ACER DRAFT FRAMEWORK GUIDELINES ON CAPACITY ALLOCATION MECHANISMS FOR THE EUROPEAN GAS TRANSMISSION NETWORK

Clause 2.4.2 –Amendment of existing capacity contracts

A) Interpretation of the clause

Paragraph 1

The network code(s) shall ensure that existing capacity contracted before the entry into force of legally binding network code(s) shall be bundled no later than five years thereafter.

Comment:

Only the sale of "*bundled*" [(1)] capacity products will be authorised at cross-border interconnection points within the European Union [(2)].

This strict provision will enter into force as soon as the legally binding network is adopted.

Existing capacity contracts must be amended within 5 years of the adoption of the network code: they will only be able to contain "*bundled*" products.

It will therefore be impossible over the medium-term (i.e. beyond 5 years) for a "*bundled capacity"* system to coexist within the European Union with border trade (flange trading).

However,

- neither the Third Gas Directive;
- nor the 2009 Gas (Access) Regulation, in particular if we refer to its Recital 19, make it compulsory to exclude a capacity offering at entry-exit border points.

Recital 19 of the Gas Regulation reiterates the preference of the Community institutions for an "*entry/exit*" system, but the introduction of such a system does not entail an obligation for users to conclude all of their transactions at virtual points (virtual hubs). The "*entry/exit*" system is not incompatible with 'flange trading' (in fact, in a number of Member States, flange trading takes place within an entry/exit framework). Clearly, Recital 19 does not aim to prohibit flange trading.

This also raises the question of the proportionate nature of such a restriction, which does not only cover situations of congestion, but applies in all scenarios, even in the case of non-congestion.

Moreover, ERGEG assumes that the implementation of "*bundled*" products will increase the volume of trade (liquidity), but it has not demonstrated that this will actually be the case.

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(1) "*Bundled*" products imply a capacity subscribed, then nominated on both sides of an interconnection point by a single shipper.

(2) Article 1.1 of the Guideline excludes a certain number of interconnection points (for example LNG terminals and gas production facilities) from its scope of application.

Paragraph 1 (continued)

Network users holding existing capacity contracts should aim at reaching an agreement on the split of the new bundled capacity. National regulatory authorities may moderate between the parties.

Comment:

1. The text requires network users holding capacity to negotiate in order to reach an agreement on the split of this capacity so that it can become "*bundled*".

At this stage, the procedure for splitting capacity between capacity holders is not specified.

The expression "*new bundled capacity*" may seem ambiguous insofar as it might suggest that the proposed split concerns only new capacity. In practice, the new rules also apply to existing contracts, because, according to the text of the FG, the bundling of existing capacities will occur progressively and no later than 5 years after the entry into force of the network code.

2. National regulatory authorities may moderate between parties.

This role of *"good offices*", which is not defined, does not seem to be justified insofar as the text provides for a binding dispute resolution mechanism to be put in place (see paragraph 2). It is therefore not necessary to create an additional level, which makes the procedure more burdensome, by involving national regulatory authorities.

Paragraph 2

If no agreement on the split of bundled capacity can be reached, the network code(s) shall entitle transmission system operators to split the bundled capacity between the original capacity holders proportionally to their capacity rights. The duration of the new bundled services shall not exceed the duration of the original capacity contracts they are built upon. Any further details of this procedure shall be set out in the network code(s).

Comment:

1. In the event of a disagreement on the split of the "*bundled*" capacities – despite the national regulator's role of "moderator" – it is for the transmission system operator to decide the split on the basis of the original rights of the capacity holders.

However, the text does not specify the splitting arrangements or procedure since it merely refers to a rule of proportionality. Does this mean calculating the average of the rights held on each of the adjacent networks by the two parties concerned? At what point in time are these rights assessed? [3].

2. There is no legal basis (regulation or directive) authorising the transmission system operator to execute (i.e. impose on capacity users) the split and hence the implementation of "*bundled*" capacities.

This power given to transmission system operators does not merely involve a simple technical adaptation of the capacity contract, but may call into question other contracts – for example gas supply contracts.

[3] For example by taking into account these rights over the total duration of the contracts.

In addition, this unilateral power of adaptation is not counterbalanced by any right available to shippers to amend or cancel their capacity contract.

This 2nd paragraph states that the details of this amicable procedure (role of the regulator) or binding procedure (involvement of the transmission system operator) will be included in the network code. But it must be noted that such a procedure, even if it is included in the network code, would ignore existing legal and regulatory texts by granting the transmission system operator, without any legal basis, the right to undermine existing contracts by imposing the new "*bundled*" capacity system.

The first draft of the "*Pilot Framework Guideline*" (10 June 2010) provided for transmission system operators "*to encourage*" the establishment of the new system [4], whereas the new version gives them the right to impose this implementation.

A change of existing contracts is – in principle – only possible via an act of state. A TSO cannot impose such a change, even if this would be based on a network code. Thus even if capacity bundling should take place it could only be applied for new capacity contracted after the entry into force of a legally binding network code, unless the holder of exisiting capacity contracted before the entry into force of the legally binding network code wishes to amend its contract.

3. Finally, the text does not provide for a possible appeals procedure to enable the parties to contest the new allocation decided by the transmission system operator.

Paragraph 3

Network codes are not meant and do not regulate supply contracts, only capacity contracts. Insofar as this Guideline could have an effect on supply contracts, implementation of network codes shall not entitle contracting parties to cancel supply contracts. It could only serve to separate and amend the capacity contract if this is included in the supply contract.

Comment:

According to these provisions, the introduction of "*bundled*" capacities shall not entitle the contracting parties to cancel supply contracts.

Accordingly, the change of system should not lead directly to cumbersome re-negotiations, in particular as regards the volume, price and duration of existing supply contracts [5].

However, the real question is not, as the Framework Guideline seems to indicate, the cancellation or not of supply contracts, but rather the risk of far-reaching changes affecting one of the parties as a result of the introduction of the "*bundled*" capacity system. In fact, this new system implies not only a change in supply points under long-term supply contracts, but also has potential consequences for other contractual clauses and for the economic equilibrium of the contracts in general. The reality therefore is that supply contracts will be impacted and the Framework Guideline does not deny this.

The supply point is an element that is difficult to separate from other essential clauses of a long-term contract and its determination is an integral part of the overall negotiations between a purchaser and its supplier. A change in this point would necessarily have an impact on the contract price, given in particular the determination of new related transport costs, and even

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[4] Article 2.3.1.

[5] "*It is not our intention to question existing supply contracts nor directly to open then to cumbersome renegotiations on volume, price, duration or other relevant characteristics*" (Letter from Lord Mogg – ERGEG Chair – to Eurogas President).

on the flexibility or price indexation formula linked to the new supply point. These elements rarely lend themselves to a clear-cut calculation and can have an adverse effect on one party's optimum contractual position. Therefore, the forced renegotiation of the supply point (something which would be unprecedented) would give rise to economic and legal risks for both parties which must not be under-estimated and cannot be eliminated by the introduction of a default clause, whose applicability and indisputable nature have yet to be demonstrated.

B) Proportionality[6]

The adoption of network codes by the Commission shall constitute a measure designed to amend non-essential elements of the Gas Regulation by supplementing it and shall be adopted in accordance with the regulatory procedure with scrutiny as set out in Commission Decision 1999/468/EC.
Under the regulatory procedure with scrutiny, in essence, the Council or the Parliament may oppose the adoption of draft measures by the Commission justifying their opposition by indicating that the draft measures proposed by the Commission exceed the implementing powers provided for in the basic instrument or that the draft measures are not compatible with the aim or the content of the basic instrument or do not respect the principles of subsidiarity or **proportionality**.

A limitation of trade on the border which would be executed without legal basis within European energy legislation (in particular the Gas Regulation) could lead to a disproportionate intervention into contractual freedom. The freedom of contract is a fundamental right which is recognized since many years in the European Court of Justice case law. This freedom protects the creation of contracts by the contract parties. In its explanations relating to the Charter of Fundamental rights of the European Union (EU CFR), the Praesidium of the Convention which drafted the Charter has based the freedom to conduct a business, stipulated in Article 16 EU CFR, on the case law related to the freedom of contract. Furthermore, measures concerning contractual rights have to comply with the right to property according to Article 17 EU CFR. In addition, such measures have to respect the principle of the protection of legitimate expectations. On this basis, future contracts and even more contracts which have already been concluded are protected by the fundamental rights.

While it is a fundamental right, the right to conduct business is not absolute either in the national law of the Member States or in the Community legal order.

Restrictions may be placed on the freedom to pursue an economic activity provided that they are required in order to meet objectives of general interest pursued by the Community and that they do not constitute a disproportionate and intolerable interference which encroaches on the very substance of the right guaranteed.[7]

Proportionality is a general principle of Community law, enshrined in Article 5 EC Treaty and in the Protocol on the application of the principles of subsidiarity and proportionality annexed to the Amsterdam Treaty. This means that an act of the Community must be proportionate to the objective it seeks to attain. According to the Court jurisprudence, to decide whether an act is proportionate requires examining whether the measure is suitable to achieve the desired end, whether it is necessary in the sense that there are no other options available which are less restrictive, and whether it imposes a burden that is excessive in relation to the objective sought.

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[6] The arguments developed under the points on Proportionality (B) and Procedure (C) will also be valid and important for the analysis of other framework guidelines in the future.

[7] Case 265/87 Schräder v Hauptzollamt Gronau [1989] ECR 2237, paragraph 15.

Measures limiting the exercise of the right of freedom to contract/freedom to conduct a business must respect the principle of proportionality. The ACER draft Framework Guideline without choice between bundled and non-bundled services does not appear to comply with this standard. In particular, also given the fact that ERGEG recognizes that a majority of participants to the market consultation wishes to have the choice between bundled products and separate entry/exit products at interconnection points, it is questionable whether the principle of proportionality has been respected.This is not just a minor technical issue for market participants because ERGEG's concept, if adopted, could influence gas transportation contracts as well as gas import contracts on account of the requirement to redefine at least the delivery points under those contracts.

The rationale used by ERGEG in favor of the proposed introduction of bundled capacity products to the exclusion of other capacity products can be summarized as follows: The objective of the FG is to harmonize capacity allocation mechanisms within the EU. The Third Energy Package requires the implementation of entry/exit systems which implies the possibility to book entry and exit capacities separately. It must also be possible to trade gas within one entry/exit system. In order to achieve this and to increase liquidity by concentrating it at virtual trading points, obligatory bundling of exit and entry capacities is necessary.

It appears clearly that the objectives set out in the Third Energy Package can be achieved without mandatory bundling of capacities but that for reasons of revised market design (see also discussions on Gas Market Target Model), ERGEG has determined that all gas deliveries/all trading must take place at a limited number of virtual trading points in the EU. What is provided in the Third Energy Package can be achieved without bundled products but ERGEG wants to go further.

From a traditional proportionality perspective, the questions that need to be answered with respect to the forced introduction of bundled products and the abolishment of flange trading are the following:

- Is the measure suitable to achieve the desired end?
- Is the measure necessary in the sense that there are no other options available which are less restrictive?
- Does the measure impose a burden that is excessive in relation to the objective sought?

When answering the above questions, it is very important to distinguish between the goals explicitly identified in the Third Energy Package and the additional goals which ERGEG is pursuing in terms of market design.

We provide the first elements of an answer to each of the questions:

Is the measure suitable to achieve the desired end?
No, except for the very short term (day-ahead, week-ahead) where it may lower transaction costs. There is no evidence that liquidity/churn ratio would increase for longer term volumes because delivered "at hub". On the contrary, if all deliveries must take place at a limited number of hubs, gas producers could adopt a "produce or buy" strategy[8] that could reduce liquidity. Therefore, ACER should perform a real impact assessment of the exclusive use of bundled products on liquidity, as it has promised it will do. If the implicit goal of the promotion of the exclusive and mandatory use of bundled products, against the needs expressed by a majority of stakeholders, is to foster a move away from oil-indexation in long-term contracts (in favour of gas-to-gas competition), one could point out that :

[8] The produce-or-buy decision is the act of making a strategic choice between producing an item internally (in-house) or buying it externally (from an outside supplier).

- This would be contradictory to the official position according to which this is a pure capacity related matter, without intended impact on other parts of long-term contracts;
- Changes to the indexation mechanism in long term contracts should be the result of market forces (market players negotiating new supply contracts or reviewing existing ones) and not of market design choices imposed without legal basis on market players by the Commission, ACER and ENTSOG.

Is the measure necessary in the sense that there are no other options available which are less restrictive?
No, as there is at least one alternative product (a so-called combined capacity product) that would bring the same advantages as the bundled product, whilst respecting contractual freedom and the right to conduct business. A combined product is similar to a bundled product in terms of simplicity of network access, capacity alignment (when a capacity booking is made for a transaction at a cross-border interconnection point, there is automatically an allocation for the same capacity on each side of the interconnection point but the possibility remains to have two different nominations and/or two different parties on each side) and reduction of transaction costs. Moreover, combined capacity products are used in the market today and have proven to be a pragmatic method to integrate markets. On the contrary, there has recently been a lack of market interest in the joint commercialization of bundled products by Fluxys (the Belgian TSO) and GRTgaz (the French TSO).

Does the measure impose a burden that is excessive in relation to the objective sought?
Yes, because in the presence of a less restrictive alternative (see answer to previous question), the forced introduction of bundled products would trigger changes to and risky and possibly unbalanced renegotiations of long-term gas supply contracts. Indeed, the supply point is an element that is difficult to separate from other essential clauses of a long-term contract and its determination is an integral part of the overall negotiations between a purchaser and its supplier.

C) Procedural aspects

ERGEG had no formal capacity to assume the role of the Agency and therefore did not have the competence to establish non-binding framework guidelines as a basis for the development of network codes. This task is given to the Agency under Article 6(4), third subparagraph of the new Regulation (EC) 713/2009 (*Agency Regulation*) and applies as from 3 March 2011 (see art. 35 (2) of the Agency Regulation). The Agency and ENTSOG now have to apply the provisions of Article 6 of the Gas Regulation

The draft Framework Guidelines have been issued for consultation of ENTSOG and other relevant stakeholders. The consultation period must be minimum two months.

However, through a letter of 27 January 2011[(9)] the European Commission has invited ENTSOG to already start preparing the network code to implement the draft Framework Guidelines under consultation. In the same letter, the Commission indicated that the network code must be submitted at the latest on 27 January 2012.

It thus appears that the intention of the Commission and ACER is to run the formal consultation process on this draft Framework Guideline as a pure formality. This is problematic at least for Article 2.4.2 of the draft Framework Guideline because ERGEG has not consulted on this article earlier in the process and no feedback from ENTSOG and relevant stakeholders has been received on this article. It is our view that the provisions of Article 6 of the Gas Regulation must be applied correctly and that ENTSOG should not be asked to develop a

[(9)] Letter from Mr. Hilbrecht to the ENTSOG President.

network code before the consultation on the Framework Guideline, duly taking into account comments received from the market, has been completed.