The European Union of the Natural Gas Industry

23rd January 2006

RESPONSE TO THE ERGEG DISCUSSION PAPER "ROADMAP FOR A COMPETITIVE SINGLE GAS MARKET IN EUROPE"

Eurogas welcomes the opportunity to comment on the proposed ERGEG Roadmap for a competitive single gas market in Europe. A well functioning gas market is an important factor in order for Europe to secure affordable supplies of gas to meet future demand, and a sound and stable regulatory framework has a key role in facilitating the development of the gas market. The regulatory focus, however, deals with an important but narrowly defined view of the main challenges in the European gas markets. In relation to the wider debates that will take place this year on market and security of supply, Eurogas is developing a long-term vision for the European gas market. That input will deal with market issues in the context of wider global considerations including security of supply and the important challenge of attracting diversified gas supplies to the European market. The comments here, prepared by the System Users Committee with input on the regional markets questions from the Supply and Markets Development Committee, focus on the more technical aspects of the Roadmap. It is important, however, for ERGEG in its further development of the Roadmap to take full account of the implications of the wider debate on security of gas supply, to emerge from DG TREN's forthcoming Green Paper on Energy Security of Supply. Eurogas draws attention to such issues in remarks on the Way Forward.

Comments on Chapters 2-5

Introduction

Eurogas wants to see steady progress towards an integrated competitive European gas market. Eurogas attaches great importance to the full, timely and correct implementation of the Directive and the forthcoming Regulation on Access to Gas Transmission Networks. Members of Eurogas will respond separately on any particular problems experienced that demonstrate the existence of market obstacles.

As experience is showing, an integrated European market will be achieved in progressive stages and Eurogas agrees that market-driven regional development is an important next step. It should be a catalyst to promote a European wide robust and liquid market. The evolution of hubs will be an important driver, and other regional characteristics will need to be considered. Eurogas would like to be involved in further analysis and study of the issues.

At this early state of consideration, Eurogas has a few general points to make. ERGEG is correct in referring to the greater complexities affecting consideration of regional gas markets than electricity markets. The set-up of the proposed regional initiatives for gas has to be approached on the basis of careful analysis and should not be modelled too closely on electricity, but take account of a range of aspects. For example, notwithstanding ERGEG's comment in paragraph 26, there is currently congestion at some borders. Also, Eurogas thinks that the proposed definition of a Regional gas market as corresponding "to geographic areas in which it is possible easily to retail gas available on the wholesale market at a nearby hub" is simplistic and needs to be reconsidered. It is obvious to try to combine countries around liquid trading points. However, markets differ in terms of liquidity, entry/exit capacity, grid and demand-structure and market volume. A balanced approach to setting up regional initiatives/markets is necessary. The regime for inter-regional trade and its consequences has to be analysed in detail.

With specific reference to hubs, Eurogas considers that their development will be among basic building blocks, additional to long term contracts, towards an efficient, liquid market. Eurogas therefore supports work by ERGEG to facilitate the emergence and development of hubs, and is finalising a paper on "Hub Service" which may assist ERGEG in their considerations. In the view, however, of Eurogas, hubs and other regional market aspects should develop not because of regulatory intervention, nor necessarily TSO initiatives, but because companies see commercial opportunities in using them and they offer possibilities to optimise companies' supply portfolios, and improve operating efficiencies both within a Member State and at wider regional level. Furthermore, the success of regional gas markets with associated higher liquidity could incentivise decoupling in the supply chain of contractual and physical flows.

Finally, Eurogas would emphasize the cautionary note sounded in paragraph 22. There is a risk that market rules developed in one region might not automatically be appropriate for all other regions. The Regional Markets concept must not raise barriers or slow down the achievement of an eventual single European market. Therefore progressive convergence of different regulatory and legislative frameworks in the Member States must continue, to ensure that the construction of regional markets does not lead to new obstacles at EU level.

Current State of European Gas Markets

The analysis correctly identifies that gas suppliers within the EU are faced with upstream market concentration, and other challenges in obtaining secure and competitive long-term supplies to Europe. In the view of Eurogas, a robust, competitive European gas market has to be able to attract gas volumes in an increasingly globally competitive market. Such a market will still be heavily reliant on long term secure supplies and will be strengthened by additional market instruments adding commercial opportunities that will increase the market's responsiveness and market liquidity. Eurogas will elaborate on this issue in its input to the gas market debate but meanwhile underlines the implications of the upstream oligopolistic supply structure, dominated outside Europe by mostly state owned companies.

In other respects, the assessment of the current state of the market and exploration of "regulatory gaps" is a balanced basis for discussion. Eurogas, however, does not see the need for further new regulation at this stage and in general considers that voluntary agreements arrived at on the basis of discussion in the Madrid Forum are a constructive way forward, provided they are observed.

In the view of Eurogas, the levels of current investment and market prices tend to indicate that there is either a shortage of gas (commodity) and/or capacity and this factor has an impact on the goal of improved market liquidity.

With regard to ERGEG's comments on retail aspects, Eurogas agrees that it is important that customers choosing to switch have a good experience of the customer switching procedure. This will drive market developments. Eurogas has already sent its paper on Customer Switching to ERGEG and is currently working on a contribution to identify best practices in policy focused on customers.

Regulatory Co-operation

Eurogas agrees on the importance of regulatory co-operation. The work of the CEER and the establishment of ERGEG have done much to facilitate this. Although in the view of Eurogas it is premature to talk of completing the legislative framework to meet gaps between jurisdictions, the situation should be monitored. If regional markets are developed the regulatory structures may have to be thought through. More complex co-operation structures could evolve which would need to be developed in a timely manner to meet the deadlines envisaged. The objective should be to have in place a stable and transparent framework, that does not lead to over-complex and burdensome regulatory structures.

In this context, Eurogas wishes to make two related points. Regulators in all Member States have to enjoy full and equal independence, especially if these regulatory activities relate to cross-border activity. Also, transparent responsibilities of regulators should entail a clear appeal structure that could be invoked in relation to regulatory decisions.

Unbundling

Eurogas wholly supports the view that network users have to have confidence in the non-discriminatory services of TSOs. Authorities' oversight should ensure that there is no possibility of abuse. The issue of possible further steps on unbundling, however, should only be reconsidered, if necessary, after the current Directive is implemented fully and adequate experience has been gained.

Transparency and Information Handling

Eurogas welcomes the recognition by ERGEG of the significant role that information about TSO operations plays in the efficient and effective operation and functioning of the gas market, and its importance to the emergence of regional markets. Eurogas wishes that the availability of such information on a consistent and unbiased basis is assured and monitored, to assess if it is adequate. Possibly, areas for improvement will be identified. There should in any case be a presumption towards publishing information on pipeline use rather than withholding it and only legitimate concerns regarding confidentiality should be allowed to prevent publication of data. This area is one whereby efforts by ERGEG to improve market information release related to TSO activity will produce immediate benefits and is a necessary precursor to any other initiatives that are taken forward, including the regional markets.

Competition and choice of gas source – availability of gas

The paper correctly describes the concentration among producers which gas suppliers face, and the framework needed to provide continued access to the current sources of gas. Eurogas welcomes the plea for the freedom of suppliers to determine from the commercial point of view only all the possible sources of supplies in each market, but notes that in some European markets this freedom is not implemented fully, because of a regulatory approach to security of supply objectives.

It is also correct to identify LNG as a possible source of increased competition because LNG offers additional flexibility options to suppliers. Eurogas notes, however, that, in view of the current imbalance between supply and demand at world level, the LNG market, in so far as it is characterised by a lack of firm contractual obligations with shippers and suppliers, but instead reflects opportunities to be balanced among markets, could lead to increased volatility in prices and LNG cargoes being redirected to the most attractive markets.

Aspects covered in para. 103 should be analysed in further detail, as the situations of a supplier willing to use the flexibility of his existing contracts, including some sales to short-term wholesale markets, and that of a new entrant looking for supplies, are completely different.

Eurogas notes the reference to gas release programmes. These may be justified under certain specific circumstances especially under competition conditions, and/or have commercial interest but if imposed often they could become a deterrent to renew or pursue new supply contracts. There is a risk therefore that they could endanger efficient gas purchasing and long-term security of supply.

Effective Access to Network Capacity

Eurogas agrees with ERGEG that effective, non-discriminatory access to network capacity is a pre-requisite for enhanced competition in the gas markets. It is essential for the continued operation of competitive markets. Whilst there has been much work in the past on Use-it-or Lose-it (or more correctly Use-it-or-lend-it) rules, there needs to be recognition that offering an interruptible product in the market will not always foster competition when players require and value a firm service. As such the development of services that improve access to firm capacity (including more active trading on secondary markets) should be facilitated. Eurogas has set out its views on possible approaches in a discussion paper on Capacity Allocation (attached). In proposing a regional solution as an interim step to a full and effective market ERGEG needs to recognise that the question of how gas can more effectively access these regional markets will need to be resolved.

Cross-border trading

Eurogas agrees with much of the argument of this section. On the important issue of interoperability, Eurogas supports the valuable work of EASEE-gas on the range of topics identified in para. 12. Eurogas also welcomes the consideration to be given to a "European train ticket" system. This is an attractive prospect that needs to be explored, and the service is not necessarily to be offered by TSOs only. Eurogas would welcome the opportunity to study this issue with other stakeholders.

Capacity Availability

Eurogas considers it essential that the regulatory framework is conducive to investment. Ample availability of capacity as well as of commodity is a precondition of a liquid, competitive market. In a regulated regime, there must be adequate returns to permit TSOs and DSOs to build and maintain an adequate infrastructure. TSOs network investments are likely to be based on a combination of contracted transportation, including long-term, and forecast transportation demand, and other market signals and on technical and output security standards. A framework permitting this, which should include regular consultation with users, will minimise investment risks, rendering binding firm commitments less necessary. In a system of competing networks, more consideration may need to be given to firm commitments.

The Roadmap raises the issue of legacy contracts on page 35. It should be clarified what sort of contracts ERGEG has in mind. As a minimum, contracts should be maintained. Provided there are effective UIOLI mechanisms in place or incentives to secondary trading, there should be no hoarding problems.

Eurogas recalls its active participation in the work of ERGEG on capacity issues, and welcomes opportunities to discuss in further detail related concepts, such as "flexible capacity services", "appropriate capacity allocation procedures" and "congestion management mechanisms".

Gas Quality

Two main issues are involved (1) conversion services i.e. H-cal to L-cal (or vice-versa) and (2) gas quality issues connected with different sources of supply. There is a need to ensure that all gas from competing sources can reach the market and are not rejected for technical or quality reasons, but different solutions may have to be found in different parts of the market, depending on volumes of gas involved, capabilities to treat it, decisions on spreading cost burdens. It is important, however, that activities undertaken are transparent, monitored and that all market participants share a readiness to solve problems.

The Way Forward - Priorities

Eurogas agrees with ERGEG that among the most important priorities for creation of the internal competitive market for gas and gas services are:

- Creation of well functioning wholesale gas markets and establishing rules for trade within such markets as well as for cross-border trade.
- Non-discriminatory access to transmission networks.
- Introduction of regulated entry-exit tariffs with a reasonable return on capital to ensure future investments in regional markets.
- Strong regulatory framework to boost cross-border investments and cross-border trade.
- Monitoring of TSO gas services markets by regulatory authorities.
- Effective unbundling of transportation activities from gas trade to allow TSOs to act in a manner which does not discriminate against any transmission system user, in accordance with the current Directive.
- A large amount of information made available by TSOs on their day-to-day operations, system situation as well as development and maintenance schedules on a non-discriminatory basis to all system users with the exception of confidential commercial information relevant to individual market participants.

Eurogas, moreover, emphasizes that the European market faces considerable challenges touched on in this Roadmap and necessitating in-depth consideration in 2006.

The market has to be developed in an approach compatible with attracting gas volumes in an increasingly competitive global market. This will boost the market dynamics, enhancing security of supply.

Shaping a stable regulatory framework to incentivise investment by regulated companies is important, but it is essential to foster an entrepreneurial climate to a growing gas market.

A policy framework should also recognize the intense geopolitical nature of energy supply, arguably highlighted by events at the beginning of the year.

Eurogas will elaborate on these and other points during the coming months.

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Eurogas considers that the Roadmap presents a useful analysis on regulatory issues and a valuable basis for future discussions on the way forward. Eurogas confirms its interest in participating in future discussions on regional markets, and the range of other issues identified for future consideration.

EUROGAS DISCUSSION PAPER ON CAPACITY ALLOCATION PROCEDURES

1. The methods of allocation of capacity in networks between competing users is a subject that is a matter of particular interest in the gas market. The EU Directives which oversee such allocations are based upon principles of Third Party Access (TPA) to networks operated by Transmission System Operators (TSOs) but with an acceptance that there may be variation between Member States as to the detailed rules around such access.

2. However, there is a level of detail below these principles that is of importance to network users in their ability to access and utilise capacity in support of their commercial needs. These are, in the initial acquisition of capacity, any future acquisition (or extension) and any subsequent secondary trading and potentially in cases of congestion management on a network.

3. In cases where there is an excess of capacity over demand, whether it is under an Entry/Exit or a Point-to Point capacity allocation model (irrespective of the Entry/Exit tariff system), there should be no problem regarding capacity acquisition or congestion management. However, (although the preference of users is normally for systems to be sized to ensure that all requirements can be met at reasonable tariffs) there are likely to be situations where there is an excess of demand over supply for transportation capacity. On these occasions a set of rules needs to be prepared that promote and support competition in the supply of gas, are not anti-competitive, and maximise the use of the system. To this end this Eurogas paper including comments on Use-it-or-Lose-it (UIOLI) provisions identifies clear rules for accessing capacity in the long and short-term. It should also be recognised that in the majority of situations, where supplier to supplier competition exists, the real issue is to ensure that capacity can be transferred between users as required to meet end consumers' needs. As such it should be required that capacity at or to the Exit Point directly connected to the end-consumer automatically transfers between suppliers/shippers when contracts for gas supply are changed by the end consumer.

4. However, there are a number of areas primarily relating to entry capacity on which it would be useful to clarify a position. These are:

   - initial allocation of new investment between competing parties
   - allocation of existing capacity between competing parties
   - congestion management
   - access to longer term capacity to prevent hoarding of firm capacity

<u>Initial Allocation of New Investment</u>

5. The preferred form of this is an open season or booking "window" where users are required to submit their requirements supported by financial commitments (i.e. obligation to pay for booked capacity or investment). This can be carried out either as a simple volume based application (against known prices) or in the form of an auction where Users can indicate a value that they ascribe to holding capacity. Both First Come First Served (FCFS) and auction models have their supporters and detractors. What is clear is that the rules must be clear to all parties and not prevent new entrants competing, but must be capable of supporting the long-term viability of networks. As such the role of the market players must not be under-estimated. It should also be recognised that differing solutions may be appropriate even within one

Member State. This has been recognised within the Directive 2003/55/EC by the acceptance that exemptions may be granted under certain circumstances with differing rules applying (Article 22).

Ongoing Allocation of Existing Capacity

6. The allocation and control of existing capacity is the subject of concern in some countries due to the perception that a party or parties can restrict access to firm capacity by hoarding capacity that is not needed or not utilised. If this is occurring, it may be anti-competitive practice and if so must be prevented by procedures sent out in Member States in accordance with the Gas Directive, related EU Legislation and competition Law.

7. There are many ways to allocate capacity between competing users which are in use in different markets. The FCFS model is preferred by most, but others prefer the auction model as they argue that FCFS may frustrate competition. It is, however, essential that whatever form of allocation is chosen, there has to be an effective secondary market and UIOLI regime to ensure that concerns about hoarding are addressed (see below para. 11 ff).

Congestion Management

8. Eurogas has identified the main conceivable causes of congestion, such as force majeure, contractual problems, emergencies or poor planning. The Eurogas position is that the TSO is liable for the compensation of damages in the event of any transport problems other than force majeure and emergencies. The main message is that a reasonable and prudent operator should not oversell firm capacity or otherwise he must bear the risks if his judgement is wrong.

9. The situations in which capacity congestion management may need to occur arise in a number of different ways. In promoting an acceptable regime it is necessary to recognise the differences that currently exist, including for example the over-selling of capacity by TSOs and therefore the alternatives that will need to be available to manage these variations. However, in developing a position on Capacity Allocation all aspects must be considered and addressed if a long-term solution for Europe is to be found.

Access to Long Term Capacity

10. To encourage investment by TSOs in infrastructure it is recognised that long-term commitments by users give a signal to TSOs of the need to maintain and develop the system. This may be in addition to any other obligations placed upon a TSO to invest or to explain their position to a regulatory body, or other planning processes used by the TSO to inform their future investment. It should also be recognised that this should give users certainty of their arrangements. However, these long-term commitments should not be used to fetter competition by preventing capacity being used.

The Secondary Market and UIOLI

11. The Eurogas UIOLI paper (attached) and its principles which met with general approval, especially by the EU Commission's DG TREN and by other stakeholders, was supported by the September 2003 Madrid Forum participants in general and its principles were incorporated accordingly into the revised Guidelines for Good Practice.

12. The paper argued for the importance of incentivising a secondary market in capacity trading by capacity holders. The paper also recognized that if a TSO perceived

capacity to be unused, the TSO could sell that unused capacity on an interruptible basis only. Whilst the position provided for the release of capacity to the market in the short-term, the paper arguably did not address the requirements of network users to have long-term certainty and access to firm capacity. It is therefore necessary to address this issue in more depth.

13. The starting point as for the first paper is that there should not be the possibility for a network user to hoard capacity or restrict the availability of unused capacity to others. There are economic rationales for a capacity holder to release unused capacity. Unused capacity does not provide revenues. In a competitive market the margins for a supplier are often small, therefore hoarding the capacity will be uneconomic. Offering unused capacity on an interruptible basis would be a less rational economic response than making it available on a firm basis, as it would be provided at lower tariffs than tariffs for firm capacity, and put the new user in a stronger competitive position as long as the capacity is not interrupted. Furthermore, Eurogas recalls that if a user were to abuse a dominant position, he risks incurring a severe penalty under competition law.

14. Nonetheless Eurogas recognizes that in order to have a sufficient firm capacity available for those who have a demand for it and not to restrict them to an interruptible service, some form of UIOLI regime may have to be introduced as a fall-back approach, as is already happening in some countries.

15. This is a complex and delicate issue because it touches on matters that are properly in the domain of competition law affecting company market trading decisions. Therefore it is not possible to envisage a general rule applying in every case where hoarding might be restricting access to firm capacity but there should be an understanding on general principles underpinning the issue although it should be handled on a case by case basis. Eurogas suggests here some general principles to be taken into account.

<u>The Main Principles</u>

- From a network user's perspective, one of the main principles is that firm capacity rights, based on legally binding contracts with due regard to competition law, must be protected and respected.

- Competition law should be the source of action in questions of hoarding, even if powers are delegated to competent authorities to determine if there is abuse of contract. An appeal against their decision must be based on competition law and related sanctions.

- If a contract is determined to be in violation of competition law, then such a contract is not legally binding and the capacity holder can be obliged to release it on the market through the legal process that could, however, involve cumbersome and lengthy procedures.

- It should be clear what mechanisms will be appropriate in different Member States and they can be expected to vary according to different national approaches. They should, however, be transparent and fair as well as operable within a reasonable timescale.

- Wherever possible and practicable if hoarding is alleged then the parties involved should be encouraged to find a solution on a voluntary basis.

- The system, however, should permit holders of firm capacity who do not need the capacity (perhaps over a period) to justify to the competent authorities why they are not using the capacity (e.g. security of supply). This would be without prejudice to any later right of appeal.

– The system should also specify the liabilities for compensation for damages in the event that a user whose capacity had been transferred without his agreement encounters as a result problems with his supply obligations.

– Any retention of exit capacity rights linked to end users should be prevented by booking conditions which are in line with supply obligations as this would be hoarding.

16. Revenues received by the TSO for resold capacity on a firm basis without title transfer but with the consent of the firm capacity holder will be passed through to the original owner of the firm capacity, as he remains party to the contract with the TSO at least until the situation can be clarified.

17. Eurogas looks forward to discussing the issues set out in this paper.