REN

REDES ENERGÉTICAS NACIONAIS

POSITION ON PUBLIC HEARING

ANALYSIS OF CROSS BORDER TRANSMISSION GAS TARIFFS BETWEEN

PORTUGAL AND SPAIN

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Question 1: Would you agree with the analysis made on current market situation and on the major issues affecting cross border trade between Portugal and Spain?

As other operators in Europe, the Portuguese and Spanish system operators have, for long, cooperated in the joint development of the transmission infrastructure capacity. The incurred costs were in the past recovered by long term contracts with specific users, including ship or pay clauses. This system allowed for years the gas market to grow in both countries and fierce competition with other fuels.

Subsequent network operators' ownership unbundling, regulation and third party access to gas infrastructures, have developed stronger national gas markets with multiple players. Still the same basic concept has been applied: existing costs have to be recovered by the operators.

In this context, "pancaking" has become a misunderstood designation for cross border tariffs that is now clarified by regulators. One of multiple positive aspects about the present study is also the recognition that pipeline operators are entitled to have a fair remuneration for their investments. A cost based tariff system must allow for remuneration recovery of such investments, independently from the location of the tariff source.

The study concludes that, depending the way tariffs are calculated and applied, they may distort the actual incurred costs by the users and prevent the free circulation of gas between both countries. This is a major challenge to NRAs.

In broad terms, REN agrees with the scenarios and main conclusions portrayed in the study, namely the pancaking effect. However, both are based in very specific conditions and do not reflect all the possibilities already available to the market players in order to optimize their cross border costs. The cost of supply from Portugal to Spain and from Spain to Portugal is different, dependent on the country of origin.

REN considers that adjustment of cross border tariffs is necessary but insufficient to induce strong cross border trade. The harmonization of the regulatory framework plays also a fundamental role.

In terms of tariffs and regulatory framework, the current situation is different at each side of the border. Therefore, it is necessary to match regulatory methodologies on both countries to avoid pancaking, in accordance with the guiding principles defined by European Union for the future European Gas Market Model. In particular, harmonization of the regulatory framework applied to similar sets of infra-structure (pipelines, underground storage facilities or LNG terminals) is a critical issue.

Question 2: How do you think that transmission network costs should be allocated at cross border IP (both in Spain and Portugal), taking into account the defined principles (coherence, transparency, cost recovery and cost reflectiveness, etc) and the starting situation of the regulatory tariff framework in both countries?

Cost allocation relates not only to the tariffs at the IPs. It must also guarantee the proper revenues/costs recovery to the transmission networks, underground-storages and LNG terminals operators, without market distortions or cross subsidies between different infrastructures and/or networks. NRAs should be aware of and evaluate these effects in the short and in the long term. The improvements should be implemented in a stepwise manner as suggested in our answer to question 4.

Question 3: Which do you feel are the most important aspects where harmonization (apart from the cross border tariffs harmonization) can contribute significantly to short term market integration?

In addition to tariffs harmonization a number of other aspects should be considered when looking into short term market integration.

Specific actions from NRAs may help to allow a better and more efficient access to cross border capacity. Some specific examples are:

- Introduction of a Virtual Interconnection Point (VIP) to deliver additional firm capacity to the market, overcoming the existing contractual congestion at Badajoz IP and operational limitations at Valença do Minho - Tuy IP.
  As discussed on the SGRI meetings, IPs capacity is still physically available between Spain and Portugal, though not commercially accessible due to some constraints in the Spanish system. Implementation of a VIP would imply that this capacity could be offered as firm capacity to market players. This would be in favor of a more intense use of the IPs capacity although without the TSOs bearing the additional risks of contractual breach or cost recovery loss.
- Allow a certain amount of the global VIP capacity to be available for short term contracts and allow operators to manage more operational flexibility gas (in particular on the Portuguese side) by increasing operational reserves for system management.
- Implementation of the SGRI actions already under discussion or agreed on:
  - Capacity Allocation Mechanism (CAM)
  - Congestion Management Procedures (CMP)

In addition the following should also be addressed with full TSO involvement:

- Harmonization of contract rules;
- Nomination procedures and rules;
- National balancing points and zones;
- Operator Balancing Agreements (OBA);

A proper coordination between the operators and their NRA's on all these aspects is essential to avoid distortions and reduce the uncertainties associated with integration.

Question 4: How would you implement the proposed step-wise approach, aiming for a more integrated market in the longer term?

The internal and regional markets integration is the target behind all European endeavors, reflected in the three EU gas directives and subsequent new regulatory instruments and European wide organizations (ACER, ENTSO-G, etc.).

The challenge of bringing two national networks together within the same market zone, as a single price zone, requires a specific approach taking into consideration all the steps required to achieve the final market model.

At present, the market model is still being discussed in Europe. REN recommends that any action in Iberia should take into consideration the European gas market construction, not risking having a specific model in Iberia that might not match the future European wide market. This approach would thus protect consumers from extra IT costs and inadequate processes or market distortions when integrating in the future the Iberian Peninsula into the European system.

The role taken by the several European wide stakeholders (market players, ACER, ENTSO-G, and other relevant stakeholders) should be addressed, in particular, integrating the efforts of Portugal and Spain with the relevant South Gas Regional Initiative. MIBGAS will therefore be a single first step towards this greater market.

Main principles must be agreed and set prior to any development. REN is in favor of ending the pancaking effect. To achieve this, it is REN' opinion that:

a. **Any system must be sustainable in terms of revenues and cost recognition**

Regulation and tariffs should be harmonized, without cross-subsidies between infra-structures, networks and countries. This goal can be achieved by an Iberian agreed tariff structure.

b. **Costs and revenues remain within each system**

In any scenario of tariff reduction or even tariff elimination at the border, it is fundamental to recognize in advance how cost recovery will occur.

The dominant gas flow is, at present, from Spain to Portugal, therefore cost shifting inside each national system, as proposed in the document, is the preferred cost allocation methodology. Cost shifting is neutral to the exporting country consumers (the decrease in exit commodity price compensates the increase in entry commodity price). For the importing country, the gas origin will reflect the real access costs incurred. This will send price signals to the market and flows will follow the capacity/cost criteria established by the regulatory models and access freely decided by the market.

As alternative to the cost shifting approach, inter–TSO compensation is therefore not seen as the best practice to allocate costs to tariffs in the case of Portugal and Spain because the correct price signals would not be present to the users.

c. MIBGAS Model must be compatible with:

Trading area with two balancing zones as specified in the proposed document. This is seen as an intermediate goal where the players will be able to be in a liquid market situation without compromising future European developments.

In this regard, to achieve the aforesaid goals, REN proposes the following steps

1. First Step

Goals: Reduce price constraints to gas flow at the Portuguese/Spanish border, give incentives to proper access to this interface

1.1. Single Capacity Allocation Mechanism (CAM) and Congestion Management Procedures (CMP) and harmonization of contract rules on both sides of the border; Setting of single cross border tariffs (as cost reflective as agreeable between NRAs) until a common methodology is agreed with cost shifting as referred before;

1.2. Changes in relevant regulatory rules to allow the former, including namely: the creation of independent entry and exit tariffs, to and from a national balancing point in each country; gas-day compatibility; nomination procedures and rules; renomination; OBA (operator balancing agreements) update; balancing agreements, contracts, etc.

1.3. Two balancing zones with a virtual national balancing point (one for each national system);

1.4. Close coordination between the NRAs is essential to avoid market distortions.

2. Second step

Goals: setting of proper tariff system and cross border capacity allocation, promotion of gas trade between the two virtual balancing points.

2.1. Setting of true entry-exit network tariffs based on the principles set up namely by the Gas Directive 2009/73/CE, the European Gas Regulation 715/2009, cost reflective additive tariffs, together with cost allocation harmonization methodologies on both sides of the border. Tariffs will be based on gas flow to and from each virtual balancing point.

2.2. Further reduction of CBT based on the cost shifting mechanism.

2.3. Harmonizing balancing rules and incentives in each network.

2.4. Implementation of the European network code and implementing into national regulations the required adjustments.

3. Third step

Goals: HUB implementation possible by connection of the two virtual balancing points in Portugal and Spain.

3.1. Elimination of CBT.

3.2. Harmonizing balancing rules and incentives in each network.

3.3. Each virtual balancing point still exists in each system but the Global System Managers in each country ensure there are no apparent restrictions (within reasonable limits by the use of extended OBA agreements) to virtual “limitless” connection between the two national virtual balancing points. This means a HUB is possible with a single price zone but with two balancing zones and two independent systems.

4. **Future steps**

Goals: full implementation of the European market model

4.1. To be defined when the proper model is agreed to the Eurozone, taking into consideration the specifics of gas trade and competition. A possible entry-exit Iberian zone(s) could be evaluated in the Iberian Peninsula but the relation with the south of France within the SGRI should be properly addressed. Future connection to other trading areas or zones in Europe must be considered.

Question 5: Would you identify new issues you think are important to create a favorable cross border trade environment? How would you set the timing and prioritization for the discussion on these issues?

To create a cross border trade environment is also necessary to examine other issues. For example, it is necessary to create a common access platform in order to operationalize all the aspects mentioned before.

Another issue that must be considered in this context is the security of supply and all assumptions associated with it. It is important to ensure how this issue will be framed in these new mechanisms and methodologies.

It is important to clarify the role of other infrastructures (terminals and underground storages) in this new model of market operation, proper incentives should be given to operators to develop and implement additional flexibility services beneficial to the market.

It is also necessary to accommodate a proper handling of the existing long-term contracts and their legal terms, respecting the corresponding clauses while ensuring they do not become an obstacle to the operationalization of new capacity and the harmonization of cross border tariffs.