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Dear Peter,

Taking forward the DA Capacity pilot

I was sorry to hear that Erik Rakhou was taken to hospital after his dedicated work at the Jour Fixe on 31 May. I wish him a speedy recovery and I hope that he will soon return to contribute to the successful completion of the work on Day-Ahead Capacity. Within EFET we have discussed the outcome of the Jour Fixe and I am writing to you to share our views on the way forward. We would be pleased for you to make this letter available to all the GRI participants.

As an organisation focused on improving market performance, the European Federation of Energy Traders (EFET)¹ has sought to improve the mechanisms around the efficient use of pipeline capacity throughout Europe. As a part of these improvements, in October last year EFET proposed a pilot project to determine whether a bundled cross border capacity product focused on a few locations could be co-ordinated by the TSOs for day-ahead capacity allocations through primary firm and interruptible capacity sales, supplemented by secondary capacity from shippers.

The initial response from the relevant system operators was positive, and the North West European Gas Regional Initiative undertook to make the pilot development a key part of its work programme.

Status of the Pilot after 31 May

During the various meetings analysing the pilot, it has become clear that there are a number of potential legal barriers, uncertain system development issues and a general lack of drive to prioritise this pilot for implementation during 2007. Despite the commitment of the regulators in Dublin to form a team to clarify and resolve legal bottlenecks, subsequent meetings have shown that there is still no definitive view on the precise legal challenges, neither is there

¹ Established in 1999, the European Federation of Energy Traders (EFET) is an industry association representing over 80 trading companies operating in 20 countries. The EFET mission involves improving conditions for energy trading in Europe and fostering the development of an open, liquid and transparent European wholesale energy market. More information about EFET views and activities is available on www.efet.org

yet a clear plan to overcome them. As a consequence, it seems that primary capacity even on an interruptible basis, has been excluded from the initial pilot project and there are continuing questions and delays regarding secondary capacity.

Does the new scope does meet the objectives of the original pilot?

Last autumn, EFET saw value in quickly developing day-ahead x-border capacity auctions to be on a compatible basis with the day-ahead capacity initiatives like the E-On choice market. EFET also considered that the main purpose of this pilot project would be to learn lessons in 2007 ahead of pursuing larger scale solutions on platforms for enabling the efficient use of capacity.

The GRI work on capacity is yielding useful insights into serious problems with allocation and congestion management, but with regret EFET has to conclude that the new scope arising from the Jour Fixe on 31 May does not satisfy the purpose of the original pilot as proposed on 9 October 2006.

We feel strongly that there is a continuing failure of TSOs to jointly maximise the primary firm capacity that is made available to the market. TSOs must work towards solving contractual congestion and in our view an essential part of the solution will be making primary capacity available to the market in a coordinated, transparent, market-based and non-discriminatory way such as auctions.

We still need a practical way forward to stimulate capacity trading this year

Given the significant changes to the scope of the pilot, particularly the focus on only secondary firm capacity, EFET is proposing a simplification to the product definition so that implementation in 2007 is still achievable:

- The product will be secondary firm entry and exit capacity with optional bundling.
- We should use an OTC platform with continuous capacity trading
- There is still a strong preference to start in areas of expected higher liquidity.
- We should be open with platform providers to agree on appropriate locations, but with the expectation to expand to all major interconnection points

Apart from enabling implementation in 2007, preferably by October, some further reasons for this simplification of the secondary product are:

- The use of continuous trading markets removes some problems with bundling capacity that is only available from shippers, (e.g. dealing with mismatches)
- There should be few, if any, revenue allocation problems

- It facilitates shipper-to-shipper trades e.g. not running in to hidden credit issues
- The traded market would provide greater flexibility rather than aiming for activity on a time-line linked (as was proposed last year) with a choice market whose continuation is now less certain.

To ensure that the necessary shipper-to-shipper agreements can be put in place, EFET will commit to the development of a secondary market gas capacity trading contract by September. I can also confirm that EFET members at recent internal meetings have indicated a willingness to participate on a suitable traded platform.

For the platform to be successful, however, Regulators and TSOs will need to:

- Resolve, on a final basis and before a scheme is put in place, the legal issues (if any) that would prevent the implementation of secondary capacity trading
- Implement the necessary system changes, simply to allow the transfer of capacity between eligible shippers within the day. In this respect we welcome the TSO proposal on 31 May of implementing a maximum lead time of 3 hours
- Ensure that full aggregate information on capacity and flows is made available to all market participants on an equal basis.

All participants should benefit from capacity trading

The advantages of a functioning secondary market are well known (and are reiterated in ERGEG's recent consultation paper *Secondary Markets: the way to deal with contractual congestion on interconnection points*): they include the reduction in the level of contractual congestion, a more efficient use of network capacity and an ability to match the demands of buyers and sellers of existing sold capacity.

Regulators and consumers also directly benefit because the existence of a platform and active bids can provide the background to any examination of capacity usage and potential hoarding intended to constrain competition.

The Gas Regional Initiative continues to have an important role to play

The lessons coming out of the pilot discussions still need resolution, particularly:

- the need for TSOs to operate harmonised primary allocation, to improve the ability to develop a regional market
- an EU law assessment of the national legal barriers that could be preventing trade or unduly constraining gas flows, together with recommended changes to remove these barriers.

In addition to ensuring that a successful capacity traded market can be established this year, the Gas Regional Initiative has an important role to play to help resolve these issues and to continue to remove barriers to gas trading.

If there are any issues in this letter that you would like to discuss then please do not hesitate to call me, or my colleagues Adam Cooper or Jacques Guldenmundt.

Yours sincerely,



Colin Lyle
European Federation of Energy Traders
Board Members and Gas Committee Chairman

Jacques Guldenmundt, EFET Gas Committee Vice-Chairman
Adam Cooper, Leader of EFET Project Group on Gas Capacity Markets