

EFET Proposal on Regional Independent System Operator (R_ISO)

A CEER Response Paper

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1. Introduction

EFET has proposed an approach where Transmission System Operators (TSOs) in a given regional market bring together network related activities, in particular those affecting cross-border issues, into a Regional Independent System Operator (R_ISO).

The European Commission energy sector inquiry¹ stated that significant differences between national systems may still reduce cross border flows and trade with respect to their optimal, efficient level. Several important features of Third Party Access (TPA) regimes still differ between European Union (EU) countries, notably: capacity booking and congestion management criteria; balancing periods; tolerances and charges; tariff calculation criteria; and other contractual conditions.

For example, it may often be possible to reserve capacity on one side of an interconnection point between neighbouring TSO systems, but not on the other as capacity products may differ. Even if capacity can be booked on several sections, such differences are likely to increase transaction time, efforts and costs for network users. This leads to what has been defined as *transaction cost pancaking* - such differences hinder trade.

The R_ISO is one out of several potential ways to overcome these issues. The extent to which it is the most appropriate approach will be determined by a number of underlying conditions which also need to be present – the likelihood of which cannot be definitively foreseen at this time. This CEER position paper reflects the CEER position adopted in its Response to a Regional Independent Operator (RIO) proposal by EURELECTRIC [C07-GA-34-08]. In this position paper CEER addresses the issues raised by EFET, gives its first views and indicates challenges in implementation. The paper introduces views on a general level due to the fact that the R_ISO model is not yet defined in sufficient detail. In particular, legal jurisdictional issues, including on cross boarder definitional concerns and decision making authorities, would need further elaboration. It is also important to note that the proposal is largely concerned with institutional issues, whereas changes to underlying market rules will also be an important part of fulfilling the proposal's stated objectives.

2. Regional co-operation among TSOs

Regional co-operation among TSOs is already practised in various forms. . These are some specific examples of alternative approaches for regional co-operation among TSOs:

- TSO cooperation for the purpose of meeting market demand and facilitating access with regard to cross-border issues (e.g. French system, GATRAC platform);
- legal obligation of national TSOs vis-à-vis a regional independent system operator within a Member State (e.g. Austrian Gas Grid Manager); and
- single-purpose companies set up by several national TSOs for the joint operation and management of capacities of a certain cross-border pipeline connecting several countries (e.g. Nabucco).

¹ cf. Final report on energy sector inquiry, DG Competition, SEC(2006)1724, 10 January 2007 <http://ec.europa.eu/comm/competition/sectors/energy/inquiry/index.html>

In the first example, two European operators of gas transmission systems – RWE Transgas Net, s.r.o. (Czech Republic) and ONTRAS - VNG Gastransport (Germany) set up a Gas Transport Cooperation Platform (www.gatrac.com) which is a cross-border partnership for the purpose to simplify cross-border transport between the Czech Republic and Germany and to make it more transparent by indicating available capacity, applicable tariff systems and other information about several networks. It gives shippers easy access to long transport routes.

In France there are two TSOs: GRTgaz and TIGF which cooperate to ensure a harmonised approach to capacity allocation through bundled capacity (available as of 1st January 2009), transparency and network access.

Another example of transnational cooperation between TSOs is the joint open season between Fluxys and GRTgaz.

In the second example, Austria implemented a transport model where five TSOs are technically operating their network and a common grid manager (Austrian Gas Grid Manager - AGGM) is handling and managing capacity. This allowed for an increase of available capacity without new investments. Experience has shown that today the grid is able to support a higher peak load of 10% in the Austrian transportation grid than before system wide management by AGGM. The Austrian transmission pipelines are operated by 5 TSOs. The main task of the TSO is to operate, maintain and extend the transmission lines pursuant to the instructions and standards of AGGM. TSOs control the transmission lines operated by them in line with the business terms of AGGM. TSOs have to enter into contracts on the exchange of data with other system operators and AGGM to provide AGGM with all information required to observe the tasks and duties of AGGM.

In the third example, Nabucco Gas Pipeline International was established by 5 national TSOs with equal ownership (i.e. 20%). In realising the Nabucco project, the task of the national TSOs is to construct and maintain the respective parts of the Nabucco pipeline whereas Nabucco Gas Pipeline International is responsible for the engineering design, the financing, managing transportation rights and acting as a “one-stop-shop” for shippers.

3. Regional co-operation of TSOs in the 3rd package

The European Commission adopted, on the 19th of September 2007, a third package of legislative proposals. The proposals include provisions on the eligibility of undertakings to be part of a joint transmission system operator (proposal to amend the Directive) and the regional co-operation of TSOs (proposals to amend the Directive and the Regulation (EC) 1228/2003 and a new proposal to set up an EU Agency). The eligibility provision has direct relevance to the concept of a joint regional independent system operator. The provisions on regional cooperation are more general and apply to all forms of arranging the system operation activities. The focus on cooperation by grid operators combined with the new obligations on the national regulatory authorities who now have an obligation and a duty to create a single energy market and role of the EU Agency in monitoring the regional co-operation of TSOs should foster greater regional co-operation.

The proposal to amend the Directive 2003/55/EC concerning common rules for the internal market in gas contains new provisions that are relevant here. Paragraph 5 of the proposed new

Article 7² allows for several undertakings which own transmission systems to create a joint venture, which acts as a transmission system operator in several Member States for the transmission systems concerned. However, it stipulates that no other undertaking may be part of the joint venture unless it has been approved under Article 9a as an independent system operator. Article 9a contains *inter alia* detailed provisions on the issues that relate to approving and designating an independent system operator.

Accordingly, the proposal makes it a precondition that the participating undertakings in a joint TSO are efficiently unbundled either applying ownership unbundling or independent system operator approach at national level.

Furthermore, in the proposal for amending the Directive, the new Article 5b on “Promotion of Regional Cooperation” states in relation to regional cooperation that Member States shall promote the cooperation of network operators at a regional level and foster the consistency of their legal and regulatory framework. The article also touches upon the specification of relevant cooperation regions, by saying that the geographical area covered by regional cooperations shall be in line with the definition of geographical areas by the Commission in accordance with Article 2h(3) of Regulation (EC) No 1775/2005.

In the proposal for a Regulation for amending the Regulation (EC) No 1775/2005 on conditions for access to the natural gas transmission networks in Recital (7) on page 22, it has been stated that “Given that more effective progress may be achieved through an approach at regional level, transmission operators should set up regional structures within the overall cooperation structure, whilst ensuring that results at regional level are compatible with codes and investment plans at Community level. Cooperation within such regional structures presupposes effective unbundling of network activities from production and supply activities in the absence of which regional cooperation between transmission system operators gives rise to a risk of anti-competitive conduct.”

The proposal for amending the Regulation contains, in Article 2h, a requirement on TSOs to cooperate regionally. According to it, transmission system operators shall establish regional cooperation within the European Network for Transmission System Operators for Gas to contribute to the tasks dedicated to them in the Regulation. Furthermore, the geographical area covered by each regional cooperation structure may be defined by the Commission. For this measure the comitology process is to be used and the Commission may consult the European Network of Transmission System Operators for Gas and the Agency.

The proposal for a Regulation establishing an Agency for the Cooperation of Energy Regulators contains the tasks of the Agency as regards the cooperation of transmission system operators. In its Article 6 it states that the Agency shall monitor the execution of the tasks of the European Network of Transmission System Operators for Gas. Article 6.6 explicitly states that the Agency shall monitor the regional cooperation of transmission system operators.

To sum up, in order to be able to establish a joint independent system operator, the participating undertakings would be required to be effectively unbundled (either ownership or ISO) according to the rules specified in the proposal to amend the Directive. Thus, the undertakings participating in a joint (regional) independent system operator would not be treated more leniently than those who choose to operate separately as an independent system operator or to choose to run the activities by following the rules on ownership unbundling.

² Article 7 relates to the unbundling of transmission systems and transmission system operators.

The proposals support and foster regional co-operation of transmission system operators but do not presuppose any joint venture like joint independent system operation. The objective is to ensure that transmission system operators cooperate in relevant issues in appropriate combinations – certain issues require a European approach whereas some issues can at least in the near future best be tackled on a regional scale but also then ensuring coherent outcome at the European level. The monitoring task of the regional cooperation activities foreseen in the proposals is planned to be given to the Agency for the Cooperation of Energy Regulators.

4. Assessment of the EFET R_ISO proposal

4.1. Main features of the R_ISO model³

The model is based on the idea that Transmission System Owners operate their network technically, and a common R_ISO handles and manages the capacities in the transmission pipelines. Commercially sensitive activities such as matching the balancing status of each shipper in the area and providing the clearing and settlement services should be managed by the Market operator e.g. based on a Hub (for that region). Only where such a Market or Hub operator has not been set up, should R_ISO be responsible for commercially sensitive activities.

The R_ISO model could more easily lead to the regional market integration than models based on national/local approach. Furthermore, ownership unbundling or national Independent System Operators alone do not solve the cross border challenges and important conditions that reduce barriers to trade would be facilitated by a R_ISO in the following areas:

- coordinated investment planning;
- cross-border open season processes;
- provisions of coordinated cross-border capacity products;
- harmonization of access;
- reduce balancing zones; and
- coherent information provisions.

The transmission system owners will continue to be responsible for the technical management and maintenance of their individual networks (at TSO level), each of which will be a component part of the Regional Gas Grid. The TSOs' primary responsibility for the development of their networks will therefore coincide with a collective responsibility to build and operate the Regional Gas Grid in a way which meets public needs established in EU legislation. Each TSO will therefore have the obligation to participate in the Regional Gas Grid.

EFET considers the R_ISO model as an important step to regional market integration and considers it as an additional remedy to effective unbundling (i.e. ownership unbundling or national ISO), since effective unbundling alone does not solve easier cross-border transport arrangements.

³ This description is based on EFET's discussion paper "Regional Gas Grids – Towards the Single European Market", October 2007, www.efet.org.

4.2. Merits of R_ISO approach

The main merit of the R_ISO model is that it is well suited to increase regional integration and to foster competition in the regional gas market. Up until now most Member States have not been able to guarantee workable competition at national level, partly because of their country size and the inherent size of the national market but also partly because of the lack of commitment. Especially for small countries but also for countries with high market concentration (i.e. almost all Member States) integration of the market is seen to promote competition through the larger geographical size of the market and the usually following decrease in market concentration.

To ensure that the R_ISO proposed by EFET will have a positive effect on alleviating vertical foreclosure at regional level it is a prerequisite that no single vertically integrated TSO can exercise a dominant position in the R_ISO. Even if the R_ISO was owned by several ownership integrated TSOs this would mean that no single vertically integrated TSO is likely to be dominant in the R_ISO. A R_ISO owned by each incumbent will not be in a position to exercise preferential treatment in favour of just one of the incumbents.

The R_ISO model is also more favourable to regional integration than the national ISO model because it establishes a multinational entity which is responsible for system operation. Under the R_ISO approach it should be more difficult to protect national supply interests by Member States in the region. The strong market position of the historical incumbents in their domestic markets is mirrored by their lack of sales in other markets. A regional set up as proposed by EFET would entail the transition from incumbents' de facto monopolistic national markets to oligopolistic regional markets. The right size of each region will be crucial in avoiding narrow oligopolies with concerted actions.

The R_ISO model would lead to larger balancing zones as current national balancing markets will be merged at regional level. In its sector inquiry⁴ the European Commission has identified that the small size of current balancing zones increases the complexity and costs of shipping gas within Europe. Furthermore, costs are increased by highly complex and divergent rules in each zone, and by the obligation to reserve capacity at each border point. Market based mechanisms for matching the balancing status of each shipper and the provision of clearing and settlement services would be affected on the regional level. Larger, regional balancing zones will lead to higher liquidity on the balancing. It should be noted that if the balancing zones are larger, in an entry exit system this may lead to increased investments in capacity or reduced capacity at entry points.

4.3. Operational weaknesses of the R_ISO approach

The proposal leaves open the solution to the main weak points of all ISO models, i.e. how to define and arrange the relationship between the R_ISO and the asset owner (national TSOs), how to make sure that decisions taken by the R_ISO are really implemented by the national TSO (such as new investment) and how to construct an R_ISO which has the financial capacity to support all its liabilities. Thus the main challenge of the R_ISO model to be solved is the legal, regulatory and operational interface between the R_ISO and the national TSOs. This inter-

⁴ cf. Final report on energy sector inquiry, DG Competition, SEC (2006)1724, 10 January 2007 <http://ec.europa.eu/comm/competition/sectors/energy/inquiry/index.html>.

face should be carefully designed and defined. A particular issue which will be difficult to tackle is the inter-TSO compensation mechanism.

An important challenge to be solved is how to guarantee the full independence of the R_ISO from the national asset owners (national TSOs) and other market participants. To address this question, EFET proposes that the R_ISO shall be established in the legal form of a company or joint venture where the other market players or other shareholders such as the EBRD, banks, equity funds, hold jointly the majority, e.g. 60 % of the company and 40 % by the relevant TSOs (TSOs must not have the majority in such a company). In any case, the governance structure should assure an independently operated entity.

4.4. Issues of coverage, jurisdiction and regulation to be solved

The R_ISO proposal is not fully elaborated with regard to the issues of the division of the EU into R_ISOs (how many R_ISOs, which Member States and their TSOs would be belonging in which R_ISOs), where the R_ISOs would be established (which are the jurisdictions where they would operate) and the relation to existing and future hubs in Europe, and who would have the regulatory powers and mandate to oversee them and ensure compliance with the legislation governing their operations. EFET proposes rather vaguely that the number R_ISOs in Europe be the smallest number that is technically and commercially viable, stretching over an area with gas demand between 50 bcm and 100 bcm.

The regional approach within the R_ISO itself raises the potential divergence of the regions and therefore an even more manifested separation of markets in Europe. Any structural implementation of the regional concept will have to cope successfully with this issue. EFET proposal does not contain a plan for co-ordination between neighbouring R_ISOs, which is necessary in order to achieve integrated European market.

As the R_ISO would consist of system operation activities of TSOs based in many countries, an issue to be solved is the jurisdiction of the R_ISO. This includes sub-issues like where the headquarters of the R_ISO is located and which country's legislation is it subject to. These are delicate issues as the R_ISO would be in charge of controlling a critical infrastructure covering many countries.

EFET proposes that European law must contain obligations to ensure that the European and/or regional grid will be developed, maintained and operated. CEER is of the opinion that the legislative priority is to set the right regional market conditions under which a R-ISO might emerge as a viable approach, rather than mandating any particular pre-determined institutional outcome such as an R-ISO. In any case the legal framework for the R_ISO must be set on the European level by a Regulation to avoid different regulatory regimes between regions. This includes harmonized technical and organisational TPA rules (e.g. allocation capacity and products sold must be made compatible) within the regional TSO cooperation and also consistency with other regional TSO co-operations.

Regional TSO cooperation in TPA services requires a corresponding tariff regime between the TSOs of the region. Tariff zones larger than the present national ones would result in a much larger market, which would increase liquidity and foster the developments of hubs in the region. A larger and more liquid market would make more difficult the exploitation of market power by natural gas producers from third countries. As noticed by some shippers, producers tend to practice price discrimination between customers, by identifying the destination market of each contract and calculating the selling price by net-back methodologies. The prohibition of destina-

tion clauses, which are against European Competition legislation, can only partly limit this practice as shippers can hardly change the destination due to transportation constraints and lack of liquid markets. A larger Entry-Exit (EE) zone would help overcoming these problems.

5. Conclusions

CEER shares EFET's consideration that the R_ISO model could be an important step to regional market integration. It is important to note that CEER considers it as a potential additional remedy (rather than a replacement) to effective unbundling (i.e. ownership unbundling or national ISO). This additional remedy should be interpreted as an example of a more detailed specification of the concept of regional TSO cooperation proposed in the 3rd package.

CEER recognises the potential merits inherent in the R_ISO model to enhance market integration. The R_ISO model may be more favourable to regional integration than any national model of ISO because it establishes a multinational entity which is responsible for system operation. In principle the R_ISO model (or any regional entity model) may have advantages in relation to more informal and loose regional co-operation. The R_ISO model could also help to increase trading activities on hubs in the region, based on a coherent and efficient TPA regime with fewer entry/exit zones. It also lends itself to contributing to coherent technical and market rules in system operation. This could reduce transaction costs for new entrants and would lead to lower prices for final customers in the long run.

On the other hand, there are also concerns about the R_ISO proposal. These include issues such as R_ISO ownership, the geographical scope of each R_ISO and inter-TSO compensation. Among the issues that need to be considered in further detail are:

- An elaborated plan of the division of EU into R_ISOs (how many R_ISOs, which Member States and their TSOs would be belonging in which R_ISOs) and the jurisdiction of the R_ISOs?
- Interaction of existing and future hubs with the R_ISO model?
- How a R_ISO would work in a region with different market design and rules and whether a certain degree of harmonisation with regard to these issues is required before the establishment of a R_ISO?

Effective unbundling is a precondition for R_ISO's acceptability. Therefore, CEER agrees with the Commission's understanding that effective unbundling is a critical precondition that needs to be fulfilled in case a joint transmission system operator is established.

The details of the R_ISO model are not sufficiently defined yet which prevents a thorough evaluation of the model and its effects on an integrated market against other models of regional co-operation. Going forward, it will be necessary to work out a R_ISO model in greater detail and CEER would welcome further input into that. It is also necessary for CEER to agree some fundamental principles that a R_ISO needs to fulfil.