

Industry & Regulation

Centrica

24th August 2006

To: ERGEG

By email: gastransit@ergereg.org

Dear Sir, Dear Madam

REF. ERGEG REPORT ON THE TRANSMISSION PRICING (FOR TRANSIT) AND HOW IT INTERACTS WITH ENTRY-EXIT SYSTEMS

I refer to your June publication of the Report on the Transmission Pricing (for Transit) and how it interacts with Entry-Exit Systems (henceforth "the Report"), on which you invited comments from interested parties. On behalf of Centrica, I wish to make the following remarks.

Background

In addition to our activities in our home market of Great Britain, Centrica and its affiliates are also active in the energy markets in Belgium, the Netherlands, Germany, Spain and France, as well as in certain North American markets. Consequently, we support ERGEG's attempts to level the playing field across the EU and encourage greater competition in European gas and electricity markets. Our interest in European gas transmission/transit is primarily focused on North Western Europe, including the UK. In particular, we are currently holders of transportation capacity rights in the IUK pipeline and for transit across Belgium. We are actively exploring further gas transit arrangements in Continental North Western Europe.

We very much welcome this ERGEG initiative, in respect of a key issue for the effective development of regional and the overall EU gas markets. As set out in more detail below, there are a number of issues relating to cross-border gas transportation that need to be addressed in order to ensure an effective and non-discriminatory access regime – including the different conditions which often apply to transit and other forms of gas transportation in the transmission network. The initiative is very timely, in two respects: firstly, the 2005 Gas Transmission Regulation (1775/2005) has recently come into effect from 1 July 2006, and secondly this Report complements the important regional gas market initiatives which ERGEG launched earlier this year.

The current situation

It is important to ensure that ERGEG's recommendations and priorities in this area are grounded in an accurate appraisal of the current situation and the principal barriers to more effective wholesale gas market development.

Looking at the ERGEG Executive Summary we are concerned to ensure that we have a shared expectation and acceptance of the current situation. Looking at the statements made here we would specifically raise the following points:

- The Directive was supposed to abolish the distinction between transit and transport (sic). However, this has not been the case.
- The GTE report referred to tries to validate certain of the current situations and practices. None of this should be used to prevent moves to a common solution over a relatively short period.
- Transit routes are not usually directly competing either with LNG or other pipelines as these developments would not occur unless they were underwritten. They should therefore be seen as complementary.
- Investments, new and old need to be handled in a consistent manner to ensure that the regime is attractive for new investment and is seen as stable for ensuring ongoing interest either by TSOs or others.
- Cost reflectivity versus pancaking needs to be addressed as a fundamental issue not "fudged" because of artificial differences between markets.

The situation we currently face in gas transit differs greatly from one Member State to another – and often differs from the conditions applicable to other gas transportation services offered by TSOs. Without a doubt the conditions in **Great Britain** are the most open and the onshore entry/exit charging regime applies equally to transit and other uses of the transmission network. This is perhaps not surprising, considering that the gas market has been liberalised here for longer than in other Member States. Nonetheless all Member States are required to comply with the same Community legislation and regulation. These are not consistently adhered to and some countries and/or TSOs are not fully compliant.

With respect to the 2003 Gas Directive, the issue of non-compliance was clearly recognised in a number of the EU Commission's infringement letters addressed to

Member States in April this year. We would encourage ERGEG to consider an early review of TSO compliance with the 2005 Gas Transmission Regulation. The position in particular Member States of most interest to us is summarised below.

Although there has been a move in **Germany** towards creating an entry-exit transmission pricing system, the gas market there is characterised by:

- the proposed retention of as many as 19 transportation/balancing zones, operated by a number of TSOs with different access and pricing regimes, with consequent issues of cost “pancaking” where shippers seek to transport gas across several zones;
- widespread legacy transmission/transit arrangements involving point-to-point (distance-related) pricing, often but not always within joint venture pipelines; and
- the proposed retention, even for non-transit transportation, of a traditional “point-to-point” charging option, in parallel with the new entry/exit charging structure.

The position in **Belgium** is particularly complex. A postalised zonal tariff regime applies for inland gas transmission (with at present four zones and three balancing parameters resulting in twelve possible balancing variables), while transit transportation continues to operate on a point-to-point charging basis. This is notwithstanding the fact that the high pressure pipeline network is a single integrated system. Transparency on available capacity and its utilisation is generally poor. Moreover, access is made more complex by the relationship between Fluxys and Distrigaz. In essence:

- Fluxys is the network operator and provider of transmission services within Belgium;
- Distrigaz is the holder of primary transit capacity under most historic arrangements and has been the seller of transit services to third parties; while
- Fluxys is the proposed provider of new transit transportation services resulting from the current open season processes.

The regulatory position in respect of gas transit arrangements is also rather opaque.

Recent investment and regulatory proposals in **France** will simplify gas transmission access by decreasing the number of zones over time, to three. The country already operates a zonal entry-exit system on the transmission networks. However there are still differences in the information made public by the two TSOs about the capacity available at the interface between the two regions. In principle, it appears that the generally applicable charging regime would also apply to any new transit customers. We are not in a position to comment on any historic transit arrangements, but it may well be that different pricing arrangements apply.

In the **Netherlands**, the market is relatively straightforward, in that GTS has operated an entry-exit system since 2003, information transparency is generally good and the overall access regime is more open than in many other markets.

Entry-exit pricing applies to new transit arrangements, as well as to inland gas transportation, and the recent open season held by GTS was also fairly straightforward for participants.

Long term vision & shorter term priorities

As ERGEG states in its Report, the Gas Directive has abolished the distinction between gas flows in transit and other gas flows in the transmission network. Thus the basic principles of third party access apply equally to all gas networks, save where a specific exemption has been granted. Despite this, there are some particular issues that may arise more sharply in gas transit, such as cross-border co-ordination, pancaking of costs, the issue of pipeline-to-pipeline competition, long term capacity allocation and congestion management.

ERGEG sets out a long term vision of harmonised and open access to networks for gas transit, based on concepts such as a universally applicable cross-border entry/exit charging regime. The discussion paper also contains suggestions for short term actions, such as a relatively detailed and fairly prescriptive open season process for capacity planning. Whilst we may agree with much of the long term vision for harmonised gas transit regime across Europe, we do not agree with all the short term suggestions made in this report, and also believe that a roadmap is required to build on short term actions in order to achieve the long term vision. (A number of more detailed comments on the ERGEG discussion paper are set out in the attached appendix.)

As can readily be appreciated from the overview of current arrangements set out above, we are currently very far from either:

- satisfactory entry/exit transmission charging arrangements within each Member State; or
- arrangements which involve no undue discrimination on the part of all TSOs, either between various transit arrangements, or between transit on the one hand and inland gas transportation services on the other.

The development of cross-border entry-exit regimes and the avoidance of undue cross-border cost pancaking, while arguably important elements of a long term vision, are in our view not the most immediate priorities.

In our view the short term priorities for gas transit are similar to those for gas transmission access and pricing as set out in the Gas Transmission Regulation. Through the proper implementation of the requirements of that Regulation, many of the practical problems encountered in gas transit activities would be addressed. Key issues for TSOs to implement include:

- Non-discriminatory access terms which should, in our view, be based on entry/exit structures wherever possible and which should make no distinction between new transit arrangements and other gas transmission services. (TSOs should also have regard to issues of discrimination as between historic transit transportation and other services, since the general obligations to operate in a non-

discriminatory manner are not set aside by Article 32 of Directive 2003/55.)

- The requirement to offer both firm and interruptible services, whereby the pricing of the latter reflects the probability of interruption
- Non-discriminatory and transparent capacity allocation
- Information transparency, especially for capacity utilisation and balancing
- Effective use-it-or-lose-it provisions to address potential hoarding of capacity and ensure the most efficient use of existing network capacity
- Secondary trading of capacity rights
- Principles of transmission tariff setting which include inter-TSO convergence in balancing arrangements (taking into account guidelines being developed by ERGEG in this respect).

Member States and the national regulatory authorities also have a role to play in ensuring the full implementation of the Regulation and in monitoring the arrangements established by the TSOs.

Beyond the implementation of the Gas Transmission Regulation in each Member State, other key measures for improved gas transit are:

- Interoperability between Member States, including the issue of gas quality, which should be addressed through greater cooperation between national regulators and network operators
- A consistent approach to capacity allocation, in order to improve the efficiency of European networks as a whole
- Transparent capacity allocation rules and publication of information by TSOs
- Greater harmonisation in gas balancing

We believe that a key facilitator of improved liquidity at and between gas hubs is the introduction of entry-exit transmission tariffs. This is lacking in a large number of Member States and is of immediate concern to shippers, initially within Member States (including a reduction in the currently excessive number of transmission/balancing zones).

The issue of removing pancaking of transmission costs is a longer term objective in our view. As a general principle, we consider that transmission access costs across two or more interconnected TSO networks should not exceed the efficient level of costs (including a normal return on capital) which would be incurred by operating those networks as a combined system. In lessening or removing pancaking of transmission costs, it will be essential to ensure that there are adequate incentives for TSOs to invest in relieving existing transmission constraints and meeting incremental transportation demands.

We would therefore suggest that the immediate focus of all those involved in the market should be on implementing the existing requirements of the Gas Directive and Gas Transmission Regulation within each Member State. This should provide the basic framework on which to build more effective network access across Europe. In this there would be an important role for national regulatory authorities, TSOs and other market participants through cross-border co-ordinating discussions and in the regional market initiatives. For ERGEG we believe that there is the possibility of improving current market arrangements by focusing on guidance for improved and harmonised information transparency and capacity allocation management.

In an appendix to this letter, we have listed specific comments on the individual components of the Report. These are in addition to the general remarks that we have made above regarding the improvements required in the gas transit regimes in Europe.

I trust that you find this response helpful. Please do not hesitate to contact me if you would like to discuss any issue raised in further detail.

Yours faithfully,

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