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Report on the conditionalities stipulated in contracts for standard capacity products for firm capacity

Fulfilling the requirement in Article 38(4) of the Network Code on Capacity allocation mechanisms in gas transmission systems

5 April 2019

The Agency's legal obligation

- (1) Article 38(4) of Commission Regulation (EU) 2017/459 of 16 March 2017 establishing a Network Code on Capacity Allocation Mechanisms in gas transmission systems and repealing Regulation (EU) No 984/2013 (NC CAM) requires the Agency for the Cooperation of Energy Regulators ('the Agency') to publish, before 6 April 2019, a report on the conditionalities stipulated in contracts for standard capacity products for firm capacity, having regard to their effect on efficient network use and the integration of the Union's gas markets ('the Report').

"Before 6 April 2019, the Agency shall, in the framework of its monitoring tasks, report on the conditionalities stipulated in contracts for standard capacity products for firm capacity, having regard to their effect on efficient network use and the integration of the Union gas markets. The Agency shall be supported in its assessment by the relevant national regulatory authorities and transmission system operators."

- (2) The Agency hired Grant Thornton Tax and Business Advisory Solutions SA., in association with REF-E SRL, VIS Economic & Energy Consultants Consulting Services S.A., Grant Thornton Advisory, Baringa Partners LLP (subcontractor), ('the Consultant') to assist with this work by undertaking a Study that describes and assesses the conditionalities *stipulated in contracts for standard firm capacity products* used in EU Member States ('the Study'). The '*Study on the conditionalities stipulated in contracts for standard capacity products for firm capacity sold by the gas TSOs*' was delivered to the Agency on 3 April 2019.
- (3) The Agency supports the factual findings of the Study. At the same time, the Agency has its own recommendations on the subject matter, expressed in the last Section of this Report. This Report, supported by the factual findings of the Study, shall be considered as fulfilling the Agency's reporting obligation under Article 38(4) of the NC CAM.

What do we mean by conditionalities in contracts?

- (4) The entry-exit system is a market access model, which allows network users to book capacity rights independently at any entry and any exit point of the system, thereby creating a dynamic way to transport gas through zones, allowing an easier reach to multiple end-users. The entry-exit model puts an end to trading along contractual paths.
- (5) The full implementation of an entry-exit¹ system has the following key features:
 - Decoupled contracting and utilisation of capacity at the system's entry and exit points, so that network users can freely use any entry and exit point of the system, and are not obliged to contract specific paths within the transmission system;
 - Unrestricted access to the Virtual Trading Point ('VTP') for all network users who have booked firm capacity at either entry or exit points;
 - Free allocability of standard firm capacity products, including short-term products (daily, within-day), to access, and hence facilitate trading at, the VTP.
- (6) Full access to the VTP in an entry-exit system is considered crucial for a well-functioning gas market. The VTP allows gas trading, virtual title products transfer within the entry-exit zone and underpins the trading activity that takes place in the organized markets. The VTPs put an end to traditional trading "at the flange", which was bilateral trading at physical points of the system. Firm capacity products allow for the effective use of an entry-exit system, since firm products allow network users freely and independently to book and allocate capacity at entry and exit points and reach the VTP on a firm basis.

¹ The entry-exit model is neither defined in the Gas Directive nor in the Gas Regulation (full legal reference in footnotes 5 and 3 respectively). Yet the features that are described all descend from the Gas Directive and Regulation.

- (7) Conditionalities exist when a network user *is not allowed* to book entry and exit capacities independently from one another, or faces restrictions on freely flowing gas from any entry to any exit point of a market area.
- (8) Conditionalities also exist when network users *can choose not to use* the freely allocable firm capacity and commit to a more restrictive contract in exchange for discounts. In this case, network users are incentivised by discounts to limit the use of freely allocable products in a given entry-exit system.
- (9) Despite the differentiation used in the current terminology, the outcomes of conditionalities either imposed *ex-ante* in contracts, or chosen by network users in exchange for discounts, lead to similar outcomes.
- (10) Furthermore, the Agency verified whether the existence of certain transit contracts leads to constraints that could be referred to as a condition on the use of the transportation networks. This situation still exist in Bulgaria, Hungary, Poland, Romania, and Slovakia².
- (11) The application of conditionalities is argued on the grounds of effective network development, with a view to avoiding the overbuilding of the mainly seasonally used gas systems. Having products with constraints is a possible answer to the question about the need for infrastructure investment to allow fully firm access to all entry-exit zones. This opens up another debate: whether conditional firm or interruptible products are applied as alternatives to deal with network constraints, while the current EU legal framework explicitly defines only interruptible and firm capacities:

Gas Regulation³, Article 2(13): “‘interruptible capacity’ means gas transmission capacity that may be interrupted by the transmission system operator in accordance with the conditions stipulated in the transport contract.”

Gas Regulation, Article 2(16): “‘firm capacity’ means gas transmission capacity contractually guaranteed as uninterruptible by the transmission system operator.”

- (12) Looking at the experiences from the past, the Agency notes that firm products were downgraded to interruptible ones when they proved insufficient to access the entry-exit points of a system as firm capacity. Such a review in itself does not mean that the product loses considerably its value. Some interruptible products function with limited levels of interruption, and still serve the network as a product of a high value. In other cases, interruptions occur more frequently.
- (13) The legislative framework only foresees firm or interruptible capacity products:

Gas Regulation, Article 14(1): Transmission system operators shall [...] provide both firm and interruptible third-party access services. The price of interruptible capacity shall reflect the probability of interruption; [...]

- (14) In sum, in all cases presented above, the conditionalities stipulated in contracts limit the access to the full entry-exit system⁴, and deviate from the underlying gas market design foreseen by the Gas Directive and the Gas Regulation, in terms of full network access and access to greater liquidity.

Gas Directive⁵, Recital (4): “at present there are obstacles to the sale of gas on equal terms and without discrimination or disadvantages in the Community. In particular, non-discriminatory network access and an equally effective level of regulatory supervision in each Member State do not yet exist.” – the intention of the Gas Directive being to trigger a change in this respect -

² Other transit contracts exist in pipelines that were granted third party access exemption.

³ Regulation (EC) No 715/2009 of the European Parliament and of the Council of 13 July 2009 on the conditions for access to the natural gas transmission networks and repealing Regulation (EC) No 1775/2005, OJEU, L 211, v.52, 14 August 2009

⁴ The revised NC CAM and the NC TAR acknowledge the existence of conditionalities: in particular, NC CAM foresees a dedicated monitoring by the Agency.

⁵ Directive 2009/73/EC of the European Parliament and of the Council of 13 July 2009 concerning common rules for the internal market in natural gas and repealing Directive 2003/55/EC, OJEU, L 211, v.52, 14 August 2009

Gas Regulation, Recital (19): “it is vital that gas can be traded independent of its location in the system. The only way to do this is to give network users the freedom to book entry and exit capacity independently, thereby creating gas transport through zones instead of along contractual paths.”

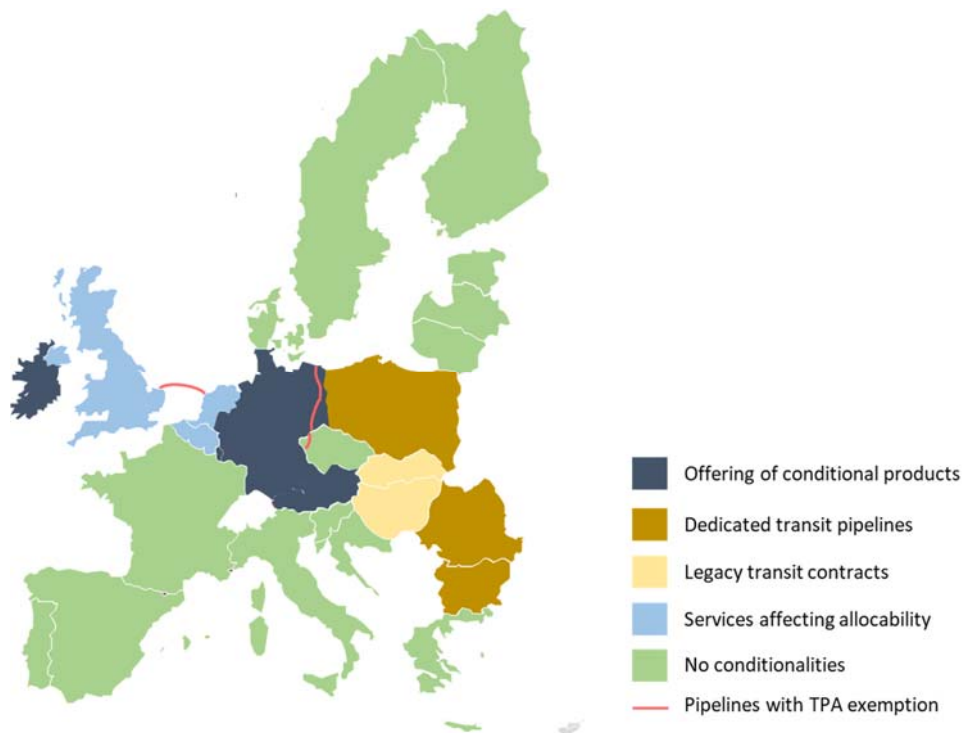
Gas Regulation, Article 13(1): “Tariffs for network users shall be non-discriminatory and set separately for every entry point into or exit point out of the transmission system.”[...] “Member States shall ensure that [...] network charges shall not be calculated on the basis of contractual path”.

- (15) The legislation is silent however, on whether other products that have a ‘mixed’ character could be introduced as stand-alone products next to the (freely allocable) firm and interruptible products, or whether such products may be detrimental to the integration of Union’s gas markets.

Findings from the consultancy Study (period analysed 2016-2018)

- (16) The Study shows that deviations from the application of the full entry-exit system access exist in several Member States. These deviations imply the use of conditional products as well as the existence of legacy contracts and occur in Austria, Belgium, Bulgaria, Germany, Hungary, Luxemburg, the Netherlands, Poland, Romania, Slovakia, and UK-Great Britain (Figure 1). Hungary, Ireland and Greece may apply new conditional products in the future⁶. The Study provides a review of the transit contracts, covering several countries in the South-South East gas region.

Figure 1: Application of conditionalities in EU Member States



- (17) The reason for the existence of such conditionalities can be:
- Commercial (linked to pre-existing legacy contracts⁷ signed before the implementation of the Third Energy Package), or

⁶ According to the interviews conducted with the respective NRAs and TSOs in the framework of the Study.

⁷ Supply contracts shall not include clauses related to capacity bookings.

- Physical (due to technical constraints on the transmission network when extended into an entry-exit system).
- (18) The main form of conditionalities stipulated in contracts for standard capacity products for firm capacity as described by the consultancy Study are:
- **Conditional products:**
 - not ensuring full firmness:
 - **bFZK: “Conditional firm capacity with free allocability”.**
It restricts the possibility to use the contracted capacity in case a predefined external condition applies (temperature condition, physical gas flows within the network). Any additional capacity is offered on an interruptible basis. Allocability of the conditional capacity is provided without restrictions. The bFZK capacity product is a firm product with free allocability up to the restrictions mentioned above.
 - not ensuring free allocability:
 - **BZK: “Firm capacity with restricted allocability”.**
The product guarantees the possibility to use the contracted capacity at the corresponding entry or exit point. Allocability depends on whether there have been appropriate capacity assignments at one or more physical entry or exit points of the system, which have been predetermined by the TSO (i.e. specific entry-exit routes at which BZK products are available have been defined by the TSO). Any additional use, including access to the VTP, is not possible⁸.
 - **DZK: “Firm capacity with dynamic allocability”.**
The product guarantees the possibility to use the contracted capacity at the corresponding entry or exit point. Allocability depends on whether there have been appropriate capacity assignments at one or more physical entry or exit points of the system, which have been predetermined by the TSO. Any additional use, including additional accessibility to the Virtual Trading Point, is offered on an interruptible basis.
 - **Services** leading to modified allocability of a firm capacity product. Users can buy them as standard firm capacity product but could later transform them into a discounted product of a more limited use:
 - **Operational capacity usage commitments (‘OCUC’).**
Point-to-point service provided by the TSO to network users for balanced transportation of gas between predefined combinations of entry and exit IPs⁹. Access to any other network points or the VTP is not possible, as nominations at entries and exits for the use of OCUC have to match, otherwise they are rejected by the TSO.
 - **Shorthaul.**
Point-to-point service offered with a distance criterion set for the provision of the service, requiring linked entries and exits not to exceed a maximum distance. The user does not have access to the VTP. In the UK, if the user pays the full price of the firm capacity, it can access the VTP.
 - **Wheeling.**
Point-to-point service provided by the TSO to network users for direct transmission of gas between two adjacent interconnection points, located within the same physical connection facility. The user does not have access to the VTP¹⁰.

⁸ Exception to this general definition exist, since there does not exist a harmonised catalogue of conditional products yet.

⁹ In the framework of proactive congestion management.

¹⁰ In most cases, the network users are using this facility to enter-exit-and re-enter several entry-exit zones with the aim to trade in the one where they entered last.

- **Dedicated transit pipelines (without third party access exemption)** are long-term transit agreements, signed before the Third Energy Package introduced an entry-exit design and which foresee a dedicated route for transit. As an outcome, it allows to by-pass to a great extent the entry-exit system¹¹ of some Member States¹². The pipelines can be fully or partially dedicated to transit and are in place in Bulgaria, Hungary, Poland, Romania, and Slovakia.

Legacy contracts not only create restrictions on the use of the network, like other conditionalities, but lack appropriate provisions on third party access.

Where are conditionalities used and how much?

- (19) Table 1 shows the use of conditional products in the EU.

Table 2: Booked capacity of conditional firm products in Member States (data for Gas Year 2017/18)

Member State ¹³	Entry IPs		Exit IPs	
	Booked Conditional Capacity (GWh/d)	Share of total booked capacity	Booked Conditional Capacity (GWh/d)	Share of total booked capacity
Austria	95	4%	156	8%
Germany	3,541	69%	1,977	57%
Luxembourg ¹⁴	20	100%	-	-

- (20) In Germany, on average around 50% of gas is flowed based on conditional capacity contracts.
- (21) In Austria, DZK capacity consisted of a smaller part of the total entry and exit capacities, 13% in the Gas Year 2017/18.
- (22) Belgium, the UK-Great Britain, and the Netherlands use services modifying the free allocability of a firm capacity product. Actual gas flows bypassing the entry-exit system are as follows¹⁵:
- OCUC and wheeling services¹⁶ in Belgium cover around on third of the total volumes of gas flowed in 2018.
 - Shorthaul services in the UK-Great Britain go beyond short distances and cover 30% of the total flows. In the Netherlands, shorthaul is currently scarcely used¹⁷ and will not be offered anymore from 1 January 2020, when the Network Code on harmonised transmission tariff structures for gas ('NC TAR')¹⁸ is implemented.
- (23) Central and South-East Europe, namely Bulgaria, Hungary, Poland, Romania and Slovakia have still capacity assigned to long-term legacy contracts, not applying the NC CAM rules. These lines serve primarily to transit gas to other destinations, but limit the development of an integrated national gas network system and wholesale market in these transit countries.
- (24) Overall, the Agency considers that the use of conditionalities stipulated in standard capacity contracts and the presence of gas transit routes in Central and South-East Europe affect a considerable part of the EU gas infrastructure.
- (25) The evaluation of whether these limits create important hurdles to gas trading in the Union are his hard to perform. For example, conditional capacities can be upgraded with investments. Absent investments, conditionalities can be only removed if cross-border capacities are reduced, with a detrimental impact on regional trade. In addition, if certain conditional capacities are no longer

¹¹ Obliging users to contract entry and exit combined.

¹² Some pipelines obtained a full or partial exemption from the application of the Third Party Access.

¹³ Ireland also has in place a conditional capacity product, but the product has never been used.

¹⁴ The table presents the capacity booked at the IPs of each country. For Luxembourg, the value concerns the Remich IP, as the only IP in the country where capacity is sold, and not all BeLux area IPs. Should the whole BeLux area be considered, then the share of conditional products (the percentage value in the table) would be lower.

¹⁵ GTS did not provide detailed data on the use of shorthaul and wheeling services.

¹⁶ Fluxys did not provide disaggregated data on the use of OCUC and wheeling service.

¹⁷ Even though GTS did not provide detailed data.

¹⁸ Commission Regulation (EU) 2017/460 of 16 March 2017, OJEU L-72

considered as firm, they will not be offered during the firm capacity allocation auctions, and where conditional firm capacities have been previously bundled with neighbouring states, such reduction of the amount of firm conditional capacities will lead to the reduction of the amount of bundled capacities at the cross-border IPs¹⁹.

Discounts: how do users pay for conditionalities?

- (26) Conditional products and services have lower prices than the full firm, freely allocable capacity. The discounts vary depending on the product/service offered, and on the country.
- In Germany, discounts vary depending on the TSO. The German NRA has proposed to create a catalogue of permissible products, to harmonise the order of interruptions and product specification, and to set a cap for the discounts that may apply²⁰. The discounts applied are between 5% and 10%, depending on the product and the TSO. The low discounts express the value of the firmness of the product and its limited allocability.
 - In Belgium, the discounts reflect the conditionality of the products (e.g. no access to the hub and obligation of the user of one entry to one exit balanced flows), therefore the discounts are much higher, surpassing in most cases 50% for OCUC, and 80% for wheeling. The current tariff review process, which has not been finalised yet, proposes discounts of 25% plus a distance component.
 - In the Netherlands, the discounts for wheeling reach around 85%. With the new tariff methodology, the discount for wheeling will be 94%.
 - In the UK-Great Britain, the discount for shorthaul is given by a formula²¹, where the discounted tariff increases with the distance and decreases with the capacity.
- (27) The Agency observes that the discounts for conditional products and services differ across the Union. This is not necessarily due to the different value the product has; rather it is due to the different role the discounts play, being either a reduced tariff or an incentive to switch away from firm products.
- (28) As part of its obligations under the NC TAR, the Agency has reviewed several tariff methodologies. The Agency is aware that interactions between conditionalities and their tariff setting need to be further investigated, in particular the connection between the Reference Price Methodology ('RPM') and the application of conditionalities. This point directly connects to the necessity appropriately to understand the value of conditional products and propose a harmonised discount for them.

Modelling and further thoughts on conditionalities

- (29) The Study does not provide a clear-cut answer to whether conditionalities should be removed, instead promotes further country-based analysis.
- (30) The Study proposes a small simulation investigating the effects of removing conditionalities with a focus on the gas flows and prices in the EU. Given the multiple dynamics that play a role and shall be isolated from conditionalities, no definite answer could be drawn from the simulation.
- (31) Therefore, the Study suggests that any decision to remove conditionalities implying an investment should be supported by a positive cost-benefit analysis ('CBA'). The CBAs relying on the necessary and accurate cost figures are better tools to inform case-specific decisions.
- (32) The Study explores also the possibility to remove conditionalities by reducing the amount of firm cross-border capacities offered to the market. This option would ensure a level-playing field and higher transparency and harmonisation across the EU. On the other hand, this solution may hinder regional cross-border trade, market integration, and security of supply.

¹⁹ The obligation to follow offer capacity in auctions and to bundle capacity exist only for firm capacity.

²⁰ To be lower than the discount applied to interruptible products.

²¹ National Grid and Ofgem did not provide detailed data.

(33) The following points are worth to be mentioned:

- The current transit users might be in favour of retaining conditional products, because these products are well-adapted to their needs.
- Some dominant network users might benefit from such products as their sizeable presence at several interconnection points with access to limited entry-exit combinations grants them a higher control over the flows. These dominant network users may know the ways in which to use the network optimally or even restrictively for other users, whereas new entrants or small players will find themselves limited in the way in which they can flow gas. The impact of these products on competition therefore might not be negligible.
- The increasing liquidity and VTP access by removing conditionalities might not trigger net benefit for a single country, but rather benefits liquidity across several markets or entry-exit zones.
- Certain Member States had already invested in their infrastructure (e.g. the Netherlands) in order to remove conditionalities, while others made a revision of products by classifying them as firm, interruptible or conditional²².
- Depending on the size of the country, the amount of the conditional products and the importance of cross-regional trades, new investments, the reduction of cross-border capacities or a combination of investments and reduction of conditional firm products, play a role in the removal of conditionalities. A detailed CBA assessment and, depending on its outcome, a plan on how to treat these products shall be the best way forward to treat conditional products.
- New investments that remove conditionalities could bring further benefits, such as the improvement of security of supply or social and environmental benefits. Ideally, CBAs should account for all possible costs and benefits.

Recommendation for further investigation

- (34) The Agency encourages the concerned NRAs further to assess the existing conditionalities.
- (35) The Agency recommends that the NRAs assess, on a case-by-case basis, the application of conditionalities versus the upgrading of the network, using cross-border CBAs.
- (36) The Agency sees benefits in creating a EU catalogue of conditional products with product descriptions, indicating the value of the products.
- (37) The Agency recommends a fully transparent and, to the extent possible, harmonised approach to the application of discounts concerning conditional products.
- (38) It is worth studying the cross-border tariff effects of conditionalities and further clarify whether discounts are appropriately set. Discounts mainly apply to conditional products for transit flows and contribute to cover the costs of an asset that is shared between domestic and transit use. The Agency encourages network users fairly to contribute to the network costs. In this context, the Agency invites the NRAs to investigate the effect of offering and pricing conditional products and services in order to limit cross-subsidies in most cases, between transit and domestic users.
- (39) Higher transparency, allowing for the full identification of conditional products, their traded volumes, and prices shall be promoted by publishing these data via the ENTSOG Transparency Platform.
- (40) With further efforts, the still existing dedicated transit lines shall be blended into the national entry-exit designs, invoking the re-negotiation/revision clause in the dedicated transit contracts. The blending is especially important when the dedicated transit lines do not allow access to the VTP and should be done in line with the requirements of the NC TAR. The Third Energy Package foresaw that transit across the EU is treated in the same way as domestic transportation. The

²² For example, this is the case of Spain, which is described in the Study.

current revision of the Gas Directive²³ strengthens the concept by requesting that new capacity contracts be also compatible with the entry-exit concept.

- (41) The Agency recommends those countries planning to carry out a zone merger – e.g. Germany - to provide a CBA of the merger taking into account cross-border impacts at regional level. This is especially recommended for mergers with a potential for creating new conditionalities, or reducing cross-border capacities.
- (42) The Agency would like to assess the full costs of building infrastructure or of the consequences of reducing cross-border capacities for the removal of conditional products and assess the benefits allowing for a more varied flow pattern. The Agency would take account of the regional context and care for several dimensions, such as the:
- Impact on the marginal gas supply sources (potential decrease of the supply prices);
 - Impact on the wholesale markets (liquidity of each impacted hub and cross-border trade);
 - Impact on competition (would smaller competitors benefit from simpler capacity products?);
 - Impact on security of supply (in particular if some cross-border capacities are reduced what options would remain available?).
- (43) It is key to discuss and finalise the definition of the entry-exit model in a new legislative process and agree to extent to which deviations are allowed and/or desirable. Two options could be considered:
- Removing the conditionalities in a selective way, by focusing on key bottlenecks impeding competition and trade, thus minimising tariff increase. Since conditionalities will remain in place, the standardisation of conditional products will remain preferable.
 - Completing the entry-exit system, providing guidance on the investments that shall be made for the completion of an integrated market, taking due account of the tariff increases that may be necessary to achieve that and minimising conditional capacity.
- (44) The Agency would welcome a set of harmonised rules, to provide for an effective and well-functioning gas and capacity trading in the EU in line with the competition, environmental and societal goals of the Union.

²³ The first and final trilogue on the Gas Directive changes was held on 12 February 2019 and a provisional agreement was reached: <https://data.consilium.europa.eu/doc/document/ST-6351-2019-INIT/en/pdf>



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