

POSITION PAPER: DEVELOPING MARKET INSTRUMENTS AT REGIONAL LEVEL

Introduction and background

1. In January 2008, Eurogas issued a Position Paper on Achieving Regional Markets (06PP646). Linked to what we would like to see in the Third Package, that paper focused on the roles of the NRAs and the planned new Agency ACER in accelerating progress towards more robust regional markets as well as the development and use of the European Network Code as an important instrument to improve TSO co-operation, in such areas as balancing, capacity allocation and management, services and investment.
2. This new paper turns to the development at regional level of market instruments, notably hubs/exchanges and secondary capacity trading mechanisms, and updates previous work by Eurogas on hub development. Eurogas considers that the Gas Regional Market initiatives offer opportunity for carrying forward the recommendations in this paper.
3. Eurogas considers that the development of hubs and other regional trading mechanisms such as exchanges is essential for the successful functioning of robust and liquid gas markets, including futures. The more attractive Europe is as a market, able to compete globally for gas supplies, the more liquid and successful hubs and exchanges will be. Assuming this and other conditions are met, liquidity will then increase in step with growing numbers of market participants and trading activities.*

Development of Hubs and Other Regional Trading Mechanisms

4. A hub is a point at which title to gas can be transferred between buyers and sellers. It may be
 - a *physical* point where several pipelines are connected, or
 - a *virtual* point within a pipeline system.

Hybrids of the above can also exist e.g. the Zeebrugge platform, which brings an element of the 'semi-virtual' to a physical hub.

Transactions at hubs will typically be performed via exchanges. These can be clearing houses or over-the counter trading mechanisms. When a hub is very liquid, (i.e. from a trading perspective it has a high churn rate), most of the trades at the hub are re-traded and only after the final trading arrangement result in physical delivery. Hubs and exchanges should play a key role in improving market transparency and thereby market functioning as well as facilitating cross-border trade and in accelerating regional markets generally. They should therefore be developed with regional trading in mind.

While a hub/exchange in every country is not necessary, hubs have to be accessible to regional market players, and therefore adequate infrastructure especially cross-border interconnections is a priority, particularly in areas which are relatively isolated.

5. Hubs and exchanges are intended to create a 'market place' for gas, providing suppliers with access to numerous buyers and sellers of gas (including producers, other suppliers, large consumers and pure wholesale traders). The possibility of short-term sales and purchases enables the supplier to diversify his gas sourcing, in terms

* For further discussion on liquidity, reference is made to a recent Eurogas note « Liquid Tradable Gas Markets as an Instrument to Enhance Security of Supply » (08NO211).

both of origin and of allocation between long, medium and short term, adding flexibility to his gas portfolio. Suppliers will make their own judgments regarding their mix of spot, medium- and long-term contracts, based on their expectations of the market.

6. Typically only a minority of sales made will be spot sales at a hub or exchange. The majority of physical deliveries will be covered by long-term contracts or based on spot indexation or other pricing systems. At the same time hubs can be a means by which a market value can be ascribed to gas used for balancing, and for contract indexation purposes.
7. There has been some progress in hub development in the last few years, but this is not Europe-wide. Volumes traded have doubled in the last two years, with trading activity mainly in northern Europe. Hubs are at different stages of development, with the NBP in the UK having the highest churn factor. Other hubs are Zeebrugge in Belgium, the TTF in the Netherlands, and the PSV in Italy, MS-ATR in Spain, EGT and BEB in Germany, PEG-Nord in France, CEGT in Austria. Increasingly the liquidity of hubs should be facilitated by consolidation of transmission/balancing zones. However the lack of cross-border interconnection capacity in some parts of Europe is constraining hub development at regional level. Therefore Eurogas welcomes that hub development and continuing progress in interconnections form a notable part of the GRIs' Roadmaps.
8. Eurogas also supports the development of exchanges which can make an important contribution to mitigating commercial risks and enhancing market liquidity by organising intraday trade – in particularly for balancing purposes – on a continuous basis. Exchanges can also efficiently organize trade at a regional level, offering forward and day ahead products, and derivatives. For day ahead products, daily gate clearing at a fixed moment seems the most appropriate approach. Secondary market trading of transmission capacity should also be promoted, especially at key nodal points. More storage capacity and more open storage access will also help facilitate hub development and liquidity.
9. Eurogas considers that hubs'/exchanges' potential can be realised in stages, starting with the initial phase of buying and selling of gas in the short and medium term. As the level of liquidity develops, market-based balancing arrangements can be envisaged, and ultimately the market will evolve to include the offering of financial products.
10. Hubs are developing differently but a key condition for a more liquid hub is the number of players. The success of a hub will depend on the level of competition in the gas available on the hub, and the corresponding opportunities for parties to manage better their supply and trading portfolios. The profit incentive for the company on the spread will contribute to the market functioning.

Provided the right conditions are in place a successful hub will develop. Some hubs have introduced the concept of a 'market maker' as a possible way of encouraging more liquidity at the hub and strengthening the spot market; in this system one or more large traders take on the role of market maker by posting daily volumes for sale/purchase with a market-based bid/offer spread and a system that allows that those who use the service are not charged excessively. The profit incentive for the company on the spread will contribute to the market functioning and makes the role attractive for some players. The prerequisite is that all hub and exchange activities are underpinned by clear and transparent rules and that no single participant is able to exert an undue influence on price.

Benefits of hubs

11. Successful hubs and exchanges offer significant benefits to suppliers large and small, in facilitating operations and improving efficiencies at a wider, regional level. Hubs can also create opportunities for risk management products, which suppliers can use to produce a wider range of pricing propositions for end-user customers (e.g. capped price offers or fixed-price deals).
12. In a liquid market, evaluations of market prices for gas for different timeframes are available and can be used for decision-making purposes by management. For example, seasonal variations in traded gas market prices may help unlock the value of storage facilities. Looking forward, intra-day trading allows market-based balancing, removing the obligation on the incumbent supplier to balance the market. Greater price transparency leads to more effective market signals. It is only when market participants adapt their behaviour in response to market forward price signals and the short-term price of gas is responsive to gas supply and demand that real efficiency gains can be made and competitive markets function most effectively.
13. The hub or exchange operator should offer services that facilitate buying, selling and in some cases physical transportation of gas from or into connected systems, and gas should be able to be exchanged under standard conditions.

Principles for effective hubs

14. Three key principles underlying an effective hub are:
 - liquidity – i.e. there is a sufficient number of willing buyers and sellers, and no single participant can exert undue influence on prices. For physical trades, this liquidity also depends on the supplier being able to move gas readily to and from the hub.
 - transparency – i.e. prices are public and available on a continuous basis.
 - depth – i.e. that reasonable quantities are offered and can be traded at the hub without significantly moving the price.

Successful hub or exchange development depends inter alia on operators' readiness to offer the services users need on a non-discriminatory basis with transparent TPA rules, based on standard agreements. This should encourage a large and diverse number of players at the hub or exchange with no single participant able to exercise undue influence. Success is also dependent on the existence of sufficient physical/contractual access for potential traders to the relevant parts of the transmission system.

15. The TSOs or hub operators should offer a range of services:
 - receiving nominations (nomination should ideally also be offered intra-day, in order to provide within-day gas sources for balancing purposes)
 - scheduling nominations
 - matching nominations and counterparties
 - allocation to counterparty level (allocation also needs to be firm and timely i.e. on-line/hourly so that customers can be notified of any constraints and hence be in a position to nominate their own back-up after the expiry of the mandatory period)
 - options on intra-day trading
 - operational balancing e.g. through the use of operational balancing agreements
 - back-up/down, at transparent and market-related prices (for physical hubs) to maintain firmness at the hub
 - quality conversion services where necessary
 - IT services, ideally web based, in order that input and output can be interfaced directly with participants' own systems, and manual entry of every data item is avoided

- tax and fiscal services (VAT treatment in particular related to the hub locations close to the border or on the border of the different countries).
16. Larger scale entry-exit zones should be the objective, coupled with market based balancing, and possibilities for improved interconnection and harmonization between neighbouring balancing regimes should be pursued recognizing that a basic function of national and physical hubs must be to serve as a balancing point. Where relevant, TSOs should therefore offer services designed to overcome the limitations of a physical hub, and should be encouraged/incentivised to address transmission constraints so that transmission/balancing zones can be extended/integrated. While TSOs should ideally offer a market-based balancing arrangement at the hub, until this can be introduced on an effective basis, TSOs must offer shippers a reasonable ability to balance by other means e.g. via sufficient balancing tolerances and the provision of relevant balancing information.
 17. When developing hubs, the level of standardisation should be maximised, and tariffs for the hub services have to be designed in such a way as to allocate the cost of the different services and provide a fair margin. Tariffs should be structured so as to encourage hub customers to trade.
 18. Each transaction at the hub has to remain strictly confidential and the nomination process has to be clear and simple, facilitated by suitable IT systems. In order to participate in the trading activity at the hub, all participants must first meet objective and appropriate financial and industry standards.
 19. Validation of transactions at hubs is essential for all players, and operators of physical hubs can increase the appeal of hubs by offering back-up services to market needs on a market-basis in the event of a temporary gas supply failure. To avoid market distortions, clear rules and responsibilities have to be fixed in the case of force majeure, with clear identification of the liabilities of the various parties.
 20. Although Eurogas considers that hubs should be market-driven and not subject to formal regulation, regulators can play a key role in facilitating their emergence and evolution. The role for regulators should include:
 - In line with their responsibilities in the Third Energy Package, overseeing TSOs infrastructure planning and fostering the creation of infrastructure in the area of physical hubs, notably interconnections
 - providing a regulatory framework which ensures transaction security and transparency of access and related services at the facility, including the possibility for users to evaluate a net (current) trading position each gas day
 - overseeing the setting-up of clear and transparent allocation rules and force majeure provisions
 - providing regulatory oversight on other aspects of hub operation in line with their overall responsibilities

Secondary Trading Mechanisms

21. It is also very important to incentivise a secondary market in capacity trading by capacity holders. Platforms to facilitate this should be established in the different regions. Eurogas welcomes the new capacity trading service on the Dutch-German border, making available day ahead secondary capacity, and looks forward to the implementation of similar services by TSOs at other interconnection points. The progress of this pilot in easing capacity congestion should be monitored, to help inform parallel developments by other TSOs at other nodal points.

Other points

22. There may be opportunities for coupling sales of commodity and capacity, but in the view of Eurogas this sort of trading activity would be more complex for gas than for electricity.

CONCLUSIONS & KEY RECOMMENDATIONS

- The NW and SSE GRIs should reinforce efforts to improve the transparency and liquidity of hubs, in line with users' needs, and promote the development of financial instruments. Steps should also be taken to enhance interconnection capacity and to optimise its use; in particular this is a prerequisite for hub development in the S Region.
- Exchanges can also contribute to mitigating commercial risks and enhancing gas market liquidity.
- In the development of hubs, TSOs should offer a range of services in line with the non-exhaustive list in Paragraph 15.
- The level of standardisation should be maximised, and tariffs for the hub services should be transparent and encourage trade.
- Regulators' and authorities' responsibilities should facilitate hub and exchange development without undue intervention.
- Provided no single participant has the possibility to exert undue influence on prices, one way to foster the liquidity of a hub is the 'market maker' model. The profit incentive for the company acting as market maker will contribute to the functioning of the hub, at the same time making the role attractive for some players.