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E.ON Position on

CEER Vision Paper for a conceptual model for the European gas market

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1 General Remarks

E.ON welcomes and appreciates the CEER Call for evidence on its vision paper for a conceptual model for the European gas market. E.ON believes that an EU wide shared target model is necessary to initiate the appropriate steps towards an integrated market. Exceptions on an interim basis should only be made for technical reasons or to smooth the transition to the target model. E.ON's envisaged target model is based on the experiences in different European markets and on the aim to create a fair and market-based mechanism to facilitate competition and wholesale market liquidity. Nevertheless, the different experiences and technical constraints in particular national markets may require consideration of interim steps to reflect those differences and manage the transition to the target model.

Gas markets in Europe have developed differently and the Network Codes should take into account these different stages of development. However, we believe it is crucial to minimize the regulatory risk by setting out clear rules that – after a certain time – will establish a pan-European level playing field.

2 Specific Remarks

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?

The high-level political goals are the integration of European markets, the emergence of a well-functioning and transparent wholesale market with a high level of security of supply, and ensuring the proper functioning of the internal market in gas. We think it is evident to work towards a low carbon society and enhanced competitiveness of the markets.

The target model should lead - within the foreseeable future - to a liquid, interconnected single EU gas market where gas flows without barriers across national borders to those markets where price signals attract supplies. Therefore, it is essential to first use existing capacity and congestion measures to the maximum and, if necessary, expand that capacity in order to have positive effects on security of supply and competition. In terms of security of supply aspects, it has to be ensured that in areas where there is no business case today (such as gas flows from west to east or from south to north) adequate transport facilities have to be ensured.

For the sake of European competition and security of supply the central task of the target model must be to force the abolition of persisting protection of national incumbents by national regulation in some Member States. In this context, we would like to mention the example of Poland (no reverse flow on the Jamal pipeline). Any legal and regulatory barriers to freely move gas across Europe have to be removed. The target model can support this by giving clear guidance to all Member States. Market opening has to be synchronized across the EU and the prevailing different speeds of development need to be avoided. This also includes regulation of retail prices which still exists in several Member States.

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;

A well-structured target model should enable short *and* long-term transport capacity. However, this should not be managed by specific long-term products which may hamper liquidity on the capacity markets. Instead, quarterly products shall be available at least 15 years/ 60 quarters ahead: We suggest a maximum contract length of 1 quarter/ 1year respectively but the ability to bid at the same time for up to 15 annual/ 60 quarterly contracts at the respective interconnection point. Enabling bookings well in advance is crucial for enabling long term supply contracts and therefore for the security of supply in most European markets.

b. the role of hubs / gas exchanges.

E.ON supports the development of hub-to-hub trading and any design of market rules should seek to foster this. Liquid hubs are needed to enable functioning markets; exchanges and broker platforms play a crucial role in enhancing the availability of reliable and transparent price signals. Nevertheless, there always has to be the possibility for OTC trading at flanges to benefit from the full potential of trading markets. Exchanges should be enabled to compete. Obliging TSOs to procure balancing energy on exchanges to the extent possible is a proven trigger for within-day trading and should therefore be supported by the target model.

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.

E.ON believes in the virtue of a pan-European balancing regime. It should consist of an identical balancing period with one single cash-out of imbalances at the end of a standard gas day.To implement this will inevitably lead to amendments in national balancing rules. The European NC should be sufficiently detailed to avoid any ambiguity that may allow different interpretations of its rules and should consider the following principles:

- Decoupling of intraday in-feeding and off-taking
- Possible but limited technical constrains for system stability
- Use of linepack first
- Procurement of balancing energy principally on intra-day markets and day ahead
- Full recovery of costs for balancing energy but incentives for efficient deployment
- Asymmetric cash-out prices to incentivize a balanced position
- Forecast of the consumption of non-daily-metered sites (NDM) by TSO/DSO

- Information close to real-time required for daily metered consumers and entry/exit points

A balancing regime will only be efficient if it facilitates (a) the secure and reliable operation of the relevant transmission system and (b) a competitive market. Daily balancing regimes reduce barriers to market entry but may require an increase in certain TSO balancing actions. On the other hand, hourly balancing regimes tend to reduce TSO activity due to the network users' obligation to match inputs and off-takes every hour but at the same time place onerous obligations on network users and therefore represent a serious barrier to entry.

The use of flexibility instruments like storage, LNG, and interruptible customers should not be restricted by law and only to certain conditions. Where measures like strategic stock or public service obligations are used, regulation should avoid distorting the commercial use of the relevant sources of flexibility. In general, any of such rules would rather undermine the efficiency of infrastructure use and may undermine rather than solve security of supply issues at a regional level.

Capacity allocation and congestion management procedures

However, even identical balancing regimes will only lead to converging within-day prices if and to the extent transport capacity between two markets is available and flexible supply is able to meet attractively priced demand. Hence, the efficient though flexible use of existing transport infrastructure within-day and the efficient use of congestion rents to signal and fund incremental transport infrastructure through the establishment of standardized capacity auctions has to complement the above mentioned balancing arrangements.

Any assessment of appropriate capacity allocation mechanisms (CAM) and congestion management procedures (CMP) should not only consider the effectiveness of existing TPA, UIOLI and flexibility instruments within a Member State but also consider the wider impact of these arrangements in the integration process and on the European gas market as a whole.

Network tariff arrangements

Network tariffs are clearly a sensitive area for harmonization, leading quickly to detailed questions about accounting, asset base value, depreciation methods etc. Nevertheless, tariff arrangements clearly are key to secure appropriate investment into infrastructure. And sufficient physical connectivity is still at the heart of any European gas market integration. In this context, it should be kept in mind that most network investments lead to only *minor* effects on retail prices for end customers while entailing *major* benefits for competition and security of supply. A European harmonization should therefore cover at least the following scope:

- Where and when to apply reserve prices on capacity auctions;
- Consider how best to deal with any excess or shortfall of auction revenues compared to a TSO's allowed regulated income (e.g. spend on further alleviation of congestion, refunds or supplemental charges)
- How to derive balancing cash-out prices;
- How to incentivize TSO to procure balancing energy efficiently and increasingly on the wholesale market;

- How to incentivize TSO to offer the maximum firm available capacity;
- How to derive trigger levels for incremental capacity at long term auctions.

Wholesale market pricing

Hub prices increasingly determine the wholesale market prices as the dominance of pricing based on alternative fuel prices has disappeared. Hence, it is imperative for market participants to have access to all price relevant supply and demand fundamentals, including aggregate real time flow information at x-border interconnection points and on the availability of production and storage capacity.

Any regulation of wholesale market prices is contradictory to the aim of creating competitive markets. Existing violations of this principle (as e.g. in Hungary) must be abolished – the sooner the better.

Gas quality specifications

E.ON supports the development of a binding common set of gas quality specifications across Europe in the near future. The common standard should apply to entry requirements for each national market provided any additional infrastructure investment necessary to meet such standards is justified by the additional competitive benefits arising from giving a particular market access to a more diverse source of supply. In such cases the TSOs would be required to procure appropriate processing/blending facilities so as to allow acceptance of EU standard specification gas.

Generally common specifications should reduce market entry barriers within the European gas market and foster the competitiveness of natural gas against other primary energy sources, especially under an environmental point of view.

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, we would strongly argue for an EU-wide gas day in order to enable a harmonized trading/balancing across Europe. The majority of European gas markets work on a gas day between CET 6 a.m. and 6 a.m. the following calendar day as defined as standard gas day by EASEE-gas. Any European wide harmonised gas day should use this definition. Alternatively, the possibility to align the gas day with the calendar day should be explored further.

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 level of depth for the EU gas market model depends on the respective market area. In terms of balancing it is e.g. necessary to encompass DSOs in order to ensure the required level of detail when it comes to information provisions and it is necessary to provide for an identical regime across all balancing zones. However, when talking about capacity allocation, the level of DSOs does not have to be considered. We find the concept of "vertical vs. horizontal depth" hard to understand.

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 constraints for an EU gas model have to be described as a possibility to design EU wide regulation versus the principle of subsidiarity. A target model should offer a long-term stable vision and be designed in a way that it will not be subject to frequent changes.

Overall, the right balance has to be struck between on the one hand sufficient detail to describe the target model to ensure it is faithfully adopted across the whole of the EU, and on the other too much detail that might interfere with existing efficient markets or the development of more local solutions that promote market integration.

The target models for the gas and the electricity market have to be developed in parallel in order to take into account the connection of both markets, especially in the field of RES intermittency topics. This implies the discussion of developments in the scope of the Madrid and Florence fora in order to account for the mutual dependencies. It is evident that market participants and stakeholders of both sectors (gas, electricity) frequently exchange views on the status of their market, 'lessons learnt' and possible improvements for both market areas.

In principle, all aspects of the gas-market should be affected by the target model in order to allow for a comprehensive but consistent market set-up:

- Details of the design of Entry/Exit systems;
- Terms for the access to the transport systems to access the wholesale markets from entry points and across borders between neighbouring entry/exit zones, including harmonized regulation on capacity products and primary and secondary capacity allocation;
- Harmonized balancing requirements on a daily basis (see question No.3);
- Clearly defined responsibilities for the expansion of transport capacities and the process leading to investment decisions;

Harmonized market-based terms for access to storages with the objective to create a level playing field for storage users and operators and to reduce potential market barriers.

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

Apart from subsidiarity issues we believe that it is inappropriate to give NRAs the discretion to introduce national measures that are incompatible with the target model. E.ON would like to urge

ERGEG – if in doubt – to rather clearly define the framework within which ENTSO-G will be able to set detailed rules. And we do believe that, although this framework might consist of a variety of clearly defined interim measures including those on the balancing period, the target model should define pan-European Network Codes.

Regulation on the level of tariffs should be excluded from the target model. Seeking to harmonize regulation of tariff levels would in our view hinder a fast track development towards the target model, because the complexity and often political sensitivity of this issue. The bundling of entry and exit capacities must not become mandatory but remain optional. The commercial freedom to trade at entry/exit flanges must remain possible.

The market for secondary transportation capacity should likewise not be regulated unnecessarily but commercial freedom to market such capacity should be maintained.

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.

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?

E.ON is in favor of creating larger, cross-border balancing zones. But, expanding or merging existing balancing zones will always come to the expense of entry/exit capacities to and from this merged zone. Therefore, the costs of any potential merger has to be carefully assessed and weighed against the benefits of a greater and more liquid market area. We believe that the regulatory frameworks of the electricity sector will have a significant impact on gas market regulation as well. The steadily increasing share of renewable energy with its increasing intermittency in the electricity market will lead to significant changes of the current electricity market set-up. Flexible gas fired power production will have to complement these sources. Therefore, the right design of the balancing system in gas is crucial to account for the named future developments.

E.ON believes that the implementation of a balancing target model harmonizing the roles of TSOs and network users in every European transmission system will lead to a natural merger of balancing zones wherever and whenever transport capacity between adjacent systems is not constrained. It will hence lead to an integrated European market not only in gas but across the commodities. Regulatory assistance may then be required in ensuring there is sufficient investment in network infrastructure and in removing any barriers to the development of the most economically efficient balancing zones – including those covering multiple Member States. There is no need for additional regulatory measures.

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

In general, E.ON supports at least further feasibility studies on implicit auctions in gas analogous to the developments in the electricity sector, meaning an auction where commodity and capacity between two adjacent markets are sold in a single activity. The effect of market coupling is limited though by technically or physically available cross border capacity. If and when there is no congestion between coupled markets, they will form a single price zone. When demand is larger than the available interconnection capacity (i.e. congestion occurs), there will still be a price difference even between 'coupled' markets. However, this difference will be reduced and the transport infrastructure will be used to its maximum technical capacity. Hence, market coupling provides one potential solution to optimise the use of the available capacity, and ensure efficient congestion management.

However, market coupling does not provide for an enlarged balancing zone: It is a pure day-ahead operation, based upon two sufficiently liquid day-ahead auctions and the central administration of all not nominated transport capacity day ahead of delivery (hence: no renomination after a gate closure is a crucial feature of market coupling). Balancing on the other hand is a pure within-day operation. To enable cross border flows of flexible gas for balancing purposes in a market coupling environment, network users must therefore have flexible access to transport capacity within-day, access that is not based on renomination rights. To fully integrate gas markets, within-day integration by harmonized balancing regimes and, ultimately, physical 'de-bottlenecking' is imperative (see electricity markets, where the focus now shifts to the intra-day markets).

Given that removal of re-nomination rights is a pre-requisite for true market coupling, its application to established, efficiently traded markets such as in Great Britain could be costly and potentially damaging to liquidity. Alternative solutions involving the retention of re-nomination rights and continuous separate within-day trading of energy alongside release of firm capacity by the TSO (based on some 'overselling' of capacity) offers an alternative and perhaps more cost effective way forward. It would of course require consideration of some additional remuneration for the relevant TSO who may face higher risks associated with the potential need to buy back capacity.

Market coupling should be considered a highly effective CMP. However, it will need some further investigation whether market coupling is really a feasible method for gas and a case by case decision has to be applied.