

**E.ON's response to ERGEG's consultation on Capacity Allocation on European Gas Transmission Networks – Pilot Framework Guidelines**

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**26 February 2010**

**General**

- *What are your main views of the proposed measures? Do you think Network codes based on these guidelines can achieve non-discriminatory and transparent capacity allocation and the fulfillment of the capacity allocation principles set out in the Third Package of Energy legislation?*

E.ON supports appropriate capacity allocation measures to promote efficient use of transmission capacities. The maximum usage of transmission systems will provide some of the essential building blocks for achieving a single European gas market. We support the harmonization of market designs through EU-wide binding rules so as to avoid NRAs having too much discretion to select from a large variety of instruments. When introducing new market mechanisms the consideration of market needs is crucial. Therefore, the mechanisms not only have to respect the requirements of end customers, but also the needs of shippers and suppliers whether existing or new to the market.

The rules on auctioning procedures should be clear and sufficiently exact to ensure consistency within the EU countries.

The framework guideline will have a strong impact on the current gas market rules and practices. To avoid any uncertainty in the energy markets on legal status we assume that the framework guideline will be approved by ACER according to art. 6 of Regulation 715/2009.

E.ON is concerned about the potential implications of the proposed measures on existing transport contracts as well as on cross-border supply contracts. The principle of sanctity of contracts is essential for a regulatory regime perceived as stable and thus for continued investment and long-term security of supply.

- *What are your views of the implications of each for the measures for sector in which you operate? In particular, we are interested to understand the nature of the implications in a qualitative way (and, if available, any quantitative evidence on costs and benefits would be extremely welcome).*

The measures as proposed by the framework guideline in combination with those recommended for congestion management will increase the available cross-border capacities, broaden the purchase possibilities for shippers, facilitate creation of more sophisticated trading products and promote competition within the EU. Auctioning as the primary allocation mechanism will send appropriate signals to the market in the form of congestion rents. They will support TSOs in identifying investment needs and provide them with the means to eliminate bottlenecks (congestion rents).

The implementation of these mechanisms will require an alignment of the existing processes and IT-systems by all market participants. The adaptation of IT-systems will require an interim period and substantial one-off additional expenditure will be incurred. A general implementation deadline of six months, as proposed in the guideline, is not adequate in this context. We believe that an implementation period of 24 months, is more realistic. Since the implementation of each topic will bind a considerable amount of resources, it is sensible to adopt a step by step approach to ensure smooth implementation. To foster market confidence the new market mechanisms must be fully supported and implemented in a harmonized way by NRAs. In particular NRAs must explicitly

recognize additional revenues to cover the additional costs. Potentially, an adaptation of national legislation will also be necessary.

### **Scope of the Arrangements**

- *Do you support the scope of the draft framework guidelines proposed?*

E.ON supports the scope of the drafted framework guidelines when it comes to the affected booking points where capacity allocation is known to be constraint. In addition the framework guidelines should explicitly list the points at which these rules should not apply, such as exit points to end-consumers and distribution networks, entry points from production networks, entry points from LNG-terminals, and entry/exit points to or from storage facilities. ENTSO-G should be obliged to update this list on a regular basis once the network code has entered into force.

However, we miss a statement of how new built capacities fit into the framework guideline.

### **Existing contracts**

- *What are in your views of the challenges that existing contractual arrangements create with regard to capacity allocation? What would be the possible ways to overcome those challenges?*

E.ON is concerned about the potential hampering of trading possibilities and security of supply by amending existing contracts. Therefore, the amendment of all existing contracts with regard to the bundling of entry- and exit capacity should not be required. Although we accept that evergreen clauses in existing contracts are not longer appropriate.

We therefore appreciate ERGEG's clear statement at the Brussels Workshop on February 2nd that "existing capacity bookings shall not be affected" and that this applies in particular to existing long-term bookings.

As already stated above we believe the implementation period to amend the high number of existing contracts should be extended to 24 months.

- *Should relevant clauses in existing contracts be amended if they contradict the new legally binding set of rules (which will be based on the framework guideline) in order to create a level playing field for all shippers?*

As stated above, contractual parties must be able to rely on their existing legacy contracts. The possibility for long term capacity contracts enables guaranteed security of supply by long import contracts. By implementing the CAM measures these market needs have to be taken into account.

- *Experts have discussed if existing / legacy contracts should be questioned if certain conditions are met, in order to free up capacity, which would then be reallocated. Do you consider such a proposal appropriate?*

As argued above a complete annulment of existing contracts would negatively affect market stability, investment decisions, and security of supply.

### **TSO cooperation**

- *Is the scope of the identified areas for TSO cooperation appropriate to ensure efficient allocation of cross-border capacity in order to foster cross-border trade and efficient network access?*

E.ON welcomes the harmonization and cooperation between TSOs on exchange of relevant data, harmonization of capacity products and capacity allocation procedures, and the harmonization of their maintenance. This will also require a closer cooperation of the relevant NRAs and the abolishment of inconsistent national regulation.

Derived from our experience in power markets, we recommend focusing from the early beginning on a common set of auction rules for all affected interconnection points with, amongst other things, clear and identical definition of force majeure and a reasonable compensation level in case of curtailment of firm capacities.

### **Contracts, codes and communication procedures**

- *Should a European network code on capacity allocation define a harmonised content of transportation contracts and conditions of access to capacity?*

As a European company E.ON supports the standardization of the key elements of transportation contracts and terms of conditions.

- *Should a European network code on capacity allocation standardise communication procedures that are applied by transmission system operators to exchange information between themselves and with their users?*

E.ON supports a standardization of communication procedures among TSOs and between TSOs and network users, particularly with regard to nomination procedures. Since the implementation would be time consuming and cost intensive, it is particularly important that there is a strict standardization to enhance economies of scale. A broader approach and less stringent implementation would potentially lead to a negative cost-benefit analysis.

It is important that the standardization will be elaborated by all market participants including not only TSOs but also shippers which will be also affected by the new processes and data formats.

### **Capacity products**

- *What are your views of our proposals regarding capacity products?*

A small range of standardized capacity products should be introduced to avoid illiquid and fragmented capacity markets. We propose the following products and recommend outlining it explicitly in the framework guidelines:

- Intraday capacity
- Day ahead
- Month ahead
- Quarter ahead
- Year ahead

Yearly products should refer to either the calendar year or the gas year, not both. To offer both starting dates would mean to inefficiently disperse the amount of available capacity on two different products. Individual contract terms can be achieved by grouping yearly with quarterly, monthly and even daily products.

Yearly and quarterly products shall be available at least 15 years/ 60 quarters ahead (see UK QSEC example). We suggest a maximum contract length of 1 year but the ability to bid at the same time for up to 15 annual/ 60 quarterly contracts at the respective interconnection point. Long term bookings are crucial for enabling long term supply contracts and therefore for the Security of Supply in most European markets.

Example: In August 2010 TSO X will hold a 'Long Term' auction for Entry capacity at IP Y. Shippers can bid for yearly contracts for the calendar years (or gas years – one standard year should be defined) 2011, 2012, ... 2025. Each shipper can bid for one/all of these years, for the first and/or last 5 years, for the year 2011, 2012 and 2015, etc. The auction design should then take into account the best combination of all bids (in terms of aggregated maximum of available capacity allocated throughout the 15 years).

For an interim period interruptible capacity is a useful instrument. However, with fully developed and liquid secondary and primary day-ahead markets, this product will lose its significance.

- *Do you agree with the idea of defining a small set of standardised capacity products that do not overlap?*

Yes, we agree with a small set of non-overlapping products. Otherwise, the capacity market would be unnecessarily fragmented and liquidity of markets reduced.

- *Should TSOs offer day-ahead and within-day capacity products?*

TSOs should definitely offer day ahead and intraday capacity. The source for intraday capacity should be the automatic re-offer of unused longer-term capacities (not nominated and subject to an automatic Use-it-or-sell-it) and/or an additional intraday maximization of capacities by a re-calculation of capacities.

- *Should European TSOs offer the same capacity products at every interconnection point across Europe?*

E.ON supports an EU-wide standard set of capacity products. The same standard set of capacity products at all interconnection points across Europe would ease European shipping and thus the integration of European gas markets.

- *Should TSOs offer interruptible capacity also in cases where sufficient firm capacity is available?*

No, in this case the TSO should only offer firm capacity. If sufficient firm capacity is available the interruption probability is zero and therefore, the price for the requested capacity should be equivalent to firm capacity. This will foster secondary capacity markets. The objective of all measures should be the maximization of firm capacities most demanded by the market.

### **Breakdown and offer of capacity products**

- *Should a reasonable percentage of the available capacity be set aside for firm short term capacity products?*

There should be a reasonable percentage reserved for short term capacity. The exact amount should be consulted with regional stakeholders upfront.

### **Cross-border products**

- *Recital 19 of Regulation (EC) 715/2009 states that gas shall be traded independently of its location in the system. Do you think that cross-border products will facilitate the exchange of gas between virtual hubs of adjacent markets?*

Cross-border products (combined or bundled) can facilitate the exchange of gas across countries. Nevertheless, TSOs must offer shippers the choice between combined/bundled and separated entry/exit capacity bookings; when doing this, TSOs should be obliged to offer at least a minimum share of available (unbooked) capacity as combined/bundled product.

Firstly, the reason for *not* prohibiting separate bookings and thus flange trading is that trading activities shall not be constricted by regulators. Rather, the market shall decide where trading is most suitable. The example of the most liquid European gas market UK shows that there are no signs that trading “at the beach” does cause any negative effects on market liquidity. There is thus *no* reason for an *obligation* to adjust existing capacity contracts to combined/bundled products.

Secondly, limiting flange trading by mandatory booking of combined products would require fundamental changes to all cross-border supply contracts with delivery at a flange. This would not be just a matter of substituting a flange for a hub in the contract. It would rather lead to the

renegotiation of the entire contract, since the delivery point has always strong implications on the management and distribution of risk between the involved parties.

Thirdly, an adjustment of existing contracts might also lower the stability of the market. The parties of the existing contracts assumed that the capacity contracts are valid for their duration. By adjusting existing contracts market participants might decrease their commitment to long term contracts. That lacking commitment due to unstable market rules might cause the risk of under-subscription of new infrastructure investments. New entrants also need to be confident that if they enter the market their terms for access won't also be subsequently changed at a future date.

Fourthly, we also believe that such a limitation of trade at the border would be executed without legal basis within European Energy Law (esp. Regulation (EC) No 715/2009 on conditions for access to natural gas transmission networks) and that such a limitation would arguably lead to a disproportionate intervention into contractual freedom. The freedom of contract is a fundamental right which is recognised since many years in the European Court of Justice case law. This freedom protects the creation of contracts by the contract parties. In its explanations relating to the Charter of Fundamental rights of the European Union (EU CFR), the Praesidium of the Convention which drafted the Charter has based the freedom to conduct a business, stipulated in Article 16 EU CFR, on the case law related to the freedom of contract. Furthermore, measures concerning contractual rights have to comply with the right to property according to Article 17 EU CFR. In addition, such measures have to respect the principle of the protection of legitimate expectations. On this basis, future contracts and even more contracts which have already been concluded are protected by the fundamental rights. Measures limiting the exercise of these rights must respect the principle of proportionality. It is far from clear whether the ERGEG proposal complies with these standards, especially whether the principle of proportionality is respected.

Finally, it appears that the far-reaching proposals of the framework guideline go beyond ERGEG's basis for authority as laid down in art. 6 in combination with art. 8 (6) of the Regulation 715/2009. While the framework guidelines and corresponding network codes should further *detail* grid access they in fact do have *relevant* consequences for the commercial framework of the gas industry in case of a significant intervention into existing contracts (as would definitely be the case in particular with obligatory bundling). Against this background we would like to point out that the network codes are solely adopted by the Commission and present no secondary legislation with participation of the European Parliament and the Council. According to the community law fundamental measures have to be regulated by community law itself while only less relevant issues can be dealt with by the implementing regulations.

- *Do you support full bundling of cross-border capacity into one single capacity product, including a limitation of the possibility to trade at the border so that gas is traded at virtual hubs only in order to boost their liquidity?*

In general, E.ON supports that TSOs should offer combined/bundled products as a service to ease hub-to-hub trading. The provision of *optional* bundled products would allow easier trading from hub to hub and might therefore increase liquidity in the EU gas markets. However, eliminating the possibility of trading at a flange is not acceptable (see reasons above). The provision of optional bundled products would allow easier trading from hub-to-hub and might therefore increase the liquidity in the EU markets. But parties should have the choice to trade at whatever point best meets their needs – ultimately liquidity will tend to concentrate at the points where most parties prefer to trade. For example in the UK in late 1990's there was systematic shift away from trading at the “beach” to trading at the NBP. This was not in any way prescribed by the UK regulator, but the establishment of the Network Code and the Entry-Exit access regime provided gave parties the option if trading at the virtual NBP hub.

- *Do you consider combined products to be an appropriate interim step towards bundled products?*

The offer of combined products at every interconnection point will be difficult but achievable challenge for TSOs. This harmonizing of products, lead times and capacity calculation should be completed before moving to combined products. The framework guideline leaves it to the NRAs

to specify terms and conditions and the handling of such a product. E.ON clearly supports a consistent and harmonized EU-wide approach.

- *Should capacity at two or more points connecting the two same adjacent entry-exit systems be integrated into one single capacity product representing one single contractual interconnection point?*

As this may require constant flow based capacity re-calculation and alignment between adjacent TSOs we are skeptical about its cost-benefit ratio – particularly since there is mostly only one IP between two adjacent entry/exit systems. Moreover, through the combination of several points which are physically not linked to each other, a considerable amount of capacity could be lost, at least if TSOs use worst case calculation scenarios.

## **Capacity allocation**

- *Should auctions be the standard mechanism to allocate firm capacity products?*

Yes. We aim at a simple, transparent and stable, market based system. And we believe that only auctions meet all of these provisions. Bids should consist of the specific price (€/MW), as premium to regulated tariff and the volume (MW) (e.g.: x €/MW) per y MW).

Bidders can submit multiple bids per product/auction. The reserve price is the cost-reflective regulated price. A reserve price should only be applied to physical transport capacity. Network users can opt for filling a bid completely or not at all (Fill-or-Kill option (FoK)). FoK enables network users to purchase long term capacity rights corresponding to a potential long term supply contract. If a user cannot bid successfully for the whole (supply contract) term he may want to decide not to rely on shorter term capacity auctions and “withdraw” his bid. In order to treat all auction participants equally, the capacity price should be determined by the market clearing price.

- *What would be the implications of using auctions for capacity allocation in the markets in which you operate? Is there any way in which auctions can be designed to overcome potential issues resulting from their introduction in those markets?*

As noted earlier auctions present a simple, transparent and stable, market based system. Nevertheless, the auction results might lead to increasing or more volatile prices for some points. TSO must be obliged to spend excess revenues (= congestion rents) on de-bottlenecking the respective IP.

- *Do you support pro rata allocation as an interim step? If yes, should pro rata allocation only be used in given situations or market conditions?*

No. Pro rata allocation has the disadvantage that in general, none of the participating shippers receives capacity according to his needs – thus also resulting in strategic bidding behavior.

## **Re-Marketing Booked Capacity**

- *Should the network code define harmonised firm secondary capacity products and anonymous procedures for offer and allocation of secondary capacity products in line with those on the underlying primary capacity market?*

There is no need to regulate secondary markets and hence they should not be part of the network code. In principal, the allocation of secondary capacity products should follow as much as possible those on the underlying primary capacity market. But we believe that the products traded on the secondary market will be in line with those allocated at the primary market as the TSO will not be able to register any other products to its systems. Sellers should be able to “slice and dice” their capacity into bits according to the set of standard capacity products. Both within-day primary and secondary capacity should be allocated via a central platform and on a FCFS basis.

Particularly, there should be neither caps nor floors introduced to the price of secondary capacity. A market price shall prevail. Potential abuse can be tackled by strict anti-hoarding rules.

## **Booking platforms**

- *Do you think that all capacity connecting systems of two adjacent transmission system operators should be allocated via a joint, anonymous, web-based platform?*

Yes, provided this, all primary capacity should be allocated via one platform if that does not mean that secondary trading is being regulated. The allocation procedures should be anonymous. Nevertheless the participants should be registered before bidding.

Secondary capacity markets should be open to competitive platforms. A reduction in numbers will inevitably be driven by the market.

*Do you agree that joint allocation of primary and secondary capacity products on these platforms would strengthen capacity markets?*

We agree. However, before a nomination gate closure there shall be no restriction for holders of primary capacity to market them separately in a non regulated secondary market. This market might be bilateral or brokered, on a single platform per market, multiple platforms per market or platforms covering multiple markets. Shippers must be able to divide their capacity into its constituent parts to sell an individual month, day or even hour taken from e.g. an annual capacity booking.