ENI POSITION PAPER ON EXISTING LONG-TERM CAPACITY CONTRACTS (EC)

Executive summary

Existing capacity can be described as long-term entry capacity that National Grid Gas (NGG) has already sold for a forward period of up to 17 years.

Long-term capacity contracts have a unique place in the UNC because NGG is allowed to sell forward NTS entry capacity via auctions to shippers while all other UNC arrangements are limited to a much shorter contract period.

Although UNC is a multilateral contract, when a shipper buys NTS entry capacity it enters into a **bilateral contract** with NGG, where the most significant contract characteristics are:

- all capacity products are sold at a fixed price determined at the allocation stage of the auction process;
- a variable revenue recovery charge (currently in the form of a unit gas flow-based commodity charge) is paid only when users use their capacity;
- the capacity payment liability is not transferable; and
- the capacity entitlement is transferable.

All existing capacity has been acquired at prices derived by the Long Run Marginal Cost (LRMC) methodology. This methodology was introduced in the mid-1990s and is regarded as being consistent with the NGG Licence relevant charging methodology objectives. Therefore the price attached to existing capacity contracts must be regarded as a **cost-reflective price**.

Under the current charging regime there is **effective discrimination against long-term entry capacity** because the reserve price for short-term capacity auctions is set at zero and long-term capacity is making an excessive contribution to Transportation Owner (TO) entry capacity revenue.

Moreover, when **Bacton ASEP** was **split** to meet CAM compliance in November 2015, some of the existing Bacton capacity - requested by the relevant holders to be allocated to the new Bacton UKCS ASEP - due to congestion was forcefully re-allocated to the new Bacton IP ASEP. This change in UNC resulted in a **substantial interference** in the **property capacity rights** of the impacted capacity owners.

In view of the above, **existing entry capacity holders should see the improvement and not a worsening of their contractual conditions in the new charging regime**. Also, considering article 35 (so-called "*grandfathering clause*") of the European network code on harmonized transmission tariff structures for gas (TAR NC), their expectation is that the new charging regime should:

- find a solution for the current discrimination against the existing long-term capacity;

- bring a relief to the damage caused to their existing capacity when the Bacton ASEP split took place;
- respect and safeguard their contractual rights.

To ensure appropriate legal treatment of existing capacity, **two solutions** are envisaged:

- **make provisions for existing capacity holders to return capacity**; and
- **to the extent that existing capacity is retained, make provisions for continued use of the current fixed-price contract terms with no application of any capacity-based revenue recovery charges**.

Inadequate mitigation of the long-term capacity contract through the UNC modifications risks shippers being less willing to book long-term entry capacity in the future, with adverse effects on security of supply.

Background

The current charging regime provides gas shippers with an option to secure long-term entry capacity at a fixed price agreed at the point when capacity is allocated via the auction process for up to 17 years. The legitimate expectations of these long-term capacity holders was and is that during the course of the contract they will have to pay, on a ship-or-pay basis, only the capacity charge fixed by the contract, while the commodity charge (that responds also to the aim of minimising NGG's under-recovery) shall have to be paid only when and to the extent that they opt to use the booked capacity.

At the same time, the current regime offers up to 100% price discounts for short-term entry capacity.

As a consequence, although long-term capacity holders buy exactly the same daily capacity product as short-term capacity holders (the only difference being that long-term users buy daily capacity rights "in bulk" or a series of daily capacity products for any given day within a specific time frame), they pay a much higher capacity cost than short-term holders, who predominantly purchase their capacity free of charge. This results in effective discrimination between long-term and short-term capacity holders because short-term holders are not making an adequate contribution to the historical costs incurred by NGG to deliver the entry capacity. In other words, short-term holders are granted access to a network paid for by long-term capacity holders; data published by NGG show that while long-term capacity products represent around 50% of the total booked capacity, their contribution to NGG's revenues amounts to 99.6%.

In general, short-term discounts in capacity price provide all gas shippers with a large incentive to secure their capacity on a short-term basis, mostly at zero price. Because large quantities of short-term capacity are sold at zero price, this results in a large TO capacity revenue shortfall.

This shortfall is resolved by the application of the uniform TO commodity charge, a charge that is applied to all flows, at all entry points. As a result, long-term capacity holders will pay significantly more, in aggregate, to deliver a therm of gas to the network, than short-term capacity holders who acquire capacity rights at zero cost.

<u>What are shippers' expectations from the new regime?</u>

All shippers want the new charging regime to provide stability and predictability of prices. In addition, they share a number of common expectations:

- that the total of Capacity Weighted Distance (CWD) Transmission Charges will not be higher than the total of TO charges (note that in the current regime the total cost of TO charges applied to unutilised capacity is equal to the fixed-capacity price);
- that the transition to the new regime will provide them with fair treatment, ensuring a level playing field among all shippers.

Shippers who book capacity on a long-term basis also expect that the new capacity regime will:

- remove the current discrimination of long-term versus short-term capacity. In the knowledge that the CWD generated reference price is cost-reflective and represents a fair allocation of revenues (and costs) then there will be no scope for short-term multipliers of less than one;
- bring relief to the damage caused to their existing capacity when the Bacton ASEP split took place;
- respect and safeguard their contractual rights.

<u>The removal of the fixed-price contract from the future regime and the effect on existing long-term capacity holdings</u>

When the new charging regime is implemented in October 2019, it is planned that the fixed-price, long-term entry capacity contract will be removed from the UNC and replaced by a new top-up floating Revenue Recovery capacity charge. The purpose of the top-up floating charge will be to ensure full NGG revenue recovery. Therefore the higher the revenue under-recovery, the higher the top-up floating charge and the more significant negative effect on existing capacity holders.

Unless long-term existing capacity holders are provided with the possibility to return the capacity that was purchased under different contractual terms, they will not be able to adjust their capacity booking behaviour in response to the significant changes in the regulatory framework brought about by the new regime. In this scenario, an important competitive advantage will be conferred to gas shippers without existing capacity (or lower levels of existing capacity bookings) because they will have an opportunity to adjust their capacity booking strategy to the new charging regime.

Furthermore, gas shippers who will be most negatively affected by the removal of the fixed-price capacity contract and the introduction of the top-up capacity tariff will be those who are not utilising their long-term existing capacity.

The negative effect that can be caused by the introduction of the new charging regime can be mitigated or exacerbated depending on the decision-making process in relation to the charging modifications to the UNC. In the worst-case scenario, the modifications to the UNC, and possibly to the NGG licence, could mean that:

- Existing long-term capacity holders, who are unable to utilise their capacity, are in a worse position because they will be forced to pay a fixed top-up charge that they did not expect to pay when they decided to make a commitment to the long-term capacity bookings;
- Existing long-term capacity holders, particularly if they are unable to utilise their capacity, will have to pay much higher total capacity charges that will put them at a significant competitive disadvantage by increasing a cross-subsidy by existing capacity holders to other users. In fact, they will provide an increased contribution to the recovery of the TO-allowed revenues and this will allow other shippers, i.e. their competitors, to benefit from relatively even lower charges.

A situation whereby gas shippers who bought long-term capacity at one price are to suffer from a significant increase in the price that they have to pay for such capacity as a result of the regulatory intervention would be improper, unfair and inconsistent with the provision of article 35 of TAR NC and therefore must be prevented.

Without satisfactory modifications to the UNC, the treatment of the existing capacity holdings in the new regime risks amounting to a serious distortion of competition, and at the same time causing the market to become inefficient and uncertain:

- inefficient as it creates a "two tier" regime for what should be a homogenous product, with certain capacity penalised by the imposition of additional costs;
- uncertain, because it undermines the sanctity of contract and exposes users to unacceptable levels of regulatory risk. This will undermine any future long-term capacity bookings, or indeed any longer term arrangements, which might be entered into between users and NGG; and shippers being less willing to book long-term capacity in the future would have adverse effects to security of supply.

An approach that distorts the price of entry capacity, and fails to take any mitigating steps to prevent the resultant damage to gas shippers who bought that capacity on a legitimate basis that existing capacity would maintain its fixed price, risks being non-compliant with a number of Relevant Objectives, given the emphasis on efficient and effective competition.

Options to provide the right solution

To mitigate the adverse effects that will result from the removal of the fixed-price capacity contract and the introduction of a top-up floating capacity charge in the new charging regime and to comply with the legal obligations set out above, before the new charging regime is implemented the modification to the UNC must:

- make provision for existing long-term capacity holders to offer an option to return their capacity; and
- to the extent that such capacity is retained, make provision for continued use on the same price terms.

The need to mitigate the effect of radical market and regulatory changes on shippers engaged in long-term supply contracts has been recognised in some other EU countries where different mitigating measures have been put in place (see examples in Annex A).

Worthy of mention are the grounds that recently induced the Italian regulator (AEEGSI) to introduce a reshuffling service allowing shippers holding long-term capacity not to use that contracted capacity in a certain gas year and to "move" it to a year after the long contract expires. In fact, AEEGSI recognised that over the last few years, the market context and the Italian and European regulatory environment of natural gas have changed in depth and that this evolution has had a profound effect on competitive balances, with particular effect on shippers having long-term supply contracts, subscribed when the market context was radically different. As a consequence, and precisely with the aim to prevent possible distortive effects of competitive equilibrium, AEEGSI has introduced the mentioned "reshuffling" option. Similar considerations perfectly fit the evolution of the transmission charging regime currently under discussion in the UK.

Annex A

Examples of how the transition to significantly different new regimes has been managed in some European countries

In **Germany**, shippers may terminate a capacity contract if the increases in transportation tariffs and charges are higher than the increase in the consumer price index for Germany. This clause is included in standard general terms and conditions for entry and exit contracts for all transmission system operators (TSOs) as defined in the Cooperation Agreement among German network operators (*Kooperationsvereinbarung* - KOV). KOV is a multilateral agreement that provides the legal framework between TSOs and shippers. Similar to UNC, KOV can be modified from time to time. Section 25 paragraph 4 of KOV provides a remedy to the network users in case of high and unforeseeable increases of the transmission tariffs arising from the yearly updates that have to be carried out by the TSOs in full compliance with the regulatory provisions in force.

In **Belgium**, a reshuffling service was introduced in 2014 and offered through two subscription windows (one in 2014 and one in 2015). The reshuffling service gave grid users the flexibility to shift a transmission service to another interconnection point or over time (for both, specifics and restrictions applied). The main goal was to allow grid users to manage their capacity portfolios and facilitate the transition in anticipation of the implementation of the Capacity Allocation Mechanisms network code (the CAM NC).

In **Italy**, as from 1 October 2017, shippers who have long-term capacity at Italian entry points can benefit from a service of flexible use of said capacity (so-called "reshuffling service"). The said flexible service allows shippers holding contracts signed before the EU's capacity allocation mechanisms came into force in November 2015 not to use that contracted capacity in a certain gas year and "move" it to a year after the long-term contract expires.

They will then be able to use the capacity they gave up in the three years following the contract's expiry at the original entry point. Shippers who do not use the capacity will still have to pay tariffs for the booked capacity and any increase in fees if the cost of transportation at the relevant entry point goes up.

The TSO will make the unused capacity available as annual, quarterly, monthly, daily and intra-daily capacity products. The allocation mechanism used will be the same as that for un-booked capacity.

The Italian regulator (AEEGSI) explicitly states that the said measure is "*needed to mitigate the impact of the radical market and regulatory change on those shippers engaged in long-term supply contracts signed in a different context*". In the consultation document that preceded the resolution at stake, AEEGSI specified this concept as follows:

- over the last few years, the market context and the Italian and European regulatory environment of natural gas have changed in depth (reference is made to the development that occurred in the wholesale market and the implementation of European rules, especially those related to Congestion Management Procedures (CMP) and the Balancing Network Code);
- this evolution has had a profound effect on competitive balances, with particular effect on shippers engaged in long-term supply contracts, subscribed when the market context was radically different;
- in this context, the Authority has been informed of the opportunity for long-term transmission capacity holders to release their capacities before the natural deadlines of contracts or to "transfer" capacities from an entry point to another entry or exit point,
- the Authority deems this information as worthy to be considered and, attentive to prevent possible distortive effects of competitive equilibrium, proposes to introduce a "reshuffling" option enabling shippers to postpone the use of (part of) the long-term contracted entry capacity at an IP to a maximum of 3 years after the relevant contract deadline.