E.ON AG response to the ERGEG Discussion Paper

"Roadmap for a competitive single gas market in Europe"

January 2006

I. Executive Summary

At a time when natural gas has become one of the key elements of the energy mix in a number of EU Member States and its importance is likely to continue to rise, E.ON looks forward to a positive and transparent dialogue with EU policy makers, legislators, the industry and other stakeholders. The steadily growing EU dependence on imports, in a market which is becoming more and more competitive on the global supply level, requires a clear and continuing focus on security of supply. Against this background E.ON as a globally active gas supply company believes it can continue to help maintain economical, efficient and secure gas supplies based on long term contractual supply and transport arrangements. If the EU can establish a sustainable and credible policy framework which minimizes regulatory uncertainty and radical changes of well proven market models, companies like E.ON will be willing and able to contribute to the necessary large and long term investments in new infrastructure.

E.ON welcomes the establishment of regional markets as a pragmatic way to address diverging market developments in the European Union's natural gas markets, but greater transparency from ERGEG on its approach for clustering/constituting/forming these markets is essential. The ERGEG initiative also needs to be in line with the existing EU and national legislation.

E.ON believes in fair and non-discriminatory market access and is positively contributing to this aim. However, EU Member States and stakeholders need to give enough time to implement the existing legislation before the next step is taken in the process of market opening. Finally, E.ON is willing to proactively offer the expertise it has gained in different regional markets to policy-makers and regulators to develop adequate and transparent solutions.

II. Introduction

EU Member States energy markets are currently being confronted with a range of varied and complex issues, which will require considerable effort and ingenuity to mitigate. Not least of these issues is the combination of rapid and unprecedented price increases in recent years and a significant increase in gas supplies from Non-European countries. This means that EU policy makers, legislators, industry and other stakeholders need to carefully address the next steps that are required to further liberalise Europe's energy markets in order to finally achieve the aim of an EU gas market.

These aspects apply particularly to the European gas market. Natural gas has become one of the key elements of the energy mix in several EU Member States and its importance is likely to continue to rise. A lack of significant natural gas resource in much of the EU means that many Member States have become more and more dependent on gas imports, particularly those from non-EU countries.

In this context E.ON welcomes ERGEG's regional initiative – as part of the ERGEG Roadmap consultation process - because we think that a number of open issues with regard to

open gas markets within the EU can be addressed more efficiently on a regional level rather than on an EU-wide level.
Nevertheless, E.ON would like to highlight the following main areas – where other adequate and balanced solutions will be required regarding the Roadmap and the regional market approach:

1. Security of supply

E.ON believes that the issue of security of supply (that means especially the long-term availability of gas deliveries to Europe) needs to be considered as part of the ERGEG roadmap initiative and put in context with current activities on an EU level regarding competition in the gas market. In this context the following aspects should be reconsidered:

- While promoting the process of liberalisation a roadmap must ensure that the high level of security of supply delivered by the gas industry can be maintained into the future (as re-confirmed by the EU Council that stated that the requirements of competition must be balanced against the need for Security of Supply). A roadmap for the future must give significant attention to security of supply aspects as a precondition of creating a functioning liberalized market. That is why security of gas supply especially from a global perspective must be considered as an integral part of future regional initiatives. This requires balancing security of supply with the development of competitive national markets, while at the same time giving due consideration to special national circumstances.

  The supply side – i.e. the global market the gas producers are active in - is increasingly becoming a central issue of competition. In this context, the natural gas industry faces the challenge of how to cope with the steadily growing dependence on imports in the future. In gas-exporting regions, the EU 25 now competes for supplies with other regions of the world such as the US and Southeast Asia as via LNG, gas becomes more and more a globally traded good. Therefore on the supply side, the gas market is changing from a regional into a global market.
- As the market for gas supplies becomes a global market and the uncertainties increase considerably regarding how the future gas demand within the EU shall be met, it is of great importance that EU policies and regulation provide a healthy environment for the realisation of additional import infrastructure. New or enhanced infrastructure, however, will not be realised if regulatory uncertainties are high and fundamental changes continue to occur. Investors need to have predictable regulation and stable market conditions. In the end, on a global level gas will flow to the markets which are most attractive to producers.
- To rely only – as envisaged by many policy makers and stakeholders – on short-term trading arrangements will limit or even curtail the investment in important infrastructure projects. Additionally, international and interregional energy trade can hardly develop viably without stable economic and political relations between gas producing, transit and importing regions. These relations increasingly need political backing. When defining further rules for regional markets security of supply considerations must not be undermined.
- With regard to the development of spot markets one has to bear in mind that against the background of an existing oligopoly of gas producers who are able to supply Europe in the long-term, market power might shift completely outside of the EU.
- Additionally, gas producers determine whom they sell their gas to. They rely on long-term supply contracts rather than on short-term supply arrangements in order to backup their large investments upstream. In order to realise secure gas supplies for

Europe's gas markets, supply companies such as E.ON have to rely on such long-term arrangements, otherwise our global competitors will pre-empt us and Europe will miss-out on access to gas supplies. Only efficient gas supply companies that are globally competitive are in a position to ensure economical and efficient gas supplies on a sustainable basis. They alone can backup the investment decisions and bear the risks connected with new substantial import projects. A roadmap must take this into account**.**

On the basis of the above made comments E.ON believes that only long-term supply and transport commitments ensure the required investments in infrastructure which safeguards long-term security of supply. A prime example in this context is the situation at the beginning of 2006, when an imminent reduction of supplies of Russian gas via Ukraine could be handled by the European Continental gas supply system. This was possible, as the system is based on long-term planning and therefore any direct mismatch between consumer demand and gas availability under the existing supply contracts could be offset by storage capacities that had been developed systematically in the past.

2. Regional initiative

E.ON welcomes the establishment of regional markets as a pragmatic way to address diverging market developments in the European Union's natural gas markets.
Nevertheless, the set-up of the proposed regional gas markets within the Roadmap has been done without any clarification of the basis of these regional market arrangements and the economic or political rational for this segmenttation of the internal market is not obvious. The establishment of regional markets might have a considerable impact on the industries business activities which need therefore to be assessed carefully in each individual regional market. In this respect it would be of considerable help if ERGEG would specify its approach for clustering/constituting/forming these markets. Market solutions should be defined as much as possible by market participants and overregulation by the European policy makers and legislators must be avoided. E.ON is willing to proactively offer the expertise it has gained in different regional markets to policy-makers and regulators to develop adequate and transparent solutions.

3. Network investments

As previously mentioned new investments are absolutely necessary for the secure supply of Europe's gas markets. However, the Roadmap should carefully acknowledge and take into consideration for the further consultation process that companies such as E.ON will efficiently deliver adequate investment in an appropriately diverse portfolio of assets provided:

- There is a sustainable and credible policy framework which is robust to future uncertainty.
- Regulators/governments do not intervene to reduce investment returns, including via *ex-post* taxation,.
- Regulators/governments support long-term contractual supply and transportation agreements as well as protect investments.
- If regulation is cost-based regulators/governments can accept a higher return on higher risk investments in new infrastructure that increase security of supply
- Regulators/governments shall apply the exemption under Art. 22 of the Second Gas Directive more frequently and on a non-bureaucratic basis.

4. Network access

E.ON believes in fair and non-discriminatory market access and wants to make it work. In its operations E.ON fully complies with the requirements of the Second EU Gas Directive. Energy market liberalisation is proceeding well in many Member States. However, Member Countries and stakeholders need to give enough time to implement the existing legislation before there is a further acceleration in the process and the possible discussion of further steps. Market conditions can also vary between Member States and regional markets. This is why different access regimes maybe appropriate.

5. The establishment of hubs

The roadmap highlights that the establishment and/or the enhancement of trading hubs is a key factor for the further liberalisation process of Europe's gas markets. E.ON believes that the creation of active gas trading at hubs across Europe might tend to suggest that markets are relatively mature and competitive. Nevertheless it is important to understand what policy makers/legislators are seeking to achieve from such arrangements. At best the existing hubs whether physical or virtual in nature tend to provide relatively short-term pricing signals. As such the primary function of trading hubs is to assist market participants in balancing and short–term optimisation of positions. This is indeed a useful function but cannot be expected to replace the need for long-term supply and transportation contracts.

E.ON believes that it is important we learn from the UK experience where perhaps the overemphasis on short-term market mechanisms has fostered an environment where strategic investment in pipeline and storage infrastructure has been delayed and hindered and as a result security of supply adversely affected.

We also believe there are dangers of regulatory imposed solutions if these are developed without the involvement of market participants. Existing trading hubs have either evolved naturally at physical points where key pipelines meet or as a result of particular market rules and/or forms of charging regime. For example the UK National Balancing trading hub Point was facilitated by the Network Code and an entry-exit charging methodology, but parties were not forced to use it. Thus the best way forward is to foster an environment that is conducive to the establishment of trading hubs but allows the market to establish trading hubs themselves in response to market need.
The key question in relation to defining regional markets and the sphere of influence of individual trading hubs is whether this should be largely defined by national boundaries or based on the characteristics of existing pipeline systems and the constraints between the pipeline systems. The latter probably represents a more economically rational approach, but could easily be in conflict with the legitimate aspirations of member states to for example prescribe certain system standards e.g. in relation to the use of storage.

With sufficient and appropriately located hubs it might be possible (where the difference between prices at adjacent hubs exceeds transportation costs) to help commercially define short-term network constraints. This might provide some assistance to TSOs in sign-posting the need for future investment but would not offer a reliable substitute for investments that are backed-up by long-term transportation agreements.

Fewer hubs covering regions that cut across national boundaries offer the prospect of greater liquidity but with greater regulatory/political constraints. More hubs covering smaller regions may help better define constraints and the need for greater interconnection with fewer regulatory/political difficulties.

6. Gaps within the regulatory and legal framework

E.ON agrees with ERGEG that the main focus of regulation is the provision of non-discriminatory access to the transmission networks and the right balance between the interests of equally both network users and network operators. From the investor perspective E.ON underlines that only a reasonable return on investment will help to promote future investment in the gas network.

There are already sufficient mechanisms for co-operation between regulatory authorities, which are linked close together via CEER or on the legal basis of the Commission's Decision 2003/796/EC of 11 November 2003 on establishing the European Regulators Group for Electricity and Gas. The German Energy Law (EnWG) e.g. contains rules for cooperation with regulatory authorities in other member states (see section 57 EnWG).

Taking full account of cross-border trade for E.ON means that regulation of infrastructure does not imply the regulation of gas trade.

It's still too early to propose further measures with regard to cooperation between regulatory authorities. Firstly all current legal instruments and voluntary agreements (e.g. Madrid-Forum) have to be proved in practice before discussing new action on EU or national level. The legal framework is quite new for each Member State and especially the new Member States and needs a chance to be proved in practice.

In general, we think that regulatory powers should be kept to the necessary minimum and that a general extension of regulatory intrusion should not be regarded as an objective per se, as the ERGEG draft sometimes suggests. In this context we especially support voluntary guidelines (such as the GGPSSO, EASEE-Gas CBPs), which could be helpful in the establishment of regional markets.

However, the role of regulators in the governance of market rules is an important consideration. Once efficient/competitive market frameworks are established we would see a more limited role for regulators in driving change, although their role in monopoly network regulation and monitoring the operation of markets would remain very important. Regulatory uncertainty can be minimised once market frameworks are established by ensuring governance of changes to market rules are managed by representative decision making bodies made up of relevant TSOs and market participants in the relevant regions. The relevant regulator would then become the appeals body for such decisions.

7. Unbundling

Throughout the roadmap it is mentioned that the ownership unbundling would be important tool to support the further liberalisation process. Effective internal separation arrangements have been established in a number of countries and the UK, for example, has established effective internal separation arrangements between trading and network businesses in both its electricity and gas markets. These include robust arrangements to prevent the transfer of commercially sensitive information between sister companies in a company group. In this context we consider that most market participants are primarily concerned about implementation of these practical and transparent arrangements and that implementation of the existing EU legislation regarding legal unbundling will achieve this. We therefore do not agree that legal separation is second best to full ownership separation. Nor do we believe it should be the role of European regulators to prescribe a particular market structure based on an assertion that ownership separation is the only effective form of separation. Even Ofgem has set a precedent in accepting legal unbundling in the UK market recently. On the basis of these comments we therefore do not consider that full ownership separation is a prerequisite for establishing efficient regional markets across Europe.

III. Response to some of the ERGEG questions:

1. **ERGEG Question:** Does this paper identify the main problems in European gas markets today? Does ERGEG's proposed way forward address your concerns, or, if not, are there other actions you believe that the Regulators need to take?

Answer:
E.ON can agree that the development of regional markets is most likely to be the most practicable approach to promote a European wide competitive market. But the Road Map is right to refer to the greater complexities, compared to electricity, affecting the consideration of regional gas markets. Such complexities especially refer to the security of natural gas supplies and its close interdependence to the producer's interest.

E.ON is strongly convinced that the right balance needs to be found among the three objectives - competitive markets, security of supply and environmental compatibility, taking into account national circumstances. For a roadmap trying to develop the single gas market it is of vital importance that the global dimension of the gas market is not forgotten besides the national or European dimension. In this context it is noteworthy that new investments in vital gas network infrastructures must be protected by regulators/governments to allow the investors to gain a fair rate-of-return. Also, it must be highlighted by the roadmap that long-term supply agreements are a cornerstone for the proper development of a secure European gas market.

2. **ERGEG Question:** Does ERGEG's proposed way forward address your concerns, or, if not, are there other actions you believe that the Regulators need to take?

Answer:
Again, we believe that the concept of security of supply needs to be carefully addressed with respect to the fast changing market environment and also that differences in market conditions are taken into consideration.

3. **ERGEG Question:** Regulators welcome feedback on the concept of the regional market in gas.

Please refer to section II. 2.

4. **ERGEG Question:** Regulators would like to hear the views of respondents on whether there are other important regulatory gaps not discussed here.

Please refer to section II. 6.

5. **ERGEG Question:** Long contracts give security to investors, but may frustrate the development of effective competition. Under the regulated approach, what steps are needed to provide the necessary degree of security to investors (for example, the existence of a regulated asset base)? If the two approaches co-exist (for example, where non-regulated infrastructure outside the EU meets regulated infrastructure inside the EU at the border), what issues are raised by the interaction? Finally, how do legacy contracts fit into this picture?

Please refer to II. 3.

6. **ERGEG Question:** Pancaking of transaction costs could be dealt with by requiring TSOs to co-operate such that market participants would only contract with a single TSO. Alternatively, independent third parties could offer a commercial service that would manage the interface between network users and multiple TSOs. Regulators are interested to hear the views of market participants on a) whether there is a market need for such a service, and b) if there is, should TSOs be obliged to offer it?

Answer:
Cross border transportation requires the ability to deal with the complexity caused by heterogeneous transmission systems within Europe. E.ON is of the opinion that there is a market need for a service that would manage the interface between network users and TSOs. Further E.ON believes that customers should have the choice between alternatives in order to find optimal solutions. This freedom of choice would be limited if a TSO is obligated to offer such a service. For these reasons TSOs themselves and independent service providers should – to the customer's choice - be legitimately able to offer this kind of service.

7. **ERGEG Question:** Regulators would like to hear the views of respondents on the possible advantages and disadvantages of an ITC scheme covering the EU-wide gas network.

Answer:
The ITC scheme may be appropriate for electricity, where limited physical cross-border flows reflect its diverse production spread portfolio across the whole EU territory. On the contrary, the EU has a high gas import dependence and transit gas flows reach very high levels in many countries, in excess of 90% of total flows. Consequently a mere "compensation mechanism" is unlikely to be sufficient to address such physical and contractual flows.
It is not clear that such a scheme is able to properly remunerate existing investments and provide the market signals for new investments. Such an ITC scheme for gas would lead to a complete change of the current market models, making many TSOs almost completely dependant on the mechanism and not able to manage their own business by commercial contracts.
There would also be significantly increased complexity and bureaucracy in both implementation and ongoing maintenance. E.ON believes that the correct focus should be on facilitating the necessary investments and transmission hubs.

8. **ERGEG Question:** Regulators would be interested to hear the views of market participants on how the detail of the regulatory framework should be developed to ensure an appropriate allocation of risks between infrastructure investors and users

Please refer to II. 6.

IV. Observations to some of the ERGEG's made assumption

Throughout the Roadmap ERGEG makes several assumptions that are from E.ON's point of view either misleading or wrong. In the following section we allow us to inform you about some corrections to some of your assumptions:

Paragraph 52 compares the churn rate of the Henry Hub in the USA with churn rates of European gas hubs. It should be noted that the mechanisms of the Henry Hub and the US market situation are entirely different from those of existing European gas hubs and that therefore simple comparisons of churn rates are not applicable.

Paragraphs 37 and 103 refers to theoretical cases in which purchasers under take-or-pay contracts rather elect to pay than to take gas which is contractually available. In addition, paragraph 103 refers to possible unwillingness of existing suppliers to release gas after customer switches. We would like to point out that the relevance of such theoretical cases has not yet been shown .

Paragraph 126 refers to regulatory oversight of swaps. To our understanding, swaps are pure trading activities. Therefore we do not see a basis for regulatory invention.

Paragraphs 7, 132 and 140 propose that the regional initiatives are to be directed by steering committees of the regulators from the Member States in the respective region and led by ERGEG. In order to direct the work of the regional initiatives in an agreed-upon manner, we propose including representative bodies from the industry in the committees. These may be the respective national associations or delegations of the European associations active in the Madrid process.

Paragraph 18 states that despite considerable progress towards achieving a single European market for gas, this goal remains some way off. Paragraph 30 states that the current legislative framework does not address everything required for the establishment of a competitive single market. Paragraph 31 states that Continental markets are characterized by a lack of liquidity. Section 3.4 repeats similar statements. We think that in the European gas liberalisation process big changes have already been accomplished and that those changes that are still ahead of us need time for implementation on all levels of the gas industry.

Paragraph 21 expresses concerns that regulators do not always have adequate powers to discharge their functions, particularly in relation to issues crossing borders. Paragraph 44 identifies the need for co-ordination of investment activity and the appropriate allocation of costs between TSOs, possibly under the jurisdiction of several national regulators. Paragraph 57 asks for full independence of regulators. Paragraph 140 refers to cases in which individual national regulators may lack specific powers. We think that it should be mainly the industry to develop gas infrastructure on the basis of investment signals from network users to TSOs. Implementation of such mechanisms on both sides of cross border points fully supports the development of the infrastructure needed and provides the basis for effective investments while avoiding stranded investments that are to the detriment of the user community. Market mechanisms should be preferred to regulatory intervention.

Paragraphs 35 and 123 ask TSOs for making available transportation capacity that exceeds the physical capacity of the network (i.e. by netting off counter flows) and firm backhaul capacity, respectively. Paragraphs 105 and 108 refer to decoupling of physical and contractual flows. We think that the marketing of firm and interruptible capacities provides a sound basis for network users, giving them certainty on the type of service acquired. Physical laws cannot be changed just by giving interruptible capacities a different name.

Paragraph 41 refers to the advantages of entry-exit tariffication systems. We would like to point out that transit through entry-exit systems may lead to considerable cross-subsidisations between transit and transport for the domestic market. We would like to confirm the statement made in paragraph 110 that cross-subsidies between different classes of network users must be avoided. In order to accomplish this, in case considerable cross-subsidisation would arise, different tariffication methods for transit should be applied. In such cases, other tariffication models should be implemented.

Paragraph 50 defines (in a footnote) that references to TSOs should be taken to include storage and hub operators. We would like to point out that the legal basis for storage operators are different from that of TSOs and that neither the Second Gas Directive nor the Regulation on conditions for access to the natural gas transmission networks even defines a hub operator.

Paragraph 53 draws a particularly negative picture of voluntary guidelines. We think that experience of the last years has shown that voluntary guidelines provide a fast, effective and efficient way to facilitate market liberalisation.

Paragraph 68 describes a possible case of capacity hoarding. On the basis of the Madrid discussions, mechanisms like the marketing of unused capacity as interruptible capacity and the implementation of use-it-or-lose-it provisions have been developed and are widely applied.

Paragraph 57: The role of regulators in the governance of market rules is an important consideration. Once market frameworks are established we would see a more limited role for regulators in driving change, although their role in monopoly network regulation and monitoring the operation of markets would remain very important. Regulatory uncertainty can be minimised once market frameworks are established by ensuring governance of changes to market rules are managed by representative decision making bodies made up of relevant TSOs and market participants in the relevant regions. The relevant regulator would then become the appeals body for such decisions.

Paragraph 93 of the paper implies that the de-merger of British BG in the UK was heavily influenced by the "depth of business separation arrangements". It is our understanding that this was not in fact a major consideration in the decision to de-merge.