Interconnector (UK) Limited
8th floor, 61 Aldwych
London WC2B 4AE

Direct Line: + 44 (0)20 7092 6525
Switchboard: + 44 (0)20 7092 6500
Central Fax: + 44 (0)20 7092 6501
Email: darren.reeve@interconnector.com
Website: www.interconnector.com

F.A.O. Natalie McCoy
Secretary General
CEER
28 Rue le Titien
1000 Brussels
Belgium

27 April 2011

Dear Sirs

IUK comments on the CEER Target Operating Model for Gas

IUK welcomes the opportunity to contribute to the debate on the Target Operating Model for gas ("TOM"). We support the further development of an internal market for gas and the delivery of widespread economic, social and commercial benefits to the European Community.

Focus of the TOM

In IUK's view, a TOM is needed to support the development of the internal market, and thereby to assist in the development of Network Codes and implementation of measures outlined in the Third Package. The TOM should recognize the challenges faced in developing the internal market and ensure that the measures by which these will be ameliorated are proportionate, appropriate and evenly applied. The TOM should be targeted at those areas where there is a clearly identified problem; it should not impose potentially expensive and disruptive system re-engineering costs where, although there may be discrepancies, problems do not exist.

The TOM should remain a target, that is, "an objective or result that is aimed at"[1]. It should provide a framework for significant, realistic and achievable progress in the development of the internal market in a feasible timeframe. It has been recognized in the presentation by Walter Boltz, that development of the internal market is two-faceted – requiring fully liberalised and competitive local markets, and harmonisation between markets in order to enable them to coalesce. It was accepted by Mr Boltz that delivery of the internal market will vary across member states, because each member state is in a different starting position. The TOM should therefore be sufficiently flexible to promote innovation and choice and to reflect genuine system needs across the broader spectrum of the European market.

Objectives of the TOM

The first objective for delivering the internal market must be to ensure each end consumer in every member state is served by a functioning wholesale market. Attempts to meet this objective are already underway, and although significant progress has been made, progress

[1] Concise Oxford English Dictionary

has been uneven. Policy makers and regulators should assess why this is so, and use this understanding to better implement existing measures to improve wholesale markets.

The second objective should be to deliver greater harmonisation of systems such that trading between markets becomes easier and liquidity can be transferred and multiplied between markets to the mutual benefit of all participants. The TOM will apply to a broad spectrum of systems and markets, and harmonisation is needed to enable them to coalesce, but each system may need to follow its own path in order to reach the goal of delivering the internal market. At this stage, this goal should remain principle based, and above all leave choice in its implementation. The TOM should avoid eroding the ability of TSOs to enable the internal market by mandating restrictive pathways that will undermine investment in the sector.

Approach to developing an appropriate TOM

The TOM is an opportunity to set the tone and pace of the development of the internal market, and its significance means it is incumbent on the industry to ensure that this opportunity is not wasted. Given the importance of the TOM, a robust process is essential, yet IUK is concerned that the project may not be following an effective process where stakeholder views are fully taken on board. It would be wrong to infer that the attendees of the workshops can bind all stakeholders to measures that will fundamentally change the structure of the market. Extreme care must therefore be taken to engage all stakeholders and empower them to discuss and challenge the structure of the TOM.

Of particular concern is the apparent approach to propose solutions without full analysis of the problem. At the recent workshop some of the analysis provided does not explain how and why the proposed measures meet their overarching objectives, and the numerous possible target models tabled make it unclear which route is to be adopted. Further consideration of the costs of delivering the benefits should be undertaken. Without robust analysis, the TOM risks supporting proposals that do not withstand scrutiny and thus will not have the support of the market. Liberalisation of the market was not intended to transfer the role of central planner from industry executives to regulators; it would be preferable to establish clear market rules and allow innovation and commercial behaviour by market players to deliver efficiency and value.

A competitive internal market for gas has been progressively implemented through three legislative packages since 1999. In formulating its view on the TOM, Interconnector has returned to the basic principles laid out in these continuing legislative packages and in the Communications that led to the Third Package, in order to understand what is achievable within the current legal framework, and to remain focussed on the task in hand.

The remainder of this document considers the problems identified, the basis upon which these problems have been identified, considers others which are relevant to the TOM and suggests a possible approach. Interconnector has endeavoured to adopt a positive and pragmatic approach, which it believes reflects the spirit of open and responsible consultation.

Principles required to deliver the Internal Market

Interconnector agrees that in order to achieve functioning wholesale markets capacity needs to be allocated and used efficiently, and balancing in transmission systems should be market based with a minimal role for TSOs. Furthermore, IUK fully supports that these mechanisms should be transparent and non-discriminatory.

However, it is Interconnector's view that many of the measures proposed under the Third Package stray from their original objective and even beyond the remit of the primary legislation. As will be further discussed, market coupling, while appropriate for the electricity industry is inappropriate for the gas industry; potential arrangements for capacity allocation and congestion management appear to be disproportionate and restrict innovation; and gas balancing proposals are over-reaching.

Many of the proposed measures are borrowed from the electricity industry and appear to be focussed on short term gains at the expense of long term security, investment and a healthy market beyond the target of 2014. A fully functioning internal market at 2014 and beyond should deliver price formation of gas and transmission capacity, such that long term investment is delivered by the market and doesn't require end consumers to bear the socialisation of costs. Whilst access to markets day-ahead or within day may improve short term liquidity, it will not improve forward trading and thus will not deliver market depth required for price formation of capacity, or provide investment signals. It is concerning that there appears to be an over reliance on punitive congestion management and market coupling measures to make short term capacity available, when there are other tools to hand that will deliver more widespread benefits.

Transmission in gas and electricity markets

The following is a non-exhaustive list of the fundamental difference between gas and electricity:

- Gas is a primary, natural resource, whereas electricity is a secondary, manufactured product
- The internal market for electricity is geographically contained within the European Union, whereas for gas a significant proportion of the upstream industry is external – Gas is where nature put it, electricity can, within reason, be generated anywhere
- The internal market for gas is in competition in a world market
- Electricity moves at approximately ~1,000,000km/h, gas moves at approximately 40km/h.
- Electricity cannot realistically be stored – there is no concept of linepack which fundamentally impacts the way in which a gas network can be managed

The conclusion from the above list should be that because of the upstream and downstream differences between electricity and gas, the function of transmission serves a different role:

- In an unbundled regime, market access for electricity comes naturally through connection to the network, therefore upstream competition is more prevalent in electricity. Market access for gas, at two extremes, can come through upstream title and physical entry capacity to hubs, or virtual access to markets and physical exit from the hub.
- Security of supply in electricity is delivered through a sufficient and diverse mix of power stations. In gas it is currently delivered through long term contracts, in future it should be delivered through long term price signals
- Electricity networks must instantaneously be in balance, therefore TSOs must operate the balancing tools. In gas networks, there is no necessity for TSOs to operate balancing tools, they need only provide a framework for shippers to balance themselves.
- Flexibility in power is achieved through flexibility in generation and excess generation capacity, whereas flexibility in gas is delivered through access to storage, LNG and flexible supply/demand points such as Interconnectors
- In electricity, supply and demand can be geographically balanced, whereas in gas it is necessary to transit huge volumes of energy across the continent

Harmonisation of market zones and the underlying transmission systems has the potential to create significant mutual benefit to each participant in the internal market. However, it is accepted that the internal market is fragmented as uneven progress has been made in liberalising energy markets across Europe. This severely limits the scope of harmonisation and a staggered and appropriate implementation to some of the currently proposed measures (e.g. balancing) should be considered.

Delivering the internal market is achievable without harmonisation of rules and protocols, it can be achieved through harmonisation of principles and mechanisms, leave choice as to which tools are used, and should be incentive based to encourage innovation. Interconnector is concerned that the level of harmonisation, either currently proposed in Framework Guidelines or being considered in the TOM, is too prescriptive, potentially disproportionate and counterproductive in its attempt to deliver an internal market. The market rules need to be flexible enough to encourage good practice where this exists and address real local issues where more rapid change is required.

Whilst considering harmonisation, it is important to avoid the creation of cross subsidies and socialisation of costs as these are not compatible with the goal of delivering a liberalised and functioning market. A one size fits all solution is not appropriate given the diversity in complexity of the systems, the TOM should allow room for innovation and not restrict flexibility in products and services, such that TSOs are incentivised to develop new services and invest efficiently.

Interconnector and the TOM

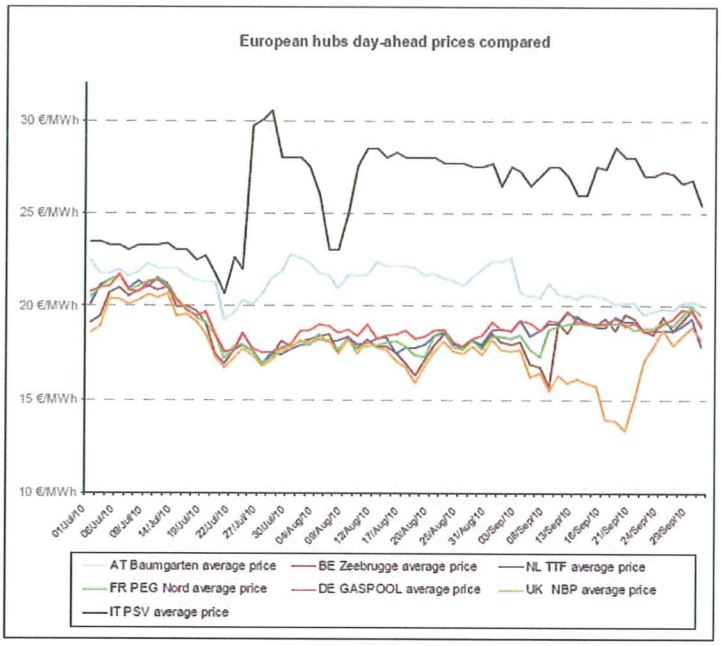
Interconnector is increasingly concerned that despite offering transparent, non-discriminatory access to cross border capacity in line with the objectives of the Third Energy Package, the implementation of the package could restrict choice and innovation. Regulation should be outcome focussed and should, we feel, avoid specifying detailed means by which outcomes should be achieved. We have been making the point for some time that IUK, as operator of a merchant pipeline between two markets in competition with other pipelines, LNG and storage facilities, is very different to a complex national transmission network. Whilst our case has received a sympathetic hearing, this is not being reflected in reality as the Framework Guidelines and Network Codes are being written with little regard for merchant pipelines operating in a competitive market. The TOM appears to continue this theme.

Developing a TOM

In order to apply appropriate measures to the market, its current state must be considered in depth. To date, uneven progress has been made in delivering fully liberalised and competitive markets in Member States. The pace of liberalisation in North West Europe has been much greater than elsewhere, such that the transition to hub based pricing is already happening in this region.

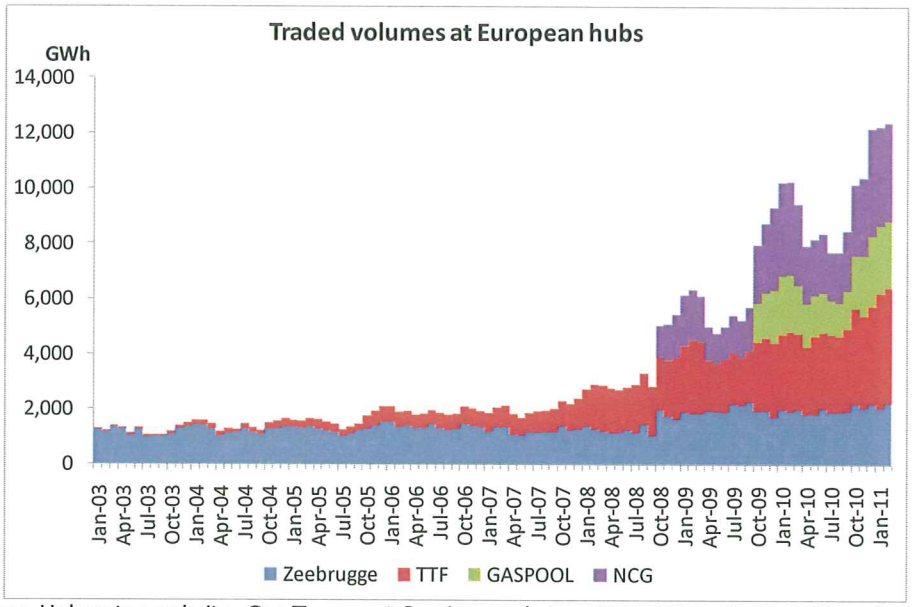
At the 3rd TOM Workshop on 11 April, the following graph[2] was presented as evidence that in NW Europe the market is not sufficiently coupled as the price differential at times reached 6 €/MWh. However, the time period in question was during Interconnector's planned maintenance period, when normal market behaviour resulted in price divergence between markets without a physical connection.

[2] From the European Commission Quarterly Report on Gas Markets, Volume 3, Issue 3: July 2010 – September 2010



This was not recognized at the workshop, but used to support an argument that otherwise lacks foundation. Since 1 October 2009, outside of the Interconnector maintenance period, the day ahead price differential between the NBP and Zeebrugge has broken through 1 €/MWh on three occasions, and on all three occasions Interconnector flows were more than or equal to 99% of physical capacity. The graph clearly shows that the markets of NW Europe are working well and are very closely aligned, with any differential reflecting no more than the cost of transport.

At the TOM event it was suggested that liquidity is not improving in the markets of North West Europe, yet traded volumes are rising exponentially, as shown in the graph below.



Source: Huberator website, Gas Transport Services website, GASPOOL website, NCG website

The presentation did not, we feel, adequately consider externalities affecting hub volumes. One example[3] is the drop in demand due to the global recession. This restricted the ability of utilities with large take or pay obligations to transact at hubs – they didn't need any more

[3] Further discussion of the interaction between hubs and long term contracts can be found in 'The Transition to Hub-Based Gas Pricing in Continental Europe', *Oxford Institute for Energy Studies,* March 2011

gas from the spot market, and they didn't want to sell at a loss. Indeed, this experience, and the increasing role the market is having in independent price formation is leading many to rethink their long term contracts[4]. There can be no doubt that prices are forming transparently at hubs and the transition to hub based pricing is happening. While IUK does not claim that the internal market is complete or perfect, this is irrefutable evidence of the success of existing legislative packages and their implementation through principle based regulation. The immediate focus should, we believe, be on applying proven, principle based regulation rigorously to areas where markets are not yet showing any signs of developing.

Looking beyond 2014 it is important to foster long term depth and liquidity in markets, such that there is transparent price formation of gas, and transport capacity between market zones that is truly market based. This will deliver long term price signals for investment in new capacity – without the need for regulatory intervention – and will foster a secondary market in transmission capacity such that contractual congestion is prevented from happening.

In our view, a strict and penal congestion management regime in order to deliver short term firm capacity (for within day allocation implicitly or otherwise) undermines the value of capacity such that price cannot be defined in the medium to long term and will not be explicitly traded on the secondary market. Thus the problem of contractual congestion will be self perpetuating. As expressed at the workshops, within day and day ahead capacity rights are not sufficient grounds to build a business model, and will not facilitate market entry to the degree perceived. Market coupling in the manner developed for electricity is not directly transferable to the gas market for the reasons given previously. However, where there is market demand and incentive for such a measure, TSOs should endeavour to offer this service as a choice. This is the sort of innovation that should come from the TSO in their role of enabling wholesale markets.

As shown, in North West Europe there is little evidence of price divergence caused by contractual congestion. Liquidity of the hubs could be improved, and greater harmonisation is certainly beneficial, but there is no need to impose prescriptive measures to fix a problem that is already fixing itself. Merger of balancing zones to extend market zones is not necessary in North West Europe, neither is it necessary to have markets in all systems. Merging balancing zones across TSO borders needs very careful consideration and it should be recognized that, amongst other things, it requires inter-TSO compensation which is not market based and risks cross-subsidisation.

At the TOM Workshop, the Interconnector was used as an example of inefficiency in which transport from the NBP to the Zeebrugge hub requires exit from National Grid, entry then exit from the Interconnector and finally entry to Fluxys. This argument could of course be extended across countries and to storage and LNG capacities. Regulation of assets needs to be undertaken in a proportionate manner on a case by case basis according to high level principles. The Interconnector service is in competition at both hubs with other sources of supply, LNG and storage, many of which benefit from TPA exemptions or are not subject to the same level of regulation.

Rather than focussing on so called pan-caking between hubs, a model with market based hub to hub transmission should be considered. It should be accepted that, provided network users have access to markets elsewhere and the ability to transport between hubs, not all balancing zones require markets. Lessons can be learnt from the US, where there is a diverse mix of hubs – in this example, gas could be purchased at a wholesale hub, and

[4] 'Europe rethinking contracts with Gazprom' *Interfax Russia & CIS Oil and Gas Weekly,* March 4 – March 10, 2010

transported to a consuming hub, the consuming hub may pay a premium but this will be the transaction cost of transporting the gas. In a functioning market this transaction cost will be minimal compared with the product cost, and there should be no difference between the implicit or explicit cost of transporting gas purchased in one hub to another. Furthermore, at any one hub, there will be a plethora of competition between sources, and places gas transmission within the internal market on the same playing field as supplies beyond the internal market.

The role of TSOs is to enable the wholesale markets, and is facilitated through providing for user-friendly transport of gas. More can be done to facilitate gas transport across operators by closer alignment of their regimes, and many small steps in harmonisation will provide widespread benefit. These include, but are not restricted to common units, common definitions of firm and interruptible capacity (or a wider glossary of terms), gas quality and a common gas day. More intrusive harmonisation steps, such as common balancing rules, will be much more difficult to achieve because of the diversity of systems to which the rules apply.

Concluding remarks

The TOM should be ambitious but remain realistic and achievable. Interconnector believes that the internal market will deliver widespread benefits, but the reality is that its current state is a vastly diverse array of transmission systems supporting a broad spectrum of markets across member states.

The TOM should be well directed. It should focus on applying proven, principle based measures to improve liquidity in markets and regions that have thus far shown little sign of improving, and seek low cost high impact harmonisation measures. It should avoid non-market based or restrictive measures that will lead to cross subsidisation or stifle the development of a secondary market in capacity by undermining its value.

Harmonisation rules must remain compatible with complex networks with well established entry-exit regimes, to regions with many TSOs and balancing zones, to single pipelines with merchant operators and no load or market to service. IUK is concerned that the measures envisioned in the TOM are overly prescriptive and burdensome – the TOM must provide room for innovation and choice, and must allow for transmission between hubs.

In order to deliver a robust long term vision for how the internal market should operate, the TOM should be supported by robust analysis and consideration of the costs and benefits. Scrutiny and innovation should be encouraged through open consultation and debate, and the opportunity should be taken to empower the industry to deliver the internal market. Developing a Target Operating Model for delivering an internal market for gas is a significant challenge that should not be underestimated, it cannot be delivered by one party alone but will require the full support of politicians, regulators and market participants alike and will take some time to achieve.

Yours sincerely

Darren Reeve
Commercial Manager