EFET Gas Committee (GC)
European Federation of Energy Traders
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Enabling Secondary Market Gas Capacity Trading

Introduction

The purpose of this paper is to add EFET's views to the debate on the elements required to enable secondary market capacity trading, and to suggest areas of immediate action from all involved parties.

The ability to obtain gas capacity rights is an essential element for operations in European gas markets. With Regulatory pressure on the development of better primary capacity allocation mechanisms and the common situation of capacity shortages, traders are becoming more interested in having a functioning secondary market to ensure the efficient allocation of capacity.

The secondary market plays a vital role in helping market participants manage and shape capacity needs to meet business requirements where the price of traded capacity is determined by agreement between buyers and sellers. The efficient use of capacity ensures that costs are minimised and that the level of capacity sterilisation[1] is minimised.

For the most part, obtaining primary capacity is a bilateral relationship between the market participant and the relevant TSO. This relationship is relatively straight forward where the product is defined, credit arrangements and IT requirements are agreed and the sale takes place. Rules may also apply that place obligations on parties, describe actions following particular events (such as Force Majeure), and outline the financial consequences of default.

The secondary market should be considered as the bilateral sale/transfer of primary (and subsequently secondary capacity) capacity between users. The level of TSO involvement is described in more detail in this paper.

In this paper we consider a number of typical secondary market transactions.

[1] Capacity sterilisation refers to a situation where capacity is effectively withheld from use by virtue of inefficient market practices. For example, penal overrun charges or inflexible allocation mechanisms may encourage shippers to overbook capacity, but closer to the delivery date a shipper may be more certain of expected capacity usage and wish to recoup some of the cost of any spare capacity. Without an effective secondary market, this capacity is never recycled and thus the total capacity of the system is under utilised or is sterilised.

Product	Credit/ Invoice with TSO	Nomination and other operational actions	Description
Assignment (and remarketing)	New owner	New owner	Capacity is sold to a new owner with all obligations passing over. Sale is by agreement with the TSO where such agreement should be possible under the standard primary allocation contract.
Transfer	Original owner	New owner	Capacity is sold by the original owner, but the new owner doesn't have financial obligations to the TSO. The parties' TSO arrangements are broadly unchanged, subject only to the usual nominations applying to the new owner.
Sub-let/usage	Original owner	Original owner	Capacity is transferred for the beneficial use of a new owner, but the nominations are managed by the original owner. The TSO does not need to be a partner in this model.

Capacity arrangements are still developing across Europe, but the nature of the relationship between a market participant and the TSO are reasonably well understood. This paper examines the additional complexity and requirements to enable the development of a more efficient secondary market.

EFET expects that the Transfer product might become more heavily used, but recognises that this will involve the resolution of more TSO implementation issues. All three products are required to allow shippers' choice and flexibility to manage capacity positions in the most efficient way possible.

Main Issues

A number of important issues require clarity in order to promote greater secondary market activity. This paper will examine **firmness, duration, payment obligations, facilitation, credit, default rules, congestion obligations, and nominations and title tracking**.

Firmness

Secondary market capacity rights from the TSO's perspective should have the same homogeneous 'quality' as capacity sold in primary processes. For this to happen, the capacity product must be well defined with transparency on all of the rights and obligations applying to the beneficial owner. As noted below, issues such as payment obligations, credit and default rules should not apply in such a way that will reduce the quality of the firmness and thus the value of such capacity.

Without this, there is a risk of fragmenting the secondary market. When capacity products are kept homogeneous in nature (i.e. firmness), there is a greater ability to re-trade the capacity further and a larger pool of buyers and sellers.

Duration
Capacity trades in the secondary market should not be limited by the duration of the original contract length from the primary market. Sellers of capacity on the secondary market must be able to sub divide their purchased capacity into the smallest element of capacity entitlement such as a day or the relevant balancing period. This will enable the maximum amount of capacity to be made available to the market and ensure that capacity is efficiently used.

Payment Obligations
The initial sale of primary capacity by a TSO to a party creates a contractual relationship. The primary buyer is obliged to pay the TSO for the capacity at the agreed price and under the agreed terms.

When the original buyer seeks to sell the capacity right to a third party, a separate contractual arrangement emerges.

EFET considers that for transactions under the transfer model, the original contract with the TSO should be kept in place so that the primary payment obligation does not alter. The primary buyer maintains the obligation to pay the TSO (and to provide credit), but the new capacity owner now has the value of the capacity including any benefits under the primary contract, i.e. including the market based compensation in the case of curtailment. Some obligations may transfer with the capacity such as the payment of charges linked to beneficial ownership (for example, commodity charges that are paid by the user of the capacity, thus the secondary owner). This approach enables less TSO credit risk assessment and speeds the trading process by removing the need for lengthy TSO approvals.

The same arrangements apply for the sublet/usage model with the exception of the way in which benefits and obligations apply to the 'new' owner. In the case of sublet/usage, the details of the benefits and obligations will be subject to the contractual relationship between the parties.

As noted above, in some cases, the original capacity buyer may wish to remove all existing primary obligations through the sale by assignment of its primary capacity position, perhaps with an intention of exiting the market.

In such a case, arrangements between it and the TSO should allow sufficient scope to transfer capacity to a third party where that party meets the TSO's usual contractual primary market requirements. In this case there is no financial impact on the TSO and it is simply operating in a prudent manner to ensure that all capacity is made available to those that wish to use it.

Facilitation
There are a number of issues to aid facilitation of the secondary market process, including a role of remarketing in competition with other platforms, harmonised and timely platforms, coordination processes and information rights. As expected, the TSOs will be at the forefront of the facilitation issues.

With respect to Assignment, it must be the case that the primary sale of capacity allows assignment by agreement with the TSO, and that this agreement should not be unreasonably withheld. As a specific case of Assignment, TSOs may want to take on a role of remarketing capacity if there is no third party buyer identified by the primary capacity holder(s), but EFET envisage that in an active traded market the value of this service would be low and hence not a priority, as any capacity not readily traded but not used would become subject to anti-hoarding mechanisms.

In order to facilitate an effective secondary market for all products, TSOs should be obliged to provide harmonised platforms and systems that allow capacity transfers to be made quickly and with immediate effect. For complete effectiveness, the confirmation should be within the balancing period timeframes. These system enhancements should given a high priority.

For capacity linked to cross border points, the involved TSOs should undertake to have coordinated processes to allow the owner of capacity acquired through the secondary market to have the full and unfettered use of such capacity as quickly as possible.

Information flows from the TSO should be consistent for all capacity holders regardless of whether the capacity was acquired through the primary or secondary market. In particular, holders of secondary market capacity should have the same rights to information systems and face no additional costs above primary capacity holders to obtain any such information.

Credit Requirements toward the TSO
If the secondary market activity is by transfer or a sublet/usage basis, the credit arrangements between the original buyer and the TSO remain the same. Similarly, the new buyer of the capacity should not be required to post additional credit with the TSO for the capacity.

In the transfer model, there may be minor credit implications in systems where the beneficial owner of capacity is subject to additional charges (for example, in the UK market some commodity charges may apply). This will be for the beneficial owner to secure as a signatory to the TSO's code.

It is important to avoid layering credit requirements for any subsequent beneficial capacity owner as this will only raise the cost of transactions and would represent an inefficient credit policy by the TSO. Also, as new entrants may rely on secondary market capacity, such onerous 'pan caking' of credit rules could represent a barrier to entry and a frustration on the efficient use of capacity.

Default
Confidence in the secondary market requires rules that protect buyers when an original purchaser defaults on the contract with the TSO. In such circumstances, EFET considers that any capacity sold in the secondary market via assignment or transfer should remain with the new owner, and that there should be no additional cost implications for this purchaser. To summarise:

- For Assignment, default does not represent a problem as the capacity and obligations are fully transferred to the new owner.
- For the transfer model, the TSO should rely on its credit arrangements with the original buyer and possibly seek remedies through an Administrator. The secondary market capacity buyer becomes a debtor to the Administrator and has no obligation to the TSO.
- For the sublet/usage model, there is no beneficial transfer of the capacity, and so the TSO may have the right to recover it. It is then for the secondary buyer to seek compensation from the defaulting party or its Administrator.

EFET considers that the credit arrangements between the TSO and the original buyer should provide sufficient cover for default risk, and that the TSO should not have the right to seek financial compensation specifically from any subsequent beneficial owner[2]. To do otherwise

[2] TSOs may have broader charging arrangements designed to recoup default costs from all system users on a non-discriminatory basis.

will reduce the value of secondary market capacity as the credit risk is passed on with the capacity in addition to the credit arrangements between the secondary market participants.

Congestion obligations
The beneficial owners of secondary market capacity should be subject to the same congestion management rules as other capacity holders.

Nominations and title tracking under the assignment and transfer model
Secondary market capacity should be subject to the same nomination procedures to the TSO as capacity bought in the primary market. The only additional obligation following a sale in the secondary market should be for the primary purchaser (or subsequent sellers) to inform the TSO that capacity has been sold or transferred and this should be reflected in each party's capacity account.

Additional procedures may be agreed between the contracting parties in the secondary market that may have different 'nomination' procedures, for example – in the case of capacity sold on a sublet/usage basis, nominations times will have to be in advance of final nominations to the TSO because the sub-lessee needs time to nominate to the TSO.

Recording title changes and beneficial ownership changes are necessary for the application of any obligated charges, to manage the calculation of overrun charges and to allow the TSO to manage anti-hoarding mechanisms such as Use it or Lose It (UIOLI).

Further implementation steps
The development of a standard capacity contract may help to speed market transactions and to improve competition. However, to have an effective contract, action is required by TSOs and Regulators to ensure that an appropriate framework is in place if the industry is to achieve the successful development of secondary market in capacity.

There are a number of linked issues such as transparency and harmonisation that will impact on effective secondary market trading, however EFET considers that immediate action is necessary and possible on two fronts:

TSOs must update their internal processes to allow the near instantaneous registration of the changing capacity rights of system users. The current slow approach, typically in continental NW Europe taking up to 10 days, is much too long for actively traded gas markets. The implementation of better systems and processes is essential if a market-based solution is to be found to enable the existing level of contractual congestion to be reduced.

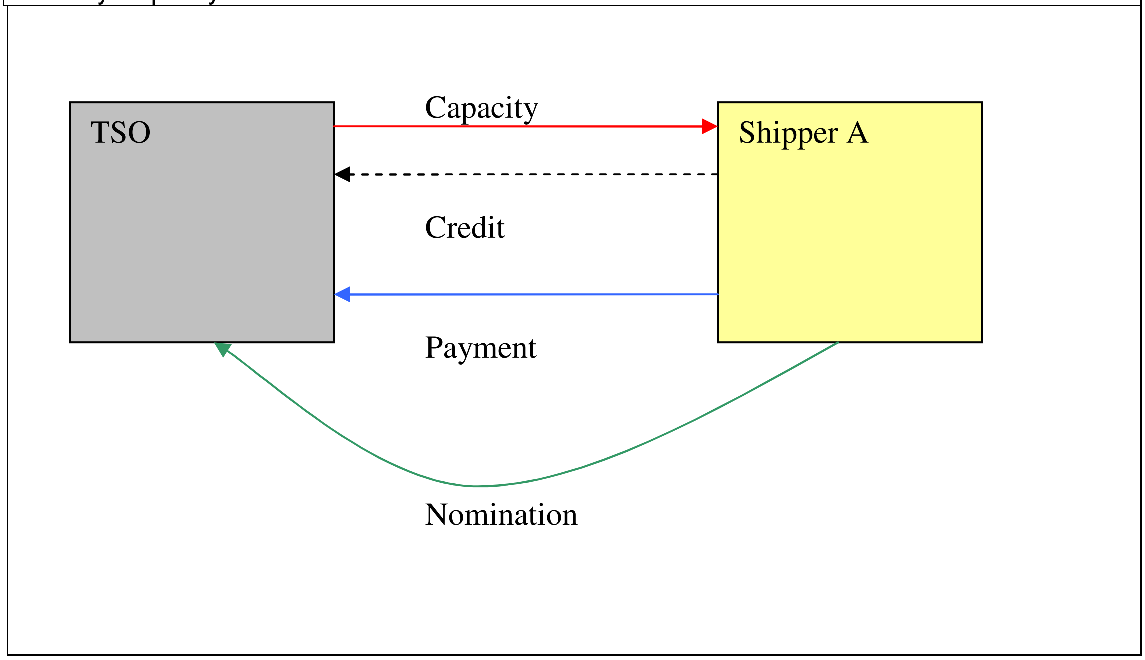
We expect that the improvements in speed will require immediate action on:
- capacity registries;
- nomination systems and assessments; and
- measurement of credit requirements.

Regulators need to ensure that there are no legal or economic barriers to secondary market sales of capacity. In particular, the existing tariff rules must not unduly impact on the prices paid in the secondary market.

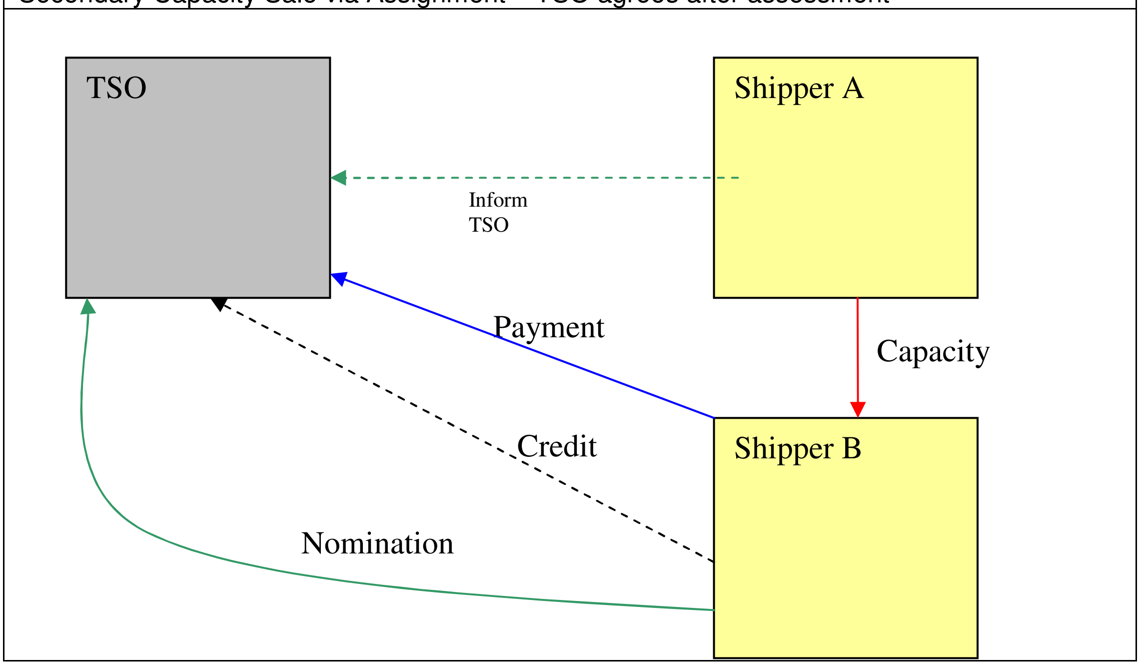
In consideration of the implementation of Article 8 of the Regulation on Conditions for Access to the Natural Gas Transmission Networks, EFET would welcome further discussions with TSOs and Regulators on aspects of secondary market trading, in particular where we can help with the development of standard contracts.

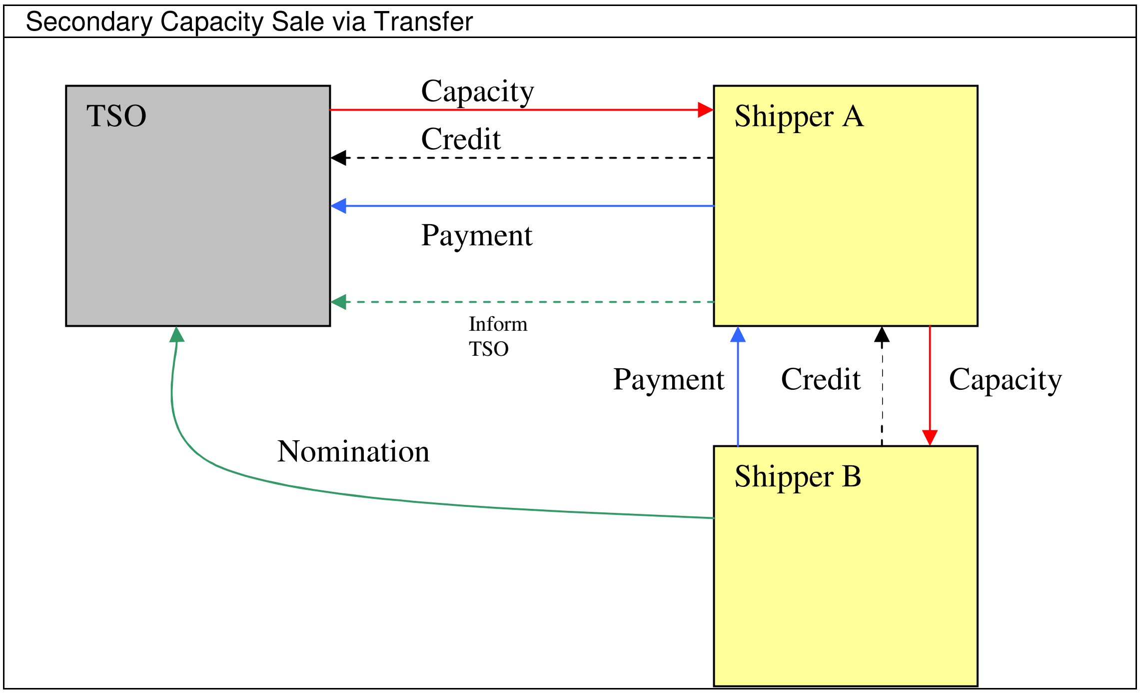
All of the diagrams represent the situation after the event.

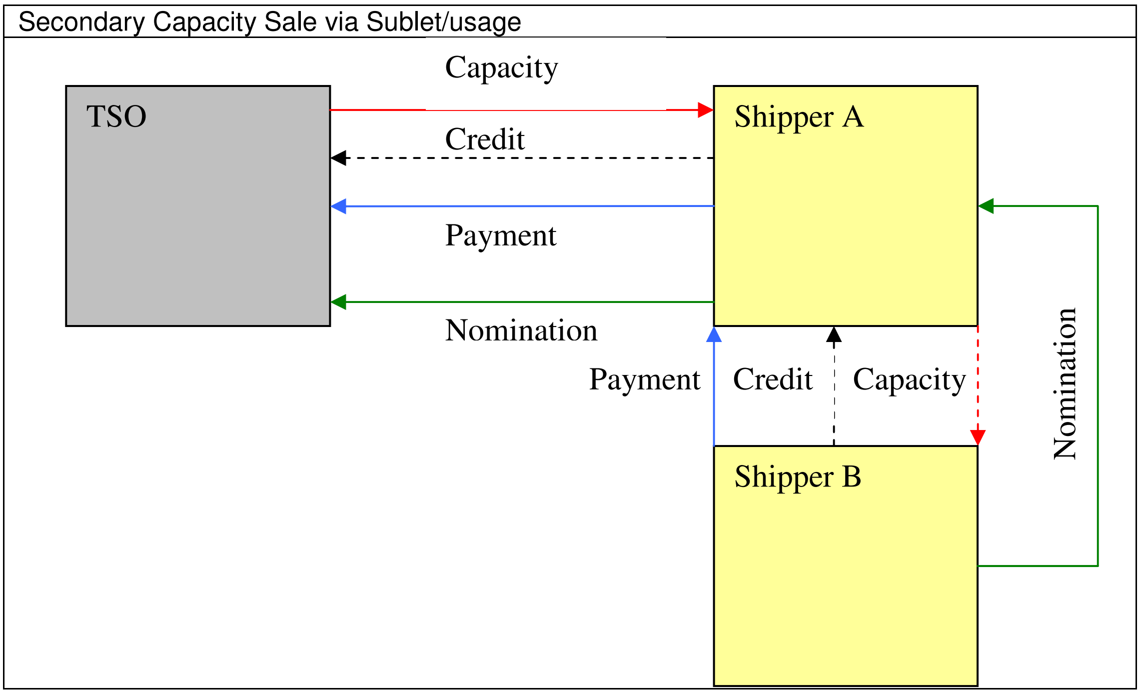
Primary Capacity Sale



Secondary Capacity Sale via Assignment – TSO agrees after assessment




Secondary Capacity Sale via Transfer
TSO
Capacity
Credit
Payment
Inform TSO
Shipper A
Payment
Credit
Capacity
Nomination
Shipper B


Secondary Capacity Sale via Sublet/usage
Capacity
TSO
Credit
Payment
Nomination
Shipper A
Payment
Credit
Capacity
Nomination
Shipper B