Mrs. Fay Geitona
CEER
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1000 Bruxelles
BELGIUM

14th January 2011

Dear Mrs Geitona

Gazprom Marketing & Trading Limited Response to CEER Consultation on CEER Vision Paper for a conceptual model for the European gas market.

Gazprom Marketing and Trading Limited ("GM&T") welcomes the opportunity to comment upon ERGEG's proposals on Congestion Management. GM&T is the UK registered wholly-owned subsidiary of Gazprom Group ("Gazprom"), responsible for the optimisation of Gazprom's energy commodity assets through GM&T's marketing and trading network. GM&T is active as a trader and marketer of gas at various points in Europe, and therefore has a keen interest in ensuring a workable EU gas market.

1. What are in your view the main goals to be aimed at by the gas target model beneath the high-level policy goals set out by the 3rd Package?

We agree with the goals for the model as set out by CEER, namely:

- Effective implementation of entry/exit systems;
- Facilitating cross border market integration into an efficient and effective competitive gas market at the Community level;
- Efficient capacity allocation procedures including market based mechanisms when demand exceeds the offer;
- Efficient usage of pipeline capacity, especially for cross-border flows of gas between trading points in Europe, with the aim to integrate national gas markets, including limiting (physical and contractual) congestions;
- Improving the integration of trading points leading to a convergence of market prices between neighbouring markets, reflecting market risks and supply/demand imbalances; and
- Improving security of supply by fostering the appropriate network, storage and LNG regasification capacity enhancement as well as upstream investments aimed at supplying the European gas market.

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The crucial question is how these goals are met, as poor market design may lead not only to failure to meet the goal, but a worsening of the situation compared to the status quo.

For example restrictions on re-nomination rights as proposed by the Congestion Management Guidelines will decrease flexibility in the gas markets, and may have adverse impacts on the way shippers book capacity. This is partly because the proposals aim to solve the problem of contractual congestion in the wrong way, and incur collateral damage as a result. Secondly proposals to exclude allocation of new capacity from the guidelines for allocation of existing capacity risk the market sending confusing signals as to the real level of demand for capacity. Thirdly it is important that the transition to entry – exit models, or the integration of balancing zones, do not enable TSOs to reduce the quantity of firm capacity available to shippers, or restrict shippers' existing firm capacity rights.

There is not space here to discuss such issues in detail but we trust they will be examined during the development of the target model. A key benefit of a target model will be a consistency of purpose underlying the development of the various elements of the regulatory framework, for example, the cross border grid codes. However regulators must resist the temptation to be overly proscriptive, and only regulate those areas which require it. For example it is perfectly sensible to regulate how shippers book capacity and how they pay for it. It is not necessary to regulate where shippers decide to trade gas, whether it be at a border, at a virtual trading point, or within a LNG terminal or storage facility. So long as buyers and sellers are able to exchange gas without undue hindrance and agree prices accordingly, it does not matter where these exchanges take place.

It is important that CEER set out clear criteria for how it will determine which trade-offs it wishes to make when developing the target model. For example a large excess of capacity is good for security of supply and for maximizing cross border trading as it ensures that capacity cannot be a constraint, but it may not be economically efficient.

2. What are in your view the major developments and anticipated changes in the European gas market (on national and international level) and where would a target model bring added value? Including:

a. the role of long term capacity contracts in the future European gas markets;

There will always be a need for long term capacity contracts in the European gas market as they are an effective way of sharing risk between TSOs and shippers, and they enable shippers of gas to manage their risk. For example the long asset lives and high front end capital costs of transmission infrastructure mean that long term capacity contracts make it easier for TSO's to underwrite the

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investment, and to justify such investments to regulators. Long term capacity contracts mean that individual shippers bear the risk of potential "stranded assets" if the capacity proves less necessary than forecast, rather than the TSO or consumers if the cost of stranded assets is spread across all system users.

From a shipper's perspective long term capacity contracts represent security of demand for producers or security of supply for consumers. Without the means to send gas to market producers cannot ensure the monetisation of their reserves. The high front end capital costs for producers in terms of investment in exploration and production mean that long term capacity contracts represent a way to manage risk, since they will always be assured of an outlet for their gas assuming they can agree a price with a buyer. (Note this is a separate risk from price risk which can be managed by the pricing and contractual terms for the sale of the commodity, gas, rather than capacity.)

For consumers, long term capacity contracts are simply the way of managing the mirror image or producers' risks i.e. consumers will know they have a means of bringing gas to market so long as they can find someone to provide it. (Again this is different from price risk.)

This is not to say that there is no role for shorter term capacity contracts which enable shippers to optimise their positions as their supply or demand for gas changes (for example as they gain or lose customers.) However it is notable that, in successful liberalised markets such as the US, long and short term capacity contracts co-exist as they serve different needs.

b. the role of hubs / gas exchanges.

Hubs and exchanges are in essence simply points at which buyers and sellers can "meet" to exchange gas for an agreed price. They clearly have an important role in a competitive market. However regulators should focus on measures that enable them to develop, rather than dictating how they should develop. Henry Hub in the US became a key pricing point because it is a physical interconnection point between several different pipelines in a major gas producing area of the US. In the European gas market the choice of an entry exit model means that virtual points will be created because of the need to establish Virtual Trading Points (VTPs). As all gas will flow contractually through these points, it makes them attractive as trading hubs and exchanges. To enable their development it is important to have in place sound capacity allocation and congestion management procedures to enable shippers to move gas to and from the VTPs. It also helps to establish balancing markets at the hubs both for shippers and for the TSOs as this will encourage liquidity. However it is not necessary to prevent shippers from trading elsewhere if they wish to, since this attacks the symptom of a poorly functioning hub (more trading elsewhere) rather than the cause (the relative unattractiveness of the hub itself).

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3. What are in your view the key elements of a conceptual model for the European gas market to contribute to non-discrimination, effective competition, and the efficient functioning of the internal gas market? Please include views on the key aspects of market design such as, capacity allocation and congestion management procedures, network tariff arrangements, wholesale market pricing, balancing arrangements and, gas quality specifications? Please consider the interaction of these arrangements.

Our views on the various key elements are as follows. Note that, in the interests of brevity, these are high level given the nature of this consultation but we are happy to provide further explanation on request.

Capacity allocation.

It is important that capacity allocation and congestion management are designed in a coherent way. The key elements of an effective capacity allocation regime are listed below.

- It is essential that allocation processes for both new and existing capacity are developed and implemented together because they are part of the same market i.e. transportation services. Shippers make no distinction between new and existing capacity, but are simply interested in buying capacity over a certain period of time, and understanding what they will have to pay for such capacity.
- Shippers should be able to book capacity on a long, medium and short term basis, depending on their requirements.
- TSOs should be obliged to maximise availability of capacity to the market, selling capacity through a mix of long, medium and short term allocation processes.
- TSOs should sell capacity in long term allocation processes at cost reflective regulated prices. Where demand for capacity exceeds that which is available in the long term allocation process, TSOs should be required to invest in additional capacity where there is sufficient demand to make it economic to do so. The trigger for any new investment should be clearly known in advance of any long term allocation process, and agreed between TSO and regulator, subject to a full market consultation process.
- In medium and short term allocation processes, where it is not possible to invest in new capacity because of construction lead times, capacity can be allocated via auction processes where those who value capacity most are allocated capacity.
- TSOs should be incentivised to ensure that the maximum quantity of capacity should be made available to the market on a firm basis, taking

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into account expected flows. Where it is not possible to make capacity available on a firm basis, capacity should be made available on an interruptible basis. TSOs should always be required to make a minimum level ("baseline") of capacity available to the market on a firm basis, based on a calculation of the physical capability of the system which is approved by the regulator.

- Firm capacity rights should mean exactly that; if a TSO cannot fulfil its obligations it should be required to compensate shippers, for example by a buy back mechanism which enables shippers to put a value on their capacity rights.

Congestion management.

Regulators need to distinguish between physical congestion and contractual congestion. Physical congestion can be solved by efficient capacity allocation processes as described above. Contractual congestion can be solved by the following means:

- TSOs should be incentivised to ensure that the maximum quantity of capacity should be made available to the market on a firm basis, taking into account expected flows. Where it is not possible to make capacity available on a firm basis, capacity should be made available on an interruptible basis. TSOs should always be required to make a minimum level ("baseline") of capacity available to the market on a firm basis, based on a calculation of the physical capability of the system which is approved by the regulator.
- TSOs should publish all relevant information to enable shippers to understand the extent of physical and / or contractual congestion. This includes details of a an entry or exit points' capacity that the TSO is expected to make available (the "baseline" capacity), planned increases in the baseline capacity and up to date information on that capacity's date of service, the amount of capacity that is booked and the amount of capacity that is available etc. Such information will enable shippers to optimise use of existing capacity and give clear signals for new capacity if required.
- Firm capacity rights should mean exactly that; if a TSO cannot fulfil its obligations it should be required to compensate shippers, for example by a buy back mechanism which enables shippers to put a value on their capacity rights.
- Restrictions of re-nomination rights or other restrictions on the ability of shippers to use the capacity they have booked (e.g. long term use it or lose it whereby unused capacity is confiscated) should be resisted as they undermine the value of the firm capacity that shippers have paid for. The

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measures described above for capacity allocation and congestion management will ensure that capacity hoarding is neither practical nor desirable.

- Please also refer to our response to the ERGEG Consultation on Congestion Management on European Transmission Networks – Recommendations for Guidelines Adopted via a Comitology Procedure.

Balancing arrangements.

The target model should aim to put in place market mechanisms for TSOs to undertake residual balancing actions via an intraday market. This market should also be used by network users to manage their inputs and offtakes efficiently over the day. For this to work effectively users must be provided with both the information and the flexibility tools to balance their portfolios within the balancing period to allow them to contribute to the efficient balancing of the system. This should include the ability to re-nominate their gas flows. Imbalance charges should be based on efficiently incurred costs and should minimise cross-subsidisation between network users and shall ease the entry of new market entrants.

Network tariff arrangements.

Regulators must ensure that a fair rate of return is afforded to TSOs which appropriately reflect the risks incurred in investing in infrastructure. However, a consistent accounting approach throughout Europe would be desirable. It is also important to put in place mechanisms which will produce forward price transparency to allow market parties to better understand the risks involved when committing to long term investments and capacity bookings.

Wholesale market pricing.

Regulators should not concern themselves with wholesale market pricing except as a result of proven market failure (for example where a market is a de facto or de iure monopoly). The burden of proof should be high, the equivalent to that required to prove a breach of competition law to prevent unwarranted interference in the market. The reason for this is that there is no a priori reason why wholesale market pricing should be subject to regulation, unlike transportation which is a natural monopoly. Otherwise buyers and sellers should be free to agree prices for gas as they see fit.

Gas quality.

We understand this is currently the scope of a study by the Commission, and we do not wish to prejudge its findings. However, based on our experience of this issue, we would like to make the following observations:

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- As well as the obvious differences between high calorific and low calorific gas, it is important to recognise the differences between regions for the same type of gas (e.g. the difference between UK and Belgian specifications for high calorific gas.)
- Gas quality has the potential to act as an impediment to the free trade of gas within Europe because of the tolerances of consumer equipment (be they CCGTs or domestic appliances) in different regions to different gas quality specifications. It is therefore difficult to apply a blanket EU wide specification for gas quality without also ensuring that all relevant equipment can safely consume that gas. Such an exercise is likely to be prohibitively expensive as it will mean inspecting every single domestic appliance.
- It therefore makes sense that gas quality should be addressed at a network level i.e. all appliances on a network should be able to cope with a given quality specification. This recognises current reality since by definition this must be true if a network is to operate safely.
- In order to ensure that gas quality is not an impediment to trade, it should be the responsibility of the relevant TSO to ensure that it can accept gas from a neighbouring TSO (so long as that gas is within the neighbouring TSO's specifications) by treating such gas as is necessary to comply with its own specifications. There are a variety of means by which the TSO could recoup the costs of such treatment but one method would be to socialise the costs across all consumers on its system as they all benefit from the ability to access the wider European gas market.

4. What level of detail, e.g. level of harmonisation, do you expect from the CEER vision paper on a conceptual model for the European gas market? For example:

a. Do we need a definition of an EU-wide gas day? If yes, what should this definition be?

Yes. A gas day of staring at 06.00 CET would be appropriate.

b. How deep should the "reach" of the EU gas market model be, i.e. should it encompass DSOs? Is there a trade-off between vertical depth (i.e. including all levels of national gas markets) and horizontal depth (i.e. integrating balancing zones cross border)?

The focus should be on horizontal depth to ensure that gas can freely move across borders. The trade off between vertical and horizontal depth is the level of complexity of reform required and hence the time taken to enact such reform. It would be better if issues such as DSOs should be dealt with at a national level

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with regards to how participants access customers on DSO networks, so that local network conditions can be taken into account. It is likely that the issues facing DSOs in different countries will vary considerably.

Hence the focus should be on enabling the wholesale market which in turn means focussing on transmission (as opposed to distribution) networks. Even here it will be necessary to enable a degree of flexibility so long as the overall goal of an internal European gas market is achieved. For example different network configurations may mean that a pure daily balancing model is not practical (for example in systems with limited flexibility / linepack). However it will still be possible to support the internal market by focussing on market based balancing mechanisms even if the balancing period differs.

5. Which areas or aspects of the gas market should be affected by the target model and what are the constraints for such a model?

The target model should focus on those wholesale market issues impacted by the Third Package (for example cross border grid codes). See also answers to (3) and (4) above.

6. Which areas or aspects of the gas market should be excluded from the target model description and left to national/regional decision making?

Areas which do not impact wholesale markets, for example distribution, should be excluded. In particular regulators should resist the temptation to dictate how or where participants should trade gas, but enable such gas markets to develop.

7. What are the options for integrating the currently fragmented European markets?

Are there any existing models you would like to recommend? In case your answer is yes, we would be interested to learn about the features of this model and if there are also any draw-backs in this model in your view.

The reason that European markets are currently fragmented is that, to date, there have not been proper capacity allocation, tariff, balancing or congestion management arrangements in place in most of the EU member states. In those countries which do have some or all of the necessary elements in place (e.g. UK, France, Netherlands, Germany) we have seen increased trading activity including arbitrage between different Member States, as well as competition in retail markets (supply to end users). We have outlined above what we consider the key elements of such arrangements to be. Therefore we do not consider it a case of a fundamental change of approach, but more a case of following through on the work already started. In this context we would recommend that CEER use the experience of the regional initiatives, in particular that of the North West Region, which encompasses a large share of European gas demand. For example the

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North West GRI spent a great deal of time on cross border capacity allocation mechanisms which gave useful lessons.

a. Should we merge balancing zones to create cross border or regional balancing zones or market areas? How many balancing zones does Europe need and how big should they be?

As the example of Germany has shown, reducing the number of balancing zones can certainly lead to an improvement in trading and competition. However care must also be taken to ensure that merging of balancing zones does not lead to a reduction in capacity available to shippers. This can be the result of the way TSOs view the risk of operating the system, and we have already seen examples of this. It is therefore important that TSOs are appropriately regulated to ensure they continue to maximise the amount of capacity rights available to the market. (See comments to Question 3 also.)

b. Is the coupling of market areas as it is being developed in European electricity markets appropriate for gas?

It is not clear that there is a common understanding of what market coupling means. Market coupling is only a means to an end. At its basic it means that gas prices in adjoining markets should only differ by the marginal cost of transportation. As noted above we have already seen arbitrage between markets where it is possible to access capacity, and market coupling exists in the sense that there is linkage between, for example, the Zeebrugge hub price and the UK NBP price. (The converse has also been observed, namely decoupling between the UK NBP and Zeebrugge Hub prices when the Interconnector has been out of service.)

If market coupling means a specific mechanism for allocation short term capacity between market zones, then regulators should apply two tests to determine its appropriateness:

- Can effective market coupling be achieved using existing methods already used in the gas industry e.g. use of short term auctions of firm cross border capacity?
- Can the electricity model work effectively in gas markets whilst taking account of the differences between the two commodities (e.g. physical properties of gas and electricity), structural differences between the two markets (e.g. most electricity is produced local whereas most gas is transported over long distances before reaching the end market).

Regulators must also be certain that any benefits in using such an approach outweigh potential costs, and not simply “cut and paste” from one commodity to another. At this stage there has been insufficient explanation of what proponents of such an approach mean at a practical level to make further comment. However

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it is far from clear that such an approach is a panacea or indeed which problems it is trying to solve.

I hope you find these comments useful. If you have any queries please do not hesitate to contact me on ++ 44 20 8614 3036 or at alex.barnes@gazprom-mt.com, or at the address below.

Yours sincerely,

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Unsigned as sent by e-mail.

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