
External report on Elering's proposed gas transmission tariff methodology

Commissioned by Elering



Publication date

05.06.2026

About the project

Project number: ELE-26-01

Project title: Gas Tariff Stakeholder Report

Client: Elering

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Report title: External report on Elering's proposed gas transmission tariff methodology

Report number: 2026-10

ISBN-number: 978-82-8368-182-6

Availability: Public

Project description

Estonia's current volume-based reference price methodology for domestic exit customers poses two main challenges: revenue uncertainty and the risk of cross-subsidisation. To address these challenges, Elering proposes to transition to a capacity-based postage stamp exit tariff, akin to a capacity subscription. This report describes the challenges present under the current methodology and how they are addressed under Elering's proposed tariff methodology.

Project team**Team leader**

Viktor Moulin

viktor.moulin@thema.no

+47 954 17 071

Contributors

Julian Hentschel

About THEMA Consulting Group

Mail address: Øvre Vollgate 6

Visiting address: Nedre Vollgate 9

0158 Oslo, Norway

Organisation number: NO 895 144 932

www.thema.no

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1 Introduction

1.1. Background

As Estonia's TSO, Elering operates approximately 973 km of pipelines to transport gas on behalf of Estonian customers. Elering's costs are covered through tariffs on entry- and exit points in the network.

Elering has identified several challenges with the current tariff methodology used for domestic exit tariffs for gas transmission. In preparation for the next regulatory tariff period, Elering proposes revising the tariff methodology to address these challenges and ensure a more stable and cost-reflective tariff framework.

The existing domestic exit tariff is a commodity-based postage-stamp tariff. Under this approach, customers are charged a uniform tariff rate multiplied by their gas consumption volumes, and the required unit rate is determined using forecasted aggregate consumption.

As a result, all customers face the same per-unit tariff regardless of their location on the network or the scale and pattern of their gas usage.

Elering's costs, on the other hand, are largely fixed independently of the gas volumes transported.

The current tariff methodology results in two main challenges:

1. **Revenue uncertainty:** The domestic exit tariff is calculated using forecasted gas volumes, but actual revenues depend on realised consumption. This creates uncertainty in revenue recovery and leads to a potential mismatch between Elering's cost base and its tariff income.

2. **Cross-subsidisation between customers:** Customers are charged according to consumption volumes rather than the costs required to serve them. Tariffs on occasional customers do not cover the associated costs for Elering, leading to cross-subsidisation between customer groups.

To address these challenges, Elering proposes transitioning from a volume-based exit tariff to a tariff based on each customer's contracted capacity.

1.2. Scope

This report focuses exclusively on the tariff methodology for domestic exit customers in the Estonian gas transmission system. The FINESTLAT inter-TSO compensation (ITC) mechanism defines tariffs for all entry points into the FINESTLAT region.

The entry-tariff revenue that results from the FINESTLAT ITC influences how much revenue must be raised through domestic exit tariffs. However, the design principles used to set domestic exit tariffs are not affected by the FINESTLAT framework. This report therefore does not examine the ITC system used for entry tariffs in further detail.

1.3. Structure

This report describes how the proposed methodology addresses the two challenges for market participants under the current methodology. Chapter 2 describes the two challenges and their consequences for the market participants. Chapter 3 describes the tariff methodology proposed by Elering. Chapter 4 then analyses how the methodology addresses the challenges. Finally, we present our conclusions in Chapter 5.

2 Description of challenges presented by the current system

2.1. Uncertain revenue

Elering operates under an allowed-revenue framework in which tariff income is intended to recover efficiently incurred costs together with a regulated rate of return. The majority of Elering's costs are fixed and largely independent of short-term variations in network utilisation.

Under the current methodology, the domestic exit tariff is determined based on forecasted gas volumes for the upcoming period. Actual gas consumption, however, may deviate from these forecasts due to factors such as temperature fluctuations or changes in market conditions. As a result, actual tariff revenue may be higher or lower than expected, creating a risk of over- or under-recovery.

Persistent over-recovery implies that customers systematically pay more than is necessary to cover the cost of the service. Since Elering is not permitted to earn above its allowed revenue, such outcomes are inefficient and undesirable. Conversely, persistent under-recovery may require corrective measures to restore financial balance, potentially including tariff adjustments in subsequent periods. Such adjustments can be abrupt and may undermine predictability for market participants.

Both over- and under-recovery contribute to tariff instability and create uncertainty for market participants. This uncertainty ultimately represents a risk for Elering that is passed on to customers through future tariff adjustments. In a

declining-volume environment, this risk becomes increasingly difficult to manage.

2.2. Cross-subsidisation between market participants

Elering is contractually obliged to maintain a specified level of capacity for each customer, and the associated costs are incurred regardless of the customer's actual utilisation of the network. As a result, Elering's cost base is largely independent of the volumes of gas transported. This reflects the capital-intensive nature of gas transmission infrastructure.

Under the current methodology, tariff revenues depend on gas volumes rather than on the costs required to serve each customer. Consequently, the cost of maintaining capacity at a

given network point may differ significantly from the tariff revenue from the customers using that capacity.

For customers who only occasionally utilise the gas network, Elering must maintain the necessary infrastructure even if their annual gas demand is zero. These customers, therefore, contribute little or nothing to the recovery of fixed network costs. Such customers nonetheless retain the option value of being connected to the system.

Since total costs must be recovered regardless, customers with more stable or higher gas consumption effectively make up the shortfall by paying higher tariffs. In practice, the current methodology therefore results in cross-subsidisation from customers with stable demand to those with occasional or highly variable demand. This undermines cost-reflectivity and may distort consumption or investment decisions.

Consequences of the current methodology for customers

The current methodology implies the following customer impacts:

Unpredictable tariffs

Volatility in aggregate consumption volumes leads to over and under-recovery of costs. This increases the risks that tariff levels need to be significantly revised.

Cross-subsidisation

Poor alignment between the tariff structure and costs-to-serve implies that customers with high capacity utilisation effectively subsidise the connection of customers with low capacity utilisation. This is a burden to customers with high capacity utilisation and a corresponding benefit to those with low capacity utilisation.

3 Description of the proposed methodology

To address the challenges associated with revenue volatility under the current tariff structure, Elering proposes a shift towards a more stable and predictable charging base. The new tariff methodology is built on a capacity-based approach, where charges are determined by each customer's contracted capacity rather than by consumption. The tariff will follow a postage-stamp model, meaning that all customers face the same tariff rate applied to their contracted capacity irrespective of their location on the network or pattern of gas usage.

Under the proposed methodology, each customer's contracted capacity will remain valid indefinitely until the customer requests a change. Customers may request a reduction of their

contracted capacity at any time, with the reduced capacity level and tariff taking effect from the beginning of the calendar month following the amendment of the contract. Requests to increase contracted capacity will be treated as new connections to the gas network and therefore require a new contract.

To discourage strategic undersubscription, Elering proposes that customers who exceed their contracted capacity will be charged based on their actual peak capacity for 36 months following the peak.

If reductions in contracted capacity across the customer base result in a situation in which Elering cannot recover its allowed revenue, Elering reserves the right to initiate a tariff revision.

4 How the proposed methodology addresses the challenges

4.1. Improved revenue stability and predictability

The proposed capacity-based tariff methodology directly addresses the revenue uncertainty inherent in the current volume-based system. Under the revised approach, the charging base shifts from forecasted gas volumes to customers' contracted maximum capacity for the tariff period.

Contracted capacity is inherently more stable than annual gas consumption, which can fluctuate substantially due to weather conditions, market developments, or fuel-switching behaviour. By basing tariffs on a more predictable parameter, the methodology reduces the volatility of tariff levels between periods and provides a more predictable and consistent revenue stream for Elering.

Capacity can still be changed within a tariff period, which implies that the risk of a discrepancy between projected and actual revenues remains. This risk could be further reduced by imposing a longer commitment period, but doing so would necessarily entail more rigid capacity contracting arrangements.

The increased predictability provided by the proposed tariff arrangements benefits both Elering and market participants. For Elering, the risk of a material mismatch between allowed revenue and tariff income is reduced. For customers, the resulting tariffs are less likely to vary sharply from year to year, improving planning certainty and reducing exposure to the risk of abrupt tariff adjustments.

Overall, the proposed methodology strengthens the alignment between Elering's cost structure, which is dominated by fixed, capacity-driven costs, and the basis on which tariffs are recovered. This alignment enhances the stability and transparency of the tariff framework.

4.2. Reduced cross-subsidisation between market participants

The proposed methodology also mitigates the cross-subsidisation effects present under the current volume-based tariff. Elering must maintain sufficient network capacity to meet each customer's contracted needs, regardless of how frequently or intensively the customer uses the system. Under the existing methodology, customers with low or highly variable gas demand may contribute little to the recovery of these fixed costs, even though Elering must maintain the infrastructure required to serve them.

By introducing a subscription-based capacity charge, the proposed methodology helps to ensure that all customers contribute to the cost of maintaining the capacity they require. Even customers who use the network only occasionally are incentivised to subscribe to an appropriate level of capacity in order to avoid the penalty regime for exceeding their contracted amount. This methodology helps to bring tariff costs for infrequent users to a level that more accurately reflects their costs to serve.

Adopting of capacity as the charging base reduces the extent to which customers with stable or higher gas consumption subsidise those with infrequent usage. The methodology therefore improves the cost-reflectivity of the tariff structure, ensuring that contributions to network costs more closely correspond to the underlying drivers of those costs.

It should be noted that there remains a risk of cross-subsidisation even under the proposed system if seasonal users routinely adjust their contracted capacities to reduce their tariff costs. To take an extreme example, a customer with seasonal consumption that renegotiated its capacity every month could potentially only pay tariffs for a few months of the year. It is therefore important that the tariff system includes measures to prevent potential tariff avoidance of this type.

Benefits of the proposed methodology for customers

More stable tariffs

The proposed methodology reduces the risk of over- and under-recovery, leading to more stable and predictable tariffs over time. This lowers the likelihood of customers facing periods of overcharging followed by subsequent corrections, thereby improving tariff transparency and predictability for customers.

More cost-reflective charges

Better alignment between tariffs and costs-to-serve implies that what each customer pays is more directly linked to what they get. Customers can therefore rest assured that they are not subsidising other users.

Changing to a capacity booking system would not meaningfully address the challenges and implies an additional cost

Elering could alternatively impose tariffs on the exit capacity booked by shippers, an approach currently applied in Finland. Under this approach, tariffs would be calculated based on forecasted aggregate bookings. Shippers would then be charged based on their actual capacity bookings. To partially account for the mismatch between the length of a capacity booking and the costs to create and maintain the relevant network, a tariff multiplier would be imposed that increases the tariff rate applied to shorter-term capacity bookings. Under this capacity booking tariff structure, the TSO's contracting party would become shippers.

Changing to this tariff structure is unlikely to meaningfully address the challenges faced under the current methodology.

Actual capacity bookings are likely to differ from capacity booking forecasts for the same reasons that actual and forecast volumes differ, such that the risk of over- or under-recovery would remain. Ultimately, this comes back to a question of how predictable the charging base is. Volumes are relatively unpredictable. Contracted capacity is relatively predictable. Capacity bookings are likely to fall somewhere between these two. If short-term capacity booking were pervasive, actual bookings during a tariff period are likely to remain uncertain and driven by weather conditions, market developments, and fuel switching behaviour.

Cross-subsidisation between market participants is also unlikely to be significantly reduced. Customers that rely on the option of capacity availability but do not book capacity would still impose costs but fail to contribute to tariffs. Since the cost implications of different booking durations are negligible, tariff multipliers would need to be increased to levels that effectively made occasional users indifferent between shorter and longer capacity products in order to prevent cross-subsidy. At this point, capacity booking and capacity contracting effectively converge to the same option.

Switching to a capacity booking tariff structure would also require the implementation of a capacity booking system and a switch in the contracting party to shippers. These changes imply a transition cost.

5 Conclusion

Elering currently applies a volume-based domestic exit tariff that does not reflect the cost structure of the Estonian gas transmission system. As outlined, the existing methodology creates two key challenges: revenue uncertainty arising from the reliance on volatile consumption forecasts, and cross-subsidisation between customer groups due to the mismatch between cost drivers and tariff allocation. The proposed capacity-based methodology seeks to address these issues by aligning tariffs more closely with the fixed, capacity-driven nature of Elering's costs.

Risk of revenue uncertainty

The proposed tariff methodology reduces the risk of a mismatch between Elering's allowed revenue and tariff income. Under the current volume-based approach, revenues depend on realised consumption, which can deviate significantly from forecasts due to weather conditions, market developments or fuel-switching behaviour. This exposes Elering to a persistent risk of over- or under-recovery and contributes to tariff instability for customers.

By shifting the charging base to contracted capacity, the proposed methodology relies on a more stable and predictable parameter. Contracted capacity is less sensitive to short-term fluctuations in consumption volumes and therefore provides a more robust basis for cost recovery. While customers retain the

ability to adjust their contracted capacity within a tariff period, the overall volatility of the charging base is reduced relative to the current system. This risk could be further reduced by imposing a longer commitment period, but it would entail more rigid capacity-contracting arrangements.

Capacity bookings represent an alternative charging base that is less volatile than volumes, but still more uncertain than contracted capacity, particularly if short-term bookings are prevalent. As such, a booking-based approach is unlikely to limit the risk of revenue volatility to the same extent as a system based on contracted capacity.

The proposed methodology therefore represents a material improvement in terms of revenue stability and predictability, while still allowing for a degree of flexibility in capacity contracting.

Cross-subsidisation

The proposed methodology also mitigates the cross-subsidisation inherent in the current tariff structure. Given that Elering must maintain network capacity to meet customers' contracted needs irrespective of their actual usage, costs are largely driven by capacity rather than volumes.

Under the existing volume-based tariff, customers with low or highly variable usage contribute relatively little to the recovery

of these fixed costs. The remaining costs must be recovered through higher tariffs. This results in cross-subsidisation from customers with more stable demand.

By introducing a capacity-based charge, the proposed methodology ensures that customers contribute more directly to the cost of maintaining the capacity they require. The presence of a penalty for exceeding contracted capacity helps to incentivise customers to subscribe at levels reflecting their expected needs, thereby reducing the scope for the cross-subsidisation of occasional users.

A tariff system based on short-term capacity bookings would not fully address this issue. Customers would likely continue to rely on the option value of access without consistently contributing to fixed cost recovery. Although booking-based tariffs can be adjusted through multipliers, fully eliminating cross-subsidisation would require these multipliers to approximate the effect of longer-term capacity commitments, thereby converging towards a contracted capacity approach.

The proposed methodology more closely aligns the structure of costs and revenues, thereby reducing the risk of cross-subsidisation

Overall assessment

The proposed capacity-based tariff methodology more effectively addresses both revenue uncertainty and cross-subsidisation than the current volume-based approach or an alternative approach based on capacity bookings. Contracted capacity provides a more predictable charging base than either volumes or short-term bookings, and it aligns more closely with the fixed, capacity-driven nature of Elering's costs.

The proposed methodology therefore offers a more stable, transparent and cost-reflective tariff framework for the Estonian gas transmission system.

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THEMA Consulting Group

Øvre Vollgate 6

0158 Oslo, Norway

www.thema.no

Berlin office

Albrechtstraße 22

10117 Berlin, Germany