

**Energie-Nederland reaction to
the draft position paper “Exploring the feasibility of implicit allocation in the
(North West) European gas market.”**

Introductory remarks:

Energie-Nederland appreciates the opportunity to comment on this Discussion Paper. Before giving an answer to each of the questions below, we would like to provide a short summary of our position.

Energie-Nederland agrees with the NRAs that there are two important questions that need to be answered to determine whether it is feasible to introduce implicit allocation in the gas market: to what extent is there added value and could it work for the gas market. There are indeed certain issues related to the appropriateness of implicit allocation of capacity for the gas market (Please, refer to our answers below). However, at this stage we consider this question less relevant, because the added value of implicit allocation of capacity for the North West European gas market is negligible.

We agree with the NRAs that the choice to implement implicit allocation – if introduced for arbitrage in case of price differences – is to be made once the CAM and CMP measures have been introduced and the effects of these measures are known. This would require a certain period of time, after which such an evaluation could take place. However, we disagree that there is an added value to introduce implicit allocation to solve the described coordination problem. Actually the members of Energie-Nederland do not recognize the presence of such a problem. As a matter of fact, none of the market participants present at the related workshop on 19 October 2012 at the offices of NMa has indicated to have experienced such a problem.

Because of the above, as elaborated on in detail in regard to the particular questions below, Energie-Nederland believes that implicit allocation shall at this stage not be introduced in North West Europe.

Consultation questions:**Q1: To what extent do stakeholders agree with NRAs analysis on the current issues related to the allocation of cross-border capacity and its effects on the gas market?**

Network users usually book cross-border capacity on a long-term basis and upon the expected peak capacity (the amount of cross-border capacity needed to deliver gas to customers during the hour with the highest demand during a gas year) because:

- in the gas business it was/is normal to have long term contracts on both capacity and commodity (for security of supply reasons).
- shippers want to have firm capacity (no change to be interrupted).
- a profiled booking is not always possible or cheaper than year capacity.

Although, the last years, we notice an increase in short term trade.

Network users are hesitant to re-sell cross-border capacity, because they want to be able to make adjustments – via renominations – in the flow if necessary to balance their portfolio. Even if network users wish to re-sell capacity they find it difficult to do so: most secondary markets do not function properly (or do not exist).

We are of the opinion, that the view of NRA's –as mentioned in chapter 2- may be more appropriate for short-term trades.

Q2: To what extent do stakeholders agree with the mentioned reasons for not using booked cross-border capacity (and what other possible reasons do stakeholders see)?

There are several reasons why booked cross-border capacity is not used. The main reason is: '*Cross-border capacity is reserved for other purposes*'. Network users who have cross-border capacity might want to make a cross-border trade, but cannot do so because cross-border capacity is reserved for fulfilling contractual obligations, for example: gas storages across the border, gas fired power plants, solve gas quality issues between two gas zones, etc. .

We can also imagine that '*Opportunity costs*' play a role.. A network user might be hesitant to sell cross-border capacity, because the price it has to pay if it turns out that he needs more cross-border capacity could be higher than the price paid when the original cross-border capacity was booked.

Q3: Do stakeholders agree that there will be a shift to short term trading and capacity booking due to the introduction of CAM and CMP, price arbitrage and the need to cope with the intermittent character of renewables?

In general, yes:

- As already mentioned, we notice an increase in short term trade, during the last years.

- CAM / CMP introduce favorable conditions for short-term products (i.e.: reservation for short term products at favorable prices). The market will use the product, which is best for the market. In this way it is expected that the market will shift more to short term products. Although, it must be noted that long term contracts are still needed to secure investments in infrastructure and securing capacity for peak demand (security of supply).
- The need to cope with the intermittent character of renewables can also bring a shift to more short term trading.

We agree with the Brattle group report "gas market integration via implicit allocation" which shows that the NW-EU gas market has already a rather small price difference. The NW-European gas market is functioning rather well and already using price arbitrage between markets. We expect that CAM NC, CMP NC and the intermittent character of renewables have a much bigger impact to the use of short-term capacity than the introduction of implicit auction will have.

Q4: Do stakeholders agree that the above effect increases the coordination problem and transactions costs?

We don't understand the question. If by "above effect" is meant that if capacity and commodity has to be bought separately there are increased coordination problems and transaction costs, then we are of the opinion that the question is not right. In our opinion what matters is, do the current market rules hinder or are suboptimal for security of supply, cost of energy and introduction of renewables? We think the current set of market rules –including CAM NC and CMP NC- is suitable for these 3 criteria.

In our opinion, the position paper is too one sided and does not sufficiently address the issue: Where does the capacity for market coupling come from? If this capacity comes from a holder of primary capacity (by i.e. UIOLI) his rights are affected and the overall effect is negative. In **appendix 2** we have added the Energie-Nederland position paper "Oversubscription and Buy Back versus Use It or Lose It", which addresses the consequence of UIOLI for our members, owners of gas fired power plants and gas shippers. In theory, it is possible that the mentioned coordination problem is suboptimal for opportunity trade (price arbitrage), but for our members it is far more important to have firm capacity and the possibility to re-nominate this capacity.

Q5: Do stakeholders think that the coordination problem and transaction costs are barriers to cross-border trade?

No, see answer to Q4.

Q6: To what extent do stakeholders consider that implicit allocation will solve the coordination problem and reduce transaction costs?

See **appendix 1**: Response Energie-Nederland to the 'CEER consultation paper on European Gas Target Model (Sept 2011)', answer to question 5. In this response we have explained why Energie-Nederland is of the opinion that introducing a (day-ahead) market coupling mechanism – *i.e. the*

specific implicit day-ahead allocation mechanism as applied in the electricity market – is not an appropriate mechanism to implement in the gas market.

Q7: To what extent do stakeholders agree with the NRA's analysis on the question when implicit allocation should be introduced (both for arbitrage in case of price differences and renewables)?

- Arbitrage in case of price differences:
We agree with the opinion of the NRA's within GRI NW to first implement CAM and CMP and wait for the results this have on the market. We expect CAM and CMP have a positive effect on the gas market and we question if Market Coupling has an added value, at that moment. We think that an investigation to implement Market Coupling could be done 3 years¹ after the implementation of CAM NC and CMP NC.
- Renewables:
To cope with the increase of renewables in the electricity market, gas fired power plants needs to operate more flexible. Therefore these power plants needs the flexibility to re-nominate capacity at the last moment. We think Market Coupling have a negative effect on the ability to re-nominate capacity, on the last moment.

Q8: To what extent do stakeholders agree with the NRA's analysis of the relevant characteristics in the gas market?

We agree with the characteristics of paragraph 5.2.

Q9: To what extent do stakeholders believe that the costs for (implementing) implicit allocation would be much lower than the benefits?

We have read in the Brattle Group report that the benefits of implicit allocation are rather limited (compared to the total turnover). If the expected disadvantages for network users (limiting of renomination rights) are taken in consideration, then Energie-Nederland is of the opinion that implicit allocation is NOT eligible (at this moment). As noted above, we think a study on the appropriateness of implicit allocation could be done, three years after the CAM / CMP NC has been implemented.

Q10: To what extent do stakeholders agree with the view of NRAs within GRI NW on pre-conditions and design issues?

In our opinion, design issues should be discussed (in total) later; after the effect of CAM NC and CMP NC is evaluated and it is decided to investigate the appropriateness of implicit allocation.

- Available cross-border capacity:
In this paragraph the NRAs stated that the available capacity for Market Coupling comes from (in

¹ A 3 years period is in line with CMP NC, article 2.2.3.

order): 1) limitation of renomination rights and 2) oversubscription & buy back mechanism. We think limitation of renomination rights have negative effects for network users (see **appendix 2**: Energie-Nederland position paper "Oversubscription and Buy Back versus Use It or Lose It",) and therefor on the gas market.

- Bundling of cross-border capacity (e.g. creation of virtual interconnection points):
We agree with the NRAs within GRI NW that the creation of virtual interconnection points could be a desirable feature (not only for the implementation of implicit allocation, but also for explicit allocation), on the condition that it results in more cross border capacity.
- Product Compatibility:
We agree with the NRA's that gas products are sufficiently harmonised already.
- Liquidity:
NRAs within GRI NW consider that both markets do not need to be liquid to establish an implicit allocation mechanism. At the moment we have no opinion on this matter.

Q11: To what extent do stakeholders a) agree that the design issues as presented in this chapter are the most important ones and b) share the considerations of NRAs within GRI NW?

In our opinion, design issues should be discussed (in total) later, after the effect of CAM NC and CMP NC is evaluated and it is decided to investigate the appropriateness of implicit allocation. See answer Q10.

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**APPENDIX 1: RESPONSE ENERGIE-NEDERLAND TO THE
CEER CONSULTATION PAPER ON EUROPEAN GAS TARGET MODEL (Sept 2011),
Answer to question 5.**

5) What are stakeholders' views on the proposed pilot projects to design and trial an implicit capacity allocation mechanism between at least two entry-exit zones in different Member States by 2014?

Recommendation of the CEER consultation document: *Keeping in mind that the ultimate goal of the internal gas market is to achieve functioning markets, European regulators, Member States, TSO's and market participants should cooperate to conduct pilot projects that design and trial an implicit capacity allocation mechanism between at least two entry-exit zones in different Member States by 2014. We recommend that the initial conclusions of the pilot projects on these approaches to be presented by 2013*

Energie-Nederland is of the opinion that introducing a (day-ahead) market coupling mechanism – *i.e. the specific implicit day-ahead allocation mechanism as applied in the electricity market* – is not an appropriate mechanism to implement in the gas market, as explained.

Argumentation why Energie-Nederland isn't in favour of Market Coupling for Gas.

Trade-off between market coupling and market freedom: a different outcome for gas.

Due to the different technical and economic characteristics of gas markets compared to power markets, the overall trade-off between efficient flow management through market coupling on the one hand and the freedom of trade on the other hand is different for gas.

Within electricity markets, the concept of market coupling was developed to ensure the optimal use of the available cross-border capacity and to avoid non-optimal flows across the limited available capacity of interconnectors. As electricity flows do not follow contractual paths but the path of least resistance, it is difficult for the market itself to economically and technically optimise interconnection flows. The introduction of market coupling in the European electricity market is only an intermediate step. The ultimate goal is to introduce *flow-based* market coupling; a system that takes into account *the actual physical flows* resulting from commercial electricity transactions and only allows those that optimise economic welfare within a defined region, subject to the defined technical constraints. As the actual physical electricity flows resulting from commercial electricity transactions are difficult to predict, assuring the technical and economic optimal use of the electricity network is a complex and data intensive task, which relies heavily on various load flow models and the specific knowledge of TSO's. One can only approach this optimally and efficiently therefore by using a central optimization model that incorporates this knowledge and load flow models.

In current gas markets, congestion often tends to be more of a contractual than physical nature. Gas flows far more slowly than electricity and is scheduled to flow in a particular direction, through specific pipe routes and at defined rates (using compression). In addition, gas is relatively flexible using line-pack, so real time balancing is not necessary. This gives market participants more flexibility to arbitrage efficiently between market areas in response to price signals. Of course, a high level of

transparency (e.g. with respect to the actual amount of available interconnector capacity) is an important precondition.

The market coupling concept requires parties to trade at a particular venue at a specific time at the day a-head stage (a day-ahead auction with a specific gate closure time). In electricity markets, this restriction of normal freedom to choose a trading venue has been accepted as pragmatic solution to overcoming the abovementioned physical problems (subject to sufficient longer term and intra-day trading possibilities continuing to exist). Furthermore, day-ahead auctions with a fixed gate closure time already existed in the various electricity market areas, whereas gas trading within and across market areas is largely conducted on a continuous basis and via multiple platforms. Introducing market coupling in the gas market will therefore imply a significant change in the current market design and a huge limitation of the current freedom of trade. Given the different physical and economic principles of the gas market as compared to the electricity market, Energie-Nederland argues that introducing market coupling is not an appropriate step to achieve further integration of European gas markets.

Alternative measures.

Although the prices in the Northwest European gas market are already increasingly converging, the efficient use of the existing transport capacity could be further improved. Rather than copying the market coupling concept as implemented in the electricity market, we suggest to focus on introducing:

- *Optimal TSO transparency* (e.g. on allocated and available interconnector capacity & actual flows); this is a first logical step as the market can never efficiently use the available interconnector capacity if they do not exactly know which amount of capacity is available. Regulation (EC) No 715/2009, which takes effect on the 3rd March 2011, should provide such optimal TSO transparency if applied consistently.
- *Harmonisation of cross border capacity allocation mechanisms and timescales.*
- *The creation of a liquid and transparent secondary market.*
- *Introduction of a use it or sell it mechanism, respecting the rights of capacity owners, applicable for gas markets that incentivises parties to relinquish unused capacity.*
- *Integration of market areas (market driven).*
- *Setting aside a fixed percentage of available interconnection capacity for short term arbitrage.*
- *Incentivising TSO's to maximise the release of interconnector capacity.*

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Appendix 2: Position Paper Energie-Nederland on Oversubscription and Buy Back (OSBB) versus Use-it-or-lose-it (UIOLI)

*A contribution by Energie-Nederland
20 July 2012*

Through this statement, Energie-Nederland would like to contribute to the discussion concerning the various mechanisms for improving the usage of the cross border capacity for gas. Below, we will specifically discuss *Use it or lose it* (UIOLI) and *Oversubscription and Buy Back* (OSBB). Naturally, Energie-Nederland is in favour of measures that will lead to an optimum and efficient use of the transmission capacity. However, the question is which mechanism will serve this purpose best.

From the point of view of Energie-Nederland, there are a number of important disadvantages attached to a restriction of renomination rights. In the opinion of Energie-Nederland, OSBB is a more effective and efficient mechanism both for the long and short term.

To summarize:

1. Restriction of renomination rights is unjust;
2. *Oversubscription and Buy Back* are much more effective;
3. The restriction of renomination rights is not practical;
4. UIOLI will have an adverse effect on competition on the whole-sale market for gas;
5. UIOLI will not contribute to the security of supply; and
6. A better solution is available.

1. Restriction of renomination rights is unjust

Via the *Open Season*, shippers commit themselves to an amount of cross border capacity for a long time. Shippers are entering into such a long-term commitment, in spite of the fact that they are really just signing a blank cheque (since they cannot make long-term agreements with the TSO concerning the price level). They take this risk, because they need the cross border capacity for their business. This could be long-term import or export contracts, but also capacity contracts in underground storages abroad. The need for cross border capacity can vary from one hour to the next within this long-term commitment and is part of the total *business case*. The moment that UIOLI is implemented, these risks will be fully for the account of the shippers. The shippers are paying for capacity that they are not allowed to use. GTS do not run any (financial) risk. According to Energie-Nederland, the distribution of risk between shippers and GTS is not in balance.

As long as the investment model for gas is not changed in the Netherlands, Energie-Nederland is of the opinion that the bought capacity cannot be reduced if there is no corresponding compensation. UIOLI should at least be replaced by "*Use it or sell it*".

2. Oversubscription and Buy Back are much more effective

The point of departure (default) for congestion management according to the CMP *guidelines* is to start with OSBB and not UIOLI (UIOLI will only apply as of 1 July 2016 if there is still a need for this measure). Based on CMP *guidelines*, TSOs must implement OSBB with the objective of offering – based on their own analyses - additional short- and long-term *firm* capacity. The moment that congestion occurs, the TSO will be able to buy back capacity in a market-based manner. *NRAs* will set up an incentive structure, so that TSOs are stimulated to sell more technical capacity in order to

obtain optimum capacity use. Only if OSBB does not work, NRAs could consider implementing UIOLI.

Moreover, according to Energie-Nederland, a restriction of renomination rights does not offer a solution for contractual congestion. By means of UIOLI, capacity will be made available on the market too late in order for shippers to be able to use it efficiently.

In order to build cross border capacity, GTS demand that shippers enter into long-term contracts with them. During this contract period, the contracted cross border capacity cannot be reduced. As a result, the situation where available capacity is equal to the contracted capacity remains, and it will seem as if insufficient cross border capacity is available. If shippers are given the opportunity by GTS to reduce the contract capacity by means of *buy back*, cross border capacity will become available immediately both for the long and short term. For these amounts, GTS do not have to expand cross border capacity. As a result, existing cross border capacity can be used more efficiently and more effectively, as well as immediately. Through a more efficient use of the cross border capacity, the total social costs also remain as low as possible.

In combination with *buy back*, it is also easy to implement *oversubscription*, as GTS in particular is in a good position to determine on which interconnection points *oversubscription* can be applied and when.

3. The restriction of renomination rights is not practical

At this moment GTS do not have a financial incentive to use capacity efficiently, and UIOLI is not going to change this.

As was stated under item 2 as well, the situation may occur where a shipper no longer needs (part of) his cross border capacity in the long term. In that case, it would be desirable for him to be able to reduce his contract capacity. At this moment, however, GTS do not have any incentive to buy back cross border capacity and deal with it efficiently. From experience we know that GTS will not buy back capacity if it turns out that shippers do not need this capacity. This is general policy at GTS. Unused cross border capacity will therefore remain unused, as GTS do not want to buy it back, which means that the contracted capacity remains equal to the available capacity. A consequence of this, is that GTS earn both from the *firm* contracted cross border capacity and from selling interruptible capacities to parties that initially would have wanted *firm* capacity.

Energie-Nederland is of the opinion that GTS, as a result of the current situation with double income, do not have an incentive to change the current situation.

UIOLI reduces efficient use of cross-cross border flexibility

As the demand for flexible gas increases, it is necessary that flexibility can be used as efficiently as possible on borders. Restrictions of the renomination rights at the cross border, will mean that shippers are exposed to the domestic within-day market, as imported flexibility cannot be used if the possibility of renomination is cancelled. This is not efficient and is at odds with the idea of market integration and creating a north-west European gas market. With the implementation of OSBB, it will be prevented that the total imbalance risks will rise and it will be possible to use the flexibility mechanisms on *cross borders* as efficiently as possible.

Rate structure GTS provides wrong incentive

The current rate structure of GTS provides shippers with a financial incentive to enter into annual contracts, even though they really only need the capacity for a shorter period. The capacity costs for a day or for a month are relatively speaking much higher than the capacity costs for a year. This applies both to domestic transmission and cross border capacity. Therefore, shippers will often find it

attractive to buy year capacity instead of day or month capacity. With a view of a more efficient use of the cross border capacity, it will therefore be necessary for GTS to make the day and month capacity rates in proportion with the rates for annual capacity. In this way, shippers will get the right incentive to book capacity for the days/months that they require it. Moreover, this is in line with the rate structure in Germany, where the costs for month and day capacity are in proportion with the annual capacity. According to the recent decision by the German regulator KARLA (*Kapazitätsregelungen und Auktionsverfahren im Gassektor*), the TSO is legally bound to adapt their rates so that the fixed capacities – at interconnection points with other countries and domestic points (e.g. between NCG and Gaspool) – that are booked for longer than a day are not more expensive than the sum of the rates of the day capacity for the booked term.² According to the German regulator, the “non-proportional” rate structure (graduated scale of rates) was not effective and he also said that a proportional rate structure would lead to an efficient use of the transmission capacity.

4. UIOLI will have an adverse effect on competition on the whole-sale market for gas

Within the context of an increased share of *renewables*, the need for a flexible usage of (gas fired) power plants continues to grow. This means that shippers are becoming more and more dependent on a properly operating (liquid) *within-day* market for gas and the accompanying capacity bookings. In addition, more and more gas will have to come from abroad in the future in order to guarantee supply security for all gas consumers. This means that an efficient system for capacity allocation and congestion management is essential in order to enable shippers to buy gas in a responsible manner without running too many risks in relation to the capacity bookings. Obviously, greater risks will involve higher costs.

The enforced restriction of renomination rights through UIOLI, will have the following consequences:

- shippers are unable to comply with their *within-day* commitments that result from their long-term contracts;
- shippers are no longer able to contribute to the extra *within-day* flexibility requirement that is created on the gas market due to the use of gas-fired power plants as *backup* for electricity generated by means of sun and wind;
- shippers are unable to balance *within-day* with foreign mechanisms, but do have to comply with the increasing *within-day* flexibility requirement;
- shippers are unable to balance *within-day* with foreign mechanisms, while in the Netherlands we have a *within-day market based* balancing regime that also depends on foreign mechanisms/positions. The Netherlands are not an island, but are a part of Europe;
- shippers on the Dutch market who do not have domestic flexibility mechanisms are disproportionately disadvantaged as a result;
- only a short-term solution is created for making cross border capacity available. Parties that do not have cross border capacity at this moment, will not get certainty with UIOLI in the somewhat longer term and are therefore also unable to make commitments with other parties.

5. UIOLI will not contribute to the security of supply

As a result of the enforced restriction of renomination rights by means of UIOLI, shippers are not compensated for bought and therefore paid cross border capacity. This creates the side effect that shippers no longer want to enter into long-term contracts via the *Open Season*, because GTS demand that long-term commitments are made for that. A shipper will have to make this commitment,

² 1 KARLA (*Kapazitätsregelungen und Auktionsverfahren im Gassektor*), *alinea 7*

with no guarantee that it will be able to actually use it. GTS will probably not invest without these long-term contracts. In the long run, this will mean that there will be insufficient cross border capacity available in order to guarantee the domestic security of supply.

As stated under 3, a restriction of the renomination rights is at odds with the idea of creating a north-west European market. After all, the risks of shippers will increase because all shippers will become dependent of the domestic *within-day* market, as *cross- cross border* flex mechanisms cannot be used effectively. These increased risks do not contribute to the security of supply.

6. Improvement of the secondary capacity market

GTS facilitate the market with a *bulletin board* for secondary capacity. However, this market is not liquid. One of the reasons is that secondary capacity via the *bulletin board* is only offered at one side of the cross border and that information by shippers is not available anonymously or on demand. As a result, the barrier is much too high to be able to guarantee a liquid secondary capacity market.

Shippers who want to offer primary capacity on the secondary market for a short period, will do so if cross border capacity can be traded with surrounding countries in a harmonized way.

Insight into cross border capacity which is available on the Dutch side of the border, offers no solution. In order to be able to trade across the border, insight is needed on both sides of the border. Only the TSOs will be able to facilitate this.

Request

Energie-Nederland ask the Dutch regulator for energy (NMa) to implement OSSB, prior to considering UIOLI. This is in line with the CMP guidelines as agreed within Europe. Energie-Nederland is a great advocate of implementing domestic measures in harmonization with surrounding countries. In order to use the cross border capacity more efficiently, it is also necessary that GTS first make the rates for day and month capacities in proportion with the rates for annual capacity, as is the case in Germany.

In addition, Energie-Nederland would like to ask the Dutch regulator for energy (NMa), in its market monitor report as part of the total analysis, to have GTS provide insight into how much primary capacity was offered by shippers in order to be bought back (surrender of capacity) or to be offered via the most recent *Open Season 2017*. Another analysis that could contribute to this analysis, is the amount of *interruptible* capacity GTS offer on the cross borders and how much additional income this generates for GTS.

After 2016, the market will be able to evaluate together with the Dutch regulator for energy and GTS, whether this mechanism has been proven suitable and whether other mechanisms are required.

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