

To:
Gas regional Initiative North-West (GRI
NW)

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Concerns: **Vattenfall's response to the GRI NW (Gas Regional Initiative North-West) public consultation on their draft position paper on implicit allocation in the gas market (also referred to as "market coupling")**

Dear Sir, Madam,

Vattenfall supports the use of market coupling, or implicit auctions in the power markets. For this reason, we can understand and support the wish to determine if such a mechanism can also be of benefit to the gas markets in Europe.

Vattenfall strongly supports the introduction section of the draft position paper of the GRI NW, as it shares our view that a very important question needs to be addressed, to ensure implicit auctions are designed in a way that is efficient and contributes to the overall market design; *what is the added value in introducing implicit allocation in the (North West) European gas market?*

We would like to take this even further back and point out the need to focus regulation on the regulated part of the market, e.g. the grid. For proper functioning of the commodity (and flexibility) market, it is most important to create a broad, stable framework within which demand and supply can find each other in the most efficient manner. Before new mechanisms and regulation is imposed onto this market, we need to establish that there is a problem, which cannot be overcome by market parties within this framework. Only when and where this is the case, can we continue to the question whether implicit allocation is the best way to solve this problem (the "added value" question, as mentioned in the draft position paper).

We ask the GRI NW to include this question, *is there a problem in the markets that cannot be overcome within the current market design and the mechanisms from CAM and CMP*, in the position paper. In addition, we believe the transportation tariff Network Code should be added, as this also expected to improve the European gas market and is closely connected to the CAM Network Code. This way we can ensure that not only value is added, but existing value is not destroyed. It must be clear that there is no added (or lost) value when explicit allocation is replaced with implicit allocation, as the result of such trades remains the same: gas is traded and flows

between two bordering hubs. The mentioned possible welfare in the Brattle report is therefore not linked to the introduction of implicit allocation. It merely indicated the possible added welfare of two bordering markets without barriers is greater than between these markets when there are certain barriers in place. We strongly believe it is more, or only useful to decrease or remove these barriers. The introduction of implicit allocation, as considered by the GRI NW, does not do this.

In relation to the above, we strongly support the suggestion of the GRI NW to await the results from the implementation of CAM and CMP, before assessing the need to implement a form of implicit allocation. We agree with the statement in the Brattle report that these will improve the efficiency of the use of cross border capacity and will thereby most likely lead to further price convergence.

Finally, we would like to state that Vattenfall believes that the difference in the way the power and gas markets deal with transport capacity contribute largely to the difference in the effects of market coupling. We believe the first option would be to change the gas transport capacity mechanisms towards the way it is dealt with in power. If this is not done, market coupling for gas must find a way to ensure it can deal with this difference. This should include an assessment of how to ensure capacity cost allocation and capacity allocation are set up transparent, non-discriminatory and do not provide signals that incentivise distorting behaviour in the market. We believe the draft position paper and assessment do not sufficiently touch upon these underlying differences and similarities between the two commodity markets.

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?

In the current market, especially in the North West of Europe, parties have a portfolio with a mix of long, mid-term and short-term commitments, requiring aligned capacity bookings. For this reason, most network users no longer book capacity mainly on a long term basis. The reason that most cross border capacities are still booked long term is not related to the overall market trend or wish of market parties. This long term cross border booking behaviour is closely linked to the current way in which this capacity is sold, especially when new investments are made. It would be good to reflect this in the text.

In the second paragraph, a reference is made to the existing UIOLI measures. However, it would be good to point out that the new EU regulation CMP will oblige the implementation of Overselling and Buy Back (OSBB), which allows the TSO to sell capacity that they believe will not be used, well ahead of the nomination deadline. This mechanism will therefore address any possible contractual congestion due to hoarding or other behaviour that implies a capacity utilization that is less than 100%, without interfering in the commodity 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)?

We would like to add a remark to reason number 2 (transaction costs). The paper mainly speaks of internal transaction costs for monitoring the market and trading. However, in the current market, most parties have sufficient resources available to monitor the market and effectuate trades, as they already need to do this for their own balancing responsibility¹. Adding within day or day ahead arbitrage does not require a substantial increase in resources and can be managed with existing resources.

¹ In the Netherlands, this is referred to as programme responsibility, or PV.

We believe it is the external transaction costs (f.i. transaction costs at hubs), rather than the internal that could decrease the level of cross border within day or day ahead trading for arbitrage, as these costs decrease the possible profits from these trades.

In addition, we believe a new point could be added, relating to the capacity arrangements at the borders:

- Firm capacity is not in all cases firm (firm conditional),
- The new cross border capacity auction at the Dutch German border requires administrative action to keep the purchased capacity separate from the rest of the capacity held by the market party, as none of the capacity purchased in the auction can be renominated.
- We understand from trac-x that the new bundled capacity auctions will still require two sets of contracts and rules. This implies that firm conditional on one side can be combined with fully firm on the other side of the border. This (lacking) level of transparency and harmonization could provide a barrier to arbitrage, due to possible risks and required additional time to assess the true firmness of the capacity and the terms & conditions, slowing the process down.

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?

As mentioned in our response to Q1, we do not necessarily believe there is a trend towards short term trading, but we do see a more balanced mix of commodity (and therefore capacity) products. This is the natural result of market based mechanisms being put in place and the liberalization of the gas markets.

Currently and in the near future, certain measures may shift this market-based balance more to one or the other side. In general Vattenfall believes that a forced shift must be avoided and the commodity market and its further development should be the guidance for the type of capacity products and other regulated services are provided.

More specifically, the increased intermittent character of renewables will lead to an increased need for flexible and reliable power production, whereby we see gas playing a big role. This role will add a more short term element to the gas market, especially on a within day basis. This change must be facilitated by the market design. The introduction of CAM provides a good mechanism that allows for all contract terms to be booked, weighing in the commercial balance between supply and demand.

CMP will have an influence, but this depends on national implementation. Overselling and buy back could and should apply to all types of capacity that are not likely to be used, so should also not shift the balance. UIOLI however is likely to lead to an unnatural (e.g. not market driven) shift of the balance between short and long term, as the accompanying renomination limitation decreases the flexibility of contracts, increasing the need for short term measures. As this is a forced shift of balance, we do not believe this contributes to a natural balance of capacity contract durations and could disturb the market balance.

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

Vattenfall believes that the shift from a more long term focused capacity booking to a more balanced mix, in reaction to the shift to a more balanced and market based commodity portfolio, ensures that market parties already are actively monitoring and acting in all aspects of the European market (or at least the markets where they are active). In our view and for us specifically, this enables us to better coordinate and more efficiently manage our portfolio than before.

We agree that there is a (small) risk involved when combining commodity and capacity at the border, when aiming to trade between two bordering hubs in case of a price difference. However, we feel that the implementation of CAM, in combination with the experience and expertise of traders when managing their portfolio, is sufficient to ensure the risk is at an acceptable level. Harmonisation of the administrative and legal conditions of (bundled) capacity auctions through CAM is likely to offer a significant decrease of this risk and should be the primary focus.

As mentioned above, Vattenfall believes that the internal transaction costs relating to arbitrage trading are very limited, as the current European market structure already requires active market monitoring and trading. Adding a small amount of arbitrage to this mix requires limited (or no) additional cost.

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

Please see our response to question 4.

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

By combining capacity and commodity bookings/allocation, naturally, the coordination problem as described in the draft paper is removed. However, implicit allocation leads to problems in other elements of the gas markets, including, but not limited to capacity fragmentation, temporary closure of the commodity market, re-allocation of costs from one type of capacity to another. We believe that the possible risk of coordination problems with arbitrage within day or day ahead do not weigh as heavy as the problems that are likely to follow from the implementation of implicit allocation.

As described above, Vattenfall does not believe that internal transaction costs are a barrier to cross-border trade in the liberalized market. External transaction costs, we believe, should and can not be solved by implicit allocation. If there are transaction costs that are too high to allow price convergence between markets, the underlying reason for such high (external) transaction costs should be found and addressed, rather than implementing a measure that masks these costs and socializes them, as was done in the French market coupling pilot.

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)?

Implicit allocation should not be introduced in the European gas market. The Brattle report and our own analysis do not show added value following the introduction of such a measure. In addition, we believe the elements of current market design that lead to a less than optimal use of price spreads follow from barriers that are not solved by market coupling, but are likely to improve by implementing the CAM, CMP and transport tariff Network Code.

Vattenfall strongly supports the view of the GRI NW to ensure that the choice to implement a form of implicit allocation is not to be made before the CAM and CMP measures have been introduced and the effects of these measures are known. We believe that CAM and Oversubscription and Buy Back will provide the European gas markets with a substantial opportunity to improve. As both of these measures improve the access to capacity, we believe they are likely to have a positive impact on cross-border gas flow when demand and supply warrant it, leading to increased price convergence.

As both capacity auctions and OSBB provide a good framework for market based commodity mechanism, these should be prioritized above mechanisms like implicit auctions, which limit currently existing market structures.

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

Please see our other considerations in this response of the most relevant elements that need to be taken into account when assessing the need for and use of implicit allocation in the European gas market.

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

The Brattle report shows a quantified benefit of implicit auctions, based on the day ahead price differences between bordering hubs. We believe this does not represent the actual benefit. Firstly, this calculation does not take into account the cost of the cross border capacity and (external) transaction costs relating to the effectuated hub to hub deal. Secondly, the implementation of CAM and CMP will, as mentioned, are likely to lead to increased arbitrage and price convergence.

On the other hand, the costs for implementing implicit allocation do not take into account the possible financial effects of certain design formats of the mechanism; allocation of the price difference between deals to the TSO, closure or restriction of the explicit market, contractual congestion of the border resulting from the fragmentation of capacity when dividing the available capacity between implicit and explicit auctions, etc.

Taking into account all of these factors, in addition to the limited financial benefit mentioned in the Brattle report, we do not see benefits significant enough to warrant the time and money that needs to be invested in this change, at this moment. We believe this assessment needs to be made again, after implementation of CAM and CMP, to analyse if the price spreads between markets are greater than they are now.

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

General comment: All pre-conditions (available cross border capacity, bundling of capacity, product compatibility and liquidity) are equally helpful for "normal" arbitrage and implicit allocation. We believe that if all pre-conditions are met, arbitrage will be made easier and more attractive, leading to more price convergence and optimized use of cross border capacity.

Pre-conditions:

- Available cross border capacity: Vattenfall does not support the allocation of amounts of capacity to the implicit auction mechanism, as it fragments the capacity markets. It could

lead to a lack of available capacity in the market, due to its reservation for implicit auctions. If price differences between bordering hubs are sufficient, it is likely that market parties wish to take the opportunity to arbitrage. However, if capacity is not available due to the reservation for implicit allocation, the mechanism defeats its own purpose.

- Product compatibility: We agree with the GRI NW that harmonized products are necessary for implicit auctions. We do however not believe that such harmonization is already in place.
- Full implementation of the 2nd and 3rd package requirements: We believe that that should be the first priority, to be enabled to assess the level of market development. It is possible, or even likely, that many barriers for good market functioning will be removed when basic market elements are properly implemented (entry-exit system, virtual hub, transparency, etc.)

Design issues:

- Time period: The draft paper describes a need for gas fired power plants to obtain cross border capacity and commodity in a limited time. This is not correct. Although power plants do require flexible gas supply with short lead times, this does not necessarily need to be obtained through cross border capacity. We believe this should be reflected in the text. In addition, we do support the suggestion that the most logical time frames for the application of implicit allocation are day ahead or within day.
- Rent & cost allocation: the GRI NW indicates that capacity costs and implicit allocation “rents” (generated income) are not discussed here, as they are currently discussed in the Tariff Framework Guidelines. Vattenfall is of the opinion that this discussion is not held in such detail in the FG and should therefore be addressed here. For us, the possible preference for the use of implicit auctions above the use of arbitrage heavily depends on the way in which capacity cost and the price difference between hubs is allocated. Vattenfall would not support a socialization of the capacity costs of implicit allocation over other capacity tariffs, as this creates a possible discriminatory differentiation between different types of capacity allocation. In addition, it does not seem likely or sensible to allocate any profit from implicit allocation, which came from the commodity, to TSOs, as they should not be involved in the commodity market unless this falls within their tasks of managing the system. We believe the true effects of implicit allocation can only be assessed when viewed in light of a certain method of cost and revenue allocation.
- Exclusivity: This issue is not addressed with so many words in the draft position paper. If implicit allocation is applied, there are several ways to fit it into the existing market with its explicit capacity auctions and continuous commodity trading. We believe, like with cost and revenue allocation, the discussion on the effects of implicit auctions on the market cannot be held without addressing this point. Most likely, the continuous commodity market, as we currently know it, will be (temporarily) suspended when implicit allocation is applied. This could have an impact on market parties, with or without existing capacity contracts, with commodity requirements, as they may not be able to trade in either market for a set period of time. These practical elements must be discussed at the start and included in the position paper.

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?

Please see our response to question 10.

We trust that our comments to the consultation are useful and will help the GRI NW to assess the way forward on this issue. In case you have any questions or comments or want to discuss the issue and our response further, please do not hesitate to contact us.

Yours sincerely,

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