



Ms Natalie McCoy
Council of European Energy Regulators
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Dear Ms McCoy

Gazprom Marketing and Trading Limited ("GM&T") welcomes the opportunity to comment upon the Draft Vision for a European Gas Target Model. 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.

GM&T has followed the developments of the Gas Target Model (GTM) closely and notes that the overall goals for the model are:

- Effective implementation of entry / exit systems (which is a requirement of Third Package Legislation)
- Facilitating cross border market integration into an efficient and effective competitive gas market at the EU level
- Efficient capacity allocation procedures including market based mechanisms when demand exceeds supply
- Efficient use of pipeline capacity, especially cross border flows of gas 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
- Improving security of supply by fostering appropriate network, storage, and LNG re-gasification capacity enhancement as well as upstream investments aimed at supplying the European gas market.

GM&T broadly supports the overall goals of the GTM and welcomes the holistic approach that the Regulators are currently taking to ensure that the Member states adopt joined up thinking when developing each of the Network Codes. GM&T especially welcomes the wording in the current draft which highlights the importance of multiplicity of contractual arrangements including both long and short term capacity holdings, necessity of long-distance gas transportation and the need for a mechanism to signal the demand for incremental capacity in order to prevent the appearance of deficits or mismatches of capacity and gas flows. However, although GM&T supports the goals of the Gas Target Model, we differ on some of the mechanisms needed to fulfil them.

Below, are some specific comments on each of the building blocks of the GTM with suggestions on how some of the current ideas/solutions can be improved to promote security of supply as well as develop liquidity in the traded markets.

Capacity

Availability of and access to capacity in both the long and short term is a key element in ensuring a well functioning market and it is therefore important that all market parties have the opportunity to purchase capacity adequate to their needs in a fair and transparent way. GM&T is particularly encouraged that the current draft of the GTM specifically acknowledges the need for long term capacity bookings. Long term contracts are an important component of the European target model as they provide revenue certainty to investors and make infrastructure investment a potentially attractive proposition. Long-term contracts are also crucial for the long-term upstream investment decisions in developing production and transportation capacities aimed at gas deliveries to the EU market. Furthermore long term contracts can ensure that customers do not end up funding the cost of underutilised assets built for international transportation purposes. Long term contracts also provide valuable information for TSOs in relation to the likely evolution of demand for capacity on the network.

GM&T is supportive of the majority of the elements contained within the current draft of the Network Code for Capacity Allocation Mechanism (CAM), including:

- Cleared price auctions
- Quarterly, monthly and daily products
- Reserve price set at the regulated tariff for capacity sold in both the long and short term
- 10% capacity reserved for shorter term products, however reserving 20% should allow greater opportunities for new entrants and smaller players to book capacity nearer the time of need
- Selling of interruptible capacity once firm capacity is fully sold, however the interruptible capacity should be offered to the market at zero reserve price to ensure that there is no impediment to arbitrage across markets

However, GM&T believes that the Network Code could be improved. Currently there is no mechanism to allow the market to signal the need for incremental capacity. 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 or release additional capacity rights where there is sufficient demand to make it economic to do so. The trigger for any new investment or release of capacity rights 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.

GM&T does not support the mandatory bundling of capacity. Bundled capacity rights should be offered as a product if there is sufficient market demand. Forced bundling of capacity to encourage trading at hubs is not necessary as traders will naturally gravitate to locations with the most potential counter-parties. Those markets which have developed successful hubs (e.g. UK, Netherlands, Belgium, France and latterly Germany) have seen this happen in practice, but trading at other points may still happen if it is convenient for both parties. Ensuring physical volumes of gas are delivered at trading hubs, will not necessarily mean that these volumes are re-traded; in this case the churn rate at hubs could actually worsen if the amount of trading at the hub remains the same but the physical flows via the hub increase.

Hubs and exchanges are in essence simply points at which buyers and sellers can “meet” to exchange gas for an agreed price and should be a matter for market forces. 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. For example, hubs should be additional but not exclusive points of delivery for all contracts.

Consideration also needs to be given to enable shippers to book capacity at several interconnections points in order to ship gas across Europe. It is essential that companies which transport gas across Europe are able to “stitch together” annual or multi annual strips of capacity at several Interconnection Points (IPs). One major risk is that if capacity is allocated on a pro rata basis at the final price step because demand for capacity exceeds supply. In this case it is possible that a shipper will be allocated his capacity needs in most quarters / IPs but not in one or two congested IPs. This risk would not occur if there were an integrated process for allocation of additional capacity and existing capacity whereby TSOs could undertake to release additional capacity where demand exceeds supply rather than pro rata capacity allocation at the final price step.

The current proposal from ENTSOG contains the ability for the auctions to close early if they are deemed to have stabilised, which will cause further problems for shippers wanting to link capacity across several interconnection points. It may be better to allow these auctions to stay open for the maximum amount of time to ensure that shippers do not face the risk of stranded capacity at interconnection points if the auctions all close at different times.

In order to aid shippers who are making bids across several interconnection points TSOs should provide information that enables shippers to see the progress of several auctions at one time. A minimum requirement will be to enable shippers to download relevant information for use by their own IT systems. If a single pan European booking platform is developed then the ability to view several auctions simultaneously should be part of the design specification.

Congestion Management/Market Coupling

The roles of CAM and Congestion Management Procedures (CMP) are closely linked, for the obvious reason that both involve allocation of capacity. Solving congestion problems, whether contractual or physical, rests on 3 pillars:

- TSOs must maximize the quantity of capacity that they release to the market.
- TSOs must make available additional capacity in the long term if demand exceeds supply and there is sufficient demand to warrant the release of capacity.
- Interruptible capacity, and all the information required to gauge its value, should be released to the market to enable capacity which is booked but not being used by the primary holders, to be utilised on fair and non-discriminatory basis.

GM&T believes that properly designed capacity allocation and congestion management mechanisms are an essential part of a properly functioning gas market. However there are aspects of the CMP proposals with which we disagree strongly, namely restriction of re-nomination rights.

Drawbacks of restriction of re-nomination rights.

The European Regulators and the European Commission consider that the most effective way to deal with congestion is to restrict the ability of existing capacity holders to re-nominate their capacity position at the day-ahead stage. GM&T considers that this is not the optimal way to free up additional short term capacity and will be counterproductive.

The Framework Guidelines for gas balancing predetermines that parties should be the primary balancer and TSOs the residual balancer in the market. Restricting parties' ability to re-nominate positions will

impede parties in balancing their supply and demand within the balancing period. If parties are unable to re-nominate, TSOs will have to undertake primary balancing which could be much more expensive than market parties balancing the system, as TSOs usually buy gas at the system average price plus a premium, these costs will then be passed directly through to customers. Market parties are best placed to undertake market based balancing trades, which promote trading and liquidity in the spot markets and should therefore not be prevented from doing so by re-nomination restrictions.

Restricting re-nomination rights at cross border points will also discriminate between different sources of flexibility as storage and LNG facilities within a market area will be able to re-nominate within-day, whereas pipeline gas will not. This will restrict the amount of flexibility that can be brought to market within-day. Discrimination between competing sources of flexibility should be avoided to ensure that within-day prices accurately reflect market fundamentals instead of being at a premium due to artificial constraints on the availability of flexibility.

Under a regulatory regime where re-nomination rights are restricted, Regulators consider that market parties have the opportunity to access the trading hub to buy gas to balance their position within-day. However, whilst this is true, at some point in the day the gas will need to be physically delivered and therefore somewhere a re-nomination will be necessary. Restricting parties' ability to re-nominate will mean that a vast amount of flexibility from pipeline gas will not be able to reach the market, reducing the amount of gas that can be traded in the market, which will have a negative impact on within-day liquidity. Restricting pipeline sources of gas will have serious consequences for Member States that have insufficient storage or LNG capacity and who therefore rely on pipeline gas for the majority of flexibility.

As the European Member States strive to meet the 2020 renewable target, CCGTs will play a very important role in filling the generation gap due to intermittent production and therefore, suppliers to power stations will need to be able to re-nominate within-day to ensure that CCGTs can ramp up to meet the demand in the electricity sector. Furthermore, due to potential system constraints in light of the flow based allocation proposals in power markets, within-day re-nominations will become even more important for gas suppliers who supply power stations to ensure system integrity in the power markets.

There have been suggestions that suppliers to power stations should have special exemptions which would allow them to re-nominate within-day, however, this solution appears to be discriminatory and will favour players who supply power stations and should be avoided. Furthermore it is not clear how this exemption would work in practice since it would require regulators to distinguish effectively between nominations related to power stations and other nominations. As many companies have a portfolio of types of end use demand, and portfolios of sources of supply, such distinction between nominations would be difficult. The most effective way to deal with this issue would be to allow all players to re-nominate positions both day-ahead and within-day.

One solution that has been suggested by some regulators to overcome the reduction in pipeline flexibility as a result of re-nomination restrictions is for suppliers to enter the day with a long gas position. The theory behind this is the supplier should be prepared to take the gamble that at some point in the day a party will want to buy gas to cover a short position and the trade could take place without the need for re-nominating at a border point. However, in the real world this solution is not feasible because the supplier would be taking on an additional and unacceptable risk that they would not be able to sell the gas by the end of the balancing period. The shipper would therefore have to either put the gas into storage with the associated costs or be cashed out by the TSO and receive a less favourable price for the gas than would otherwise be the case. It makes no sense to burden suppliers with additional risk, when the re-nomination system is working well.

Restrictions of re-nomination rights and market coupling

GM&T notes that the current draft of the GTM identifies implicit auctioning/market coupling as a way to ensure functioning markets; this option goes hand in hand with the restriction of re-nomination rights as market coupling will only work if shippers are unable to re-nominate after gate closure. Regulators must be careful not to import all the options that are perceived to be working well in electricity into gas due to fundamental differences between the two sectors.

Given the instantaneous nature of power and due to the fact that it follows the path of least resistance, the grids need to be managed on a second by second basis and therefore, freezing nomination schedules is an essential part of managing the system. One of the benefits of market coupling in power is that it facilitates capacity to be optimally used, particularly for periods when the positive price direction is uncertain at the time of nomination of capacity (increasing the risk that the nomination is made in the 'wrong' direction). This contrasts with the gas market where the system needs to be balanced over a period of hours, days or even longer and therefore continuous trading by market parties is beneficial to the TSOs in helping them to manage their Grids. Currently re-nominations can be made two hours before delivery which means that shippers can flow gas from a high priced market into a lower priced market by changing their nominations instead of needing an exchange/TSO to do so. Furthermore, as with the restriction of re-nomination rights, given gas comes from a few sources, there may be insufficient gas in the national markets within-day to satisfy changes in supply and demand, whereas in power, every market has its own generation capacity, which can be sold into the within-day market and does not rely on cross border re-nominations.

Alternatives to restriction of re-nomination rights.

The main reason to introduce CMP measures is to ensure that parties do not hoard capacity and instead all unused capacity is freed up for shorter term optimisation. Although restricting re-nomination rights would reduce the incentives to hoard, GM&T considers that the following suggestions which also reduce the incentives to hoard capacity are better alternatives as they avoid the drawbacks outlined above. In addition a properly functioning CAM, with the ability to signal the need for incremental investment as part of the long term auction process as outlined above, should help congestion problems arising.

TSOs should be incentivised to “over sell” firm capacity when they believe that there will be physical capacity available that will not be used but has been booked. Such a mechanism can avoid undue sterilisation of capacity as a result of under-utilisation by firm capacity holders, without unduly impacting those firm capacity holders’ rights, whilst at the same time enabling other participants to take advantage of market opportunities. Such an approach can also be used if TSOs receive bookings for additional capacity far in excess of likely flow requirements, and thereby avoid unnecessary physical investment.

If TSOs feel uncomfortable about over-selling capacity to the market, the next best solution would be to sell interruptible capacity day-ahead and within-day at a zero reserve price when the TSOs have a better idea of the supply and demand conditions for the following day. As long as sufficient information is provided to parties to allow them to assess risk of interruption then this also becomes a useful congestion management tool.

The TSOs should be encouraged to facilitate secondary capacity markets. Shippers should be able to buy and sell capacity between them, and TSOs should facilitate such transactions by transferring rights and obligations to the new owner of capacity. This will enable shippers to optimise their capacity holdings as their circumstances change. TSOs should enable shippers to buy and sell capacity as easily and quickly as possible, both for long term transactions, and for short term (e.g. day ahead). There should be clear mechanisms for the transfer of rights (e.g. to flow gas) and liabilities (e.g. obligations to pay).

TSOs should be incentivised to buy back surrendered capacity from market parties, either in whole or in part. TSOs should offer and allocate this capacity anonymously together with other primary capacity, according to the same terms and conditions. If for whatever reason TSOs fail to sell the surrendered capacity then the capacity stays with the original capacity holder and the cost is covered by them. This process ensures that TSOs will not face the risk of under recovering the allowed revenue and it in no way hinders or limits the possibilities to trade capacity directly between market parties

An additional way to gain access to capacity in the short term and one that is already used by a number of market parties is the use of virtual transportation capacity. Geographical differences in the gas price can be traded, hedged and managed by swapping gas between locations. These financial instruments have the same effect as accessing physical transportation capacity and will ensure that hub prices converge. Indeed they are an example of market efficiency by avoiding the need for additional physical transportation capacity at all.

Tariffs

Tariffs are an area that must be looked at as soon as possible as they directly impact both the CAM and CMP procedures in ensuring that reserve prices are set at the correct level to guarantee the optimum amount of capacity is sold in each auction. Linked to this is the need to consider how the structure and designing of tariffs will influence revenue recovery by TSOs. As a rule tariff design should minimise under or over recovery of revenues by the TSO, as the mechanisms required to correct such under or over recovery often lead to distortions and cross subsidies between different network users. Regulators must ensure that a fair rate of return is afforded to TSOs which appropriately reflect the risks incurred in investing in infrastructure in different countries. 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.

Balancing

Market based balancing is crucial for the promotion of liquidity at trading hubs, where market players are responsible for balancing their own positions by buying and selling gas on the day ahead and within-day market. Therefore as mentioned above the ability to re-nominate gas flows within-day is essential for market based balancing to work effectively. Without re-nominations, shippers will be on the whole unable to properly balance their portfolio within-day and therefore there will be a need for the TSO to become the primary balancer of the system which will have a negative impact on liquidity in the spot market.

An important element of market based balancing is to ensure that the TSOs are obliged to enter the market to buy/sell gas when the system is out of balance to further promote liquidity in the day-ahead/within day market. However, it is important that TSOs only take on a residual role in balancing the market, if they take on a primary role as a result of the restriction of re-nomination rights, it would lead to consistently higher balancing costs given that TSOs usually pay a premium for gas in the market.

To ensure that within-day liquidity is fully promoted, the optimum balancing period should be a day as daily balancing allows all forms of flexibility to compete against each other for balance of day products instead of having to rely on more expensive temporal products. Therefore daily balancing should keep prices lower than may be the case under shorter balancing periods.

For market based balancing 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.

The current draft of the Framework Guidelines for gas balancing includes most of the measures mentioned above and is therefore an important step towards the promotion of liquidity at trading hubs, however, without parties' ability to re-nominate gas flows within-day, both hub liquidity and system integrity will be impeded.

Furthermore, the current draft of the framework guidelines suggests that within-day constraints are allowed for systems that are unable to cope with pure daily balancing but these cannot be in the form of within-day cash out. GM&T considers that for markets which cannot adopt a pure daily balancing system due to the lack of linepack, a balancing system which cashes out parties who are out of balance in the same direction as the system once the system exceeds its safe operating parameters is effective as long as it is accompanied by relevant and timely information e.g the new Dutch regime. These regimes do promote trading at least on the day ahead market and ensure that parties are cashed out on a cost reflective basis. Regulators must be careful not to rule out regimes that actually do promote trading, instead of promoting regimes that would force parties to follow their demand profile each hour or face a 'financial penalty' without physical settlement. More thought needs to be given to within-day constraints before regimes like the Dutch regime are ruled out completely.

However, it must be noted that market based balancing will only help promote liquidity in the spot/prompt market. The forward markets in Continental Europe are illiquid and even in the UK, where market participants can generally obtain quotes for around four years ahead allowing them to hedge positions over this time horizon, liquidity is significantly lower further along the curve you go. Hub prices will never be reliable price indices on which to base investment decisions, unless liquidity in the forward markets improves.

Merging market areas/trading region approach

GM&T supports the concept of functioning markets and agrees that it would be beneficial for all market areas to have access to a sufficiently liquid trading hub. GM&T considers that the North West European hubs are well established and liquidity has improved each year. Therefore it is sensible to leave these hubs to develop as the market sees fit without forcing a trading region/merged markets approach on them. There may be merit in adopting a trading region/merged market area approach in Eastern Europe where the gas markets are too small to muster sufficient liquidity on their own and where trading hubs have barely emerged. However, care needs to be administered as to how this is achieved.

Whilst the trading region approach as developed by the Florence School of Regulation and Wagner, Ebling and Company, is a useful concept in theory, GM&T has concerns regarding it in practice. Removing imbalances from the trading region would not be a useful concept as this is what drives liquidity in the spot market. Furthermore, separating national systems from supranational systems, could lead to an increase in concentration in the retail market. Having a liquid wholesale market does not always drive competition benefits downstream. This has been seen in the UK where, although the NBP is the most liquid hub in Europe, the downstream market is still dominated by the big 6 suppliers.

The merged market area approach, whilst having the potential to promote competition can also lead to significant TSO incurred costs in managing the system constraints, given entry paid gas can be moved virtually to any location in the region without acquisition of further capacity. These constraint costs have been prevalent in the Germany as market areas have merged and capacity that was firm has become interruptible. Making the merged area too large will mean that TSOs will have to buy large amounts of locational gas to ensure that it can manage the system which is likely to be smeared over all users of the

system. Therefore, when considering the merged market approach, it is likely to work better between countries where no congestion exists. Before the merged market model is put in place a thorough cost benefit analysis needs to be undertaken to ensure that the competition and liquidity gains outweigh the constraint costs. If the merged market model is adopted significant regulatory oversight is needed to assess whether the constraint costs that have been accrued are reasonable. However, the decision to merge markets should never be at the expense of existing capacity.

Yours Sincerely

A handwritten signature in black ink, appearing to read 'Fiona Strachan', with a long horizontal flourish extending to the right.

Fiona Strachan
Regulatory Affairs Manager