

Our date
14.01.2011

Our reference
CEER gas target model

Administrative officer
Paolo Natali

Your date
03.11.2010

Your reference
C10-GWG-70-03

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London, 14 January 2011

Mrs Fay Geitona
CEER/ERGEG

gas_target_model@ergeg.org

Re: Call for Evidence on the CEER Vision Paper for a conceptual model for the European gas market.

Dear Mrs Geitona,

Statoil welcomes the opportunity to respond to the call for evidence on the conceptual model for the European gas market. We regard the development of such a model as an important part of delivering the European internal gas market. We are, however, mindful that progressive liberalisation of national markets and harmonisation remain the main instruments to establish liquid and well functioning markets across Europe.

Please find below our answers to the specific questions posed in the consultation paper.

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 gas target model should in essence be the delivery of the processes set in motion by the Third Package. In other words, a vision of what the exchange of gas across Europe at large might look like, including the provision of guidelines to set the relationship between users and operators of the system. In so doing, the target model should also be designed in a way that would provide sound market signals for investment. Indeed, at present the EU27 region is a very fragmented constellation of different gas market models, probably as many as the number of balancing zones, and harmonizing this complex framework is an important goal of the gas target model which CEER should develop. An EU-wide model should therefore help shape national regulations in ways that facilitate cross-border exchange, via the harmonisation of capacity allocation mechanisms (CAM), congestion management procedures (CMP) and gas balancing rules. Having a target model will also enhance compatibility between various national codes.

In order to facilitate high level harmonization at the European level, the gas model should also allow current and future national regulation to be adaptive to specific regional or local issues and circumstances. Adaptability has been one of the key success factors in liberalised markets and as such there should be some accommodation for unforeseen innovations, issues or events likely to change the nature of the target model as its implementation is pursued.

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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;**
- b. the role of hubs / gas exchanges.**

The main change that we foresee is the globalization of gas markets, a phenomenon which stresses the need for market integration at European level.

In Europe, the following dynamics are also likely to be important issues:

- new volumes will become available, and will therefore enter European markets from different routes: LNG capacity expansion, gas volumes from the Caspian reaching the European borders, and possibly in the medium to long term indigenous unconventional gas;
- significant market development is taking place in some countries, and this might in the medium term affect flows; similarly, other countries will experience the effects of policies aimed at putting gas in direct competition with other sources for electricity generation;
- gas flows will change and become more volatile as a consequence of the availability of new routes (e.g. Southern Corridor, Nord/South Stream) as well as the response to price differentials between markets.

Long term capacity contracts must continue to be a provider of stability to markets, and they will do so if the industry believes the market model is a sound one.

Furthermore, the increase in traded volumes implies a need for an ever better functioning market. The improvement of liquidity is an important goal for both industry and policy-makers, not least as it is necessary to enable market-based balancing. This is only possible when there is a well-functioning intra-day market where TSOs can utilise that market to fulfil its system balancing requirements with confidence.

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.

An overarching observation needs to be made, as with every new form of regulation: to maintain firmness of capacity and a stable investment climate, existing contracts should not be subject to change. Existing contracts have been agreed upon on the basis of the existing market conditions at the time the contract was signed and taking into consideration the value of the capacity such conditions being given. Any forced contract alteration could change the value and firmness of each capacity contract and could remove the ability to utilise this capacity for firm commodity commitments.

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Insofar it is understood as a live document we see value in a conceptual model for the European gas market as a facilitator for necessary adaptations in less liberalised gas markets. A conceptual model for the European gas market should include guidance/practical suggestions along the lines of the 11 network codes foreseen by the gas Regulation in order to facilitate further market integration.

(a) Capacity Allocation Mechanisms

Harmonization goals for CAM should consider that, at present, the gas transmission frameworks of the European market areas show the following features:

- capacity charging structures differ along four main dimensions: entry-exit versus point-to-point, uniform versus locational, entry/exit tariffs versus postage stamps, differentiated versus uniform approach with regard to cross-border transmission;
- the basis for charging varies between 100% capacity to 50%-50% capacity-commodity;
- the products offered other than firm capacity vary from country to country, with the result that the variance among the definitions of interruptible capacity (and relative price) is significant. Products such as backhaul are only offered in some areas, and there are no clear guidelines as to the pricing of non-annual capacity products.

The ideal CAM would be a locational system, both internally and cross-border, with entry-exit tariffs. A high share of commodity over capacity charge would be desirable, as well as the widest possible range of products other than firm capacity, as much as possible standardized across balancing zones. Such a system would represent the maximum number of options for shippers, and therefore guarantee the maximum liquidity internally and externally.

We believe that an integrated model for market-based capacity allocation, which is able to signal ex-ante the capacity price levels that represent existing grid costs, investment triggers – tariffs and minimum booking – for new capacity, as well as to encompass the potential for overselling capacity by TSOs, is the best way forward. The model aggregates capacity demand at each entry and exit point and puts a price on different levels of demand factoring the need of the TSO to invest in new capacity to satisfy all requests for access to the network or to oversell beyond technical available capacity.

For long term capacity bookings, the auction should ensure that shippers can help supporting and securing investments and that they can do so under transparent conditions regarding investment trigger levels and prices levels. On this basis, the bidding process should require shippers to indicate the amount of capacity they wish to book against which the pre-set price levels covering TSOs' costs and allowed revenue are set. In such a model, long term capacity is requested by network users at pre-defined price levels auctions that are designed to:

- Capture the ability of regular auctions to attribute capacity in the amount desired by network users at a price close to the one indicated for that specific booking level;
- Ensure that all demand for primary capacity is met where it is economic and efficient to do so;
- Ensure a high level of predictability both in the short and long run of available capacity;
- Avoid non-transparent and discriminatory capacity allocation as they imply no priority order;
- Reduce pressure on second best options, such as anti-hoarding rules and interruptible capacity.

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Short-term auctions should be designed to reflect the market value of capacity. Such auctions could be set up the same way as the long term capacity bookings. However, the nature of short term products and the utilisation by shippers could suggest a pay as bid auction mechanism, possibly with a zero or low reserve price, where capacity goes to those who value it most. In any case, there would need to be a mechanism to deal with the TSO losses and profits from this process. Scarcity is likely to lead to higher prices and therefore higher profits for the TSO, not providing TSOs the incentives to invest, where congestion occurs.

The auction process should take place on a regular basis, becoming a systematic feature of the investment planning cycle. It should provide a flexible mix of products and transparent allocation rules. A pre-defined percentage of capacity should be reserved for short term auctions, to ensure the large variation of needs of the commodity markets are met.

Building on existing experience with auctioning procedures in fully liberalised markets and existing infrastructure (existing trading platforms) auctioning modalities should be coordinated across the EU to ensure an open and effective gas market.

It would be advisable to reserve capacity for short term bookings and potential market entrants. Statoil envisages somewhere between 80% - 90% of firm available (technical max +/- operational) capacity reservation for long term bookings. The remaining 10% - 20% will be made available in the Monthly and shorter allocation process, in addition the monthly process can sell the unsold from the long term booking.

(b) Congestion Management Procedures

Overselling and buy-back

Statoil proposes a commercial mechanism that maximises the available firm capacity by incentivising the TSO to sell more capacity than it is physically available and potentially buy-back in case of congestion, based on an educated assumption that not all shippers utilise 100% of their capacity rights, 100% of the time.

This system does not represent a way to re-allocate unused capacity, but rather to allow the TSO to increase its sale of firm capacity by assessing the grid situation. Combined with a transparent mechanism to calculate the available firm capacity, it incentivises TSOs to optimise capacity utilisation, without decreasing the level of firmness of already booked firm capacity.

The accompanying buy-back mechanism is initiated only if and when the system unexpectedly does encounter physical congestion. It allows the TSO to buy back capacity rights from those shippers that do not value it, without impacting the rights of those that really see value in using it. It allocates the risk of physical capacity overrun to TSOs.

As with all commercial solutions there is a need to ensure that the pipeline system can maintain its integrity and as such it may be necessary for the TSO to be able to override such commercial frameworks for force majeure circumstances, such events should however be clearly defined within the contractual framework so ensure transparency for all parties.

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Capacity overselling by TSOs should be done in a way that does not create uncertainty. A clear ex-ante indication of price of capacity should be provided. Timing of buying-back should be well aligned with market dynamics and should occur while trading activities are still taking place to allow coherent adjustment of volumes in the market.

Secondary capacity market

A market based approach to ensure an efficient use of existing capacity consists of setting up a market for secondary capacity trading. The main benefit implicit in such a system consists of a continuous commercial and voluntary opportunity to solve situations of contractual congestion. Shippers who hold capacity are enabled to sell when they do not plan to use the capacity or are not commercially required to hold it, while shippers who need capacity are enabled to buy when primary capacity is not available. However, by no means secondary trading can be seen as the sole and exclusive CMP or as a sufficient measure to ensure an efficient use of capacity or to avoid anti-hoarding.

To ensure that market participants make use of secondary markets, access should be maintained simple and cheap, the possibility to split and combine (bundled) products, i.e. fragmentation in time and volume, should be foreseen, and secondary capacity prices should be allowed to compete with primary capacity prices.

Statoil believes that the principles enshrined in the EASEE-gas Common Business Practices on Secondary Capacity Trading provide adequate guidelines.

(c) Management of Storage Capacity

Storage capacity is one of the most important flexibility available to shippers. However, access to storage varies considerably from one country to another. It is important that regulators enable storage regulation that takes into account the different stages of market development. As such it should be possible to enable a flexible application of TPA rules to storage dependent on the degree of competition in that market.

(d) Market-Based Balancing

Market based balancing is fundamental to generating greater competition and liquidity in gas markets. Market participants should be primarily responsible for balancing the system, and the TSO's role should only be residual, i.e. take stock of the aggregated imbalance position and buy/sell gas in traded markets to restore balance.

Shippers should be financially incentivised to balance the system through cash-out prices derived from the marginal cost of any residual balancing actions taken by the TSO, which in turn should be financially neutral to the costs/revenues arising from these actions, i.e. any costs/revenues resulting from the cash-out mechanism should be smeared back to shippers in a non-discriminatory way.

The target model should make sure the following specific actions are taken in order to make market-based balancing possible:

- develop measures to facilitate both day-ahead and within day trading;

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- eliminate any storage capacity reservation for the TSO as it would distort the market mechanism.

(e) Transparency

Price discovery and transparency of underlying supply and demand fundamentals underpin traded markets and providing signals for long term investment. Much of the data relating to supply and demand fundamentals is covered by the Third Package. It will be important to ensure that TSOs comply with this fully and provide such data in a timely and user friendly manner.

In order for shippers to respond in a rational economic manner to the financial incentives created by a market based balancing regime, they need to have full visibility of their own imbalance position, and of the system as a whole, along with the residual balancing actions taken by the TSO and the cash-out prices derived from such actions. Hence the TSO should capture all the data necessary to be able to provide shippers with accurate within day estimates of their imbalances.

National regulators should:

- require the TSO to provide shippers with regular updates on their imbalance position within day; shippers will then be fully responsible of the financial exposure arising from being out of balance, and can respond to the financial incentives to restore a balanced position;
- require gas exchanges to publish details of all bilateral trading activity and residual balancing activity on an anonymous basis, as well as calculate and publish real-time cash-out prices based on such activity.

However, information that could put the parties' commercial interests at risk should be avoided. Disclosing booked capacity and nominations may work well for the electricity market but well this is significantly different to the gas market.

(f) Rules regarding harmonised transmission tariff structures

Transmission tariff structure should reflect real costs incurred. The way these are calculated should be clear to all market parties.

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?**
- 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 EASEE-gas preference for 6am-6am CET seems to be widely accepted among the industry.

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Horizontal depth should be taken into higher consideration than vertical depth, cross-border integration being the first priority of the gas model. Therefore, it is better to concentrate efforts on the wholesale market first, by reducing the number / integrating balancing zones across borders.

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?

Besides the competitive structure of the market already addressed by the Third Package, the additional focus areas should be transmission (CAM/CMP), storage, balancing, and transparency. Please refer to question 3 on market design.

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

The target model should relate to the wholesale market, and leave out what does not have any bearing on it.

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?

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

It should be left to the markets themselves to determine the optimum number of balancing zones, by looking at where sufficient cross-border interconnection is in place and price signals indicate that two zones might be integrated. Neither of the two extremes (27 or more balancing zones, or a single one) are optimal choices.

Certainly some similarities can be drawn with the electricity markets, but there are important differences, the most prominent of which seems to be the difference in interconnection volumes among market areas. A different set of solutions is therefore needed for gas market coupling.

Statoil appreciates the opportunity to communicate our opinion in this regard and we remain available for any further discussions on this matter.

Yours faithfully,

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