

To: ERGEG

By e-mail: gasbalancing@ergeg.org

26 September 2005

Dear Sir/Madam,

**GAS BALANCING – CENTRICA RESPONSE TO THE ERGEG DISCUSSION
PAPER FOR PUBLIC CONSULTATION**

I refer to your Discussion Paper on gas balancing dated 18 July 2005 and have pleasure in attaching the response from Centrica plc.

I trust that you find the response helpful. Please do not hesitate to contact me if there are any points you would like to clarify or discuss.

Yours faithfully,

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ERGEG Discussion Paper on Gas Balancing

Response from Centrica plc

This document sets out the response of Centrica to the ERGEG Discussion Paper on Gas Balancing dated 18 July 2005. The response is presented in three parts, as follows:

1. A number of comments on the descriptive material set out in Chapter 2 of the ERGEG Discussion Paper
2. The “key questions for stakeholders” set out in Chapter 3
3. The suggested changes to the existing CEER gas balancing principles set out in Chapter 4.

Centrica welcomes the decision of ERGEG to review the existing CEER principles, in the light of (inter alia) a recent high-level review of the existing gas balancing regime in Belgium, Netherlands, France, Great Britain and Spain, as well as the opportunity to contribute to this review as part of the public consultation process.

Centrica’s existing European gas activities are concentrated in the Benelux market area, especially, as well as in Great Britain where we remain the largest single user of the onshore gas transportation network. Our response therefore draws, in particular, on our direct experience of gas balancing regimes in those markets.

Description of gas balancing regimes and approaches

We have a number of comments on the descriptive section of the Discussion Paper, which provides the basis for the “key questions” and the proposed balancing principles.

It is important, in an unbundled gas industry structure, to make a clear distinction between those tools (sources of flexibility) which are generally available to shippers and those which are available to TSOs (cf. the list on page 9 of the Discussion Paper, which combines the two). For example:

- flexibility in supply contracts (including production) may not be available to TSOs, unless national laws or regulations allow a specific and limited exception to the general principles of unbundling;
- linepack services are rarely available to shippers, as such, but may be reflected indirectly in balancing tolerances;
- access to storage is principally a matter for shippers, but some storage facilities or capacity (e.g. on-system LNG or local diurnal storage) may be reserved to the TSO for the purposes of achieving overall system security & residual balancing; and
- TSOs may have access to limited rights of “transporter’s interruption”, which is distinct from a shipper’s contractual right to interrupt supplies to certain end customers.

Figure 2 of the Discussion Paper provides a useful overview of this situation, subject to the comment on linepack set out above.

As to the high-level summary of existing balancing regimes which is set out in Figure 3, we recognise that it is difficult to capture the full complexity of the current situation in such a table. We would, however, like to point out that:

- the UK system is certainly market-based and benefits from a level of wholesale market liquidity (including as regards within-day trading) which is much greater than elsewhere in the EU;
- it is nevertheless set within the context of industry-wide agreements, specifically the Network Codes, which are subject to a significant amount of regulatory oversight under the terms of the gas transporters' licences;
- ex-post trading of shipper imbalances is certainly allowed in Great Britain, but there is no provision for "pooling" of imbalances as between shippers.

Key questions for stakeholders

As regards ERGEG's view of an efficient balancing regime (Figure 4 in Chapter 3 of the Discussion paper):

- under the first point, we would expect regulators to allow TSOs to recover only the efficiently incurred costs of system balancing;
- under the second point, the cash-out regime should also be transparent and non-discriminatory, as well as cost reflective;
- in point 8, we are not convinced that unbundled linepack services should be made available by TSOs.

These remarks are further elaborated in our responses, set out below, to the "key questions" and proposed balancing principles.

Question (1):

Are there other features that should be reflected in a gas balancing regime to help ensure efficiency and to maintain safety and security of the system?

We concur with ERGEG's conclusion that, in some gas balancing regimes, shippers face penalising (non-market) cash-out penalties, with a resulting barrier to entry which is exacerbated by the lack of sufficient timely information to manage imbalance risks. This is compounded, in some cases, by a mis-match between the design of the regime (e.g. hourly balancing) and the instruments available to shippers to manage their imbalance positions within the applicable timescales and tolerances.

We consider that the most important features to be reflected in a gas balancing regime include the following:

- a requirement on the TSO to use non-discriminatory market based procedures;
- appropriate incentives and opportunities (including *ex post* trading of imbalances) for shippers to manage their own imbalance positions; and
- incentives on the TSO to act efficiently and minimise the costs it incurs in carrying out its balancing function.

Further observations on each of these key features are set out in the remainder of our response, below.

Question (2):

Should the incentives to balance become stronger the further away a shipper is from being in balance or are there are other ways of ensuring that shippers have appropriate incentives to minimise their imbalance positions? Should shippers be allowed to trade their imbalance positions on an ex-post basis as a way of improving overall efficiency?

In countries where a market based cash-out mechanism is feasible, we consider that this will normally provide, of itself, a sufficient incentive for shippers to manage their imbalances positions effectively. Shippers who are significantly “short” in a period when the system is “short” would normally face a high cost in line with prevailing market prices, especially if the regime is based on marginal cash-out prices.

In those EU Member States which are not yet in a position to support such a mechanism, graduated incentives across different tolerance bands might provide the basis for an acceptable regime, at least on a transitional basis. However, care needs to be taken not to impose unduly onerous (penalising) cash-out prices, disproportionate to the instruments available to shippers for the management of their imbalance positions.

We agree that shippers should be allowed to trade their imbalance positions on an ex-post basis. This will help to ensure that the overall imbalance charges faced by shippers reflect the true economic cost of balancing to the TSO, which depends in turn on the net system imbalance across the shipping community as a whole.

Most gas pipeline systems have commingled input streams, i.e. inflows of gas which belong to a number of different shippers, and precise information on individual shippers’ inputs (and thus imbalance positions) is often not available until after the close of the relevant gas day. This is the case in the UK, for example, and is a further major argument in favour of allowing ex-post trades between shippers once the precise data becomes available.

Question (3):

Does hourly balancing create any barriers to the development of competition?

Our observation and experience is that hourly balancing, in practice, is often unduly onerous on shippers and thus acts as a barrier to competition. It is sometimes associated with excessive cash-out penalties and shippers rarely have access to the instruments (information and trading opportunities) they would need to balance their positions within such a short timeframe. Relatively minor imbalances, from an overall system viewpoint, can then lead to substantial penalties for an individual shipper, which translate into a material increase in the overall cost of gas transportation.

Although we recognise that there are substantial differences among EU national gas markets – including the overall flexibility available to balance the network – our view is that daily balancing should be the norm unless there are convincing and legitimate reasons (e.g. small transmission systems with little linepack and inadequate access to storage capacity) to justify an hourly balancing requirement.

We refer also to the recent Madrid Forum discussions, where the majority view was in favour of a daily balancing system.

Question (4):

What information is required to ensure that gas balancing regimes operate effectively and efficiently and how often should this be provided? What is the best way of ensuring that this information is provided to all parties on a non-discriminatory basis?

We believe that TSOs should be required to provide all shippers with relevant aggregated information and each individual shipper with confidential information specific to them. In general, this information must, as far as possible, be both timely (such that the shipper can act on it within the relevant balancing period) and strictly non-discriminatory. It is especially important that the TSO's merchant affiliate (if there is one) does not receive any better information than its competitors; a suitable regulated compliance regime may well be required to ensure that this is the case.

The aggregated information required by shippers is largely focused on indicators of actual or predicted system imbalance – such as daily demand on the system, gas in- & out-flows, actual and predicted linepack and the amount of gas in storage. Shippers also need to know the cash-out price applicable to the current balancing period.

Individual shippers ideally need a real-time view of their own imbalances, to set against the imbalance prevailing in the system as a whole. Information would include all details relevant to the shippers' current status in view of the TSO. In practice (see the response to question 2 above), allocation data on commingled gas inflows may not be available until after the close of the balancing period. Shippers may seek to balance in real time on the basis of their input nominations, but should be allowed to engage in ex-post-trading once data on their actual imbalance position becomes available.

Question (5):

Should linepack (where technically feasible) be made available to shippers on a non-discriminatory basis to improve access to flexibility? Are there any other steps that could be taken to improve access to flexibility that would not impinge on the safety and security of the system?

While we understand and agree with the need to make available to shippers all reasonable flexibility which is surplus to the TSO's own requirements, we are not convinced that linepack should be made available to shippers in any explicit, unbundled manner. There are a number of reasons for this:

- the sheer complexity of devising a workable scheme, including determination of the linepack which can reasonably be made available and the use of linepack which is made by each individual shipper;
- the benefits of reserving linepack management to the TSO, which is generally much better placed than shippers to do so efficiently; and
- the fact that, in countries with a liquid, transparent within-day traded gas market, there is generally no need to make linepack available in this way.

Where within-day traded markets do not yet exist, which is unfortunately the case in the large majority of EU Member States, we believe that system flexibility can be made available to shippers more simply and effectively through the use of appropriate imbalance tolerances.

Question (6):

Do differences between (neighbouring) gas balancing regimes distort or the incentives provided to market participants? If so, what degree of consistency would be appropriate to overcome these problems? Would there be any disadvantages from introducing more consistency in features of (neighbouring) gas balancing regimes? How could this consistency be facilitated – for example would legislation be required or could it be achieved through better co-operation between regulators and TSOs in different Member States?

We take the view that major cross-border differences between balancing regimes are a significant potential barrier to trade, competition and long-distance transit.

We note, for example, the significant differences in North West European balancing arrangements as summarised in Figure 3 of the Discussion Paper, for example:

- daily balancing in Belgium, France and Great Britain; but
- hourly balancing in Germany and under the basic GTS transportation service in The Netherlands (subject in the latter case to the possibility for shippers to buy additional flexibility services).

It is unlikely, in our view, that such significant differences are objectively justifiable, in terms of the different technical and operational characteristics of the gas networks concerned.

If there are major differences in balancing arrangements between two connected markets, this is also likely to lead to distortion of shipper behaviour, such as to transfer cost between the two. In other words, shippers will tend to use the more flexible of the two balancing regimes in order to help balance their positions under the more restrictive one.

The most important aspect to harmonise, as far as possible, across borders is the basic structure of the balancing regime – e.g. balancing periods, information provision and cash-out pricing mechanisms and (absent any significant differences in market price).

If objectively justified by different system characteristics, we consider that different balancing tolerances as between neighbouring regimes would not generally be a serious obstacle.

We believe that there is a need for greater cross-border co-operation between national regulators in the gas sector, along the lines of the recent consultation paper on regional power market integration issues by the CRE (France), CREG (Belgium) and DTe (The Netherlands). Such co-operation would nevertheless be facilitated by appropriate EU guidelines or (preferably) a binding regulation on gas balancing.

Question (7):

Would cross-border (or international) balancing zones help facilitate the development of competition in gas across Europe? What technical, legal and practical issues would need to be overcome if cross-border balancing zones were introduced? What impact could cross-border balancing zones have on the development of hub based trading and regional markets (see for example the recent ERGEG document on regional markets in electricity)?

Centrica believes that the first priority is to reduce the complexity of national balancing arrangements and to move towards a single (H gas) balancing zone in major markets such as France and Germany which are far from achieving this today. This would also facilitate the development of liquid, traded gas markets which in turn provide the instruments needed by shippers to manage their own positions more effectively.

In our view, a larger number of balancing zones within a single national market is only justifiable where there are significant technical constraints on gas flows between zones – e.g. where there are real transmission bottlenecks and/or different grids for L and H gas, with very limited interchange between them.

The development of cross-border balancing zones, though desirable as a longer term objective, would no doubt involve a further level of complexity. Based on recent experience in the Bunde-Emden area (Netherlands/Germany), we observe that very considerable commercial and regulatory drive and determination are likely to be required to overcome the obstacles involved.

Question (8):

Would it be appropriate to increase the level of consistency between balancing rules for transit and transportation systems?

We are very much in favour of greater consistency. Whether complete harmonisation is possible will depend (inter alia) on the degree of interconnection and interchange between the relevant transit and transportation systems.

The principles involved here should be similar to those outlined for other neighbouring regimes (see qu. 6 above). In other words, the fundamental balancing regimes should be aligned as far as possible, but with different balancing tolerances used where necessary to reflect the different technical characteristics of imperfectly-interconnected systems.

Question (9):

Would the introduction of Operational Balancing Agreements (OBAs) between transit and transportation systems improve transparency on how the balancing regimes interact? If so, what should be included in the OBAs?

In our view, the introduction of standard Operational Balancing Agreements between transit and transportation systems, including both commercial and technical provisions, would help to improve transparency, establish a level playing field and facilitate increased competition.

Suggested changes to the existing CEER gas balancing principles

Principle 1:

We support the suggested change and have no comments on the proposed wording.

Principle 2:

We support the suggested change, with one exception. In the second paragraph, we suggest that the words “where part of a vertically integrated company” should be deleted. The principle of non-discrimination should apply whether or not the TSO’s

commercial affiliates are part of a vertically integrated company (which could be interpreted to mean one which has its own upstream E&P activities).

Principle 3:

We support the change but believe it should go further in the direction of saying that daily balancing should be the norm, unless there are compelling technical and operational reasons to believe that this would compromise the safety and security of the system concerned (see qu. 3 above).

Principle 4a:

Given the fundamental responsibility of the TSO for balancing the system, as reflected in principle 1, as well as the desirability of market-based mechanisms, we do not understand the need for the exception in the first paragraph (“Unless a TSO is not permitted to accept bids and offers for balancing gas...”). We do not support the proposition that a TSO should be so prevented and we therefore suggest that these words should be deleted.

Principle 4b:

We support the suggested change. It would also be desirable to capture the principle of revenue neutrality for the TSO (i.e. “no cross-subsidisation between network users, nor between shippers as a whole and the TSO”).

Principle 4c:

We generally support the suggested change, as regards the trading of imbalance positions.

However, we do not consider that the concept of “pooling” imbalance positions is sufficiently well-defined for us to reach a view on its desirability, at this stage. Thus the last sentence of the suggested change should either be deleted or substantially clarified.

Principle 5:

We support the broad principles behind this suggested change, but consider that a clearer distinction should be drawn between market-based balancing systems (in paragraph 1 of the suggested change) and less mature systems (paragraph 2) in which the provision of tolerance services is both reasonable and desirable.

We therefore propose to add, in the first paragraph after “minimised as far as possible” the words “in mature market-based balancing systems”.

To allow additional flexibility in balancing regime design, we also suggest that the words “or daily imbalance positions” should be added in the last sentence of first paragraph, after “secondary trading of tolerances”.

Principle 6:

In line with our response to qu. 4 above, we propose to add to the first sentence of the suggested change, after “network users”, the words “, both in aggregate for the system as whole and (on a confidential one-to-one basis) for the individual shipper concerned”.

Principle 7:

As set out in our response to qu. 6, we consider that the most important features to harmonise, as far as possible, are fundamentals such as the balancing period, cash-out

pricing mechanisms and information provision to shippers. If there are sound technical and operational reasons to fall short of full harmonisation, then a difference in tolerance levels would generally minimise any distortion to gas shipping, trade and competition.

The suggested wording does not currently reflect this ordering of harmonisation priorities.

New Principle 8:

As per our answer to qu. 5, we are not convinced that it is desirable for shippers to be offered unbundled linepack services, which is what this new principle appears to be proposing.

The principle we support is that, where linepack provides system flexibility over and above the needs of the TSO itself, then (in cases where liquid within-day traded gas markets do not exist) this flexibility should be offered to shippers indirectly through appropriate balancing tolerances.

If the intention behind the new principle is in line with our remarks, then the suggested wording will need some modifications to make this clear.

The final sentence, regarding the TSO's responsibility for overall system balancing, appears to address a different point. We agree that a number of different tools may be used by the TSO for this purpose – such as investment in extra pipeline capacity, compression, LNG and/or other diurnal storage. In our view, the principle does not need to be prescriptive; there is, however, a key element missing from this last sentence, which is the requirement and incentive structure for the TSO to take these decisions in an efficient (least cost) manner.