



Public Consultation European Gas Market - Target Model

**Response to CEER Vision Paper (Call for Evidence) for a
Conceptual model for the European gas market**

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Introduction

Having read the consultation documentation, attended the first workshop and engaged various stakeholders, OGP believes it has a grasp of the intention of the Gas Target Model and agrees with the need for such a model.

The initial views of OGP were encapsulated in the presentation made at the Vienna workshop of 3rd Dec 2010 and this paper is a further reiteration, expansion and consolidation of the views expressed in that presentation. The paper addresses the questions raised in the consultation document:

Q1. 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?

- To describe a vision of how the EU gas market will work and what products will be available to customers to complement the model, from short term to long term
- To define a regime that offers customers more choice of products in transportation and more locations for delivery
- To achieve consistency in operational functions, such as transportation, across the EU
- To define stakeholders responsibilities, accountabilities and limitations
- Establish overall behavioural rules and participants performance norms to enable smooth functioning of the market
- To provide a list of each Framework Guideline and associated Network Code with sufficient description of the contents of each to prevent ambiguity and alleviate misunderstanding
- To provide descriptive and pictorial definitions of the regions covered by the model
- To establish and define initial gas hubs, balancing zones and entry/exit points
- To be non-prescriptive in order to allow adaptability to meet local, national or regional circumstances. This is particularly important in terms of investment and the related security of supply considerations. For example, defining a maximum duration of capacity booking contract to say 5 years, as mooted, would put major upstream projects at risk through non-securing of long term sales agreements and hence project sanction. We note the recent Commission proposals for the Caspian Development Corporation as a possible case in point. Such a contractual period would also represent a backward step compared to products currently offered in the UK, for example.
- To present a set of guidelines that will achieve consistency across the various aspects of regulatory policy within the context of a single market.
- To identify opportunities to streamline, simplify or remove regulation where efficient competitive markets develop or already exist.



Q2. 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;

The target model needs to be ambitious in seeking to satisfy customer demands in terms quality and variety of choice. These choices are likely to include a range of capacity products on a range of timescales. In the UK, for example, auctions for long term entry capacity can trigger further investment in the grid if signals (backed up by financial commitment) are seen for periods of up to 10 years. Such a regime is desirable across the EU, one that allows customers to regularly signal needs via a consistent, predictable and transparent approach. In the UK, this approach has attracted investment of c. £10bn in the last few years such that nearly 30% of current gas supplies have been developed as recently as 2006. We see that, of necessity, the European gas market must remain one that is fundamentally based on long term contracts.

In the context of implementation of the 3rd Package and development of the Network Codes, specifically the one covering capacity allocation, it would be inappropriate to consider a revision or reopening of existing long-term transportation contracts as a means of allocating capacity to others. In the absence of any competition concerns, it appears to be difficult to justify such a move.

b. the role of hubs / gas exchanges

Hubs and gas exchanges will play a vital role in the target model. In an era of import dependence and an increasingly global gas market, liquid markets are required to generate market signals for shippers to manage their global portfolio risk better.

However, trading does not have to take place at hubs or exchanges only. As such, regulators should not mandate the use of hubs or exchanges but instead recognize that the market will gravitate towards the use of such mechanisms at its own pace. Experience from developed markets has shown that while non-hub trading can still take place, over a period of time the majority of it will switch to hubs. This reinforces the need for no-prescriptive guidelines in the target model.

Q3. 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.

We underline the importance of market-driven developments supported, where necessary, by proportionate EU rules. The items mentioned are relevant to the development of a conceptual model and all concern areas in which Framework Guidelines/Network Codes are, or soon will be, in preparation and will eventually be of a binding character.



Already they should be planned to interact with each other in a coherent way. The market model, however, which will be non-binding, is a steering instrument, a framework into which progress on codes and rules fit and which may consist of elements that bring added value to rules and codes, in particular on the access regime to networks. The market model should respect the different considerations applying to storage and LNG, be coherent with the widespread recognition for investment along the gas chain and respect the sanctity of contracts. Further comments on the individual items are offered below:

CAM

The ideal CAM would be a locational system, both internally and cross-border, with entry-exit tariffs. Capacity should be allocated through standard products (e.g., daily, monthly, and quarterly) and it should be possible to combine these standard products into longer profiled capacity contracts to provide further flexibility within the market. Such a system would represent the maximum number of options for shippers, thus facilitating market liquidity. Auctions for long term capacity bookings should provide help to shippers in supporting and securing investments under transparent conditions regarding investment trigger and price levels.

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.

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

CMP

Two main mechanisms:

Overselling and buy-back: 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.

Secondary capacity market: Shippers who hold capacity should be 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 should be enabled to buy when primary capacity is not available.

Balancing

From experience, we prefer a daily, market based balancing regime, though we note that this may be impractical in some localities.

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 TSOs 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.

Transparency

In order for shippers to respond in an economically rational 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 imbalance positions.

National regulators should require the TSO to provide shippers with regular updates on their imbalance position within day, and 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.

Tariff structures

In relation to the issue of tariffs, we consider that many market participants would want both a transparent non-discriminatory charging methodology and stability of transportation charges. Given the inextricable link between the setting of the regulated asset base, the rate of return and subsequent transportation prices (to recover allowed revenue), certain aspects of neighbouring TSOs' price controls may need to be harmonised.

By way of example, two TSOs may have revenues set for different periods and/or at different times or may be allowed to under/over recover revenues in a different fashion. Given that both these situations will have an impact on subsequent tariff levels, it is not immediately clear that stability of tariffs will be achieved. As a minimum, consistency in the methodology for tariff calculation and transparency of tariff calculation will be key steps forward.

Q4. 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)?

Harmonization should not be an end in itself, but key principles and some practices need to be harmonized to the extent possible in support of a competitive pan-European gas market with a level of detail appropriate to the key elements.



(a) We recommend that a common time zone reference for the definition of a common gas-day should be adopted as far as possible. In this regard, we see no reason why the EASEE-gas preference for 6am-6am CET should not be adopted. It appears to be widely accepted among the industry.

(b) The target model should focus on developing a consistent model at the wholesale market level at interconnection points. The reasons for this view are twofold. Firstly, successful and competitive wholesale markets are a prerequisite for a competitive gas market that brings benefits to consumers. Secondly, a concentration on 'vertical depth' would be impractical. The differences between regional/local markets would make such an option unrealistic and would slow down progress in areas where agreement could be reached. Notwithstanding the vertical versus horizontal spread discussion, it is felt that cross border integration must be a first priority.

Q5. Which areas or aspects of the gas market should be affected by the target model and what are the constraints for such a model?

A range of aspects can be expected to be affected, but within the existing legislative framework (3rd package), and with due consideration for the imperatives of security of supply, among priorities on which guidance is necessary, we identify:

- capacity allocation methods, including auctioning of primary capacities as well as secondary capacity allocation, and a choice of a range of capacity products for trading at hubs or at the flange;
- well-designed balancing frameworks, essential for both competition and the secure operation of the European gas system, underpinned by an appropriate level of harmonization and a common understanding on the roles and responsibilities of shippers and operators;
- criteria for a potential integration of entry/exit zones across borders; also possible solutions for handling differences in gas quality;
- recognition of the importance of a regulatory framework conducive to investment;
- a market responsive congestion management system which does not cause problems for shippers in meeting their firm delivery contracts;
- tariffs that are transparent, cost-reflective objective and non-discriminatory

In summary, the model must focus on the downstream wholesale markets and the activities that are key to effective operations.



Q6. Which areas or aspects of the gas market should be excluded from the target model description and left to national/regional decision making?

In principle all aspects of the market relevant to the achievement of the internal European market and covered by the Third Package relate in some way to the eventual model, but some aspects will be more appropriately covered in the EU rules and codes, and other aspects are better left to the responsibility of national decision-making and NRAs. The target model should focus on high-level steering through a framework in which more detailed aspects of Third Package implementation should fit. Though consensus has to be found among stakeholders as discussions proceed, at this stage, we would suggest that non-downstream aspects are excluded from the model.

Q7. 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?

(a) We do not agree that there should be a deliberate policy of merging balancing zones. Zones should be encouraged to develop to their optimal size, not forced beyond a level at which economic benefits cannot be identified.

(b) It is not clear that market coupling is appropriate for gas. Essentially it was developed for electricity as a congestion management tool, and already different approaches are under consideration for congestion management for gas. Also there would be capacity allocation related considerations. Therefore we are cautious about the practicality of this approach. However, if in any region market participants are interested in carrying out a pilot, this might be useful.