



**Secondary Markets - the way to deal with
contractual congestion on
interconnection points –
An EREG Conclusions Paper**

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Executive Summary

The consultation on secondary markets launched in May 2007 received 16 responses from stakeholders in the form of answers to the paper's questions and by providing additional advice.

- The respondents broadly agree that improvements of market mechanisms in secondary markets are necessary and possible all over the EU. In particular, transparency, a short implementation lead time and standardisation of products and services were called for.
- The establishment of a central platform for anonymous trading with bundled products has been supported by the respondents. However, a few respondents suggest not outlawing bilateral and separated trading of secondary capacities.
- Numerous ideas were put forward on how to improve primary capacity markets. Improvements achieved in this field were seen as a prerequisite of a functioning secondary market which, in turn, efficiently contributes to solve contractual congestion.

In the light of these comments ERGEG recommends drastically reducing the implementation lead time and – depending on member states law – establishing mandatory or non-mandatory central trading platforms. TSOs should be incited to take a more active role in solving congestion.

The very important issue of primary capacity allocation and congestion management, including congestion management via new primary capacity development, should be addressed by ERGEG in 2008.

ERGEG will work on improving the current guidelines annexed to Regulation 1775/2005 on Capacity Allocation Mechanisms and Congestion Management Procedures in 2008.

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1 Introduction

1.1 Public Consultation: The way to deal with contractual congestion on interconnections points (10 May 2007 - 4 July 2007)

On 10 May 2007 ERGEG launched a public consultation on Secondary Markets – the way to deal with contractual congestion on interconnection points – An ERGEG Public Consultation Paper [E07-GFG-22-14a] (hereinafter ERGEG Public Consultation Paper), which is based on the responses to a questionnaire “Primary and Secondary Markets on Interconnection Points” conducted in the North West gas region of the Gas Regional Initiative (November 2006)¹.

In this public consultation document on secondary markets, ERGEG asked stakeholders the following consultation questions:

Consultation question A:

Please comment on whether you feel the outcomes of the qualitative and quantitative study on the performance of the secondary market in the North-West gas Regional Energy Market of the Gas Regional Initiative reflect the performance of the secondary markets in the whole of Europe.

Consultation question B:

Please advice on how you suggest improving the secondary market design for transportation capacity products (e.g. week/month/season/year(s)).

Consultation question C:

Please comment on the possible ideas to enhance Use It or Lose It (UIOLI) provisions. Which possible (positive) incentives are there for shippers to offer capacity on the secondary market?

Consultation question D and E:

Please comment on the final thoughts for the way forward. Please feel free to provide us with additional comments.

The responses to these questions will be evaluated in this paper. Based on the evaluation, recommendations and conclusions will be provided.

¹ On 21st of June ERGEG organised a workshop attended by EFET and GIE/GTE. In this workshop various ideas on improvement of secondary market and its incentives were discussed. These workshop results are also considered as input for this public consultation.

1.2 Responses received

EREGG Public Consultation Paper received 16 responses. Out of these responses, 14 were non-confidential and two respondents requested confidentiality. Table 1 shows the list of non-confidential responses received. All non-confidential responses are published on EREGG's website². The list of respondents shows a good mix of different types of individual market participants (from all stages in the gas value chain). In addition, three representative organisations (representing the different steps in the gas value chain) have responded.

Table 1: List of non-confidential responses

Company/Organisation
British Gas
Centrica
Edison
EFET ³
ENI
Eurogas ⁴
ExxonMobil
Gas Terra
GEODE
GTE ⁵
Merrill Lynch
RWE
Shell
Statoil

1.3 Relevant recent developments

EREGG presented to stakeholders a working paper for discussion in May 2007⁶, which enclosed some draft recommendations on the operational design of the secondary markets and pointed out some impacts of the primary markets.⁷ Some of the comments received are based on this paper, too.

² cf. http://www.ergreg.org/portal/page/portal/EREGG_HOME/EREGG_PC/ARCHIVE1/Secondary%20Markets

³ Representative organization, please refer to website for a member overview:
<http://www.efet.org/Default.asp?Menu=82>

⁴ Representative organization, please refer to website for a member overview:
http://www.eurogas.org/organisation_members.aspx

⁵ Representative organization, please refer to website for a member overview: <http://www.gie.eu.com/>

⁶ Secondary Markets: The Way to Deal with Contractual Congestion on Interconnection Points? REF: E07-GFG-22-14.

⁷ Download this at
www.ergreg.org/portal/page/portal/EREGG_HOME/EREGG_PC/ARCHIVE1/Secondary%20Markets

European Association for the Streamlining of Energy Exchange (EASEE)-Gas will issue a Common Business Practice (CBP) on secondary trading in capacity for consultation in late 2007. The CBP will especially focus on the implementation lead time.

2 Consideration of Responses

2.1 Reflection of the situation in the whole of Europe (Question A)

2.1.1 Recap of ERGEG Public Consultation Paper

ERGEG Public Consultation Paper was based on an analysis of the performance of secondary markets in the North West (NW) region. The consultation document raised the question of whether the findings of this analysis reflect the performance of secondary markets in the whole of Europe.

2.1.2 Respondents' view

The vast majority of the respondents state that in principle the findings are also applicable to other interconnection points across Europe. Even though differences based on prevailing market structure, e.g. in terms of number of players and source portfolio, exist, secondary market trading remains weak due to a very low level of activity of capacity traders on the secondary markets.

2.1.3 ERGEG's view

There seems to be broad agreement among market participants that secondary capacity trading is not working effectively throughout Europe. The answers to the ERGEG Public Consultation Paper confirm ERGEG's assumption of a generalisation of the findings of the analysis in the NW region. Furthermore, these findings are also confirmed by the European Commission's Sector Inquiry from January 2007.

2.2 The design of the secondary market (Question B)

2.2.1 Implementation lead time

2.2.1.1 Recap of ERGEG Public Consultation Paper

ERGEG's Public Consultation Paper identified the relatively long implementation lead times as a key impediment to short term capacity trading. As the analysis in the NW region has shown, Transmission System Operators (TSOs) took up to 10 days (average 4-5 days) to ratify a capacity transaction.

2.2.1.2 Respondents' view

It appears most market parties agree that the long lead-in times make trade in secondary capacity on a short-term basis (i.e. day-ahead, week-ahead) practically impossible. There was general consensus among respondents that the lead times need to be shorter, preferably down to a maximum of few hours. Respondents also made reference to the CBP on secondary capacity trading currently under approval within EASEE-Gas⁸.

2.2.1.3 ERGEG's view

We believe that requiring all European TSOs to reduce their implementation lead time will reduce one major barrier for the liquidity on the short-term secondary market⁹.

2.2.2 Concentrating supply and demand

2.2.2.1 Recap of ERGEG Public Consultation Paper

ERGEG Public Consultation Paper highlighted that the design in place for concentrating supply and demand is an important factor in the success of a market. In this paper it was explained how the successful concentration of supply and demand is determined by:

- the market mechanism in place,
- the platform facilitating this market mechanism,
- the type of transfers which are allowed.

ERGEG Public Consultation Paper signalled a number of flaws with the manner in the market mechanism and the actual facilitation of this market mechanism in the NW-European region. The paper identified the work on a pilot for short term (day-ahead) trade in secondary capacity rights, initiated by the European Federation of Energy Traders (EFET) and supported by ERGEG, as an opportunity for a study on improving the concentration of supply and demand on the European secondary markets.

⁸ An update of the current status (3-9-2007) of the CBP workgroup (as presented by EASEE gas):

“EASEE-gas, through the development of the Common Business Practice (CBP) on secondary capacity trading, is aiming to shorten transaction lead times and harmonise the secondary capacity transfer process throughout Europe in an attempt to improve liquidity of secondary markets and increase the use of capacity. The members of the EASEEgas task force, including several European Shippers and TSO's, have reached agreement on the CBP proposal and have submitted this to EASEEgas for approval.”

⁹ Regulation 1775/2005/EC, Art. 8 states that: “Each TSO shall take reasonable steps to allow capacity rights to be freely tradable and to facilitate such trade.” During the already mentioned pilot focused on improving secondary trade on Oude Statenzijl and Ellund the TSOs involved agreed that a reasonable step is the reduction of the implementation lead time to a minimum of three hours. We invite all European TSOs to cooperate with the EASEE gas project.

2.2.2.2 Respondents' view

The majority of respondents support the view that auctions are the most beneficial market mechanism for promoting liquidity on the European secondary markets. Auctions are seen as the preferred mechanism especially for short term products. However, a number of respondents indicate that other market mechanisms, such as continuous trade or Over-The-Counter (OTC), ought to remain optional. In addition, respondents point out that platforms which actively support the market mechanism, so-called trading platforms, are necessary. Some respondents are of the opinion that the trade of capacity rights should continue to be allowed on the basis of bilateral transfer, assignment or usage/sublet. TSO involvement is in any case required, especially for registration of transfers (the implementation lead time) and issues such as checking credit worthiness where necessary.

2.2.2.3 ERGEG's view

ERGEG understands that the comments as a whole support the view that an online, user-friendly, and secure cross-border trading-platform(s) needs to be established. However, the response to the ERGEG Public Consultation Paper showed how the opinions on the right market mechanism for concentrating supply and demand on such a platform seem to differ. It appears that a market party's preference for a certain market mechanism depends on its activities on the commodity market and the type of capacity product (short term vs. long term) it is interested in buying or selling. Early indications of the pilot project in the NW-European region show that platform operators offer a range of different market mechanisms which allows market participants to choose their preferred mechanism. We propose to study the outcomes of the pilots, mentioned above, on Bunde and Ellund and to see what type of market mechanism is most preferred by the market during this pilot. However, it will be up to the market parties to decide what type of platform they prefer to trade secondary capacity rights on.

2.2.3 Provision of information on the secondary market

2.2.3.1 Recap of ERGEG Public Consultation Paper

ERGEG Public Consultation Paper identified the lack of transparency on available capacities, prices and capacity products as one of the main shortcomings in the design of the secondary markets.

2.2.3.2 Respondents' view

All market parties agree that more transparency is required on the outcomes of the transfers on the secondary market. However, it is the degree of transparency that is the subject of discussion. Some respondents advocate full anonymity for the trading shippers (which implies that only information on general market outcomes can be published), while other respondents argue for publication of shipper specific information.

2.2.3.3 ERGEG's view

A compromise therefore needs to be found between providing sufficient information for shippers in order to make the most rational decision possible and at the same time providing sufficient anonymity to prevent anti-competitive behaviour.¹⁰

The TSO should be encouraged to facilitate trading by creating a platform allowing for anonymous transactions. It will be the task of the National Regulator Authority (NRA) to check the performance of the platform on the anonymity issue and to ensure that the platform operates in a non-discriminatory manner. Furthermore we suggest to limit the information presented on the online platform to general market outcomes and to provide no information on the outcomes of individual transfers. In this way the anonymity of individual parties will be protected, while on the other hand shippers will have sufficient information to make rational decisions concerning trade on the secondary market. These anonymous platforms may or may not be mandatory. Subject to national laws, shippers trading on the secondary market may or may not be free to choose platforms.

2.2.4 Bundling of exit and entry capacity on the secondary platform

2.2.4.1 Recap of ERGEG Public Consultation Paper

ERGEG Public Consultation Paper makes reference to the NW region, where a pilot project was initiated with the aim to set up a platform for the trade in secondary market capacity in order to facilitate auctions of bundled day-ahead exit-entry capacity products on both sides of an interconnection point.

2.2.4.2 Respondents' view

Although the bundled offering of secondary exit and entry capacity rights on a platform would reduce the overall costs involved in a transaction, not all shippers are automatically in favour of such a measure. Some respondents voiced fears of far-reaching restrictions for market participants if only bundled secondary capacity products are offered.

¹⁰ One has to remain aware that the relatively low number of players on certain interconnection points will make it possible for other shippers, with sufficient insight on the position of other shippers, to determine on the basis of generalized market outcomes, who sold what to whom. However, on the most prominent interconnection points in the European region the number of players is such that it is not very likely that shippers will be able to do so.

2.2.4.3 ERGEG's view

Along with the majority of respondents, ERGEG is convinced that the trade of bundled capacities will help to reduce the capacity bottlenecks, to enhance transparency and to concentrate the gas-liquidity at the hubs. However, at the same time some responses made it clear that these market players feel a need for the flexibility to also opt for trading in non-bundled capacity rights¹¹. ERGEG sees the development of cross-border secondary trading-platforms as a prerequisite for the bundled offer of capacity products. Although the offer of bundled products on the primary market is not a prerequisite for the trade in bundled products on the secondary market (the platform could actively bundle secondary entry and exit capacity), the development of primary bundled capacity is a very important condition for improving the liquidity on the secondary market.

2.2.5 Standardisation of contracts

2.2.5.1 Recap of ERGEG Public Consultation Paper

A transaction on the secondary market requires a shipper-shipper contract, or in the case a Central Counter Party (CCP) is involved, shipper-CCP contracts. ERGEG Public Consultation Paper addressed the need for standardised contracts as a prerequisite for the development of a liquid secondary capacity market.

2.2.5.2 Respondents' view

Respondents agree on the importance of standardised contracts for both sides of an interconnection point. This should be accompanied by the harmonisation of products and services and the creation of a common trading framework. As a particular field for standardisation, credit assessment procedures were mentioned by some respondents.

2.2.5.3 ERGEG's view

The responses received reaffirm ERGEG's view on the need for standardized contracts and harmonised products. In this context we would like to remark that EFET has indicated on several occasions that they are working on a standard contract for the transfer of capacity rights between shippers. However, the current status quo on harmonisation of the access conditions for the different European TSOs now appears to make this a challenging task¹².

¹¹ In principle we prefer the trade in bundled capacity rights. However, we feel that as long as primary capacity rights are not yet bundled, it is desirable that shippers are still allowed to trade on the secondary market. If a buying shipper only requires individual entry or exit capacity, or if a selling shipper is only in the possession of individual entry or exit capacity, it is desirable that these shippers are still allowed to trade these unbundled rights on the secondary market.

¹² This is a preliminary assessment, based on the experiences of the ERGEG day ahead capacity pilot project.

2.3 Thoughts on the incentives like UIOLI (Question C); ideas on the way forward and additional comments (Question D; Question E)

The comments on these issues deliver a widespread spectrum of ideas and recommendations to improve the secondary markets and – for most of the comments – to improve the primary markets. They could be divided into two groups: ideas concerning the provision of incentives for trading on the secondary market and ideas concerning other means of ‘recycling’ unused primary capacity rights.

2.3.1 Incentives for trading on the secondary market

2.3.1.1 Recap of ERGEG Public Consultation Paper

ERGEG Public Consultation Paper suggests changes in primary markets, which incite primary capacity holders to offer their unneeded capacities on the secondary market. In the working document, some of these incentives are drafted, e.g. covering of back-up-needs by balancing, bundle and harmonisation of capacities, improvement of transparency for interruptible capacities.

2.3.1.2 Respondents’ view

The respondents agree on the necessity of broad improvements of primary capacity allocation and provided several recommendations for positive incentives:

- *“Better use of interruptible capacities will have a positive impact on the liquidity of primary and secondary markets”,*
- *“Incentives for TSOs to sell more firm primary and in particular for traders to buy more interruptible capacities, what requires by far more and better information on risks of being interrupted”,*
- *“Bundling of exit and entry capacities even on primary markets”,*
- *“Harmonisation and standardisation of products”,*
- *“Auctioning of primary capacities”.*

2.3.1.3 ERGEG’s view

The comments demonstrate that there are a lot of ideas concerning incentives for trading on the secondary market. The respective contribution received in this consultation is a valuable input to ERGEG’s work on the design of the primary market which is envisaged for 2008.

2.3.2 Improving the ‘recycling’ of primary capacity rights

2.3.2.1 Recap of ERGEG Public Consultation Paper

The question of how a stricter application of firm UIOLI could be done was discussed in the ERGEG Public Consultation Paper. Some more negative incentives are drafted within the working paper¹³, such as buy-back-options, a limit of re-nomination rights or capacity release.

¹³ See footnote 6 above.

2.3.2.2 Respondents' view

Some comments are very clear with respect to refusing any tackling of the rights of primary capacities. On the other hand, some respondents recommend fundamental solutions, e.g. ownership unbundling to solve capacity problems was suggested by a respondent. Below are a number of suggestions raised by the respondents on improving the amount of recycled unused capacity rights:

- *“Enhancement of “rucksack”: Even the entry-capacity goes with the customer”,*
- *“Stricter application of UIOLI with large capacity holders”,*
- *“Publication of detailed reasons of interruption may lead to a higher level of firmness of interruptible capacities.”,*
- *“Enhancement of UIOLI to Use It or Get Paid for It (UIGPFI) which means a payment to the capacity-holder in case of surrendering its capacity”¹⁴.*

2.3.2.3 ERGEG's view

The respondents' comments are demonstrating that there are a lot of ideas concerning capacity allocation mechanisms and congestion management procedures. The focus on secondary markets was a good starting point and should be followed by a more general view on these issues. The respective input received in this consultation is a valuable input to this upcoming discussion.

¹⁴ Article 2.2. (2) of Regulation 1775/2005/EC establishes that the primary capacity holder has the right to offer his capacity to the secondary market against a reasonable price. In the event the capacity goes unused, the TSO shall make this capacity available on the primary market. The revenues from this released capacity shall be split.

3 Conclusions and Recommendations

The Public Consultation confirmed that NW-EU situation is applicable to the whole of the EU. Access to interconnection capacity between the different European transmission networks is key to creating one internal market. The market potential of the current infrastructure is far from fully utilized. At the moment, many interconnection points suffer from contractual congestion, which implies that not all physical capacity is being used. Addressing the issue of contractual congestion is seen as a clearly recurring theme throughout the whole EU.

We see that, on the one hand, improving the design of and facilitation by TSOs of the secondary markets is a must. On the other hand, we observe a need for improvements in the primary market, focusing on improving the overall utilization rate of primary capacity rights and on improving the amount of recycled capacity. The consulted parties agree that measures are necessary and come forward with various ideas but urge to be careful when implementing concrete measures in practice. One general line occurs after careful analysis: TSO's are to take a more active role in solving contractual congestion.

3.1 Improving the performance of the secondary market

TSOs are encouraged to actively work to establish centralised (1 counterparty) trading platform with the possibility of trading cross border bundled products where they exist on the primary market and the possibility of daily (concentrated liquidity) anonymous trading via central counterparty. Shippers trading on the secondary market should be free to use such a platform or not. Furthermore we feel that it is the responsibility of TSOs to drastically reduce the implementation lead time of a transfer between two shippers from up to ten days to up to a few hours.

ERGEG will carefully consider if the same centralised EU secondary market design needs to be implemented in the whole of the EU. We believe that the outcomes of work on the secondary pilot within the NW region of ERGEG's Gas Regional Initiatives could be awaited for that. Based on the outcomes of additional study, one could choose an obligatory solution for the whole EU and design guidelines in 2008. However, we would like to stress that this is just an option; further study and discussion will shed more light on what the best way forward will be. In addition the North/ NW pilot will shed more light on the manner in which TSOs are to actively participate in improving the performance of the secondary market transmission capacity rights.

3.2 Improving the overall 'recycling' of unused primary capacity rights

Due to their 'ultimate responsibility' for providing shippers with access to transmission capacity, TSOs should improve the offer of interruptible capacities (bundling cross border, better information on interruption, more harmonisation in timing of offer of that capacity etc.) and start reporting to the market and regulators regularly on how they apply UIOLI provisions and offer unused capacity to the market. National regulators should closely monitor these efforts.

Concerning improvement of other congestion measures, we believe that a possible no-regret measure could be the requirement (if necessary), by legislation, of a more active role and responsibility for TSOs in solving contractual congestion. A possible way of forcing TSOs to take such an active role is to attach financial consequences to a TSO's failure to prove to the regulator that it has given its best effort to solve congestion.

EREG will work on improving the current guidelines annexed to Regulation 1775/2005 on Capacity Allocation Mechanisms and Congestion Management Procedures in 2008.