

Minutes of Meeting

CAM Network Code: Sunset Clause Workshop, 6th Oct 2011

ENTSOG Offices, Avenue de Cortenbergh 100, Brussels,

10.30-16.00

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1. Introduction and background to the Sunset Clause

ENTSOG introduced the session and outlined the background to the Sunset Clause. It was highlighted that, while ENTSOG acknowledges and shares the concerns of the market regarding this issue, it is required by the Framework Guideline to include such a clause in the NC. ENTSOG hoped through this workshop to inform stakeholders regarding the issues that must be dealt with in developing the clause, and to stimulate debate.

2. Update on ENTSOG work on Sunset Clause text

ENTSOG outlined the work currently being done internally to develop the Sunset Clause and highlighted some of the key questions that remained to be answered, including the feasibility of bundling the contracted capacity, treatment of the remaining unbundled capacity, contractual translation, proportionality, and roles of the TSOs and NRAs.

One network user noted that ACER's legal impact assessment on the Sunset Clause had concluded that a two contract model for bundled capacity was not feasible and asked what ENTSOG was doing in response to this. ENTSOG replied that its current thinking was that the IA seems to not consider a number of factors (eg liability, tax, revenue, jurisdiction,...) to confirm the feasibility unless the construction of the so called single contract only refers to the concept of coordination to sell bundled products, which might be then translated through various related agreements.

Another network user asked when information would be provided on the firmness of the bundled product. ENTSOG replied that this was an issue for individual TSOs to handle and would not be within the scope of the CAM network code.

3. Sunset Clause and Default Rule - simulation

Participants carried out a simulation in which a number of players at an IP attempted to reach agreement on the split of bundled capacity, and were given a default rule that would apply if they failed to do so. In order to facilitate the simulation certain simplifying assumptions were made (e.g. considering only one period of time, pricing was deemed to be irrelevant, no issues with confidentiality of information).

4. Conclusions of simulation and discussion

ENTSOG explained the factors that had been considered in developing the options for the default rule to be presented at this workshop. ENTSOG considers that an effective default rule must take the form of a mathematical formula, in order to avoid confusion and dispute. This rule must respect proportionality and non-discrimination. On this basis ENTSOG had identified three broad options for the capacity that is to be bundled:

- "Minimum default rule": capacity on the less booked side of the IP determines the amount to be bundled; remaining unbundled contracts are cancelled.

- “Maximum default rule”: capacity on the more booked side of the IP determines the amount to be bundled; shippers are allocated additional capacity to make up the difference in bookings.
- “Partially unbundled default rule”: capacity on the less booked side of the IP determines the amount to be bundled; remaining contracts stay unbundled.

ENTSOG demonstrated the allocations that would result in the simulation scenario under each of the possible default rules. For the maximum default rule, the results may vary depending on whether or not a point is congested, which determines whether the additional capacity is firm or interruptible in character.

The spokespersons from each group were asked to present the outcomes of their negotiations and to comment on the process of trying to reach agreement.

Group 1 – minimum default rule

- Agreement was reached between the shippers but not with the TSOs. Therefore the default rule would possibly apply.
- Two shippers reached agreement quickly while it was more difficult to reach agreement with the third shipper. The group therefore questioned whether it would be possible to respect such ‘partial agreements’, with any default rule applying only to capacity in relation to which no agreement had been reached.
- The TSO on the side of the IP with higher bookings did not accept any situation in which his capacity bookings would be reduced.
- The group noted that:
 - Under the minimum rule, only 90 units of capacity would be available for bundling so some shippers would not get what they needed to serve customers.
 - In practice, underlying supply contracts would in fact be affected, so the negotiations would be more challenging.
 - Agreement would be easier where no congestion existed but in this case, the benefits of mandatory bundling were questionable.
 - The result of mandatory bundling was a reduction in shippers’ flexibility, as all shippers had previously been happy with the unbundled situation.

Group 2a – maximum default rule with capacity constraints (congestion on one side of IP)

- The contracting parties did not reach agreement so the default rule was applied.
- The group did not work hard to reach agreement as a number of obstacles were quickly

identified that would make this process very difficult, including the need for major renegotiations of supply contracts, legal issues and commercial risks.

- The group noted that:
 - Under the maximum rule, 10 additional units of capacity would need to be sold on the less booked side of the border.
 - There was an outstanding question of how the additional 10 units would be created. Overselling would raise issues regarding the firmness of the capacity and also tariff issues, while investment would have a long lead time.
 - This option raises discrimination issues as the 10 additional units would be given to the incumbent not allocated via auctions. What if another network user wanted to buy these units?
 - Shippers were unhappy with the application of any default rule and questioned the legality of taking capacity contracts away from them.

Group 2b – maximum default rule with no capacity constraints

- The contracting parties did not reach agreement so the default rule was applied.
- Two of the shippers agreed on the split of bundled capacity but the third did not. As with Group 1, the group questioned whether any default rule should apply to all capacity or just capacity on which no bundling agreement could be reached.
- No shipper was willing to purchase the additional 10 units of capacity on the side with lower bookings. The group questioned whether all shippers should be required to share this ‘burden’ or whether the TSO should be forced to take back unbundled capacity.
- The group noted that
 - In practice, commodity contracts would change as a result of the sunset clause and that this would alter the nature of the negotiations
 - The choice of default rule would impact shippers’ strategies.
 - Although commodity pricing was deemed to be irrelevant in the assumptions to the simulations it would in practice strongly influence development and process of the contractual negotiations.
 - The application of the default rule was felt to be discriminatory to the shipper holding 100 (exit-)capacity.

Group 3 – partially unbundled default rule

- The contracting parties did not reach agreement so the default rule was applied.
- Two of the shippers agreed on the split of bundled capacity but the third did not, as it did not want to enter the other market. In general, shippers were focused on staying within their original markets.
- The TSOs were largely excluded from the negotiations and those playing the role of shippers acknowledged that this may have hampered the process
- The group noted that
 - The value of unbundled units was questionable in a 'bundled world'
 - Within a small group as in this simulation, all players could infer each others' commercial drivers. In real life it would be easier for shippers to conceal their interests.
 - The choice of default rule would impact shippers' strategies.

Comments on the default rule options

- It was noted that the termination of booked capacity was a major disadvantage of the 'minimum default rule' option. This could lead to a significant increase in tariffs in order to recover revenue from remaining contracts. The greater the mismatch in capacity, the more pronounced this issue would become.
- A concern with the maximum rule was the question of how the additional capacity needed would be generated. All potential options have significant disadvantages. One network user noted that under the 'maximum default rule' option, the extra units might be more expensive if there was some buyback risk associated with them. It also depends on the incentive regime within a country how much capacity could be made available in addition (vs. the risk for the TSO).
- It is possible that a maximum default rule could also go against the Framework Guideline, Third Package and CMP Guidelines, and be discriminatory, by allocating capacity outside an auction process.
- The greater the mismatch in capacity, the more pronounced these issues with the maximum rule would become.
- Users noted that a partially unbundled option would not be acceptable if all nominations had to be from hub-to-hub and no flange trading were possible, as the unbundled capacity would be valueless. ENTSOG noted that under the Framework Guideline interruptible capacity could still be sold and traded unbundled.
- A network user suggested an alternative option in which the bundled capacity would (in the example) first be split 45:45 between the shippers originally operating on the two sides of the IP, and would then be split 22.5:22.5 between the two shippers operating on the entry side due to their equal bookings. The question of how to treat the remaining 10 unbundled units would remain. ENTSOG thanked participants for the alternative suggestion and agreed to give

consideration to this option. ENTSOG noted that it remained open to alternative proposals for the default rule.

- One network user felt that the minimum rule was unacceptable and that the partially unbundled rule could be a compromise.
- ENTSOG noted that there was some uncertainty regarding the meaning of a 'proportional' split of bundled capacity and that any guidance from NRAs/ACER would be welcome. ACER said that it could be argued that any of the described alternatives was proportional, and suggested that simplicity could be an important factor to consider.

Comments on the negotiations

- It was noted that in practice capacity bookings would not be known, making negotiations more difficult. However, it was felt that any requirement for shippers to publish their business strategy would be severely detrimental.
- Participants discussed potential competition law concerns regarding the co-operation and information sharing that would be required in order to begin negotiations. One network user felt that shippers sharing their strategies could be counter to competition law, while another believed that in practice negotiations would be bilateral so this concern would not arise.
- Users tried to understand the others' strategy
- Users want to stick to their strategy
 - Otherwise they would have split their contracts before (secondary)
 - Users have contractual obligations towards their customers (commodity)
 - They have payment obligations towards the TSOs
- TSO has interest to keep or maximise the booking level
- All users were happy before the start of the negotiation, otherwise they would have already traded their capacity (bundle) on a secondary basis
- Stakeholders noted that after bundling, their flexibility concerning their booked capacity is reduced. Users also noted that they would not be able to nominate the full capacity that they had initially contracted.
- Negotiation is more difficult because the negotiation depends on the trading options and potential activities users could have in markets. It was remarked that with the same capacity somewhere else the same result could not be reached. Stakeholders consider the obligation to be active at the other hub clearly as a commercial risk instead of a commercial opportunity, especially when they do not have any interest in entering into another market.
- As a result from any Default Rule, the shippers' commodity contracts would have to be re-negotiated additionally. The participants' aspiration that the supply contracts may remain unchanged when applying a default rule did not prove to be true.
- The role and attitude of NRAs during the negotiation (mediation and possible sanctions) is unclear and may treat or interact with shippers on one side differently than on the other.
- Stakeholders noted that suppliers will have an advantage in the negotiation as they generally have the better position – discrimination against the others considered.

- The application of the Default Rule or a negotiation outcome may be partially acceptable for at least two parties – but no case resulted for all being satisfied with none of the options.
 - No negotiation round was fully successful but would be much more difficult in reality, considering the extremely simplified simulation. In practise there would be many more parties, users have strict obligations towards their customers, contract durations are different, U-turns and wheeling are applied, different numbers of TSOs can be on one side of the border or a shipper (subsidiary) may have capacity on both border sides already.
 - Default rule would have always been applied

The issue of partial agreements was discussed:

- An agreement seems easily possible between two parties (partial agreement). When more players are involved the situation changes and they would feel disadvantaged compared to the two that found an agreement.
- ENTSOG noted that the question of whether to respect ‘partial agreements’ was an outstanding question to be answered when drafting the sunset clause.
- One network user noted that if capacity on two sides of an IP was held by two affiliate companies (a producer and a marketer), they would probably be able to reach agreement easily on its split. Enforcement of a default rule against all parties would mean that this agreement was not respected and the two affiliates could end up with different amounts from their original bookings despite their willingness to agree.
- ENTSOG queried whether there was a legal risk in allowing partial agreement of capacity splitting – as those not satisfied with the settlement could take legal action against those who were.

Comments on the sunset clause generally

- There had been a decision not to implement the sunset clause in Germany. This was thought to be due to legal concerns. It was pointed out that the same concerns would be valid at an EU level.

5. Conclusions and additional considerations

The majority of participants were against the application of the Sunset Clause. Bundling of existing capacity raises significant legal, tax and regulatory concerns and poses a considerable commercial risk to network operators and users.

The simulation game illustrated the difficulties that may arise in negotiations aiming to split existing capacity contracts. Even with the simplified scenario employed in the game no negotiation was fully successful. Due to these difficulties it seems very likely that it will be necessary to often apply a default rule.

None of the default rule options discussed were fully satisfactory for users and it will be necessary to choose the ‘least bad’ option. There was some feeling among workshop participants that a variant of

the 'partially unbundled' approach could be an appropriate way forward. Subject to internal approval, ENTSOG intends to consult shortly on this topic in order to gain further views on the alternatives.

ENTSOG thanked participants for an interesting and productive workshop.