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Survey on the development of the applicable capacity allocation mechanism in the Balticconnector interconnection point

1 Background

In the Energy Authority's confirmation decision "Confirmation of the applicable capacity allocation mechanism in the Balticconnector interconnection point" (1950/533/2020), the Energy Authority obliges Gasgrid Finland Oy to submit to the Energy Authority by 30 April 2021 information about how the applicable capacity allocation mechanism in the Balticconnector interconnection point can be developed so that it better responds to capacity demand taking into account legislative requirements.

In this survey, Gasgrid Finland Oy proposes how the capacity allocation mechanism in the Balticconnector interconnection point could be developed for the future. When making the proposal, Gasgrid Finland Oy has been gathering feedback from the market participants and the Estonian Transmission System Operator Elering AS concerning the capacity allocation mechanism.

2 Gasgrid Finland proposes continuing the existing capacity allocation model in 2022

Gasgrid Finland proposes continuing the existing capacity allocation model in 2022. Capacity shall be allocated implicitly on the basis of a) shippers' confirmed nominations b) cross-border trades on gas exchange(s) in part of day-ahead and within-day products.

At the time of preparing this survey, Gasgrid Finland does not see any significant changes to the current capacity allocation mechanism. Gasgrid Finland proposes that the terms of the current capacity allocation mechanism be assessed in detail in the second half of 2021, when the Energy Authority has issued an opinion on the capacity allocation mechanism applicable in Balticconnector. The rationales for Gasgrid Finland's proposal for a capacity allocation mechanism in Balticconnector are that:

- The existing capacity allocation model enables deeper market integration – a regional tariff zone, where there are no entry or exit capacity charges between countries in the tariff zone. The ITC model enabling the regional tariff zone reduces the competitive threshold for trading between the countries because capacity products between the countries have no price. Zero-priced capacity at interconnection points within the tariff zone allows gas energy to be imported from where it is cheapest. Switching to capacity auctions at borders would easily create a price for transmission products between countries even if there were no physical congestion between the countries. This would have increasing impact on Finnish end consumers' prices and weaken the effectiveness of the regional tariff zone.

- Article 3(6) of the Capacity Network Code 2017/459 defines the implicit capacity allocation method as follows: implicit allocation method means a capacity allocation method where, possibly by means of an auction, both transmission capacity and a corresponding quantity of gas are allocated at the same time. In Balticconnector, the implicit capacity allocation mechanism is based on confirmed nominations. The market participants' nominations are announcements according to which the market participants request Gasgrid Finland to transport the amount of gas. At the same time when Gasgrid Finland confirms the nominations made by market participants, a corresponding amount of transmission capacity will be allocated to market participants. An implicit capacity allocation mechanism shall also apply to capacity allocated through the Gas Exchange(s). At the same time as cross-border trade over Balticconnector is concluded through the exchange(s), a corresponding amount of Balticconnector's capacity is allocated to complete the transaction. According to Gasgrid Finland's interpretation, both the capacity allocation mechanism based on confirmed nominations and through the exchange(s) complies with the capacity network code, because in both cases, both transmission capacity and the amount of gas corresponding to the transmission capacity are allocated to market participants at the same time.
- Puiatu compressor station commissioning was 29.04.2021. Also, Paldiski compressor station is likely to be commissioned during 2021. A comprehensive understanding of likelihood of congestion in Balticconnector at times of higher capacity will not be available until the 2021-2022 heating season. Congestion is unlikely to occur during the summer months. This means any decision to switch to auctions should not be made before seeing whether the capacity increase will affect congestion during the winter.
- Based on feedback from market participants (webinars, direct feedback to Gasgrid), the existing capacity allocation model would work better than an auction mechanism for market participants. Even though neither capacity allocation mechanism is perfect, the auction mechanism is largely considered to be the worse alternative compared to the existing procedure. Market participants have adjusted to using the existing mechanism and the auction procedure would require new types of procurement procedures and commitment to auctions scheduled to take place at certain times on certain days.
- The application of an auction mechanism in Balticconnector would result in a price being set for capacity between Finland and Estonia within the regional tariff zone. In accordance with the confirmed reference price methodology, postage stamp methodology, the reference prices for all entry and exit capacities should be the same at all entry and exit points. The reference price, i.e. the price of the yearly capacity product, should be used as the auction reserve price, unless discounts can be applied in accordance with the Article 9 (2) of the Regulation 2017/460 (Tariff Network Code, TAR NC).
- Gasgrid Finland and Baltic Transmission System Operators (TSOs) are continuing discussions to extend the ITC model to Lithuania. Moving forward, switching to a common balancing region with the Baltic states may make the auction platform redundant.

- The existing capacity allocation model allows for flexible cross-market trading in GET Baltic, because capacity products are zero priced. If capacity auctions were to be put in place, this implies a price would also need to be imposed on capacity products allocated within GET Baltic because otherwise market participants who have made bilateral gas supply contracts would be in a different position to those who procure their short-term capacity products implicitly through trades executed in GET Baltic. Therefore, the current implicit capacity allocation through GET Baltic would not be possible with the current model.
- If market integration progresses towards a common balancing region, the TSOs must plan physical balancing in the region so as to be able to ensure security of supply also in the event of various risk scenarios materialising. An example of a risk scenario is where Balticconnector can continue to be physically congested if market participants want to import more gas from the Baltics to Finland than the volume that Balticconnector can physically transmit. Regulation 2017/459 on a network code on capacity is applied in the interconnection point in the joint tariff region and this imposes detailed auction requirements on the auction calendar and auction principles. Balticconnector would not be a commercial interconnection point in the same way in a common balancing region. The capacity allocation mechanism could therefore be applied only as necessary, i.e. in winter, when capacity is more likely to be inadequate.
- Also, Elering supports continuing the existing capacity allocation mechanism in 2022.

3 Introduction of the auction mechanism would be possible on 1 July 2022 at the earliest if it is necessary to switch to auctions

Introduction of capacity auctions in Balticconnector would be possible from 1 July 2022 at the earliest. The capacity auction would be held for the first time on July 1, 2022 in accordance with the capacity network code (CAM NC) for a yearly product with a duration of October 1, 2022 to September 30, 2023. After that, the auctions are carried out according to the auction schedule in accordance with the capacity network code. However, Gasgrid proposes not to introduce the auction methodology before 1 October 2022 meaning that the first auctions would be organized for quarterly capacity for the period of 1.1.-31.3.2023. This would give the TSOs enough time to monitor the capacity adequacy during the 2021-2022 winter before a start is made on ramping up any auction platform. The proposal is based on the following:

- Introduction of the auction mechanism would require changes in market rules and TSOs' information systems and this would take at least 6 months to do. Besides this, the market rules must be confirmed in parallel in both Finland and Estonia-Latvia.
- The auction platform or associated service must basically be put out to tender (2-3 months) and time (2-3 months) must be allowed for the introduction of the auction platform.
- Market participants must have time to prepare for the introduction of auctions in their own operations, also including long-term gas procurement and sales contracts

and information systems. At least 6 months must be allowed for preparation once the market rules have been confirmed.

- Introduction of auctions would require changes to GET Baltic's implicit capacity allocation mechanism. Even though TSOs set the floor price of capacity products to be auctioned at zero, a price will be created for them in auctions if demand for capacity products exceeds availability. Capacity is now allocated free of charge in GET Baltic, but use of the auction mechanism would distort competition if a price were created for the same capacity product in auctions but not in GET Baltic. Planning and rules are required for the capacity allocated to GET Baltic and the determination of its price. This would take an estimated 2 months in conjunction with when the market rules are updated in their entirety. In addition, the change may require updates to GET Baltic's systems.
- The capacity auction in Balticconnector changes the applicable principle in a regional tariff zone, according to which there is no tariff at the connection points between the countries belonging to the common tariff area. Revenue from capacity auctions would affect the ITC mechanism between TSOs. The relevant agreement would need to be updated accordingly. Depending on the potential impacts on tariffs, this work would require 2-3 months up to one year in parallel with the changes in market rules, if auction mechanism has impact on tariffs in FINESTLAT market area due to country-specific tariff approval and public consultation processes.

3.1 Estimated effects of introducing auctions

Auctions are likely to have the following effects on market activities:

- A market price spread would be created between Finland and Estonia-Latvia as a result of the price formed for capacity in auctions and the application of the implicit capacity allocation applied to GET Baltic.
- The development, licence and maintenance costs of the capacity auction platform would be passed on to capacity product prices across the ITC region. On the other hand, the revenue from auctions would ease the upward pressure on prices.
- TSOs, GET Baltic and market participants will incur costs as a result of the change in the capacity network mechanism because of IT system development needs, rule changes, contract changes and orientation needs.
- Market participants will be able to procure their long- and short-term capacity products at auctions and thus hedge the transmission volumes required by their gas supply contracts beforehand. This would add the predictability of market function and reduce the need for risk premiums in gas supply contracts. On the other hand, if a common balancing region were to be formed, an auction platform might only be needed for a short time.

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