The European Regulators Group for Electricity and Gas

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Response to ERGEG Consultation: Gas Balancing, An ERGEG Discussion Paper For Public Consultation (18 July 2005)

Merrill Lynch Commodities (Europe) Trading Limited (MLCE) appreciates the opportunity to comment on ERGEG's gas balancing consultation.

MLCE considers that efficient gas balancing arrangements are a core part of the measures required for the development of efficient traded markets. Along with entry-exit systems and market based allocation of capacity, gas balancing allows market participants to undertake efficient intermediation and develop confidence that gas can be marketed close to the day.

We support the view that shippers should be responsible for primary balancing actions and that TSOs should focus on residual balancing. Defining shipper responsibility will encourage greater liquidity, and reduce the chance of the TSO crowding out commercial activity. ERGEG are correct to identify issues such as shipper incentives and the contractual avenues available to the TSO for balancing.

- Commercial incentives for shippers should relate as far as possible to market priced cash-out. It is important for shippers to be able to assess the likely costs of imbalance so that the exposure can be managed.
- In markets where imbalance costs have been volatile and difficult to assess, shippers have sometimes reacted by taking the safe option which can be detrimental to trading activity.
- Incentives for shippers could include dual cash out models where long and short players receive (pay) a price differential to the market to cash out imbalance positions. In liquid markets we would prefer single cash out models, but we recognise that the level of liquidity required is often not present in developing markets.
    - The differentials to the market price need careful assessment. In our experience TSOs seem keen to pass as much risk as possible onto shippers, and this could be achieved by setting penal cash-out prices, rather than choosing some market based measure.
    - The additional approach of using marginal prices set by the TSO would also create incentives on shippers to balance and would set imbalance prices in a manner likely to meet the requirements of cost reflectivity.
- The way in which a TSO participates in the market for balancing services is also very important and needs to reflect the level of market development. In less developed

markets, the TSO is likely to require more services as the balancing risks are greater. In more developed markets, shippers are better able to access services that can be used to meet primary balancing goals should market trading alone prove insufficient.

  - Careful consideration is needed on how TSO's acquire and use services for balancing purposes. Regulators need to assess the level of risk and to provide a framework that allows a TSO to meet its obligations, without crowding out shippers. If for example, a TSO contracted heavily in the market (including long term tools) then a shipper's ability to undertake primary balancing may be reduced and this could justify further market intervention by the TSO.
  - Markets are stimulated by TSOs having to participate in short term balancing activity.
- TSOs are likely to have more information than the rest of the market on the state of the system, so its actions will be watched carefully by the market and may act as a signal on the state of the system. This responsibility will require the TSO to act in a manner that is consistent and efficient. Importantly, some of the focus is taken off the TSO when information transparency is improved (for example on line pack, supply and demand and overall state of the system).

In developing gas balancing zones, we consider that larger zones are better for the development of trading liquidity. However, the assessment of TSO risk is an important factor in determining the size of such trading zones. If TSOs are allowed to minimise risk there will be a tendency toward multiple zones within and across networks. This is detrimental to the development of trading as the fragmentation of liquidity will lessen a shipper's ability to manage imbalance positions. Regulators need to assess the risk factors that drive the creation of multiple balancing zones and consider measures that can minimise this outcome.

- Larger balancing and trading zones increase security of supply as larger areas should be better able to manage locational supply or demand issues. It would also increase the volume of balancing services available for the system operators.

Specific consultation questions

Question (1)
Are there other features that should be reflected in a gas balancing regime to help ensure efficiency and to maintain safety and security of the system?

The use of market based procedures for the TSO to obtain balancing services is appropriate, but consideration should be given to the way in which these services may affect other market players. For example, we would expect that balancing services should reflect the need for short term gas sales or purchases, rather than annual quantities much better suited to operational gas. It a TSO decides to obtain balancing services that are longer dated it risks crowding out shippers seeking services that may be useful for primary balancing actions. If shippers are outbid (which is likely as a TSO may pass costs through) then the shippers primary balancing role becomes more difficult, and a TSO may have to undertake larger amounts of 'residual' balancing.

By restricting the TSO to short term balancing actions there is also the benefit of stimulating short term market activity. The short term actions may also provide useful pricing signals for cash out calculations (see discussion under question 2).

Question (2)
Should the incentives to balance become stronger the further away a shipper is from being in balance or are there are [sic] other ways of ensuring that shippers have appropriate incentives to minimise their imbalance positions? Should shippers be allowed to trade their imbalance positions on any ex-post basis as a way of improving overall efficiency?

As noted above in our general comments, the use of market based prices for cash out is the best possible starting point. We are not sure whether setting up multiple bands for imbalance prices is necessarily efficient, as bands and price differentials will require constant reassessment. A pragmatic approach could involve small charges above and below market rates to ensure that there is some cost of imbalance. In addition, consideration could be given to using TSO energy trades to set some marginal prices for cash out.

- Opting for small fixed differentials and using TSO energy trades for some marginal price setting will reduce the chances of having to reset bands and will provide more stability in the arrangements.
- Regulators should avoid the introduction of penal regimes to encourage shippers to balance as these will only reduce trading liquidity and will require subjective assessments on prices. Further, there may be regulatory or legal hurdles for TSOs being able to impose penalties.

We consider that ex-post trading of imbalances would improve efficiency. The activity does not alter the TSO's position, but it will reduce the imbalance revenues that it would have to recycle. By having the industry manage some of the imbalance costs, the TSO is less exposed to concerns about non-discriminatory returns of imbalance revenue. Incentives on shippers to balance will not alter too much as the cost of trading out of imbalance positions is likely to be only marginally less than being cashed out.

Question (3)
Does hourly balancing create any barriers to the development of competition?

We believe that hourly balancing is detrimental to the development of competition because it restricts the development of the traded market. Our experience in hourly markets is that the arrangements are overly complex and that liquidity is fragmented. Further the inability to access flexibility that matches the balancing period increases the risk of facing imbalance charges. When these charges are high there is little incentive to 'market' gas at the traded point, so most participants only use trading to shape portfolios rather than to buy or sell significant volumes of gas. The lower liquidity has an effect of reducing price discovery and hampering the development of other risk products that could be used by customers.

Balancing systems that are daily based allow more time for shippers to manage positions and therefore develop more confidence to take positions based on fundamental views.

Question (4)
What information is required to ensure that gas balancing regimes operate effectively and efficiently and how often should this be provided? What is the best way of ensuring that this information is provided to all parties on a non-discriminatory basis?

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Information transparency is an important aspect of any balancing mechanism that relies on greater actions from shippers to manage primary imbalances. If imbalance charges are set based on market prices, shippers will need to understand the current state of the system.

- For example, if imbalance charges are set based on a TSO's system trades, a shortage of gas in the system will mean that that the TSO will buy gas and possibly set higher imbalance charges. If shippers were aware that the system was short, prompt market prices would likely increase and this would act as a signal for short players to reduce imbalances prior to any TSO action. The market signal allows the TSO to avoid taking actions and therefore minimises the amount of residual balancing.

The minimum level of information required is an assessment of the expected demand, the starting line pack and projected closing line pack. Information releases should occur in regular intervals during the day. Where possible, consideration should be given to the provision of supply information on the most disaggregated level possible. By understanding the stocks and flows on the system shippers can assess the best way to deal with imbalance positions.

- All information should be provided on web based media to ensure that access is simultaneous to market participants.

Question (5)
Should line pack (where technically feasible) be made available to shippers on a non-discriminatory basis to improve access to flexibility? Are there any other steps that could be taken to improve access to flexibility that would not impinge on the safety and security of the system?

The provision of line pack always appears to be a good idea, but even in more liberalised markets such as the UK this has proved very difficult to implement.

- Marketing line pack will reduce the level of system security available to the TSO unless it can be demonstrated that the line pack is genuinely surplus to requirements.
- Line pack valuation will be affected by the cost of alternative flexibility tools such as storage. Line pack services could be expensive in some markets if storage is not fully commercialised.
- The changing supply dynamics in Europe in addition to the introduction of more competitive forces could alter the way in which gas flows in many TSOs. Line pack may provide a buffer to such system flow changes. If a TSO sells these services but is unable to deliver, there may be additional costs for other shippers.

Overall, we do not believe that line pack services should be a focus at this stage. As a flexibility tool it should rank below the use of storage which is still far from being fully commercialised.

Question (6)
Do differences between (neighbouring) gas balancing regimes distort or [sic] the incentives provided to market participants? If so, what degree of consistency would be appropriate to overcome these problems? Would there be any disadvantages from introducing more consistency in features of (neighbouring) gas balancing regimes? How could this consistency be facilitated – for example would legislation be required or could it be achieved through better co-operation between regulators and TSOs in different Member States?

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Different gas balancing regimes will impact on the way in which market participants assess and deal with issues. Consistency in gas balancing regimes would have a number of advantages in terms of reducing the level of complexity and lowering the risk of inefficient use of flexibility.

- Lower levels of complexity will reduce the barriers to entry. Understanding one balancing market will allow a shipper to more easily expand into other markets. Large difference in approaches would require more specialisation and cost.
- Efficient use of flexibility emerges when it can be used in markets that value it most. If gas balancing charges are penal, flexibility will be drawn to these markets in order to avoid charges. If flexibility is diverted by inefficient charges then this is a tax on the neighbouring market which will have to find alternative (and more expensive) solutions.

Systems, as physical assets, are unlikely to be homogeneous. We would expect that TSOs would not want to be held to a single gas balancing solution as this may not be efficient. However, work by EASEE-gas has shown that pragmatic steps can be taken to improve the interactions between different European markets.

We do not believe that additional legislative approaches are needed at this stage. Existing rules would, if implemented effectively, provide sufficient impetus to further market development. MLCE does not consider that there is a choice between more legislation and better co-operation. Better co-operation between TSOs should be the result of mutual interest if the TSOs are operating in a way to develop better services for all clients, and Regulator co-operation should be occurring through the various fora.

Question (7)
Would cross-border (or international) balancing zones help facilitate the development of competition in gas across Europe? What technical, legal and practical issues would need to be overcome if cross-border balancing zones were introduced? What impact could cross-border balancing zones have on the development of hub based trading and regional markets (see for example the recent ERGEG document on regional markets in electricity)?

Cross-border balancing zones may very well help the development of competition. Larger, efficient zones would increase the amount of trading liquidity and hence sharper price discovery. Greater liquidity also enables the creation of better risk products for consumers. Larger zones would also speed the development of trading hubs, as cross border hubs have been stymied by the lack of co-operation between TSOs which has resulted in hub services that are often inferior to those a company could achieve by dealing with each TSO separately.

The practical issues facing greater zones are:

- TSO co-operation – which is not as evident in gas as it is in power. There is a question whether unbundling of TSOs from marketing arms has been sufficiently robust to allow TSOs to operate without concern for the costs of competition on other parts of the undertaking.
- Depending on the zones or regions, early clarity will be required on taxation issues as well as legal certainty on where activities take place. Without clarity, many shippers will simply assess the potential risks unfavourably and may decide to not participate in markets.

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- Transparency will have to be very high, as the TSOs will be responsible for managing periods of constraints. Typically constraint costs are put back on the industry and if so it should be able to assess the performance of the TSOs to ensure that the most efficient remedies are being used. For gas balancing, this will require regular briefings on incidents and issues.
- Regulatory jurisdiction should also be determined. Should a balancing zone fall across borders, shippers should know how disputes and investigations will be held and how any penalty regime will operate.

Question (8)
Would it be appropriate to increase the level of consistency between balancing rules for transit and transportation systems?

The first step should be greater clarity between transit and transportation. There is a view that transit somehow receives lower regulatory scrutiny so this encourages many TSOs and shippers to claim that flows are transit in nature, even though systems can have a number of input and off take points.

Increased consistency between transit and transportation may have benefits of reducing complexity, but as the two services are different (if properly defined) then it would not be unreasonable to expect balancing rules to also differ.

Question (9)
Would the introduction of Operational Balancing Agreements (OBAs) between transit and transportation systems improve transparency on how the balancing regimes interact? If so, what should be included in OBAs?

In general, the use of OBAs between different TSOs should be examined, particularly if there is a desire to create regional balancing zones.

For transit and transportation, OBAs could reduce some of the risk that certain parts of the system are being supported at the cost of others. But this will require greater transparency to ensure that any interaction between transit and transportation does not lead to prioritising balancing services for particular customers.

We would not want to see any cross subsidisation between the different types of services. For example, using transportation flexibility to support transit flows may increase balancing costs for one customer at the cost of another.

I trust that you find this response useful for the consultation. If there are any areas you wish to discuss further I can be contacted on +44 (0)207995 9021 or by e-mail at adam_cooper@ml.com.

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