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Dear Arina,

RE: Open letter: Call for evidence on the use of the gas interconnectors on GB's borders

E.ON welcomes the opportunity to respond to this call for evidence. Above all, it is critical to note that we do not see a serious market failure issue here. We believe that the cross-border gas flows under consideration here are generally economically efficient, but there are some instances of inefficiency that perhaps need to be better understood.

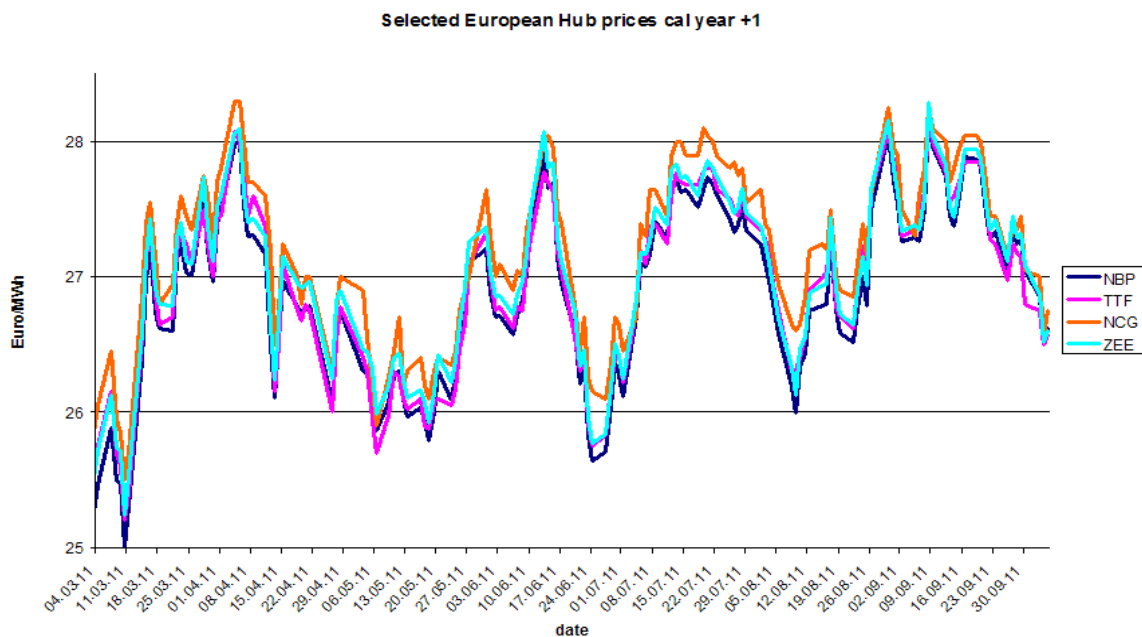
Whilst it is clearly important to give due consideration to issues which may be hampering cross-border gas flows, our view is that given the significant amount of recent changes to market rules (particularly in Belgium and the Netherlands), time must be allowed for these new arrangements to properly 'bed in' before considering further significant interventions. We also expect to see the forthcoming European Network Codes improve the efficient utilisation of cross-border infrastructure in future. Nonetheless, in our response we highlight a number of matters which the regulators may wish to explore further before any decision is made on next steps.

Question 1: What are your views on the economic efficiency of cross-border gas flows between GB, Belgium and the Netherlands? How important do you consider this review into cross-border flows to be?

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European Regulators are seeking the implementation of a common internal energy market by 2014. It is our understanding that such a market will be characterised by a common wholesale price and we would expect to see increasing price convergence from 2014 onwards as the common European energy market takes shape. The efficient use of existing and incremental infrastructure has a critical role to play in achieving price convergence between markets. It is important, therefore, that potential barriers to cross-border flows are given proper consideration and a call for evidence to the market is a constructive way of appraising the issues before possible interventions are even considered.

The analysis presented in the initial assessment suggests that cross-border flows between GB and Belgium / Netherlands have not yet reached an economic “optimum”. We agree that economic theory suggests flows against price differentials (FAPDs) should not exist in a pure, economically efficient world. In practice, however, markets are often not as simple as this and rarely achieve an economic “optimum”. It is also important to acknowledge and understand the important difference between “efficient” and “optimum” in any analysis. Sub-optimal usage does not directly equate to inefficient usage, because the law of diminishing returns means that there is often little economic value to be gained from the last few percentage points of optimisation. As the analysis, below, illustrates, prices in the GRI North-West have already reached a level of convergence that would not exist, if pipelines were not being used efficiently.



We believe that the considerable improvements in market design over the last few years, particularly in the Netherlands and Belgium, should lead to more efficient use of transport infrastructure. Whilst it is important to look for opportunities to efficiently improve harmonisation of markets, it is equally important to give parties time to adapt to the new market rules before further changes are introduced.

Question 2: What is your experience with cross-border gas trading between GB, the Netherlands and Belgium? What, if any, are the key barriers to economically efficient gas trades happening across our borders? Please provide any evidence or analysis that would contribute to our understanding of the observed behaviour of cross-border gas flows.

The observed economically inefficient behaviour; namely 'Flows Against Price Differentials' and transport capacity not being used to its absolute maximum, could, in part, be explained by several issues that are not all fully explored in this initial assessment. These include:

The Real Time “Value” of Arbitrage

Market participants may not exploit arbitrage opportunities to a greater extent because the opportunities presented are often less attractive than the initial assessment implies. This is simply because market participants cannot always guarantee that they are able to immediately execute all three legs of an arbitrage trade. This may be due to:

- Price volatility: Whilst there are arbitrage opportunities at day-ahead and within-day, these are subject to very fluid prices in the three separate markets. Arbitrage opportunities that appear to be very clear in an ex-post analysis may be far less clear in ex-ante forecasting and in real-time market operation. For example, a shipper buys NBP gas and wants to sell ZEE gas, but by the time he is about to re-nominate his IUK flows, the ZEE price drops and there is no longer an attractive opportunity.
- There is a real cost attached to unwinding or altering existing trading positions.
- Bilateral credit arrangements and credit limits can hinder the conclusion of deals.
- Shippers may have more pressing and important operational problems to manage on-the-day than simply trying to extract extra value from interconnector positions – e.g. dealing with an unexpected supply contract failure.

Business Models

In the initial assessment, it is noted that the majority of gas shipped across the interconnectors may not be priced according to spot markets and its flow may be determined according to strategies not immediately related to short-term signals. It is important for us to state that those are legitimate commercial strategies, even though they may lead to FAPD, and the scale of their potential impact on the analysis should be considered further.

Cost of Flexibility

Existing capacity holders have contracts in place to supply flexible gas across borders. In order to honour their contractual obligations, the capacity holders may not use their maximum pipeline capacity for a 'balance of day' deal concluded day-ahead, unless they are willing to either (a) take at least a price risk in pure daily balancing regimes (National Grid NTS) or (b) the risk of punitive hourly imbalance charges (GTS and Fluxys).

Marginal Cost of Transport

For network users, the marginal charges imposed for trading between GB and Zeebrugge or between GB and the Netherlands may, in some instances, be hampering cross border trade. For example, we believe that GB SO/TO entry-exit charges at Bacton¹ have an explicit and direct impact on the utilisation of IUK and BBL capacity. It is not clear from the limited analysis presented how these charges have been accounted for in the assessment of capacity utilisation and FAPDs.

Interactions with other Trading Hubs

NBP, TTF and ZEE do not exist in a market vacuum. TTF and ZEE interact with each other and the PEG-NORD and GASPOOL hubs. Price differentials between TTF/ZEE and these other hubs will have an impact on TTF/ZEE's interaction with each other, and with NBP. In some circumstances it might be commercially rational to transport gas against a price difference for one arbitrage opportunity, in order to gain a larger arbitrage spread on the second arbitrage opportunity.

¹ **UK > Continent:** TO charges 0.12 €/MWh, SO charges 0.29 €/MWh and **UK < Continent:** TO charges 0.41 €/MWh, SO charges 0.29 €/MWh

Relative Liquidity

It is well observed that the NBP is the most liquid trading hub in the EU, especially in respect of within-day liquidity, therefore in some circumstances it might be rational to transport gas against a price difference, in order to deliver gas into a market where it can be more easily or quickly sold. In general, there will always be a greater availability of suitable counterparties at NBP than TTF/ZEE and this could also involve lower credit risks / costs and a lower concentration of credit risk.

Question 3: How could current market arrangements be improved so that they better promote the objectives of promoting a competitive internal market, eliminating restrictions on cross-border trade in gas and enhancing the integration of national markets as well as security of supply? In your response, please specifically refer to a) IUK, b) BBL, c) the adjacent market arrangements and d) whether more common arrangements are needed where relevant and possible.

The market changes in Belgium that took effect on 1st October 2012 means that the GB, NL and BE gas markets all now operate on broadly similar models; i.e. virtual hub trading and entry-exit transportation. This change alone should enable more efficient competition and cross-border trade between the three markets. The new rules should also be given sufficient time to become fully integrated into market activity, before further changes are considered.

In terms of the wider European regulatory framework, access to day-ahead and within-day capacity at market-based prices is key to enhancing cross-border trade. For instance, the provisions of the EU Network Code on CAM will provide for such short-term access. They will not, however, provide for market-based pricing if short-term auctions begin at a regulated reserve price which is up to 175% of the respective price of a yearly capacity product, for example. Prohibitive capacity and commodity charges are without doubt the biggest barrier to further integration of NW European gas markets.

Question 4: Should we try to proceed with minimum necessary changes or should the regulators be looking more holistically at a wider review of arrangements that may present barriers? Should we be considering piloting some deeper regional integration or joining initiatives that are already going on in Europe?

This call for evidence will, no doubt, generate a significant number of industry responses and new or alternative analysis may be brought forward, which must, of course, be properly

considered. Therefore, we recommend a proportionate approach, whereby industry responses are first considered and analyzed and the findings then presented back to industry by the regulators. If, in the regulators' view, this should result in compelling evidence to support the case for change, then any proposals for such change must then be consulted on separately to this call for evidence.

Question 5: What process may help us to achieve the best outcome? What role should regulators, market parties and TSOs have in this process? How would it interact with pan-European policy initiatives?

We suggest that particular focus is concentrated on the forthcoming European Network Codes, particularly the Tariffs NC (short-term reserve prices and commodity charges) and Balancing (within-day obligations and charges). It is important that the regulators are involved early and closely in the development of the various European Network Codes to help deliver an efficient European energy market.

Yours sincerely,

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