ConocoPhillips response to ERGEG Consultation on
Existing Transparency Requirements for Natural Gas

As can be seen from the EU's 2005 gas and electricity market inquiries (below), reliable and timely supply information is integral to a much wider set of fundamental reforms for both electricity and gas that are necessary to further the creation and operation of liberalised, competitive and liquid traded energy markets in Europe.

The presently inconsistent nature of information provision across the EU should also be recognised. We therefore broadly welcome initiatives that seek to improve energy market transparency and to reduce uncertainties which adversely affect future investment in the energy sector and hence security of supply.

Key to the success and usefulness of such initiatives is that they should be both evidence-based and guided by clear objectives. Transparency can serve many different purposes and can serve the interests of different market parties in different ways. Moreover, there is almost always a natural presumption in favour of more and more information provision, but in reality the provisions of Competition Law, the interests of consumers and the practicalities of effective market operation necessitate genuine practical boundaries to this.

As a matter of good regulatory practice clear objectives should be defined and evidence presented of shortcomings in existing arrangements for which improvements may be needed. As currently presented, the consultation questions invite unsubstantiated views from across the gas market and thus risk giving air to potentially disproportionate persuasion by arguments founded purely on the commercial self-interest of individual parties and/or different market sectors, furthered by a belief that there are no practical boundary conditions. If ERGEG's recommendations from this exercise are to be credible, even-handed and even workable then a high threshold for supporting evidence will need to be set and we are concered that any reference to the need for such evidence is missing from these two particular questions.

We note, in particular, the ongoing implementation of the provisions of the EU Third Energy Package and the adoption of the transparency provisions of Regulation 715/2009. Together this legislation will set a new benchmark in disclosure of information on market operation across the EU. The level playing field prescribed by these two important pieces of legislation will drive significant improvements in energy market transparency. But until they are fully implemented, consistently applied and properly enforced across Europe it would be premature, discriminatory and potentially detrimental, to press for additional measures at this time. Indeed, it will be somewhat unrealistic for parties responding to this consultation to point, in any meaningful and quantifiable way, to where improvements are justifiably required whilst Member States are still to fully implement these obligations.

It should also be remembered that this yet-to-be implemented new legislation had, as its genesis, the 2005 EU inquiries into the electricity and gas markets, where the following as found:

- too much market concentration in most national markets;
- a lack of liquidity, preventing successful new entry;
- too little integration between Member States' markets;
- an absence of transparently available market information, leading to distrust in the pricing mechanisms
- an inadequate current level of unbundling between network and supply interests which has negative repercussions on market functioning and investment incentives;
- customers being tied to suppliers through long-term downstream contracts;
- current balancing markets and small balancing zones which favour incumbents

As such it is to be hoped that some 3 three years after these findings the resultant legislation will resolve the identified shortcomings. To our knowledge no Member State national regulatory authority has requested further market information since the 2005 inquiry. Related

to this, attention is drawn to a recent report by Poyry[1] on the GB gas market, arguably the most transparent gas market in Europe, if not internationally. Of all the issues reviewed and recommended for change, no proposals were made in the area of further transparency of the gas value chain other than between GB and Norwegian TSOs.

In this paper ConocoPhillips offers responses to the two questions most relevant to its businesses in the EU.

Is there an area along the gas value chain (production, transmission, LNG, storage, distribution, wholesale market) where in your view additional transparency requirements are needed? Please specify what you miss in your answer.

Yes.

The ERGEG consultation document usefully lists all of the existing legally binding transparency requirements across the EU. They are substantial and to our knowledge have yet to be implemented. This must be done in any consistent manner across the EU. Such information will make a substantial difference to the development of the internal market in natural gas across the EU, signalling where gas is required and the means by which it can reach such markets. We would argue that until such far-reaching requirements have been implemented and proven, it would be far too premature and potentially lead to discriminatory regulation against the countries who's information disclosure practices are more advanced, to embark on yet a further round of data disclosure.

Do you think that further transparency is required for the production (upstream) sector? If your answer is yes, please specify what is missing in your view, and what additional transparency requirements you would want to see? If your answer is no, please explain why.

No.

When there is a discussion on transparency and data disclosure it is important to recognise that such information may relate to only a part of a market. For example, a request for more operational data from upstream would appear to only have benefit to participants in the corresponding operational/balancing markets. It is our understanding that most participants are active in the trading of periods further out such as month ahead where price formation is generally unaffected by the frequent operational issues of the upstream. As such any proposed change in current information disclosure requires a thorough discussion about any benefits accruing to different market segments and the corresponding market participants.

We are aware that discussion on transparency in gas markets follows on from that in electricity. It is understandable, at first glance, that it may be a reasonable supposition that any regime developed for electricity should also apply to gas. However, there are fundamental differences between the two that should be understood and fully considered before any proposals for change can be taken forward.

Unlike the electricity generation market, in which there is an instantaneous requirement to balance supply and demand, gas is balanced over much longer periods, usually daily. Gas production and sales contracts are typically based around a 'Gas Day' concept in which gas is sold on the basis of an end-of-day quantity, and the regime is designed to cope with the within-day production variations that occur in the normal course of events. Daily balancing of the gas market is the preferred option of the European energy regulators.

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1 http://www.gasforum.co.uk/admin/documents/528_GB_Gas_Security_&_Market_Arrangements_v1_0.pdf

The operation of a "gate closure" mechanism in the electricity market means that in the event of an outage at a power station the balancing obligation is removed from the generator and balancing actions are conducted by the TSO. This very important distinction means that whilst the market is aware of the outage, **the generator is not exposed for these particular periods to becoming a distressed purchaser**, thus avoiding distorting the market with price jumps or additional volatility. The market participant suffering the outage simply pays the cash out price for that period.

No parallel arrangement exists in upstream gas production. Thus any requirement to disclose instantaneous production outages would most likely lead to within-day gas price volatility. Moreover, recognising the gas supply flexibility that exists within the normal 24-hour balancing period, such volatility would be driven not by supply/demand fundamentals but rather by speculative positions taken by parties seeking to exploit market reaction. Caution therefore needs to be exercised in responding to further calls for production information disclosure for fear of driving un-necessary wholesale market price volatility, with benefit only for a very narrow set of market participants in the balancing part of the market at the expense of the consumer.

Publicising an outage before a position can be balanced also advertises a short position and reveals a distressed buyer, trying to ensure that the commitment they made to deliver gas to a customer is actually met. The situation is exacerbated when the supply from a field is dedicated to a buyer. Often in such situations, if the buyer's nomination is not met on a day then the subsequent deliveries are discounted in price for the equivalent shortfall volume. As such a buyer knowing that their supplier is in difficulties can nominate maximum deliveries in the hope that such a request is not met and subsequent deliveries are reduced in price. No such situation is believed to exist for electricity.

The knowledge of individual upstream outages will add unnecessary costs to the already significant costs a company faces when production has been cut, and risks a permanent rise in supply costs if field owners are forced to hold additional "insurance" to avoid such an exposure. For example, standby storage (which will increase costs and remove storage availability from the commercial market) or withheld production from other facilities. This may also accelerate early economic termination of older fields where fluctuating production increasingly tends to occur. Producers might also choose to purchase call options which can be exercised in the event of an unforeseen outage. These measures could serve to increase wholesale costs and eventually the costs to consumers. Ultimately such costs could feed through to the development costs of new fields and present a further hurdle to their development, thereby endangering indigenous gas production.

It is essential, therefore, that any outage disclosure rules should specifically permit Production owners, placed in distress by a supply failure, to have a period of time between the failure occurring and the reduction in flow-rate becoming apparent at the system entry point, in which to cover their position (and no more) before disclosure is necessary. Such action represents the best way to avoid unnecessary turbulence in the markets and is in the best interests of the consumers and the wider gas community.

Gas supply is far more elastic than that for electricity. Unlike the electricity market in which each generation unit is discrete and independent, gas production facilities tend to be linked to gas gathering systems, of which there can be several at any given entry point to a Transmission System. The outage of an electricity generation plant is generally noticeable almost immediately by the market, which is able to track electrical frequency on transmission grids. Disclosure of electricity outages therefore represents a confirmation of what is already known. This happens in a very short timescale because of the instantaneous nature of transmission and the co-location of production and supply. Gas production on the other hand can be located long distances from the supply market and it can take a number of days to travel along the transportation pipelines. In the event of an outage at any single production installation, the 24-hour balancing period provides for end of day quantities to be made up in a variety of ways:

- Flows from the same installation at a higher rate later in the day, to 'catch up';

- Using gas in the pipeline (linepack) to manage end of day deliveries;
- Turning up production from another field within the same gas gathering area (this commercial practice is known as 'substitution', where operators tend to hold balance accounts or contracts with other operators to optimise the reliability of gas deliveries);
- Turning up spare production from another field within a company portfolio;
- Using storage capability to meet customer demand.

In contrast to the electricity market, in which the EU is essentially self-sufficient (and most Member States are individually self-sufficient), the EU gas market is increasingly reliant on imports from Russia, Algeria, Norway and global LNG markets. Presently, the disclosure of upstream information from indigenous production would apply to less than 40% of EU gas supplies, and this percentage will decrease as indigenous production declines in the years to come. Thus, an inappropriate disclosure requirement risks putting indigenous production by EU and Norwegian (EEA) producers at a significant disadvantage relative to competing non-EEA producers not subject to such disclosure requirements. Non-EEA producers would clearly stand to benefit from early disclosure of production outage information by EEA producers.

Concluding remarks

ConocoPhillips supports the introduction of appropriate measures to improve energy market transparency and reduce uncertainties which adversely affect future investment in the energy sector. Effective transparency, however, is best ensured through a framework in which information disclosure obligations are established according to the practicalities of market operation and are balanced in the interest of consumers and all other market participants.

In many NW European markets significant usable production information is already provided (free) to the market in real time. Elsewhere, TSOs still have to implement such reporting of information. There needs to be consistent provision of information at all major entry / exit points for all TSOs. When this has become well and uniformly established across the EU, its proper functioning should be independently assessed and verified. Only in the event of manifest failure should any further obligations be contemplated.

It is not appropriate, and it is potentially damaging, to implement arrangements that apply to electricity markets in the upstream gas market because they are fundamentally different in terms of structure, functioning and technical operation.

Indeed, rather than improve the functioning of the gas market, ConocoPhillips is concerned that an inappropriately designed, one-size-fits-all obligation for the disclosure of production information is likely to create unintended and adverse consequences e.g. an increase in volatility of prices across the market that will have impacts for consumers and producers alike.

Furthermore, indigenous production risks being disadvantaged vis-à-vis competing non-EEA sources of supply, particularly in the short-term traded markets. This will introduce additional costs of compliance, put major external suppliers at a competitive advantage and could jeopardise EU security of supply because indigenous sources of supply may attract less investment.

In light of the above, ConocoPhillips supports the implementation and subsequent co-ordination of transparency under EC No. 715/2009 – i.e. harmonisation of information flows across each of the 27 Member States. This will initially become the responsibility of ENTSOG.