

Mrs Fay Geitona
CEER
28 rue le Titien
1000 Bruxelles
Belgium

14 January 2011

C10-GWG-70-03 Conceptual model for the European gas market – Call for Evidence

Dear Mrs Geitona

Introduction

EDF Energy is one of the UK's largest energy companies with interests that include nuclear, renewables, coal and gas-fired electricity generation, combined heat and power, and energy supply to end users. We have over five million electricity and gas customer accounts in the UK, including both residential and business users.

EDF Energy welcomes the opportunity to respond to CEER's Conceptual model for the European gas market – Call for Evidence. We fully support the development of a fully liberalised integrated EU Gas market that will deliver competitive prices, along with sustainable and secure gas supplies, in the interests of all consumers. We recognise that the framework guidelines (FGs) under the Third Energy Package are making strong progress on this front by resolving some of the capacity, information and liquidity issues (Bottom up approach) highlighted in this consultation. We agree that a conceptual model for the European gas market should give guidance for the ongoing and future drafting of FGs and Network Codes (NCs). However, a careful balance needs to be struck between further integrating markets through merging balancing zones / coupling markets and relying on the FGs to deliver the same target model to secure equal access to transmission capacity.

We note that there are some significant issues which need to be addressed in order to create an effective conceptual model that can be practically implemented:

- The release of capacity is key to opening up European trade and the focus of the conceptual model.
- We realise that increased capacity will only be forthcoming if the incentives are there for the transmission companies to invest (via price controls or tariff setting). This should therefore be a priority in the development of the market model.
- Network charging principles and methodologies should facilitate cross-border trade in order to create consistency of approach between transit countries.
- Market-based gas balancing will be required in the model. Balancing mechanisms have a significant impact on market participants' behaviour in the market. They need to recover the costs of balancing the system and should be harmonised, where possible, to ensure effective and efficient flow of gas, especially at peak times.

- The model must acknowledge the differences between markets at different stages of maturity, including how they source their gas and whether this is through indigenous gas supplies or imports, when assessing the effectiveness of the target model. A toolkit of different capacity and balancing rules for different markets may achieve the same result and do so more efficiently.
- Long-term capacity rights should be treated as property rights. The use-it-or-lose-it principle should only apply when it can be demonstrated clearly that this capacity will not be used over the long-term or is needed by market participants. An open season for capacity demand at certain points could be a way to create demand and price discovery.
- Once established, the market needs to be effectively policed to avoid abuse of dominant position, using the competition framework.

Our responses to the consultation questions are contained in the attachment to this letter.

Should you wish to discuss any of the issues raised in our response or have any queries please contact my colleague Sebastian Eyre on + 44 20 3126 2325, or myself.

Yours sincerely,

A handwritten signature in black ink, appearing to read "D. Linford".

Denis Linford
Corporate Policy and Regulation Director

Attachment

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EDF Energy's responses to your questions

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?

Energy policy objectives

European energy policy is undergoing a period of fundamental change with the opening of markets, combined with the uncertainty of demand due to the introduction of stringent low-carbon renewable energy targets and tight deadlines. This is set against uncertainty in gas supplies with notable reliance on imports due to insufficient indigenous gas production within EU member states. A significant amount of market and transportation flexibility is therefore needed to ensure that gas efficiently flows to where it is required.

Maximising current and future capacity release

The most important barrier to cross-border trade is the availability of transmission capacity which can only be addressed with increased investment in pipeline infrastructure and not in the development of market mechanisms. We would therefore argue that development of price controls for each member state is a priority. The price controls will appropriately incentivise TSOs to maximum capacity release and invest in this new infrastructure for cross-border trade that will meet future European gas demand.

Common principles for network charging to facilitate for cross-border trade

The Commission should consider the development of equitable charging methodologies for the costs of infrastructure based on the principle of cost reflectivity. This should facilitate trade which falls below the high level policy goals defined in the Third Package. For example, TSOs might propose capacity, commodity, temporal and locational charging methodologies. Each of these can have significant impact on different consumers and gas shippers and should be considered very carefully prior to implementation.

From the UK's experience, we advise the Commission to decide on the formation of cash out prices which are not simply part of the balancing regime but a key determinant of the philosophy of the market. We recognise that the majority of respondents (26) to the Gas Balancing FGs consultation supported marginal cashout prices.

Force majeure and compensation arrangements

In developing the concept of the market, the Commission should consider the issue of force majeure and market design. This is important given the development of compensation in a number of scenarios ranging from a gas crisis to extreme winter peak day. Furthermore, the definition of the conditions for the resumption of the market is also important to market players. We would suggest careful consideration of this issue.

Credit

Credit rules have been an important determinant of market activity for existing players and in terms of ability to attract new entrants. Credit and collateral requirements are undoubtedly a hurdle which might affect the success or otherwise of European trade..

Policing the market

Once established, the market needs to be effectively policed to avoid potential abuse of dominant positions, using the competition framework. From a market design perspective, at every stage of the process, participants need to understand how to comply with the regulations and codes. The enforcement of regulations preventing hoarding of capacity could prove to be a contentious issue. There might, for example, be legitimate reasons why a firm might book what could turn out to be "extra" capacity if it was following an inaccurate demand forecast or was concerned about system conditions and cashout prices.

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;

As stated previously, the EU gas market is undergoing fundamental change to meet the supply and demand challenges emanating from an increase use of gas in heating and generation use. This is as a result of the Renewables, Industrial Emissions and Third Gas Directives. The increased use of CCGTs will continue to meet the increasing levels of intermittent generation. At the same, time long-term gas supply contracts are also changing with many legacy contracts coming to an end and new contracts based on more flexible delivery and pricing terms.

Long-term contracts also represent the natural balance between risks associated with up-front costs faced by investors in production assets, and the requirements faced by gas suppliers. These contracts provided the commercial framework for the early development of the industry. The contracts are fully defined property rights of long standing and can only be seen as foreclosing the market if they prevent other participants who want to supply their customers. The Commission may want to balance the danger of market foreclosure in the short term, and in the long term the potential to threaten new investment in new capital intensive production assets if investors are not certain of a reasonable return.

b. the role of hubs / gas exchanges.

Hubs and gas exchanges are vital to the development of competition and liquid markets. However, they have evolved organically at strategically key network points through a combination of excess gas flows and price discovery. Whilst we recognise some markets can be naturally coupled, such as the Iberian gas market, we do not believe that others

should be forced to couple. We believe that market forces will ultimately decide whether markets should naturally link and this remains a challenge of any target gas 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.

- Ensuring effective capacity allocation – the optimisation of gas capacity release is key for markets to develop effective markets, and all efforts to incentivise TSOs to release maximum technical capacity, both current and future, is essential. Existing capacity rights should be respected however, we believe these could be reviewed alongside existing long-term supply contracts in the interest of optimising capacity release. The use of open seasons for price and demand discovery should be used rather than auctions where necessary. However any auction process should be based on a clearing auction.
- Congestion management is an integral part of creating liquid and competitive hubs. TSOs should be incentivised to maximise capacity release through selling unutilised capacity and implementing an oversubscription and buyback mechanism as proposed by the Commission in their recent Congestion Management Procedure (CMP) guidelines. Short-term capacity auctions could be used to resolve constraints where capacity is oversubscribed at interconnection and cross border points.
- Efficient Gas Balancing zones – while we recognise the benefits of coupling and merging markets within member states, such as in Germany and France, we do not believe that cross border markets need to be coupled in order to have efficient trading and liquidity. Indeed, this may increase the complexities of trading due to different taxation and fiscal regimes across member states. Access to markets through open and equal capacity rights is the key to creating competition which will create liquidity and price competition for consumers. The benefits for arbitrage between markets should not be underestimated in the interest of attracting players to market, as this has macroeconomic benefits as well.
- TSO incentives – there is a clear need for, and alignment of, price controls in each Member State to incentivise investment that optimises current and future capacity release, in order to deliver true cross-border trade. Monopoly networks need to have direct financial incentives for the correct level investment which balances risk and reward. Article 13 (2) requires the TSO to invest in “sufficient cross-border capacity to integrate European transmission infrastructure” using an “economically reasonable” and “technically feasible” test;

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?

We believe there should be a clear definition of an EU-wide gas day. We also believe that while it should aim to be aligned across all Member States, it is not necessary to harmonise timing. We note that several closely linked markets in north-west Europe, namely NBP and Zeebrugge/TTF have been working fluidly over the last 10 years, despite the timing and operational differences, resulting in liquid hubs and trading opportunities.

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 development of competitive, integrated and liquid markets is the priority. We do not believe that the EU Gas model should go as deep as the Distribution network zones at this stage. That is not needed in the overall aim of the single internal market and could hamper the efforts in implementing the basic target model. There is, however, merit in integrating balancing zones across borders through new innovative products, such as bundling entry/exit capacities, as this will help markets develop.

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 areas identified under the Third Package should feature largely in a gas market target model, namely capacity allocation; constraint managements; information provision; interoperability; and harmonisation of rule and tariff principles where possible.

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

We believe the target model should aim to harmonise the principles of market arrangements and rules where possible, but that it is not essential to begin with. There should be certain elements that should be left to National Regulatory Authorities to consult on and implement in the spirit of the Third Package, such as the development of tariff structures and use-it-or-lose-it rules.

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?

We are not in a position to understand exactly what market areas/ balancing zones will ultimately be derived. We would expect an extensive cost benefit analysis given the risks associated with a poor market design. It is also the case that we do not know the impact of network codes on the development of European markets but we would assume that they could have an impact on the nature of the balancing zones.

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

There are some obvious differences between gas and electricity markets, including real-time balancing, production and storage which have an impact their market design. Market coupling has worked well as a model. We are less certain on how this will be applicable to gas. This is because as we have not seen any detailed proposals of how the model might be adapted. However, we remain open minded on the issue.

EDF Energy
January 2011