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Our reference
ERREG CAM CMP Consultation

Administrative officer
Strategy and Analysis

StatoilHydro

Your date
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Your reference
StatoilHydro position

Internal

ERREG

Attn.: Mrs.Fay Geitona

1000 Brussels
Belgium

Response to questions posed in “ERREG Principles: Capacity Allocation Mechanisms and Congestion Management Procedures”

Dear Mrs Geitona,

We welcome the opportunity to respond to the above consultation and we appreciate the importance of addressing capacity allocation mechanisms (CAM) and congestion management (CMP) at interconnection points as we regard improvements in these areas as essential towards the construction of the European internal gas market.

Progressive liberalisation of national markets and harmonisation remain the overall instruments to establish liquid and well functioning markets across Europe. It is therefore important to note that these general rules should be applied at all entry points on any given grid as well as cross border points. The issues you address are only a small part of this wider picture but they can help moving in the right direction.

Our position in this respect is that some basic principles should form part of your proposals:

1. Precise **calculation of and transparency on infrastructure utilisation levels** are the basis for any of the decision to be taken with respect to modifying CAM and CMP;
2. **Market based allocations mechanism** remain the most efficient and most transparent option;
3. **Flexibility** is an important tool for shippers and traders and the limitation of it should not be pursued unless a cost-benefit analysis is underrate;
4. A wide **variety of capacity products** available in the market is essential to meet the needs of shippers and traders and to facilitate liquidity in the markets;
5. Simplification and reduction of transaction efforts at interconnection points by establishing **single booking procedures** is critical to transparency and to market integration.

This is the background for the answers you find attached to this letter.

Please do not hesitate to contact us should you have any further questions or concerns.

Kind regards

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Questionnaire

1. Do you agree with the problems that ERGEG has identified with capacity allocation and congestion management? Are there other aspects that should be taken into account?

On a general level we would like to stress that effective transmission unbundling works as a general precondition and appropriate incentive environment for efficient capacity allocation mechanisms (CAM) and congestion management procedures (CMP). From an equally high level perspective we would also like to underline that poor CAM and CMP, by not solving contractual congestion problems, could have a perverse effect and lead an overly high demand for new investment as market participants would see this as the only way of obtaining capacity.

This said we welcome the recognition that in some European markets, problems exist with regard to CAM and CMP both in the long and in the short term.

We share the ERGEG view that capacity mismatch and different nomination procedure at interconnection points substantially limit the ability of the markets to integrate and to respond efficiently to price signals. Differences in products and units of measure create unnecessary barriers and put additional constraints on the development of secondary markets. Limited information and non optimal communication procedures on available capacity, gas flows, supply/demand balance, pricing and volumes sold under each capacity product prevent new entrants from accessing markets and hamper the possibility for any CAM or CMP to work properly.

In contrast, we question the decision to limit the scope of the prospected new guidelines on CAM and CMP for interconnection points in Europe. Market dominance is often the consequence of the control exerted by incumbents on import pipelines at the borders with Europe. Hence a major contribution to enhanced competition in the Internal Gas Market would come from unlocking capacity at import entry points. ERGEG should consider including reference to such points.

We remain concerned about the lack of reference to any harmonization mechanism in those situations where transmission system operators adjoining more than one system choose to apply different terms and conditions at the interconnection points to different systems.

Where suggested principles are only to be applied to congested or potentially congested points, as the consultation document indicates, we fear this may lead to increased complexity and confusion on a pan-European basis, as different rules could consequently emerge between different interconnection points.

2. The scope of ERGEG's principles and of the derived proposals covers bringing capacity to the market where there is currently contractual congestion. Do you agree with this approach?

We expect that the solution proposed by ERGEG would bring some capacity to the market where there is currently contractual congestion, but the overall goal must remain to improve the traded market throughout Europe.

Although we maintain our overall positive assessment of the analysis provided in the consultation document and we support the emphasis put on transparency, information requirements and communication procedures, as well as the general principles set out, it is not clear to us that the ERGEG proposal would be the best solution where contractual congestion occurs.

3. In principle, European regulators consider FCFS allocation potentially discriminatory. Do you share this view? What do you think about the proposed mechanisms (OSP with subsequent pro-rata allocation or auctioning)?

We agree that FCFS is not an appropriate approach in a liberalised gas market and that it is potentially discriminatory, particularly where it applies to congested points. We are equally concerned about the underlying approach of FCFS being used for congestion management. For example, the principle of CMP described as Last Committed First Interrupted (LCFI) in the ERGEG paper is potentially discriminatory for the same reasons as FCFS is for capacity allocation whenever congestion is to be managed.

The primary allocation of existing capacity needs to be re-thought so that there is a market-based allocation method wherever congestion needs to be managed. This leaves us with a strong preference for an auction mechanism over any alternative solution. A pro-rata mechanism could create perverse incentives on shippers to over-estimate their requirements, to secure a greater proportion of available capacity and fails to externalize the right price while remaining open to some degree of uncertainty, in particular where a developed secondary market for capacity is not in place. Conversely, an auction has the inherent ability to discover the value of capacity and leads to a more efficient use of the available resources.

Finally, any investment decision for additional capacity should be based on a pre-agreed economic test that has been defined between the regulators, TSOs and market participants. Any related assignment of capacity at a stage where a final investment decision is far from being taken should be avoided to prevent strategic behaviour that could ultimately jeopardize the actual realization of the new capacity.

4. In your view, what is the future importance of the proposed capacity products (firm, interruptible, and bundled) and of the proposed contract duration (intra-day up to multi-annual)?

Market participants need a variety of standardised capacity products to be available. We consider that flexibility in terms of product choice and duration at the primary allocation stage, not only provide a better opportunity to get a shipper's capacity portfolio right, but importantly reduces the reliance on second best measure to deal with contractual congestion, i.e. UIOLI procedures, especially in those markets where limited liquidity is available. Moreover, any definition of ceilings and pre-determined quotas of products of a given duration may fail to respond to market needs. Hence we think such measures, i.e. quotas of products of a given duration, should remain a last resort option to be recalled only where major competition concerns are in place.

5. What is the role of secondary capacity trading?

Secondary capacity trading is a tool for optimising shipper trading portfolios. In a fully functioning liquid market, shippers have no desire to miss market opportunities, carry imbalance positions or not deliver on contracts, nor do they wish to pay for capacity, which they no longer require, provided they have the confidence that a proportion of capacity is available to meet shorter term requirements.

A properly functioning secondary market discloses the price of congestion. For points with no congestion, the secondary market would compete with primary capacity prices, both firm and

interruptible. For congested points the value represents the economic costs of alternative optimisation solutions. In doing this secondary markets offer a mechanism for efficient allocation.

We would strongly support any measure that would favour the development of liquid secondary capacity markets. We also believe that the EASEEgas CBP on secondary capacity trading should immediately be implemented by all TSOs to match the already established deadline the end of May (see the CBP on www.easee-gas.org). Only with a short transfer lead time is it possible to utilise capacity offered on the secondary market.

6. How do you assess the proposed measures to enhance the availability of firm capacity and to improve short-term and long-term congestion management?

Broad access to flexibility is a crucial element in the creation of liquid energy markets as it allows responses to changing market conditions. Re-nomination rights are widely acknowledged as essential for an efficient gas market to be able to respond to volatile demand or market signals in general.

The proposal to limit re-nomination rights would restrict the ability of market participants to supply flexible products, including physical and virtual storage and production and import flexibility. Restriction of re-nomination rights would be especially problematic for markets that continue to have hourly balancing requirements.

In particular, restricting re-nomination rights could lead to:

- Inaccurate and even misleading information as nominating too far in advance is unlikely to provide a very accurate representation of actual flows.
- Influence a shipper's decision to self-interrupt if they are unable to re-nominate to reflect it.

Concerns also exist with respect to how shippers might be penalised, were they to move outside of the tolerance band, within the relevant balancing regime, as charges may be incurred where there is a significant divergence between nominations and actual flows.

Practical examples of the application of ERGEG's particular approach to curtail re-nomination rights should therefore be worked through and compared with alternative approaches.

With respect to long-term congestion management, our main concern remains the need to provide clearly defined and extensively discussed ex-ante conditions for the withdrawal of unused capacity. Once more the development of a functioning and liquid secondary market would provide the necessary incentives leading shippers not to sit on unused capacity but in principle it should be up to the shipper to decide what it is doing with the capacity. Alternatively creating incentives to sell it on the secondary market when they are not planning to use is a good idea.

7. What are your views on the proposals? Do they address the problems? Will they lead to more effective capacity allocation methods being developed?

With its initiative, ERGEG chooses to focus on enhancing the availability of short term firm capacity rather than long term. Whereas we believe that the integration of European markets does require the release of additional – short and long term – transmission capacity, we also believe that there

is a huge potential in maximizing available capacity through improved methods of capacity calculation, in particular the implementation of dynamic modeling by TSOs.

Where there is contractual congestion it is unlikely that all capacity will be nominated and as such there will always be unused capacity – which represents a loss. TSOs should be able to anticipate and react to this outcome by initially selling more than 100% of the capacity that is actually available. In the unlikely event that more than 100% capacity is nominated TSOs could opt to 'buy-back' capacity from market participants. In this way, all capacity is utilized and those market participants that have been constrained will be paid a market price in compensation.

To do so TSOs should move to a maximum technical capacity approach that takes into account a certain risk of not being able to deliver all the sold capacity. TSOs should be entitled and obliged to buy back capacity at a market price in the –unlikely– event, that they cannot fulfill their obligations. Certainly, this approach requires that revenue regulation of TSOs is adjusted accordingly in order to allow for symmetric risks and chances.

Regulators could also ensure that TSOs have appropriate incentives to improve their modelling capabilities by defining tariff methodologies and formulations that take into appropriate consideration commodity flow over capacity. These would work as automatic motivation for TSO to ensure full utilization of pipelines and they will show them the value of a fully transparent system.

8. Are the needs of shippers performing supply activities properly taken into account?

We believe the answer is to be found in the response to other questions.

9. Are the proposed measures suitable to facilitate development of liquid gas markets?

The measures could help in some markets, but some measures, such as the unilateral restriction of re-nomination rights, are not the best approach as they could make the development of an intra-day gas market more difficult.

We would like to reiterate that without greater transparency none of the proposals will be effective.

10. In your view, how important are compatible booking and operational procedures between adjacent systems?

Compatible booking and operational procedures between adjacent systems remain highly desirable as they facilitate understanding of capacity utilization level at interconnection points and decrease transaction costs and efforts. They also have the potential to increase liquidity at hubs because these would become the most natural trading platforms, rather than borders.

11. Do the proposed measures increase the efficient use of the system? What aspects would you support and like to see further developed?

Capacity calculation and transparency on capacity utilization levels remain the core factors to establish a liquid and a functioning internal gas market and the aspects we regard as the most important and the first to address. The possibility to reveal the real value of existing infrastructure as well as the existence of anti-competitive behavior depends on having these factors in place. Conversely, any CAM or CMP will deliver a limited service and offer limited efficiency if understanding on availability of capacity remains undisclosed to shippers and traders.