

**Response to Consultation
On
The feasibility of implicit allocation in the (North West)
European gas market**

2nd November 2012

EUROPEX

Rue Montoyer 31 Bte 9

BE-1000 Brussels

T. : +32 2 512 34 10

E.: secretariat@europex.org

1. Introduction

ACER (the Council of European Energy Regulators) in close cooperation with stakeholders has developed the first European Gas Target Model. In this framework, the National Regulatory Authorities (NRAs) within the Gas Regional Initiative North West (GRI NW) came forward on the question whether implicit allocation should be introduced in the gas market and hence produced a joint position paper which explores the feasibility of introducing implicit allocation in the gas market. Based on the above mentioned position paper, the NRAs within the GRI NW have jointly launched a public consultation to provide stakeholders the possibility to share their views.

EUROPEX welcomes the initiative of the GRI NW and the possibility to comment on the position paper. Here below you will find our contribution to the public consultation and we believe that the final paper will be an important tool for the implementation of the European internal gas market.

2. Issues associated with the allocation and use of cross-border capacity

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?

Europex largely agrees with the NRAs' vision and analysis on the current issues related to the allocation of cross border capacity and its effects on the gas market. Contractual congestion combined with the absence of a liquid secondary market of capacity is an issue if it prevents cross-border arbitrages that would otherwise be done by other shippers (that currently cannot book short term capacity). However, this is more related to the CMP guidelines implementation than to the implicit allocation debate.

Nonetheless, if capacity is released at a very late stage (e.g. a few hours before the start of delivery) it seems likely that the coordination issue will become critical and could in turn prevent arbitrages. Market coupling would in this respect ensure the optimal usage of capacity by solving the coordination issue. Improving the arbitrages between hubs would then strengthen local price signals and liquidity, making it easier for new entrants to serve customers into this market or for large consumers to directly source their natural gas on their local market.

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)?

Exchanges do not have information specific to their activity that could help explaining the shippers' behaviour with regard to the use of subscribed capacity.

3. European measures to solve current allocation issues

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 renewable?

Europex agrees that CAM and CMP are likely to increase the amount of available short term capacity on the primary and/or secondary markets, which would support further short-term cross-border trading insofar as coordination has been properly addressed.

With regard to the further development of renewable energy sources for power generation and to the intermittent character of wind and solar power generation, Europex shares the (quite generally admitted) view that natural gas role as a necessary complement to guarantee security of supply (like hydroelectricity) will become more critical. Considering its role as a “back-up” for intermittent energy sources and the low predictability of wind and sun’s availability, natural gas demand for power generation would then be quite volatile and difficult to accurately anticipate. A liquid spot (or even within-day) market would therefore be helpful to cope with such volatility. Reactive gas storage and efficient cross-border arbitrages (explicit or implicit) will help to obtain the required level of system flexibility.

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

The availability of more short term capacity is not going to increase the coordination issue. However the loss of opportunity (and the loss of ‘welfare’) which might result from a coordination issue will increase with the quantity of available short term capacity that is not effectively used for arbitrating price differentials.

In the same way, renewable energy sources in electricity driving a need for short term arbitration will result, should the coordination issue be confirmed, in not arbitrated large price differentials leading to a larger loss of welfare. In this respect, security of supply should equally be taken into account as an inefficient flowing of natural gas to the gas-fired power plants could result in spikes in electricity prices (or electricity balancing charges in case the gas unavailability is not correctly anticipated), or in the worst case scenario to power outages. It should be noted that the coordination issue is likely to be more acute when buying and shipping gas to supply a power plant as one will then also have to monitor the spot electricity prices to arbitrate the spark spread.

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

It is difficult for Europex to answer to this question on traders/shippers' behalf. However, it appears that some participants (especially amongst the small ones and the new entrants) decide to trade on local exchanges, also in order not to have to deal with the sourcing and shipping complexity, the transaction costs associated to the management of the whole chain being considered too high. This barrier might not be an issue as such in case the arbitrages are properly done by other shippers, resulting in liquid local markets with correct price signals. However, larger shippers (having access to other European markets) might also be confronted to coordination issues when it comes to trading in the short term. As long as a perfect market functioning is not guaranteed, other mechanisms should be developed and introduced to support the functioning of wholesale markets (inter alia through market coupling with implicit capacity allocation or the creation of larger market / wholesale market areas).

4. Added value of Implicit Allocation

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

By definition, implicit capacity allocation solves the coordination issue of booking capacity and commodity separately. In this respect, coupled electricity markets (both day-ahead and continuous intraday) show that not only orders from an adjacent market can be matched but also orders from more distant coupled markets. Such long chains of capacity bookings seem difficult to achieve on a short term basis via explicit capacity bookings.

It should be also noted that the coordination issue is not the only element to consider when assessing the benefit of market coupling. Market coupling helps to develop liquidity and foster competition in local (interconnected) markets which is one of the key objectives of the European Gas Target Model.

5. Considerations on the introduction of implicit allocation

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)?

According to Europex, the full implementation of the Congestion Management Procedures and Capacity Allocation Mechanisms codes would be useful, but not a pre-

requisite for the introduction of implicit allocation mechanisms. In case of a positive cost-benefit analysis duly taking into account market participants' views, implicit allocation mechanisms should be implemented as soon as some basic pre-conditions are met (more detailed in question 10). The larger the coordination issue and impact in terms of welfare loss and the larger the expected contribution of market coupling to the development of local market liquidity, the more urgent it is to implement implicit allocation.

One of those pre-conditions is the availability of short-term bundled capacities (on Day-ahead and/or Within-Day stages). If this condition is not achieved before full implementation of the CAM/CMP at some interconnection points, then implicit methods would obviously not be implemented before this date at those specific points.

In case of possible earlier introduction of implicit allocation of capacities, pilot projects could already be implemented. Such mechanisms should however seek to be compliant with the network codes and guidelines to come (CAM and CMP).

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

Europex welcomes the work of NRAs, which endeavour to take into account gas market specificities when designing a gas market coupling mechanism. Europex agrees that the introduction of implicit allocation should not necessarily disturb business as usual and that market coupling designs could be adapted to reflect the specificities of the gas market.

Below you find our comments on the following developed points:

Continuous trading and ability to renominate

Market participants have always been trading gas on a continuous basis. Gas being a storable commodity, the gas market indeed offers enough flexibility to allow market participants to trade on a continuous basis¹. Implicit allocation mechanisms could be adapted to those habits in the gas market. The implicit allocation of the capacity will have to meet the TSOs' requirements which may result in a coupling of markets at specific moment(s) of the day (and a concentration of continuous market liquidity around these periods of time) but this does not mean that a separate coupled commodity market must be put in place. Such a separate market would on the contrary split the commodity market liquidity, which is not desirable.

It is possible to design a market coupling mechanism that does not abolish renomination rights for shippers. However, capacity made available for implicit

¹ Gas markets are in this respect very different from electricity markets as the gas TSOs do not impose to shippers to nominate balanced inputs and off-takes at a day-ahead stage, which is one of the main reasons for having an auction on day-ahead electricity markets.

capacity allocation must be firm. Any capacity that can be subject to renomination should therefore not be offered to this allocation mechanism unless contractual firmness is guaranteed by TSO (which would then make a counter-trade if necessary).

Cross-border-flow and security of supply

Europex agrees with the fact that physical congestion is in general less likely to occur in gas than in power as cross-border capacities have been traditionally designed to cover the import needs of a market ensuring security of supply. The situation has become more complex as gas flows are less predictable (with inter alia reverse flow installations, cross-border trading and more supply sources), this might result in physical congestions on some pipes where gas is not going through the historical direction. These cases of congestion do not necessarily result in security of supply issues but rather reflects maximization of arbitrage opportunities between concerned markets. Nevertheless, solving the problem of inefficient use of the capacity should solve congestion issues in many cases. Additionally, explicit allocation of capacities cannot guarantee a totally efficient use of the interconnection even with auctions being generalized and CAM/CMP being enforced. If coordination is an issue, one can imagine that shippers will buy short term capacity for its option value without always knowing whether or not they will use it; hence leading to inefficiencies. On the contrary, capacities that would be implicitly allocated are *de facto* used by shippers.

Long-term investment

Even though Europex is convinced that the tariff design for capacity allocation should not impede long term investment, cost recovery issue should not be specifically addressed within the implicit allocation debate. Selling capacities explicitly or implicitly can both comprise a reserve price or not (see question 11) and the explicit vs. implicit allocation is therefore neutral on the possible lack of revenue issue to which the TSOs might be exposed.

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

Europex agrees with the fact that implementation costs must be lower than the benefits expected by the introduction of implicit allocation of capacities before such implicit allocation would be implemented.

Moreover, all the benefits from introducing implicit allocation of capacities have to be taken into account and not only the welfare gains from price differential between zones:

- Potential increase of liquidity in the two underlying markets;
- Better coordination of commodity markets and capacities for market participants, lowering the transaction costs especially for smaller participants;
- More efficient use of capacity, decreasing the need for additional investments by TSOs;
- More efficient use of capacity, fostering price convergence and supporting also small shippers and new entrants to access the supply market by trading locally;
- Political goal of more connected markets (Gas Target Model).

Those effects might be more difficult to assess but still have not to be forgotten when it comes to assessing the added value of introducing implicit allocation of capacities.

When it comes to assess costs of introducing implicit allocation mechanisms, costs of introducing explicit allocation could also being taken into account.

Cost-benefits analysis should be assessed on a case-by-case basis depending on the region and on the model to be implemented. Indeed, benefits can vary a lot from a region to another (size of the market, price differentials) as well as costs from a model to another (complexity of the algorithm, number of parties involved in the project, etc.).

6. Design Issues related to the implicit allocation mechanism

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

Europex welcomes the work done by NRAs to assess pre-conditions for implementing market coupling in the gas market. Here are the comments of Europex on the following developed points:

Available cross-border capacities on the short term - In order to implicitly allocate short-term capacities between two markets, it is obviously necessary that some capacities are still left or made available to be allocated. Those capacities could be: capacities not booked in the long term that are still available for day-ahead or within-day, capacities freed-up by limitation of renomination rights (CMP), contractual new firm capacities from overselling/buy-backs mechanisms (CMP), reserved capacities for the very short-term, etc.

This would also be the case for explicit allocation of day-ahead and within-day capacities. Already today at some interconnection points, some capacities are available at Day-Ahead and/or Within-day stages. Concerning the interconnection points where no capacity is available, market coupling could only be implemented when some capacity becomes available (freed-up by limitation of renomination rights or overselling process). Those measures will have to be

implemented in the frame of the CMP guidelines but could be implemented before in some countries.

- *Bundling of cross-border capacities* – This prerequisite is fundamental as well as the existence of two virtual hubs;
- *Product compatibility* – Commodity products similar definition in the two hubs to be linked will facilitate the implicit allocation of capacities as it allows much more straightforward matching algorithms. Europex agrees that such product suite alignment is already observed to large extent today at most interconnection points and should not be an issue. Indeed, exchanges always take into account market participants needs when designing the tradable products. Europex considers that there is no need to set rules on the way products are defined by exchanges and that any attempt to do so is likely to have undue and counterproductive effects as it might prevent to adequately take into account some specific market needs;
- *Liquidity* – Europex believes that a good liquidity in the commodity market is not necessarily a precondition to introduce implicit allocation mechanisms. On the contrary, Europex agrees with the NRAs that implicit allocation of capacities can help building liquidity in some less liquid hubs. Moreover, if commodity markets are not liquid, one can guess that capacity markets will not be liquid either and that an explicit mechanism would have the same risk of mispricing the capacity. Europex however recognizes that merging zones should also be envisaged (and especially in case of small illiquid zones when costs/benefits analysis would not be positive).

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?

Europex welcomes the design issues presented in this chapter on implicit allocation of capacities.

Time period: Day-Ahead and Within Day

Europex believes that implicit allocation of capacities should indeed focus in short term products. At day-ahead and within-day stages, there is no risk of maintenance on capacity, which can be then easily bundled with commodity without questioning the firmness of the transaction. The development of well-connected liquid spot markets (with some market price convergence) is likely to result in the convergence of futures markets anyway, with positive outcomes in terms of risk hedging for market participants.

Dual system or implicit allocation

Europex has no specific view on this point. Depending on the model selected for implicit allocation, it could be possible to have a dual system. Would implicit and explicit capacity allocation mechanisms coexist, it is important to make sure that the capacity is allocated to the system which values it the most.

Reserve price and rent allocation

Europex is convinced of the importance of the tariff topic for market participants and TSOs. Furthermore, we strongly believes that this question should be tackled in the Tariff Framework Guidelines rather than in an implicit allocation consultation. Indeed, selling capacities explicitly or implicitly can comprise a reserve price or not. In case of implicit allocation of capacities with a high reserve price, capacities would be allocated only if price spread between the two concerned hubs is high enough. With an explicit mechanism, shippers would not have any interest in buying capacity at a higher price than the commodity spread between the markets. If a shipper would do so, this would prove the inefficiency of explicit mechanisms. It is to be understood that TSOs would not have more revenues from an explicit mechanism than an implicit mechanism with the same reserve price. The question of the rent allocation also has to be tackled in a more general framework on tariffs as this topic also applies to both types of mechanisms (explicit and implicit).

OTC or use of an Exchange

Europex considers that the allocation of capacities through the commodity market needs a transparent and non-discriminatory framework. Shippers should legitimately have an equal access to capacities made available by the TSOs and not risk any discretionary practices. The trading platform used for implicit allocation of capacities should guarantee at least the following:

- Non-discrimination between market participants (including anonymity, equal access to information and therefore no voice orders, etc.);
- Transparency;
- Prevention of market manipulation through market surveillance;
- Financial security (every trade covered by collateral so no risk of counterparty default), which is also a prerequisite for ensuring anonymity and non-discrimination;
- Reliable, transparent price for implicit allocation;
- Secured notification system (with single-sided nomination, there is no risk of mismatch between two counterparts resulting in non-firm capacity allocation).

OTC trading does not offer those guarantees, only exchanges do. Those guarantees are of utmost importance and especially for new entrants and/or small network users. New entrants do not suffer from market power distortion on an exchange thanks to anonymity and same access to information.

Continuous or discrete auctions

The principle of implicit allocation of capacity is to have capacity and commodity bought and/or sold together. Market participants and TSOs do not seem to see the need today for changing from continuous trading to auction in the commodity market because of the flexibility given by the gas specificities. Europex believes that implicit allocation mechanisms could easily be integrated in the continuously traded commodity market. However, the implicit allocation of the capacity will have to meet the TSOs' requirements which may result in a coupling of markets at specific moment(s) of the day (and a concentration of continuous market liquidity around these periods of time by introducing implicit capacity auctions for instance) but this does not mean that a separate coupled commodity market must be put in place. Such a separate market would on the contrary split the commodity market liquidity, which is not desirable.

- End -