ROADMAP FOR A COMPETITIVE SINGLE GAS MARKET IN EUROPE

Response to the ERGEG Discussion Paper dated 21 November 2005

Centrica very much welcomes the ERGEG gas roadmap initiative, in terms of both its general assessment of priorities and its practical focus on regional traded gas market development. We consider that it will fit well with a number of other important initiatives and provide a useful framework for effective co-operation between regulators, as well as among TSOs and hub operators.

We set out below our responses to the various questions set out in section 7 of the ERGEG roadmap document. Before doing so, it may be helpful to spell out, for background, the nature and extent of our involvement in the European gas market.

Centrica's involvement in the European gas market

Our position in the European gas market is primarily concentrated in North West Europe and can be summarised as follows:

- In the UK, we are the largest retail gas supplier (under the British Gas and related brands) and we also operate around 3 GW of gas-fired power generation, giving us a total annual gas requirement of the order 35 bcm.
- Through our ownership of the Morecambe gas fields and our other upstream interests on the UKCS, we produce over 20% of our total gas needs. The large majority of our needs is purchased from the market, through a mixture of longer term contracts and shorter term trading arrangements.
- In Belgium, we and our partners Gaz de France have a combined 51% stake in SPE. Taking SPE's gas-fired power plant together with its gas sales to end customers, the company has an annual gas requirement of the order 1.5-2.0 bcm.
- In The Netherlands, our subsidiary Oxxio is the leading new entrant retail energy supplier, with around 180,000 gas customers.
- We hold gas transportation rights in the Interconnector UK pipeline and in Continental North West Europe.
- We still have a number of gas export contracts concluded in the mid 1990s and we have concluded, more recently, a number of larger gas import contracts – e.g. with Statoil (Norway) and Gasunie (The Netherlands).
- We are significant wholesale gas traders, including at hub locations such as the UK NBP, Zeebrugge (Belgium) and the Dutch TTF.

Given the growing UK gas import requirement, the needs of our Continental European businesses in the Benelux area and our role as an important gas trader, we have a considerable interest in the creation of a more competitive single gas market in Europe. We therefore strongly support the general objectives set out in the ERGEG roadmap document, which offer the prospect of significant benefits to energy customers and the European economy as a whole.

Key points of our response

Our detailed responses to the proposed Roadmap are set out below, in order of the questions raised in the ERGEG consultation document. For ease of reference, the key points can be summarised as follows:

- We strongly support the Roadmap initiative and look forward to playing an active part in the ensuing process, with particular reference to the North West Europe regional market area which is our key focus of attention.

- Although it is not the only element, we agree that *"liquid and competitive wholesale markets are a prerequisite for the benefits of competition to flow to end users."*

- Throughout the Roadmap process, effective co-operation between regulators and TSOs is required within a consistent overall framework, in order to facilitate fully open and non-discriminatory transportation into, out of and between traded gas market hubs.

- A key starting point is action to address the current lack of information transparency in a number of key Member States. "Quick wins" in this area are essential to improve the working of the market and to ensure that the rest of the Roadmap is well-directed.

- As is now well recognised, liquid wholesale markets will benefit considerably from appropriate and consistent transmission network access terms – i.e. entry-exit tariff structures, initially within Member States but also (as a longer term objective) across borders.

- A further key aspect is the "firmness" of existing gas hubs, which needs particular attention for those which are physical and not "virtual".

- Effective and co-ordinated action is also essential on other key issues mentioned in the ERGEG document – e.g. TSO unbundling; access to gas storage and flexibility services; gas blending and quality conversion services; gas balancing, UIOLI and secondary trading in capacity.

- Rather than weakening the investment climate, a well-functioning wholesale market will help provide the correct incentives for investing in necessary infrastructure.

- We consider that significant progress can and should be made within the existing legal & regulatory framework, especially in terms of prompt, full and effective adherence to the 2005 Gas Transmission Regulation.

- Legislative action will, however, be necessary & desirable to rectify some “gaps” identified in the ERGEG paper, e.g. as regards RTPA for gas storage and the harmonisation of regulatory powers and objectives to facilitate the development of regional wholesale markets.

- Within the regional initiative for North West Europe, it may be necessary to create sub-groups in order to ensure a manageable and effective process. Steps also need to be taken to ensure that stakeholders (e.g. gas traders & shippers) are kept fully informed of progress, on a regular basis, consistent with the timescale envisaged.

- Finally, we consider that early steps should be taken to address key “roadblocks” identified within the various regional initiatives during 2006 – rather than waiting for final reports at the end of 2006 before making a start.

General questions

1. Does this paper [the ERGEG Roadmap] identify the main problems in European gas markets today?

Taken together, we consider that the ERGEG Roadmap, the recent DG Comp Energy Sector Inquiry Issues Paper[1] and the European Commission's latest progress report on creating the internal energy market[2] present a thorough and consistent view of the main issues affecting European gas markets today.

The ERGEG Roadmap clearly focuses specifically on the development of liquid and effective wholesale gas markets, rather than on retail competition issues and problems. This is based on the view that *"liquid and competitive wholesale markets are a prerequisite for the benefits of competition to flow to end users."* (Roadmap, paragraph 2).

While this is certainly a necessary condition for sustainable retail competition, in our view, it is not a sufficient one. In other words, there are other important problems in European gas markets today (e.g. ineffective retail unbundling, below-market administered retail tariffs etc) which fall outside the main scope of the Roadmap. We nevertheless agree that the Roadmap provides a realistic, focused and pragmatic starting point to address the key wholesale gas market problems and constraints.

Within the wholesale market scope of the ERGEG Roadmap, we also consider that a number of complementary issues would warrant greater emphasis and attention, such as:

- access to gas storage facilities and flexibility services;
- access to gas blending and quality conversion services; and
- the need to integrate into the Roadmap programme ERGEG's important ongoing work on gas balancing.

A further key point, which DG Comp has already picked up in the recent follow-up questionnaire to its Gas Sector Inquiry[3], is the whole question of information transparency. The current lack of transparency in several key Member States is an important impediment to the development of an unambiguous and correctly-prioritised Roadmap action plan to address other issues. We therefore wish to emphasise the importance of achieving "quick wins" in this area to support development of the wider Roadmap programme through the remainder of 2006 and beyond.

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[1] Energy Sector Inquiry – Issues Paper, 15 November 2005
[2] Report on progress in creating the internal gas and electricity market, November 2005
[3] Gas Sector Inquiry – Transparency Survey, December 2005

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

This is addressed, in part, by our answer to question 1.

A further point to be emphasised is that, even within North West Europe, the current regulatory position in the various Member States is quite different, in terms of key factors such as:

- gas industry structure and ownership – including, in particular, the extent of TSO unbundling;
- the maturity, legal powers and resourcing of the regulatory institutions;
- existing network access regimes; and
- the extent of competition in wholesale and retail gas markets.

In our view, co-ordinated action to *"promote liquid and competitive trading at and between gas hubs"* (Roadmap paragraph 2), which requires significant cross-border actions, must necessarily go hand-in-hand with a "levelling up" of national regulatory regimes to a broadly consistent level. Two relevant examples include:

- action to address the regulatory shortcomings recently identified in a CREG consultation document[4], particularly as regards both gas transit through Belgium and access to the Zeebrugge hub; and
- the ongoing work of the BNA, in consultation with the industry, to put in place the basic regulatory framework for regulated third party access to gas networks in Germany.

Introduction

3. We particularly welcome, in response to this consultation document, examples from industry participants of problem experienced in European markets that demonstrate the existence of obstacles to further progress towards a competitive single European gas market.

In general terms, as mentioned above, we concur with the analysis set out in the ERGEG Roadmap and the European Commission's Energy Sector Inquiry Issues Paper. These identify, in general terms, many of the most significant obstacles to further progress towards a competitive single European gas market.

Experience in North West Europe during this winter to date, particularly as regards gas flows through the Zeebrugge-Bacton interconnector, suggest that the European gas market does not, as yet, respond quickly or efficiently to short-term price signals – even when these are

[4] The Functioning of the Natural Gas Market in Belgium: CREG consultation report, September 2005

highly significant. There appear to be a number of reasons for this, including the following:

- Significant physical transmission constraints on the Continent, particularly as regards the flow of gas from The Netherlands, Germany and France into Belgium
- Constraints arising from material differences in gas quality and quality specifications – even within the broad category of "H" (high calorific) gas – which impede the full and flexible use of existing infrastructure
- Limited liquidity at traded gas hubs, for a combination of reasons including the foregoing and other factors identified in the ERGEG Roadmap document
- Unliberalised (restricted and quasi-administered) access to gas storage in a number of Continental jurisdictions (e.g. France and Belgium)
- Limited fuel-switching capability among larger gas users in a number of Continental European markets, at least as compared with the UK
- Differences in national supply security standards and policies across the EU.

The creation of a properly-functioning and competitive single European gas market will require industry, governments and regulators to address these issues, as well as others identified in the ERGEG Roadmap.

4. Regulators welcome feedback on the concept of the regional market in gas.

The concept of regional markets in gas is somewhat less obvious than it is in the power sector, where long-distance cross-border energy flows are less significant and long-standing transmission constraints create clearly-identified regional markets (Iberia, Scandinavia/Nordpool, Italy, France/Germany/Central Europe etc), each of which has its own separate price dynamic.

In the gas sector, by contrast, indigenous production is much lower and long-distance (or even trans-Continental) flows are a long-standing feature of the industry. Nevertheless, the proposition that wholesale market development can most usefully be promoted on a regional basis makes sense from a number of viewpoints:

- The most important obstacles to "*liquid and competitive trading at and between gas hubs"* are essentially regional in nature (i.e. typically capable of being addressed by and between 2-4 Member States)
- Given the very different starting points referred to above, it is more realistic at this stage to look for harmonisation and co-ordinated action on a regional basis, rather than across the EU as a whole

- Regional initiatives are likely to attract the maximum commercial drive and focus, since there are, as yet, relatively few commercial actors with truly pan-European gas activities or aspirations.

Current state of European gas markets

5. Regulators would like to hear the views of respondents on whether there are other important regulatory gaps not addressed here.

Before addressing the specific question of regulatory gaps (section 3.5 of the Roadmap), we would like to make some brief comments on the earlier parts of section 3, as follows:

- We concur with the stated advantages of decoupling physical and contractual flows (Roadmap paragraph 35). “Netting off” or “gas swap” arrangements have historically been quite common in the European gas industry; however, the challenge is to ensure that such services are consistently made available to the market on a non-discriminatory basis.
- Roadmap paragraph 36 highlights the key point of non-transparency. This is improving selectively, particularly as regards the GTS network in The Netherlands, but the overall position remains unsatisfactory. We believe that there are, for the time being, physical congestion constraints within North West Europe – but the precise nature and extent of these remains difficult for independent shippers to assess.
- Paragraph 37 raises the issue of consistent application of “use-it-or-lose-it” (UIOLI) principles. To the extent that physically constrained capacity is available to third parties only on an interruptible basis, it is often difficult to assess either the likelihood of interruption or even the price applicable to interruptible transportation.
- Re paragraph 38, we understand that there are real gas quality constraints on the full and efficient use of existing transportation capacity. This reinforces the need (identified in paragraph 39) for blending and quality conversion services to be made available to the market, on a fully non-discriminatory basis.
- We strongly support the view (paragraph 41) that entry-exit transmission tariffs are a key facilitator of liquid trading at and between gas hubs.
- We concur with the Roadmap observation (paragraph 41) that TSO unbundling in some Member States is as yet insufficient to ensure that access is fully non-discriminatory in effect.
- Paragraph 42 touches on important legacy contract issues, particularly in relation to joint venture gas transit pipelines. We consider that the legal and regulatory framework requires (inter alia) the consistent and transparent application of UIOLI to these pipelines. Another important issue is the fact that the tariff

arrangements in these legacy contracts may cut across the general objective of moving to an entry-exit pricing structure.

- We generally concur with section 3.4 (regarding liquid hub-based trading). There is one further important factor to be highlighted, which is whether a hub can be regarded as "firm" (as with the UK NBP, which is essentially backed up by entry-paid gas on the national transmission as a whole) or "non-firm" (as with Zeebrugge, where "off-line" contractual back-up must be obtained from time to time).
- As paragraph 52 implies, the importance of physical congestion has been clearly highlighted, during November and December 2005, by the massive price differentials between TTF and Zeebrugge. As we understand it, this reflects in turn the impossibility of physical flow via Zelzate into Belgium, pending the development of extra gas compression.

From this analysis, it follows that the principal focus of regulatory action should be **facilitation**, primarily around transportation access into, out of and between gas trading hubs. Subject to the effective application of competition rules and any relevant aspects of financial regulation, we consider that trading itself is likely to develop best as a largely unregulated activity, from an energy point of view. Having said that, strongly dominant positions (e.g. that of Gasunie, in the Dutch L gas market) are clearly not conducive to the development of liquid traded markets. In this case, regulatory intervention (e.g. gas release programmes) may be required to "kick start" the development of hub trading activity.

As regards the regulatory gaps identified in Roadmap section 3.5, we agree that voluntary agreements (guidelines) are very much a second best solution. Given some reluctance to consider new European legislation until 2007, however, we consider that guidelines nevertheless have an important interim role to play in several areas, e.g.:

- TSO unbundling, setting out both the detail of effective implementation and compliance monitoring/reporting arrangements
- Gas balancing (following the recent ERGEG consultation)
- Access to quality conversion and blending
- More detailed guidelines on the application of UIOLI and secondary trading in capacity, pursuant to the 2005 Gas Transmission Regulation[5]

The development by ERGEG of appropriate interim guidelines would also facilitate the prompt and effective introduction of new legislation, where necessary, when this is considered by the European Commission in 2007.

[5] Regulation of the European Parliament and of the Council on conditions for access to the Natural Gas Transmission Networks, September 2005

The regulatory gaps identified in Roadmap section 3.5 relate primarily to cross-border consistency in regulatory arrangements and the powers of the national regulators. We agree that these are areas which should be considered and addressed in any new European legislation and we would add to that list two further sets of issues, as follows:

- Those points proposed above for interim guidelines which, to the extent that the guidelines are insufficiently observed, should then be considered as matters for further legislation
- Further legislation to ensure that essential "ancillary" services (e.g. balancing, blending and quality conversion, gas storage and flexibility services etc) fall fully and unambiguously within the scope of the regulated third party access regime. (This should not, in our view, exclude the possibility of exemption in specific cases where this would not impede the development of a competitive single European gas market.)

6. 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?

In a fully liberalised energy market such as the UK, we consider that there is scope to use both the regulated and the commercial model to promote new investment in infrastructure. Typically:

- The regulated model is appropriate for facilities which exhibit the characteristics of natural monopoly (i.e. most transmission and distribution investments) or where the investor would otherwise be in a position to exercise significant market power.
- A commercial model is generally appropriate elsewhere, subject to certain regulatory safeguards (such as UIOLI, to ensure that scarce capacity does not become "sterilised") and the normal application of competition law. This is the basis on which, for example, exemptions to the full regulated TPA regime have been granted to projects such as BBL (for initial forward flow capacity) and several UK LNG regasification terminals.

There is strong evidence, from UK experience, that significant investment can be brought forward on both bases. Under the regulated model, a high level of investment has been shown to be fully compatible with an incentive regulation regime which allows efficient TSOs to earn back their cost of capital.

In the case of the liberalised commercial model, some UK investments have been underwritten (at least in part) by long term contracts.

However, this is not universally the case and those long term gas purchase agreements which have been entered into (including our own) are typically priced in relation to the traded wholesale gas market. In other words, the traded gas market itself provides, directly or indirectly, a significant element of the total “security package” for investors in this liberalised environment.

The traditional commercial model in a non-liberalised gas market was clearly quite different. One example is transit gas pipelines, as discussed above, which are typically characterised by the following arrangements:

- A separate joint venture company which owns and operates the pipeline (e.g. MEGAL, TENP, SEGEO etc)
- Reservation of the entire pipeline capacity on a long term basis, by a group of shippers who are typically also shareholders in the JV pipeline company.
- Tax-efficient financing structures based on a very highly geared JV pipeline company.
- Long term gas purchase agreements entered into by the shippers, combined with long term sales agreements and/or a dominant (if not legal monopoly) position in the end user market.

Legacy contractual arrangements of this nature were often put in place well before the introduction of energy market liberalisation measures. The challenge is therefore to integrate them, as far as possible, into a liberalising market structure and apply consistent approaches to maximising capacity utilisation (e.g. UIOLI and secondary trading in capacity), but without eroding the necessary investment incentives (e.g. for pipeline upgrading and debottlenecking) on the part of TSOs.

The Roadmap (paragraph 71) refers to the possible co-existence of two approaches to investment security. In fact, we currently face the co-existence of at least four different approaches, viz:

- The regulated approach discussed above.
- A “liberalised” commercial model, within parts of the EU
- The legacy, or non-liberalised commercial model, within other parts of the EU gas market
- The commercial model applicable to connected non-EU gas infrastructure projects (e.g. offshore pipelines), which are by definition outside the scope of EU legislation.

It is this complexity, and in particular the juxtaposition of fundamentally different approaches, which poses challenges in the creation of more effective traded gas markets within the EU.

As to the fourth of these approaches, industry is reliant on the extent of progress within various bilateral and multi-lateral relationships (e.g. agreements between the EU and the EEA countries, the Energy

Charter Treaty[6] agreement with Russia etc). Should the existing arrangements leave undue market power with certain individual importers of gas into the EU, then this may require action at an EU or Member State level (e.g. the obligations on Eni to release gas to third parties, at the Italian border) to redress the situation.

Priorities

7. 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?

We agree with the objective of facilitating network access for shippers and avoiding the "pancaking" of transaction costs. As a general principle, we consider that transmission access costs across two or more interconnected TSO networks should not exceed the efficient level of costs (including a normal return on capital) which would be incurred by operating those networks as a combined system. At the same time (see questions 9 & 11 below), it will be essential to ensure that there are adequate incentives to invest in relieving existing transmission constraints and meeting incremental transportation demands.

Within many EU Member States, there is in fact only one TSO, or else one which accounts for the overwhelming majority of the national transmission network. In other Member States, particularly Germany, this is not the case and we note with interest the intention to move to a "two contract model" in that country – i.e. a single contract for access to the transmission network (irrespective of how many different grids are actually used) and a singe contract for access to the distribution network.

In Germany, the immediate priority is to establish a "no pancaking" regime within that country, as shown by the recent compromise proposal of the BNA to the Network Access Consultation Group. In Belgium, to take another example, the CREG recently[7] rejected the proposed network code pending further work by Fluxys to rectify some shortcomings and transit transportation remains outside the legal & regulatory framework applicable to national gas transmission[8]. Further

[6] Unfortunately not yet officially ratified, on the Russian side

[7] CREG Decision (B)051020-CDC-481 dated 20 October 2005 relating to the request for approval of Fluxys S.A.'s network code

[8] See the CREG consultation report cited under reference 3, especially the CREG commentary in relation to gas transit at section 2.1 thereof

progress in these areas must necessarily take precedence over a reduction in “cross-border pancaking”.

However, other Member States have already established a “one contract” transmission access model which it should now be possible to build on in the context of cross-border transportation and trading. We therefore agree with the Roadmap’s proposal that consideration also be given to reducing the number of contractual interfaces across borders.

One possible approach is illustrated by recent developments in the UK, where there are now a number of different distribution network operators. We note two features, in particular, of the UK arrangements:

- The Uniform Network Code (UNC), which provides a single contractual framework for gas network access; and
- The role of Xoserve, a JV organisation owned by the various network operators, which provides a single interface with shippers for a number of important transactional services related to network access.

This sort of approach could potentially be applied in respect of future inter-TSO co-operation. In our view, however, the primary obligations on TSOs should be focused on ends (objectives and timescales), rather than means. Appropriate TSO co-operation in this respect could take the form of:

- inter-TSO contracting; and/or
- joint appointment of a separate body to manage some of the shipper interfaces, along the lines of Xoserve in the UK.

The longer term vision, implied by if not explicitly stated in the ERGEG document, is some form of “cross-border” entry-exit transmission pricing model. Under such a system, cross-border shippers will still need some form of direct contractual relationship with the “entry TSO” (the TSO into whose system they first input gas) and the “exit TSO” (or possibly DSO), being the network operator from whose system the gas is eventually delivered. Essentially, this would amount to the application, across TSO networks in different Member States, of the approach currently being developed to provide access to multiple transmission networks within Germany.

From a wholesale market development point of view, this model clearly has a number of major advantages. However, it is also important to consider how investment in new cross-border transmission capacity would be remunerated in this case – given that the relevant TSOs would be “missing” a source of revenue (at either entry or exit, as the case may be) normally available from within-country transmission contracts. Two models could potentially be envisaged, akin to those mentioned in paragraph 71 of the ERGEG document, viz:

- a regulated model, whereby the cross-border investments are integrated into the TSO’s overall regulated asset base

and earn a regulated rate of return, subject to the potential for out-performance within incentive regulation frameworks; or

- a contractual model, whereby shippers (in effect) make capital contributions in return for long term capacity rights at defined entry and exit points in different Member States, but subject to a requirement for UIOLI and secondary trading.

8. 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.

It follows from our response to qu. 7 that we consider there would be significant advantages in such an arrangement, at least as a clearly-stated medium term objective backed up by appropriate TSO obligations.

We do, however, consider that it will be difficult to make major progress in this direction until a sufficient number of Member States has established a workable uniform and "pancake-free" transmission access contract regime within their own borders. This is certainly the case within North West Europe (UK, Belgium, Netherlands, France & Germany), the region which is of primary interest to Centrica.

9. 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.

While there are, in our view, some important gaps in the existing European legislation (see our response to qu. 5, above), we are nevertheless convinced that very material further progress in wholesale market development could be made on the basis of existing legislation – in particular, via prompt, full and effective adherence to the 2005 Gas Transmission Regulation.[9]

Among the most important issues addressed in the Regulation are, in our view, the following:

- Some important principles of transmission tariff setting, including inter-TSO convergence in balancing arrangements (Article 3)
- The requirement to offer both firm and interruptible services, with the price of the latter reflecting the probability of interruption (Article 4)
- The principle of non-discriminatory and transparent capacity allocation (Article 5)
- The use-it-or-lose it provisions of Article 5.3 (a) and 5.4
- Information transparency - especially as regards capacity utilisation, under Article 6.3, and balancing, under Article 7.6

[9] Op. cit. (reference 4)

- Trading of capacity rights (Article 8)

We consider that these arrangements, properly implemented, would do much to provide transparent, non-discriminatory and economically efficient access for network users – without any significant erosion of the investors' "security package" or incentives to make further investment in the network. This can readily be demonstrated by the continuing large-scale investment (of the order £300m or just under €450m per annum) in UK gas networks, which are already subject to provisions of this kind.

We also see a significant role for national energy regulators and ERGEG, in terms of monitoring TSO compliance with the Regulation and putting in place any more detailed national measures necessary to complement the Regulation.

We note that section 7 of the Roadmap does not explicitly pick up the questions raised in paragraph 130 of the ERGEG document, as regards gas quality. In our view, there are two somewhat different sets of gas quality issues, which are likely to require different regulatory solutions:

- First, there is the question of highly restricted access to "L gas" for supply to retail customers in The Netherlands and in parts of the neighbouring national markets. Where L gas supply is tightly held and quality conversion capacity is fully booked on a long term basis by dominant incumbents, competition in retail supply to L gas customers will remain very limited. The solution here is to eliminate any "pre-emptive" long term contracts and/or to facilitate wholesale trade in L gas (e.g. by moving bulk supply/delivery points from the City Gates to trading hubs).
- Second, there is an "inter-operability" issue between transmission networks for internationally traded H gas (e.g. Russian gas vs. Norwegian gas vs. LNG). The responsibility for investing to overcome such constraints should normally rest with TSOs, with cost recovery from network users taking place on a contractual or an "RAV" basis, as the case may be.

In both cases, we consider that the process or finding appropriate solutions is likely to be facilitated by greater information transparency and (where this is not already the case) by effective TSO unbundling.

The way forward

10. Respondents are requested to comment on the appropriate definition and selection of regions for the regional initiatives.

We are not well placed to comment on all the regions mentioned at paragraph 136 of the ERGEG Roadmap. Our principal involvement is in the North West Europe region, including the UK, which includes

Zeebrugge, Eurohub, TTF and NBP. We agree that it is logical to consider these actual and potential hubs within a single regional initiative – as significant transportation capacity between them is already available or is likely to become available through foreseeable investments which are committed or planned for the coming years.

We would, however, suggest that the scope of this regional initiative should be expanded somewhat to consider:

- Trading at the northern and eastern PEGs, within France, and the possibility that the number of trading/balancing zones within the French transmission network will be further reduced via further network investment in the next few years.
- The possibility of virtual hubs within Germany, once the transmission access regime is restructured. (This would certainly be facilitated by the latest BNA compromise proposals.)
- The scope to encourage wholesale trading in L gas (for example, by moving the delivery point in Gasunie sales contracts with Dutch retail suppliers from the City Gate to the TTF).

While we consider North West Europe to be an appropriate regional definition, we can nevertheless imagine that for practical purposes it might be necessary to define sub-groups to focus in more detail on particular issues which may arise – e.g. at a sub-regional level. For example, different issues are likely to arise in relation to:

- promoting further trade at and between hubs which already functioning with at least some liquidity (Zeebrugge, TTF); and
- development of hubs which are as yet embryonic (e.g. the French PEGs) or not yet operational (e.g. Eurohub).

We look forward to playing a full and active role in the North West European regional initiative. In terms of the process, we consider that:

- The formal launch of the regional initiatives should take place as soon as reasonably possible.
- There needs to be regular reporting and involvement to ensure that stakeholders are kept fully up-to-speed with developments.
- In turn, this should allow any formal consultation processes to be kept to a shorter duration.
- Care needs to be taken that stakeholders are not given too little information too late, especially as things move towards the implementation phase.
- Regulators also need to ensure that consultation is fully open and non-discriminatory, with particular regard to the merchant affiliates of TSOs or hub operators.

In terms of the outputs from the regional initiative (paragraphs 141-144 of the ERGEG document), we have three principal comments:

- We envisage a set of regional "Roadmaps" akin to that recently produced in the power sector by CRE, CREG and DTe[10]
- We consider that these could be produced, in outline form, by June 2006 – and revised versions could be put out for consultation later in the year, as envisaged by ERGEG
- We are particularly concerned that urgent actions (capable of being resolved within the existing legal & regulatory framework) should not wait until 2007 – but rather be initiated during 2006 if the regional initiatives identify a clear and pressing need for them.

11. Regulators would like views from stakeholders on some specific questions relating to the identification of relevant regions:

- **Is physical congestion at border crossings important in gas markets, and what is the relative significance of contractual constraints?**

  Given the lack of transparency identified in several recent reports, including the ERGEG Roadmap, it is difficult to answer this question with a high degree of confidence. Nevertheless, it seems clear that (in the short term, at least) there are some real issues of physical congestion – for example, the lack of compression sufficient to ensure a physical flow of gas from The Netherlands and France into Belgium, at Zelzate and Blaregnies respectively. There also appear to be physical constraints on the flow of gas through Germany into Eynatten, on the German/Belgian border, though here the issues of physical and contractual congestion are somewhat more difficult for us to disentangle.

  That being said, one cannot be confident that maximum/optimal use is being made of the capacity which does exist, including via gas swaps and displacement (e.g. of Norwegian volumes into IUK). This reflects:

  - the lack of transparency, including as regards gas quality constraints and the scope to overcome them;
  - the lack of effective UIOLI and/or secondary trading in capacity;
  - differing and sometimes non-transparent supply security standards across Europe; and
  - various other (contractual, political or environmental) constraints on the ability of the European gas market to respond even to significant short-term price signals.

- **In what way is this situation likely to change with increasing imports in future?**

[10] "Regional market integration between the wholesale electricity markets of Belgium, France and the Netherlands", December 2005

This is also rather difficult to predict, since it will depend on the complex interaction between investment to debottleneck transmission capacity, growing demands for gas within-country (e.g. new gas-fired power stations, which are committed or planned in most if not all North West European markets) and the increasing requirement to move gas in transit across borders between EU Member States.

It is nevertheless encouraging to note a number of committed investment projects in North West Europe, including:

- Development by Ruhrgas' of its pipeline system into Eynatten
- Reinforcement of the Wingas pipeline system in Germany (both STEGAL and WEDAL)
- Construction of a new line in The Netherlands between Bunde and Balgzand, to feed the BBL interconnector pipeline
- New compression near Zelzate, to support physical flow from The Netherlands into Belgium
- Proposed upgrading of the Belgian transit system
- Investment in the French network, to address internal transmission constraints and add additional cross-border capacity

Most of this new capacity should come on stream within the next 3-4 years and should help to achieve a significant amelioration of physical congestion. We have outlined earlier in our response the measures which we consider should be taken to ensure that "contractual congestion" does not impede the most efficient use of this new capacity.

- **How can different regions be distinguished in terms of:**
  - **the sphere of influence of different gas hubs;**
  - **physical and/or contractual constraints at the region's borders;**
  - **different pricing mechanisms;**
  - **other (explain)?**

This point has already been addressed, at least in part, by our response to earlier questions. We consider that hub development needs to be considered from a medium term perspective (i.e. over a period of 3-5 years), over which time we expect that a number of important short-term capacity constraints will be alleviated.

The close relationship (on most occasions) between wholesale gas prices at NBP and Zeebrugge shows the pattern which is likely to emerge when inter-hub transmission constraints are absent or exceptional. By contrast, the huge basis differentials recently observed between TTF and Zeebrugge can only be explained by a binding transmission constraint.

We do not believe that short term price differentials between geographically proximate hubs, however significant, would justify the definition of each traded area as a separate region. If they did, then The Netherlands (for example) would currently have to be defined as a unique traded price zone – which cuts across the whole rationale behind the Roadmap, i.e. the promotion of *"liquid and competitive trading at and between gas hubs",* in order to further the development, over time, of a single European gas market.

As existing physical constraints in North West Europe are alleviated – and provided measures are taken to ensure that contractual constraints do not become a significant obstacle to inter-hub trade – we would expect a much higher degree of wholesale price convergence to take place in the region.