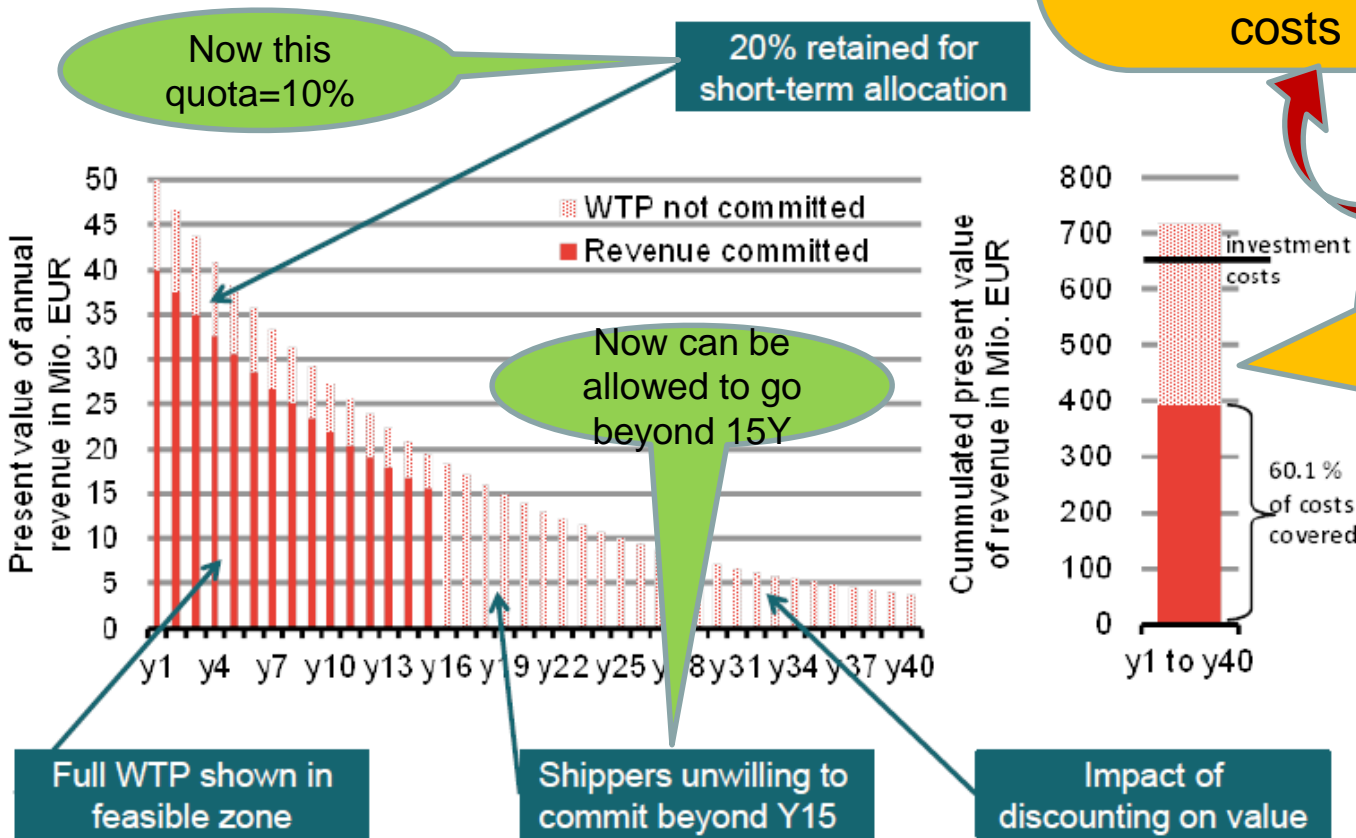
Counter-financeable way (10% quota inclusive)

- 100% long-term booked capacity MINUS 10% quota for short-term potential bookings
- Discriminatory for shippers (they book 100% capacity, pay for 100% but receive only 90%), but no need for NRA/TSO to finance 10% quota



Frontier Economics at CEER Workshop: CAM NC approach downgrades new project bankability

Stylised examples to show issues



But no bank will provide you debt financing when 1/3 project costs is uncovered

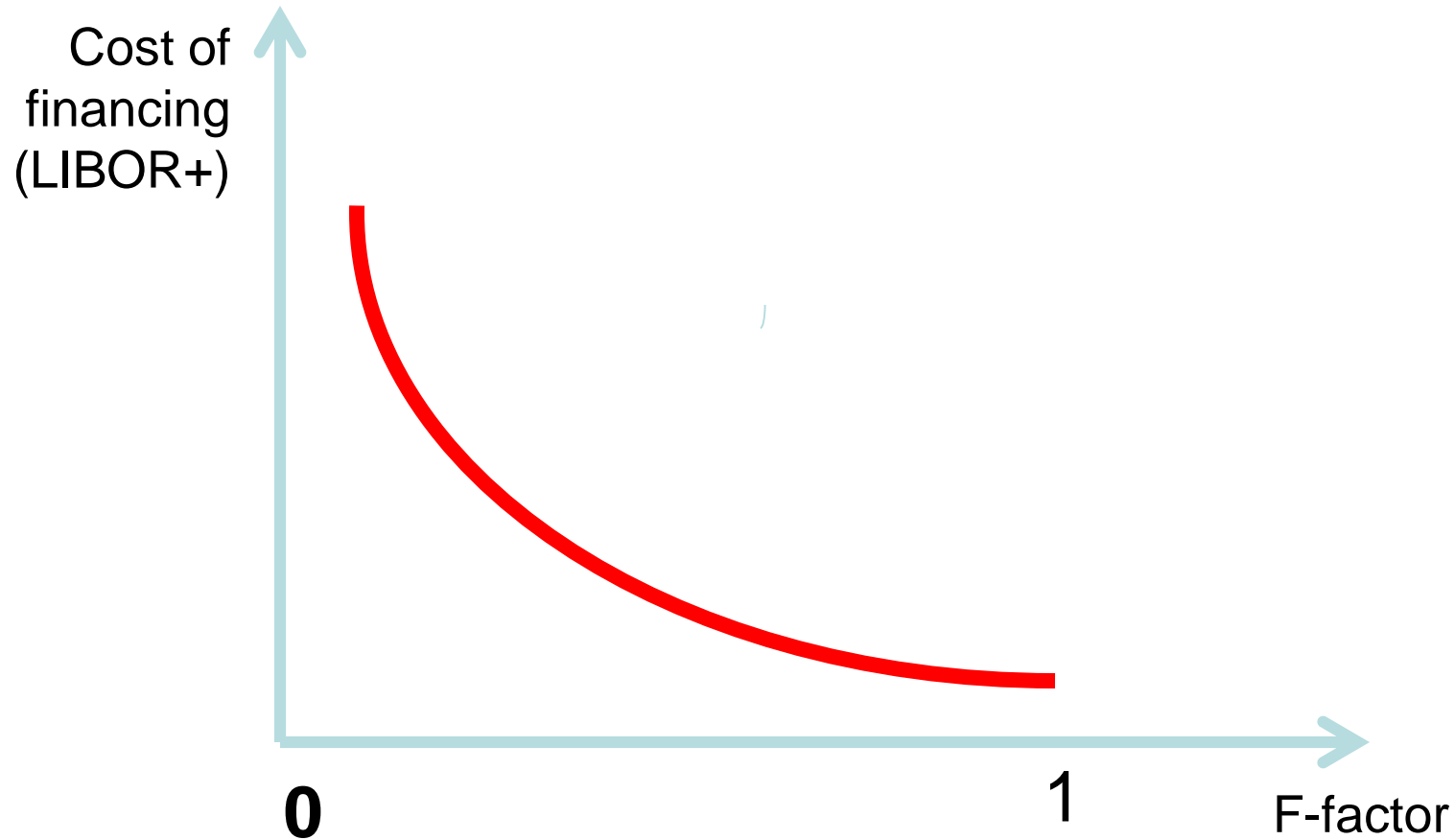
Now 1-F in this example should be less than 40%, but will still stay high, say 30%+

Cited from Frontier Economics presentation at CEER Workshop on Blueprint on Incremental Capacity, Brussels, 03.06.2013

Investment of €650m and annual revenues of €50m with a 6.5% real discount rate



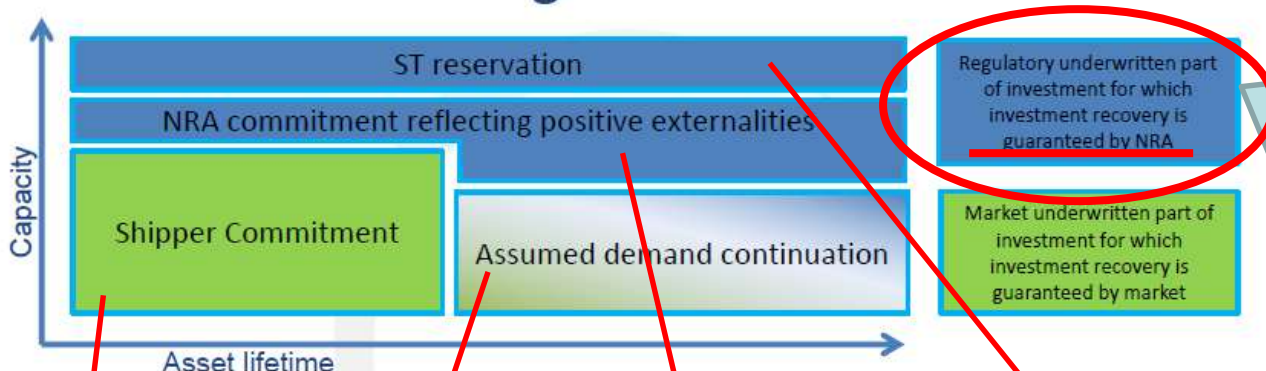
F-factor value vs cost of financing





F-factor: “NRA to guarantee 1-F” = most important proposal on possible draft solution, but ...

Setting the f-factor



NRA to guarantee ‘1-F’ = best effective proposed draft solution.
But Q: What type of guarantees NRA can provide that will be taken by the financial markets?

Positive externalities: Shall compare current costs of network users to benefits for them from the investment.

Higher externalities ==> Lower f-factor

Assumed demand continuation: Based on LT assessment on security of continuance of demand after booking horizon.

Longer commitment period ==> Higher f-factor

ST reservation quota: The recovery of costs related to the part of incremental/new capacity set aside for short term bookings shall always be guaranteed by the NRA or Member state. In transit countries and price cap regimes, applying the ST reservation quota to incremental/new capacity can be an obstacle for passing the economic test.

Higher quotas ==> Lower f-factor



F

Market part 1-F

Non-market part 1-F(A)

Non-market part 1-F(B)



...what financeable options to cover 1-F

- Whole 1-F: Socialization in MSs which territories will cross New Capacity project:
 - In case the flows promoting dev't of New Capacity will come from non-EU in the East/South-East & will pass through CEE MSs, this option seems to be non-financeable
- Market part 1-F:
 - Project promoters? But since ACER prefer pro-rating which will not guarantee firm bookings for project promoters with LT bookings (adequate to their supply obligations), this will discriminate them
- Non-market part 1-F or whole 1-F:
 - “NRA to guarantee” => which sources potentially available?:
 - Direct EU funding (infrastructure support funds)?
 - Financial institutions under EU control (EIB, EBRD, areal/regional dev't banks, like BSDB), but how this will correlate with these banks Policy Memorandums?
 - Internal EU cross-subsidies? Big concerns...
 - What else?



Another facet of F-factor: who decide & who take the risk

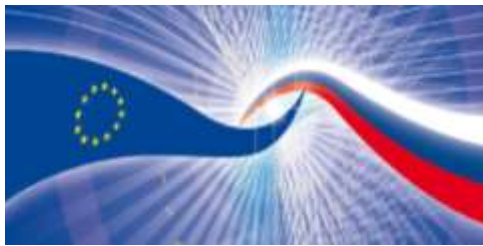
- ACER Guidance + 14.01.2014 ACER statements (J.Heidelberger): NRAs will decide on F-factor adequate for TSO to start financing => major economic problem:
- Decision takers (NRAs) & risk-takers (TSOs & shippers / project promoters) are different entities =>
- This can be considered as discrimination of risk-takers, e.g. promoters (adding them incremental risks or even preventing to implement the project by making it non-financeable)
- How to settle this dilemma?



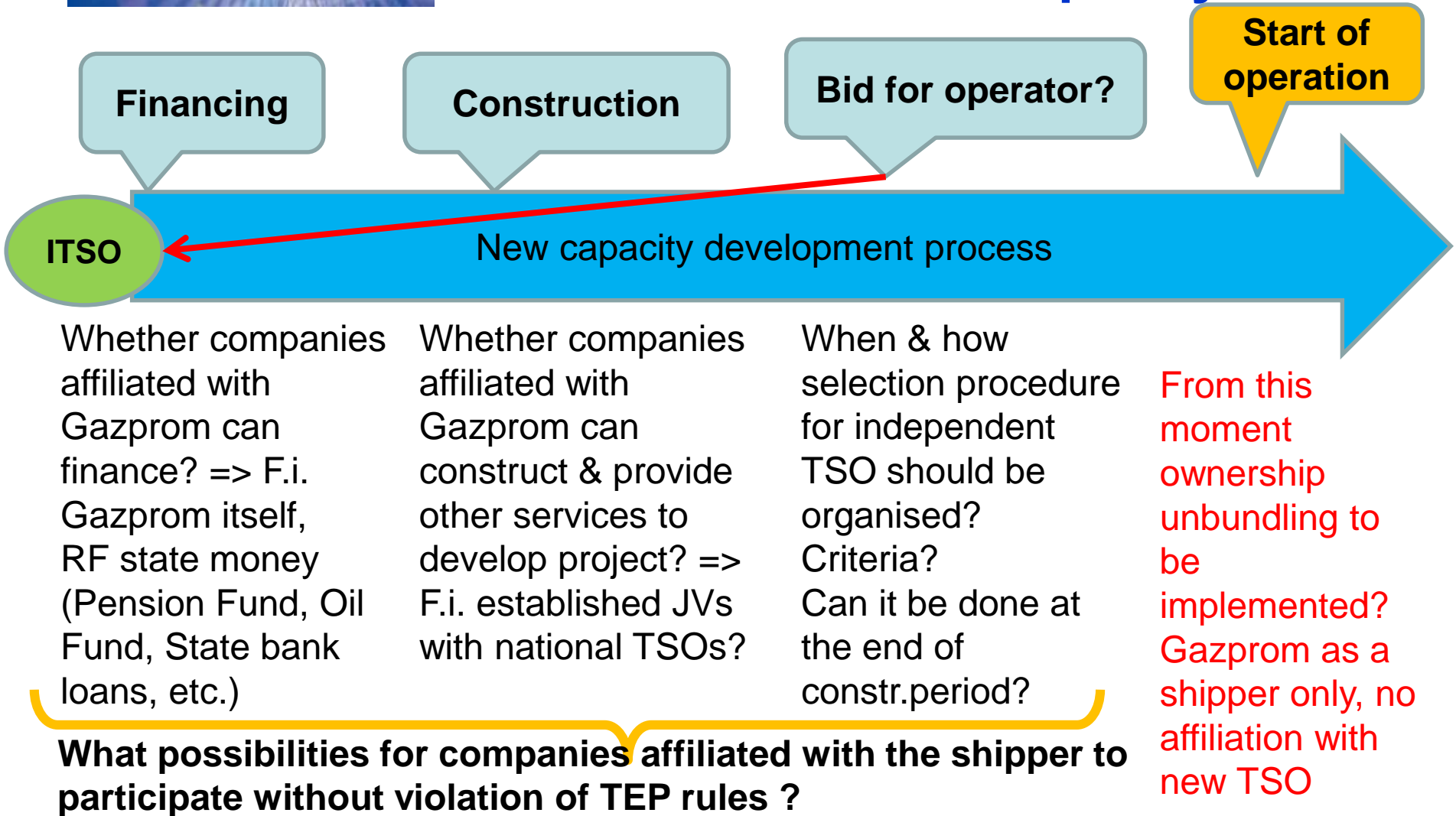
7. Project promoter participation in financing & project management support (implementation of ownership unbundling principle); possibility for newly established (incl. cross-border) ITSO & its relations with companies affiliated with shippers prior to start of operation of new built capacity



- These issues proposed to be addressed in the later joint sessions; next slide is just to remind the issue (as demonstrated at WS2 meeting in SPB in Sept'2013)



New TSO: at which step ownership unbundling rules start to act in case of new capacity dev't?





9. Tariff issues for new capacity & financeability (floating tariffs vs their predictability, possibility for tariff ring-fencing through pay-back period)



Outstanding Issues from ACER Guidance

- ACER Guidance helpful as leaves more room for manourvre in developing suitable framework for new capacity
- Questions requiring clarification derive from the two Codes which impact new capacity
- Tariffs Network Code ACER Framework Guidelines
 - Tariff Methodology
 - Fixed versus Floating Tariffs
 - Setting of reserve price for auction / open season
 - Economic test (implementation for tariffs)
- Incremental and New Capacity ACER Guidance
 - 8 topics examined above



Tariff Methodology

- ACER Tariff Framework Guidelines assume entry exit model and appropriate tariff methodology
 - Is this appropriate for pipelines which are not part of a network e.g interconnector or large new supply pipeline with limited connections to other network?
- EU Network Code on Tariffs assumed to apply to new capacity unless Art. 36 exemption or alternative arrangements
 - If Tariff Network Code is not appropriate, does an alternative methodology need to be developed and set out in the Open Season process?
- Tariff methodology assumes that shortfall in revenue at one point can be shared across other network users via floating tariffs
 - Is this practical if size of new capacity is disproportionate to size of entry exit zone (transit gas problem). Should new capacity be ring fenced?
 - Floating tariffs make it difficult for shippers to make sufficient long term commitments to meet the economic test. Option of a fixed tariff?



CAM NC amendment & draft NC HTTS: possible approach re New Capacity - correlation between two NCs (*)

	Existing Capacity	Incremental Capacity	New Capacity
Capacity allocation mechanism (<i>CAM NC + amendment</i>)	Auction	Auction	Coordinated Open Season
Tariff methodology (<i>draft NC HTTS</i>)	System-based	System-based	Project-based (project ring-fencing through pay-back period ?)

(*) CAM NC = Capacity Allocation Mechanism Network Code; NC HTTS = Draft Network Code on Harmonised Transmission Tariff Structures



Notion! This presentation is about **NEW CAPACITY only**

- Please bear in mind that all material in this presentation addresses only the issues of creating **NEW CAPACITY** (due to its inevitably cross-border character both today & in the future) and has not addressed the issues of creating **INCREMENTAL CAPACITY** (since the latter is purely internal undertaking of the EU)

Thank you for your attention

Andrey A. Konoplyanik

+ 7 499 503 6006

andrey@konoplyanik.ru

a.konoplyanik@gazpromexport.com

www.konoplyanik.ru

Alex Barnes

+ 44 774 775 6032

alex.barnes@gazprom-mt.com
