ACER

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Supplementary Response by O&GUK/Gas Forum to ACER's request for information

Dear [redacted],

We acknowledged that our response to you on 23 January did not include all the information you requested in your letter of 23 December. We have now gathered the necessary information and data and seek to complete our response with this letter. In addition to answering your questions, we also take this opportunity to provide you with some more evidence concerning (i) NBP and beach gas trading in the UK and (ii) interconnectors and UK-continent cross-border trade. In our view, an understanding of the 'special nature of interconnectors', recognised in the Network Codes, and the nature of the existing UK-continent cross-border trade is central to our amendment application.

Risks and costs of the two options under discussion in the UK (Q. III)

The overwhelming risk for downstream network users (shippers) of the two options discussed in the Gas Day Working Group (GDWG) since November is that the GB market cannot successfully implement new arrangements which allow the co-existence of two different gas days in the UK. All but one or two of the 13 sub-terminals have expressed their intention to remain on the existing 6am-6am gas day, so the potential mismatch of flow data after 1 October 2015 will affect about 30 bcm per annum of gas entering the NTS network.

Any new arrangements will have to be commercially acceptable to all parties, legally well-founded and approved by the regulator Ofgem. This is not just a problem of timing, even though it will be difficult to put only Option A (the scaling option) in place by 1 October 2015. The difficulties are more fundamental and relate to commercial, legal and regulatory obstacles. The UK does not yet have even a secure temporary solution to the problem. If it was easy, we would already have such a solution.

The terms of reference of the GDWG drawn up by DECC in November are for an 'interim solution' to the problem created by two different gas days. Therefore, for the upstream industry, which is outside the scope of the EU network codes, there is still a possibility that it will be forced at some time in the future to change all its operations to 5am-5am. This may provide a permanent solution for shippers without upstream interests but it is not economic or practical, nor was it intended by the authors of the network codes.

At the GDWG meeting on 5 February, it was agreed to appoint an external consultant to specify the necessary steps towards Option A, the so-called Phase 1. A second implementation phase may follow but there is no assurance that this can be done. The UK gas market is still some way from even an 'interim solution' which would mitigate the negative consequences of two different gas days in the UK. There is still no agreement on the involvement of National Grid in Option A or how this might be integrated with the existing claims validation service administered by CVSL.

If Option A is implemented, by 1 October 2015 or soon after, the uncontrollable risk of higher imbalance charges for shippers will be reduced but it will not be eliminated. Only the addition of Option B, a linepack flexibility service or inter-day balancing service, completely eliminates this risk of higher imbalance charges. This commercial service would have to be approved by Ofgem and would have to be paid for by shippers according to an approved charging arrangement. Both Options A and B are expected to entail significant up-front development costs on IT systems and on new legal agreements. The development costs of Option A are estimated, at this early stage, to be less than £0.5 million but the operating costs are now yet known. There has been no discussion or estimates of the cost to develop and operate Option B which remains for almost all shippers the preferred 'interim solution'.

UK upstream gas day change: when could it be implemented? (Q. IV)

Under the existing EU network codes and UK national legislation, there is no obligation on any UK gas producer, offshore operator or terminal operator to change its gas day or to change its operations in any way. It is the obligation to change in the downstream network on 1 October 2015 and the absence of any obligation to change in the upstream which is responsible for the current problem. A new barrier to trade between the upstream and downstream will be created on 1 October unless a solution is found. Upstream operators are of course willing to participate in the search for an agreed solution which would help to mitigate the risks for shippers and the NBP market.

The UK upstream regulator (DECC) could in future resolve the problem if it passed legislation to force the upstream to move to a 5am-5am gas day. However, it can only do so at considerable cost and disruption to the upstream at a time when the UK government is seeking to encourage new investment in the upstream, not to drive it away. DECC has indicated that it has no plans to force the upstream to change and it cannot do so in time for 1 October 2015. It would probably take upstream operators several years to complete a change in the upstream gas days because it would need extensive changes to complex IT systems, the review and revision of bilateral upstream commercial contracts and offshore interventions to change meters, including some fiscal meters. Some offshore interventions would have to be planned during scheduled turnarounds. If UK legislation were to be passed in mid-2015, the changeover could perhaps be completed gradually between 2016 and 2018 but only at an estimated total cost of €50-60 million. Under current plans, responsibility for regulating the UK upstream will pass from DECC to the new Oil & Gas Authority (OGA) in 2016, which itself may slow the implementation of any enforced change on the UK upstream.

Shippers' opinion and UK-continent cross-border trade (Q. V)

The questions you raise about the functioning of the interconnectors between the UK and the continent (IUK and BBL) are critical to the validity of our application to retain the UK gas day unchanged. We address this in 'Interconnectors and cross-border trade' below.

The membership of O&GUK and the Gas Forum includes many active IUK and BBL shippers and traders. We would be willing to assist you in identifying them if you wish. In preparing our submissions to you, we have <u>not</u> approached IUK or BBL shippers individually or as a group, nor have we conducted a survey of shippers. The evidence of their position on this issue is in the submissions they make directly to ACER.

We have informed the UK gas industry of our application to ACER through routine industry meetings and have raised the issue informally with the European Commission, European industry associations and TSOs in adjacent member states. We have also has some contact with both IUK and BBL before and after we made our application in July 2014. Our contact with IUK has been more extensive than with BBL because of the more active role IUK trade plays in cross-border arbitrage as the only bi-directional interconnector between the UK and the continent.

Based on our informal direct contacts, a majority of IUK and BBL shippers support our amendment application or are sympathetic to it. It is true that a minority of shippers see harmonisation of the gas day between the UK/Ireland the continent to be desirable because of operational convenience – all balancing and all nominations will be on a single 5am-5am gas day. The shippers which do not have a UK upstream position or do not purchase gas at the beach in the UK appear to be more likely to hold such an opinion. When we have raised the issue of the possible adverse impact on NBP market liquidity, we have found shippers become more concerned about the risk of harmonisation and willing to adopt a neutral position towards our amendment. All IUK shippers to whom we have spoken informally recognise the efficiency of existing IUK arrangements and the ease of cross-border trading. None has suggested that harmonisation will itself make the cross-border trade more efficient.

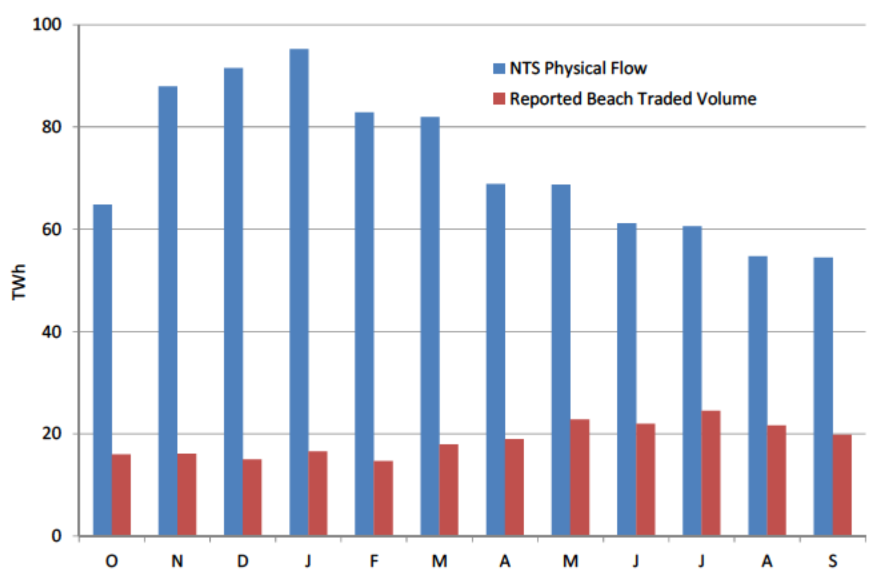
In our view, operational convenience is not the same as economic efficiency. If shippers and regulators consider the issues of hub liquidity, entry/exit tariff design, capacity bundling and others factors which influence cross-border trade, the case for leaving the UK/Ireland with a non-harmonised gas day is strengthened.

NBP and beach gas trading in the UK

ACER's own work on revised Gas Target Model presented in January identifies only two EU hub markets, NBP and TTF, which currently meet the criteria to be considered liquid, active and well-functioning. It is, of course, no coincidence that these two markets grew up based on indigenous production and a well-regulated downstream network. In the UK, the spot gas market emerged spontaneously based on UK production and was later transformed through the Network Code into the NBP market by respecting the close commercial and operational integration of the upstream and downstream. Unfortunately, the new EU network codes have overlooked the important interface between the upstream and downstream within individual member states in their efforts to promote cross-border trade between member states. Our amendment seeks to maintain the integrity of the UK upstream-downstream interface and the liquidity of the existing NBP market. We do not believe that in doing, this there will be any detriment to the already efficient highly cross-border trade between the UK and the continent.

In the hearing in December, we referred to the beach market in the UK and said that if the UK is forced to live with two different gas days, there may be an erosion of trading at the NBP and a drift back to trading at the beach. By 'beach trading' we mean trading at the entry point of the NTS or at a delivery point further upstream.

NBP Physical Flows and Reported Beach Trade Oct 2013 – Sep 2014



We have now collected and analysed the data provided by National Grid for total reported physical NBP trading and physical NTS gas flows and data on beach trading recorded by CVSL. The volume of total reported NBP trades in the 12 months October 2013- September 2014 was 969 TWh/month, which represents a churn factor of 14 times the reported physical flows of 72.7 TWh/month. These physical volumes are closely aligned with the total claims made by shippers to CVSL. The volume of beach trading over these 12 months was 18.8 TWh/month or 28% of all claims made by shippers.

We cannot be sure of the reasons for beach trading of all participants. However, it is clear that many small and medium-sized UK producers already prefer to sell at the beach, often to aggregators or large downstream shippers, in order to avoid the costs associated with a gas marketing and trading operation. As production volumes have fallen in the last decade (to 35 bcn in 2014) and trading margins have declined, it appears that more producers have chosen to sell their gas at the beach rather than at the NBP.

The UK gas market began as a beach market before it was successfully channelled to the NBP. If the UK has to live with a 6am-6am gas day upstream and 5am-5am downstream without any mitigating new arrangements, we expect that more producers will choose to sell at the beach to aggregators, with adverse consequences for both supply-side competition and for NBP market liquidity. The beach market is already moderately active, albeit at a lower level than the NBP, and standard beach contract terms are well-established across the industry. An erosion of NBP liquidity after 1 October 2015 and arise in beach volumes should not come as a major surprise.

Interconnectors and UK-continent cross-border trade

The argument for our amendment is based not only on the costs and risk for the UK gas market but also on the absence of any expected benefits in the cross-border trade between the UK and the continent via IUK and BBL. (When we refer to 'the UK' below, we mean the GB and Irish gas market which is unique in the EU is being entirely integrated across two member states).

There will an economic benefit to EU gas consumers from harmonising the gas day in the UK/Ireland with the continent if, and only if, the price-responsiveness of cross-border trade (or arbitrage efficiency) improves following the harmonisation. If there is no improvement in price-responsiveness and arbitrage efficiency, then there will be no economic benefit from harmonisation. It is our main contention that there is very unlikely to be an improvement in the functioning of cross-border trade and arbitrage efficiency on the IUK and BBL arising from the harmonisation of the gas day between UK and the continent. This argument applies only to the UK/Ireland, not to the entire EU, and it does so because the only connections that the UK/Ireland has to other member states are through interconnector pipelines. In other words, the position of the UK/Ireland market is unique in the EU. Acceptance of our amendment does not create a precedent which could be used elsewhere in the EU.

The special nature of interconnectors. Our amendment asks ACER to give expression and meaning to 'the special nature of interconnectors' as mentioned in the Network Codes.

Maritime interconnector pipelines have linepack and hence operational flexibility, which means they are fundamentally different from onshore cross-border IPs. Both IUK and BBL are well-managed and efficiently operated. Both are physically and commercially capable of operating with different gas days at each end of the pipelines, as they always have done. The lowest-cost and most efficient way to implement the spirit and objectives of the EU network codes is to leave both the interconnectors and the UK upstream-downstream interface to operate as they always have done. What exactly is the case for change?

Existing UK-continent cross-border trade. The arbitrage across the IUK is recognised by all European gas traders and by all consultants to whom we spoke as the most price-responsive and efficient in the EU. This has been achieved with a non-harmonised gas days even since the interconnectors were commissioned. In our view, it is unwelcome for the Network Codes to impose the splitting of Bacton entry capacity and the change of the gas day in the UK since both these changes will risk undermining trading flexibility, arbitrage efficiency and market liquidity, contrary to the objectives of the Third Energy Package

Regulatory investigation of interconnectors. The joint investigation of the use of gas interconnectors by Ofgem, CREG and NMa in 2012-13 provided much useful information and revealed the highly efficient and price-responsive use of both IUK and BBL. The call for evidence included a question about how existing arrangements could be improved. It is interesting that none of the respondents suggested that harmonisation of the gas day across the interconnectors would be desirable or would improve cross-border trade. All the focus among shippers was correctly on the GB commodity charge as the most important barrier to trade, not gas day harmonisation. Since the IUK provides shippers with extensive within-day flexibility based on hourly IT systems, there is no reason to believe that harmonising the gas day would have any material effect on the efficiency of its operations.

Compliance with CAM Network Code. Both IUK and BBL have been preparing to comply with the introduction of CAM on 1 November 2015 and the proposed change in the GB gas day on 1 October. The imminent publication of BBL's concept document should shed more light on its plans. We understand that IUK could continue to operate with non-harmonised gas days and comply with the capacity bundling requirements of CAM. However, the TSOs would need confirmation that they are permitted to bundle capacity at the Bacton entry/exit point based on a 6am-6am gas day and to bundle capacity at the continental entry/exit point on a 5am-5am gas day.

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