

ACER position paper for consultation: Exploring the feasibility of implicit allocation in the (North West) European gas market

A EURELECTRIC Response paper



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EURELECTRIC Response to ACER position paper for consultation: Exploring the feasibility of implicit allocation in the (North West) European gas market

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EURELECTRIC welcomes the opportunity to respond to this consultation and thanks the NRAs in the NWE region for allowing us an extra two weeks to submit our response.

Implicit allocation was the subject of much debate during the development of the Gas Target Model last year. In our response to the final consultation¹ we stated that “market coupling – adequately tailored to gas sector specificities – should be considered once the Network Codes/Framework Guidelines on Capacity Allocation (CAM), Congestion Management Procedures (CMP) and Balancing have been implemented and the impact of these can be assessed.” None of the information presented in the consultation, or in the accompanying assessment by the Brattle Group, persuade us to change this view.

In the same response we also stated that “we agree with the proposal to implement pilot projects to design and trial an implicit capacity allocation mechanism in different member States by 2014” and that “projects such as the one developed by GRTGaz and Powernext – which allows for continuous trading throughout the day – should be further considered”. We recognise that this consultation has been raised to explore the feasibility of an implicit allocation pilot project between different Member States and it is useful in this respect.

Our response to the Gas Target Model consultation took a pan European view of future gas market development based on the views of our members, who operate throughout Europe. However, this consultation focuses on a specific proposal to implement a pilot project in the NWE region. The views expressed here should not therefore be taken as applying to potential pilot projects in other regions, although there may be some commonality. To the extent further pilot projects are proposed we will consider these on their own merits.

The justification given by NRAs for why a pilot project in the NWE region is currently necessary (i.e. to resolve the coordination problem and to reduce transaction costs) and the lack of any convincing cost benefit analysis fail to persuade us that there is a pressing need for this particular pilot project to be taken forward at this stage. Bearing in mind the extent of the difficulties that would need to be overcome² and the resource intensity required for development, we are concerned that doing so now could distract from the goal of completion of the internal gas market by 2014 and be wasted effort.

¹ EURELECTRIC’s Response to the CEER Vision for a European Gas Target Model dated September 2011

² Whilst implicit allocation is referenced indirectly in the CAM and Balancing Network Codes these references are unlikely to provide a sufficient mandate for stakeholders to make binding decisions on the design issues for implicit allocation and to ensure implementation by stakeholders, even when the Codes do come into force.

Nevertheless, we accept that a limited pilot project could help to better inform a cost benefit analysis and provide further insight into the extent and nature of problems which will need to be overcome. If NRAs in the NWE region, or any other region, are able to provide details of where a pilot project could realistically be applied along with a high level project plan for its development and implementation, this would help us to gauge how much stakeholder commitment would be required and may make the case for pursuing it more persuasive.

Projects such as the one developed by GRTGaz and Powernext continue to interest us and we would support further national initiatives being developed jointly by TSO and exchanges along these lines. However, whilst GRTGaz/Powernext initiative has, on occasion, helped to narrow the spread between PEG-Nord and PEG-Sud, we are not aware it has had any appreciable benefits regarding liquidity, flexibility for gas-fired power stations or reduced transaction costs.

Our response to the specific questions raised in the consultation is included below.

1) To what extent do stakeholders agree with NRAs analysis on the current issues related to cross-border capacity and its effects on the gas market?

The issue of contractual congestion in European gas markets is well documented and one which the Commission has recently taken steps to address through the implementation of binding Congestion Management Guidelines. We believe these measures will help to significantly alleviate contractual congestion, where it exists, and free up more unused capacity for potential use by other network users. In conjunction with the implementation of pan-European measures included in the CAM Network Code, which envisages bundled capacity products and standardised capacity products, along with harmonised allocation mechanisms and timescales, network users will be better able to efficiently access cross-border capacity than is currently the case. As a consequence, gas flows between market areas in response to differential price signals will become more frequent and efficient, leading to greater price convergence. As the Brattle Report points out, we are already witnessing this in NW European gas markets and it is encouraging to see moves toward early implementation of the CAM Network Code in a number of other markets.

The consultation also highlights the potential difficulties for network users in coordinating the acquisition of cross-border capacity and commodity within day. Whilst we recognise this is an issue going forward, as explicit auctioning of within day capacity in accordance with the CAM Network Code becomes the norm, the fact that within day capacity has not been widely or consistently allocated through explicit auctions to date means that network users have not yet had to address this coordination problem.

2) 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)?

The reasons mentioned for why network users may not use booked cross-border capacity seem valid.

As gas markets become more liquid and wholesale prices become more transparent and reflective of changes in supply and demand, network users will increasingly regard capacity as a means to optimise their portfolios and to arbitrage price differences between market areas, rather than just as means for fulfilling contractual supply or demand obligations. We believe that the Balancing Network Code will play a major part in generating incentives on network users to trade, thus stimulating liquidity. Harmonising imbalance cash out prices based on the cost of any TSO balancing actions will also remove the unduly penal balancing prices that exist in some European markets, which may cause a network user to be hesitant in selling cross-border capacity it later finds it needs.

3) 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?

The introduction of the CAM Network Code will, in many cases for the first time, allow network users to profile their bookings of cross-border capacity between short, medium and long term products. This will, we hope, lead to a significant increase in short term commodity trading, but at the same time we expect it to promote opportunities for greater medium and long term commodity trading too.

Due to the current uncertainty surrounding the future role of gas in a low carbon economy and the increasing competitiveness of European gas markets, we would be surprised if network users choose to book cross-border capacity up to 15 years in advance (as provided for in the Network Code) for fear of stranding. However, the extent to which they are prepared to commit to longer term bookings (e.g. 5 – 10 years) will be significantly dependent on how tariffs and reserve prices are set under the Tariff Network Code. In particular, the extent to which the payable price remains fixed or is allowed to float for the duration of the booking, will influence the extent to which network users are prepared to commit long term. Also, if short term products are auctioned at a significant discount to annual products, this is likely to encourage network users to shift their capacity bookings towards short term products, particularly in the absence of congestion³.

As previously mentioned, capacity will increasingly be seen by network users as a means to optimise their portfolios and to arbitrage price differences between market areas. With capacity being able to be purchased in future for annual, quarterly, monthly, day-ahead and within-day periods, we see opportunities for arbitrage increasing in each of these periods, not exclusively in the short term.

³ Significant discounts for short term products could risk jeopardizing the economic sustainability of some gas transmission systems. NRAs should carefully balance the objective of promoting short term liquidity with the need to ensure economic sustainability of the system.

Capacity will also be used by network users to optimise their portfolios. Those network users who operate gas-fired power stations can be expected to require more flexibility in their portfolios going forward. Higher renewables penetration can be expected to reduce overall power station load factors and make running times and response times more unpredictable. Some network users may decide to use cross border capacity to gain access to gas in adjacent markets to provide extra flexibility in their portfolios, although storage, flexible supply contracts, LNG and fuel switching can also be used. As within day liquidity increases network users will also be increasingly able to trade at the virtual point in their national markets, and traders and wholesalers will acquire cross border capacity to move gas between market areas in response to price signals set in national markets.

4) Do stakeholders agree that the above effect increases the coordination problem and transactions costs?

The extent of the coordination problem is largely unknown at present due to the absence of within day capacity auctions at cross-border points, so we have no way of knowing if it will increase. Also, the Tariff Framework Guidelines and Network Code have yet to be decided upon, so we find it difficult to predict the extent of any possible shift towards short term capacity booking.

Increasing renewables penetration is already being seen in a number of European electricity markets and is widely predicted to increase over the coming years. This will almost certainly result in gas-fired power stations having to run more flexibly. However, we are not aware this phenomenon is causing any material problems for gas transmission systems at present, although it is causing major distortions in some European electricity markets. The uncertainty about the extent and speed of renewables penetration makes it difficult to gauge when it could become a problem for gas TSOs and, if it does, whether a potential inefficiency in coordinating the acquisition of capacity and commodity at cross-border points exacerbates it. Some gas TSO will better able to manage increased ramping up and down of gas-fired power stations on their networks than others, depending on their linepack and the location of the power stations on the system, but this is recognised in the Balancing Network Code through the possibility of having within day obligations.

To the extent that short term trading and capacity booking, price arbitrage and the intermittent character of renewables do become more prevalent, the transaction costs to network users of monitoring and trading on price differences may increase. However, increased short term trading and capacity booking should help to stimulate liquidity in national markets and increased renewables penetration may result in greater price volatility. So network users should have more opportunities and incentives to trade within day at the virtual trading point in their national markets. Greater liquidity will reduce the bid-offer spread and the cost of executing trades in national markets, so network users may not have to participate directly in adjacent markets to get the best deal.

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

We do not think they are significant barriers to cross border trade currently. At this stage we believe that the measures contained in the CAM Network Code and CMP Guidelines will be sufficient to alleviate contractual congestion and improve the efficiency of cross-border gas flows throughout Europe. The Balancing Network Code will provide a common basis for TSO balancing in Europe and will increase the likelihood of network users, or possibly TSOs, buying/selling balancing gas in adjacent markets. We are also encouraged by ENTSOG's commitment to work with its members towards early implementation of the measures in the CAM Network Code and by the increasing signs of momentum towards a third party developed pan-European capacity booking platform.

We believe network users are better placed to bear the risk of holding and optimising the use of cross-border capacity than TSOs, in the same way as we believe network user are better placed to balance the TSO's system efficiently in response to market based incentives. We accept that coordination of capacity and commodity acquisition within day could become a problem. But we are inclined to think that network users will quickly learn to manage the risk of being long, or short, capacity, or commodity, during the one hour period in which within capacity auctioning takes place, on each hour of the gas day that capacity remains available. We also agree with the Brattle Report that network users are unlikely to bid systematically too much or too little for interconnection capacity in an explicit within day auction, and that on average implicit auctions and competitive explicit auctions can be expected to yield the same revenues.

Greater coordination and interoperability between TSOs on both sides of the interconnection point will also be promoted through the Balancing and Interoperability Network Codes. Key issues for coordination could be the resolution of discrepancies, nominations and timings, which will become increasingly important as gas-electricity systems have a growing interrelationship.

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

Implicit allocation could overcome any potential coordination problem in future provided it takes place either on a continuous basis or during allocation windows opened each hour during the gas day (to match the explicit within day capacity allocation process)⁴. However, regardless of whether within day capacity is allocated implicitly or explicitly, the standard two hour lead time between allocation and flow change will apply. Network users who have gas-fired power stations within their portfolios may prefer the immediacy of trading gas at the virtual point within their national markets to bidding for commodity (and implicitly capacity) for delivery two hours later⁵.

⁴ The method for applying within day implicit allocation may differ depending on the markets being coupled. For example, in markets where significant within day trading already takes place continuous trading may be more appropriate than auction rounds and vice versa.

⁵ The two hour lead time will start from the next hour bar for both implicit and explicit allocation. So the period between a bid for capacity or commodity being accepted and gas flowing will nearly always be greater than two hours, but never more than three hours.

As regards transaction costs, whilst the incremental costs of monitoring and trading in adjacent markets would be avoided by network users who prefer only to trade in their national markets, the costs of trading on the exchange set up to allocate commodity (and implicitly capacity) might be expected to be higher than trading commodity and capacity separately on the OTC market.

7) 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)?

We fully support the NRAs' argument that the forthcoming introduction of the CAM Network Code and the Congestion Management Guidelines can be expected to increase liquidity and price convergence, As such, we agree that we should wait for these to be implemented fully before considering whether implicit allocation may ne needed to provide an even greater stimulus towards achieving these objectives.

However, we fail to see why this argument should not apply equally to the potential coordination problem. The coordination problem is largely theoretical at this stage, as within-day capacity is not typically made available on a bundled basis through consistent and harmonised explicitly allocation processes. But this will change with the implementation of the CAM Network Code. The Balancing Network Code will also provide impetus for within day price formation and greater liquidity in within day trading at the virtual point. These should improve the efficiency of flows between market areas and the flexibility for network users to trade gas for use in gas-fired power stations.

We also struggle to understand how implicit allocation can be introduced solely for the purpose of resolving the potential coordination problem, but not for increased liquidity and price convergence at this stage. Does this mean, for example, that only network users who have gas-fired power stations in their portfolios will be able to participate⁶ on the gas exchange where implicit allocation takes place? Will a specific level of within day capacity be set aside for these network users and will TSOs allocate the remaining within day capacity explicitly to other network users at the same time?

We see no reason at this stage to introduce implicit allocation in relation to the potential coordination problem. NRAs should assess this again once they see what the real extent of the coordination problem is and what benefits, in terms of increased competition and liquidity in national markets, arise from implementation of the forthcoming CAM and Balancing Network Codes. In our opinion it would be disproportional to embark on an extensive implicit allocation project at this stage based on the evidence presented in the consultation. Doing so risks detracting regulatory and stakeholder effort from the more important objective of developing and implementing the harmonised European market rules and obligations laid out in the Gas Regulation.

⁶ Participation should not be forced on network users, either in a formal or quasi formal way.

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

We agree with the NRA's analysis of the relevant characteristics of the gas markets and the key differences between gas and electricity markets. Chapter 5 of the Brattle Report provides further supporting detail.

As pointed out by numerous stakeholders in the Gas Target model discussions last year, gas and electricity markets have fundamentally different characteristics. It would be naïve to think that the implicit allocation arrangements prevailing in European electricity markets can simply be cut and pasted across to apply in European gas markets, or that the reasons they have been applied in electricity and the benefits they provide will apply equally if the same arrangements were introduced in gas.

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

We are not able to speculate on the costs of implementing implicit allocation or whether these will be lower, or higher, than the potential benefits. Whilst the Brattle Report attempts to quantify the possible welfare benefits of an implicit allocation mechanism between Netherlands, Germany and Belgium, this assessment is made against the status quo. A more reliable assessment of the potential welfare benefits of implicit allocation would be against the harmonised congestion management and explicit capacity allocation arrangements that are expected to be implemented in the next few years. Obviously this cannot be done at this time, but we would support a more thorough assessment of the potential costs and benefits once the Congestion Management Guidelines, CAM Network Code and Balancing Network Codes are implemented and a pilot project could help to inform this.

The Brattle Report points out that the estimated welfare benefits of implicit allocation are relatively small considering the total value of gas traded. However, all of these estimated benefits are based on improved price convergence, which NRAs have accepted is not a reason for introducing implicit allocation at this time. Brattle make no attempt to estimate the benefits resulting from implicit allocation arrangements alleviating the coordination problem (either current or future) and reducing transaction costs. This seems surprising, as these are the reasons why NRAs think this implicit allocation pilot project is needed now.

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

The pre-conditions for implicit allocation stated in the consultation seem appropriate.

Clearly, in order for implicit allocation to proceed, a certain amount of capacity needs to be set aside for the TSO or market operator to allocate implicitly. Whilst there are a number of potential sources of such capacity (e.g. capacity made available through over-selling- and-buy-back, firm day ahead use-it-or-lose-it, or from the percentage set aside for short term capacity), it is not clear whether the drafting of the CAM Network Code or Congestion Management Guidelines enable this to be used for implicit allocation. Early implementation of the firm day ahead use-it-or-lose-it mechanism, as defined in the Congestion Management Guidelines, to facilitate this pilot project would not be appropriate in our view.

Also, as the consultation points out, where alternative pairs of physical entry and exit points between two markets exist, a virtual interconnection point will be necessary in order to apply implicit allocation. Whilst the CAM Network Code provides for virtual interconnection points, these are subject to certain criteria being met. Even if they are met, there is then a five year period in which they shall be implemented. Implementation will be more difficult if there are multiple TSOs involved and will have significant repercussions for TSOs in relation to tariff setting, revenue recovery and possibly price control.

Product compatibility is also a necessary pre-condition for implicit allocation. As the Brattle Report points out, where TSO's systems either side of the interconnection point operate different balancing regimes (e.g. hourly versus daily, marginal cash out prices versus proxy cash out prices) within day implicit allocation will prove difficult. Also, the issues of force majeure and who carries the commodity risk of any non-availability of capacity are critical.

We share the NRAs view that both markets do not need to be liquid to establish an implicit allocation mechanism. However, we do not think that implicit allocation will necessarily be better at helping to build up trading volumes in less liquid markets than explicit allocation. Liquidity may also be adversely affected in liquid markets if, in order to implement implicit allocation with a less liquid market, changes have to be made to the market rules and processes developed to encourage liquidity in the liquid market. Wholesale market liquidity is driven by market size, market based incentives, efficient and non-discriminatory market rules, transaction costs and fair access to infrastructure. To the extent that difficulties exist in any of these areas liquidity will be adversely impacted, regardless of whether cross-border capacity is allocated implicitly or explicitly.

11) 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?

The main high level design issues identified in the consultation seem appropriate.

At this stage we do not have firm views on the high level design issues and each of these will need to be considered and defined in more detail before we could give definitive views. However, if implicit allocation is being proposed in order to help generators in arbitraging between the electricity balancing and gas balancing market, it at least seems appropriate for the design issues to focus on within-day markets and continuous trading.



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