



Memorandum

To Commission of the European Communities
DG COMPETITION
B-1049 BRUSSELS
Belgium

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Date 2 May 2006

Subject BG Group Response to DG COMP Sectoral Enquiry Preliminary Report

BG Group Response to Energy Sector Inquiry Preliminary Report.

BG Group (BG) welcomes the opportunity to comment on the Sectoral Enquiry Preliminary Report. BG is an integrated gas major with interests in Exploration & Production (E&P), LNG, power and gas marketing and distribution worldwide. In Europe BG has interests in E&P in the UK and Norwegian sectors of the North Sea, and in Italy. BG is currently constructing two LNG import terminals, one at Brindisi in southern Italy (100% owned), and one at Milford Haven in Wales where BG is a 50% shareholder and has 50% of the capacity rights. BG is a major gas wholesale trader at the National Balancing Point (NBP) in the UK where it supplied approximately 6% of UK demand in 2005. BG is also active at the Zeebrugge Hub and at the Dutch TTF. BG has capacity rights in the Bacton-Zeebrugge Interconnector, and in Belgium between Eynatten and Zeebrugge and Zelzate and Zeebrugge.

BG has consistently supported the energy liberalisation agenda in Europe and, therefore, welcomes the efforts of both DG COMP and DG TREN to make the ambition of a European internal energy market a reality. We believe that the Sectoral Enquiry and the analysis contained in the Preliminary Report provide a firm basis for further action to improve the competitiveness of the European energy markets. BG believes that the Commission and Member States' regulators should focus on developing competition at the wholesale and large consumer level as the initial means of fostering a liberalised energy market. Wholesalers, traders and large consumers are best placed to help create a competitive market provided the right conditions are in place, such as gas hubs and access to pipeline capacity. Focussing on access to transit and transmission pipelines to enable free movement of gas should be considered a priority over measures to enable competition for small distribution customers. The experience of the UK was that, once the conditions were in place which enabled competition at the wholesale and large consumer level, the smaller customers were soon offered a choice of suppliers.

Based on the information in the Preliminary Report and on BG Group's experience, the following steps need to be taken to realise the goal of an internal gas market:

- Ownership unbundling of pipelines from supply affiliates. This will solve problems of conflict of interests, lead to fairer management of capacity and encourage maximisation of capacity utilisation.

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- Effective rTPA, including congestion management and robust 'Use it or Lose it' (UIOLI) mechanisms, on all pipeline capacity including transit pipelines. Access to capacity, particularly transit capacity, is crucial to enable trading across markets.
- Consistent application of regulation between Member States to ensure that there are not artificial impediments to the free flow of gas across, between and within markets.
- Regulated Third Party Access for storage wherever there is insufficient competition in storage and flexibility services.

Our more detailed comments are attached. We would be happy to discuss them in more detail should you wish to do so.

Should you have any queries please do not hesitate to contact me at the above address.

BG GROUP DETAILED COMMENTS ON PRELIMINARY REPORT

1. The more detailed comments that follow are based on BG experience of energy liberalisation in other markets, such as the UK and US, and on BG experience of liberalisation to date in continental Europe. Our comments focus on the gas markets only.

Storage.

2. As the Report correctly notes (paragraph 95) flexibility is key to enabling companies to supply customers and meeting TSOs' balancing requirements. Therefore, access to storage is essential if new entrants are to succeed in the market. As noted in the Report (paragraph 160), the legacy structure of many European markets means that much storage is controlled by incumbents; the Second Gas Directive requires only negotiated third party access which means that there is greater scope for incumbents to deny access to new entrants even if there is capacity available. Therefore BG believes access to storage should be regulated until such time as a competitive market in storage and flexibility services exists rendering the need for regulation redundant. At the very least the Guidelines for Good TPA Practices for Storage System Operators (GGPSSO) should be fully implemented and complied with, which does not appear to be the case currently (Paragraph 163). rTPA or implementation of the GGPSSO would help address the problems highlighted of booked storage not being fully utilised (page 184).
3. It should also be noted that new investment in storage can be encouraged by appropriate regulatory regimes. Ownership unbundled storage operators will wish to maximise their revenues, not protect the interests of incumbents with long term storage bookings, and will wish to provide additional storage capacity if there is market demand. New entrants may also wish to invest in new capacity, and the Article 22 Exemption from rTPA process could encourage this, where rTPA applies to storage. So long as exempted projects were to be subject to conditions which meant they would not undermine the competitiveness of the internal market, such an approach would provide additional storage capacity. This would in turn support the development of competition in the market by allowing wider access to flexibility.
4. Regulation of access to storage will also become more important in the event that Member States apply strategic storage requirements on market players. If only incumbents can access storage on reasonable terms such requirements will only further hinder development of the market without regulated Third Party Access (rTPA).
5. It is important, when discussing LNG storage, to make a clear distinction between purpose-built LNG peak shaving storage plants and LNG storage as part of an LNG re-gasification terminal (Footnote 18 page 18). In the latter case, LNG tank storage is usually part of the process for enabling the transformation of batches of LNG delivered by ship into natural gas for despatch via pipeline. LNG storage tanks at such terminals do not usually therefore constitute "storage" in the sense discussed above and should not be considered subject to regulation or third party access regimes which apply to storage.

Transportation Capacity: Unbundling.

6. The report has outlined a number of problems with access to capacity, ranging from insufficient congestion management and UIOLI arrangements and lack of transparency of available capacity to lack of development of new capacity in response to apparent congestion on existing pipelines. Perhaps the single most important action that could be taken to help resolve these problems would be full ownership unbundling of TSO's from gas marketers and suppliers. We therefore agree with the Report's statement that "ownership unbundling appears to be the most efficient way to eliminate incentives for preferential treatment within vertically integrated incumbents" (Paragraph 146).
7. It is important to stress that this arises from the need to move from one form of market structure (the old fully integrated monopolistic structure) to another (the new liberalised structure). Whilst there are ownership links between transportation companies and gas suppliers there will always be potential conflict of interests as the need to protect the supply company's market position as competition develops will conflict with the need for the transportation company to enable all parties to use the pipeline systems on an equal and non-discriminatory footing. The potential for such conflict of interest is clearly highlighted by the fact that, in certain cases, the supply affiliate has access to strategic information of the transport company or that the parent company has to approve TSO investment decisions (paragraph 147).
8. BG notes with concern that some TSOs have admitted that they have different contractual arrangements in place with their supply affiliates compared to those with other shippers (paragraphs 149 and 150), or that full separation is not in place (paragraph 148) more than a year after the Second Gas Directive came into effect and more than two years since it was passed. BG itself has experience of having to sign contracts with a supply wholesale competitor when managing its capacity in the Belgian market. BG therefore agrees with the Report's assessment that incomplete legal and management unbundling is contrary to the Second Gas Directive and lays the ground for discriminatory behaviour of vertically integrated operators in favour of their own affiliates to the detriment of new entrants (Paragraph 144).
9. Ownership unbundling would have the following advantages:
 - a. It would encourage TSOs to maximise use of their systems, irrespective of which shippers used their systems. The potential conflict of interest between TSO objectives and supply affiliates objectives would be eliminated. This would go a long way to resolving the issues arising out of vertical integration of current incumbents.
 - b. Ownership unbundling would be far simpler and more cost-effective to monitor from a regulatory perspective than legal unbundling with its associated compliance regime needed to ensure that discrimination was not taking place. Regulators would simply need to ensure that TSOs were behaving fairly to all their customers. The incentive to maximise revenues on their systems would ensure TSOs would respond to economic drivers. There would be no need for compliance regimes.
 - c. As TSOs respond to economic drivers, the pipeline network will develop as required by the market as TSOs respond to shippers' demands for capacity and different transportation services. Regulators can oversee this process to ensure that shippers are charged fair tariffs for the

services they use. In the US, where pipeline operators were unbundled in the 1980s and forbidden to supply gas, the market has responded successfully to demands for both new pipeline and LNG terminal capacity.

- d. Full unbundling, coupled with the proper congestion management of capacity by TSOs, would solve the current problem where new entrants have to go to their competitors in order to gain access to capacity.
- e. Concern about confidentiality and transparency of information would also be eliminated. TSOs would be able to aggregate information without the current concern that supply affiliates would find out information about their competitors' capacity requirements.

Transportation Capacity: Treatment of Transit Capacity.

- 10. It is clear both from the report and BG's own experience that ineffective access to transit pipelines is a serious impediment to the development of the internal gas market. BG agrees with the Report that access to transit capacity is vital for cross border trade (Paragraph 50) and that the EU needs to enable and facilitate cross border trade as 25 liberalised markets will not guarantee competition at an EU level (Paragraph 49).
- 11. The most important step to help resolve this would be to treat transit capacity in the same way as transportation capacity, subject to effective rTPA and congestion management systems. This will require the co-operation of regulators from different Member States because of the cross border nature of transit pipelines. However, BG believes that ERGEG can provide a suitable forum for ensuring that there is consistent treatment of transit pipelines. In particular, the forthcoming work on gas hubs by ERGEG should include work on transit TPA as flows of gas between hubs via transit pipelines will be an important enabler of liquid gas hubs. It is not clear to BG how or why transit pipeline owners and capacity holders are able to claim that transit pipelines are not subject to EU legislation. Any legal loopholes that may exist on this issue should be closed.

Transportation Capacity: Congestion management and 'Use it or Lose it'.

- 12. One of BG's major concerns arising from the report is the physical under-utilisation of capacity by primary holders set against the alleged non-availability of capacity to new entrants due to contractual congestion. The lack of proper congestion management and UIOLI mechanisms are a major contributing factor to this. BG itself has found it difficult to access capacity when moving gas between hubs (for example between TTF and Zeebrugge for onward transportation to the UK).
- 13. As outlined below BG does not agree with the analysis of TSOs (paragraph 187) that UIOLI either does not apply or cannot be applied effectively, to transit pipelines. The TSOs' attitude is all the more worrying when it is seen that not only do incumbents dominate primary capacity (Paragraph 198) but that the five pipelines analysed by the Report are not fully utilised (Paragraphs 211 and 212).
- 14. BG is firm supporter of the importance of firm primary capacity rights, particularly when shippers have made large financial commitments on a ship or pay basis

which underpins investment in new capacity. However, BG does not believe that such firm capacity rights are incompatible with proper congestion management or UIOLI mechanisms to ensure that physical utilisation of capacity is maximised. Indeed, one would expect that where shippers have “ship or pay” agreements but do not intend to use the capacity for a certain period, they would have a commercial incentive to trade capacity to offset any loss incurred from not using their full capacity allocation. TSOs should facilitate such trading of secondary capacity.

15. Likewise UIOLI is not incompatible with firm primary capacity rights, if correctly structured. First, in a pipeline system, the primary capacity holder should always have the right to use its capacity rights. Capacity can be assigned to other users on an interruptible basis to enable this to happen. The problem, highlighted by the report, of the uncertainty of such interruptible rights can be addressed by TSOs providing data on how much physical utilisation there is on a pipeline on both an historic and expected basis, enabling holders of interruptible capacity to gauge the likelihood of interruption. Furthermore, the existence of a robust UIOLI regime, should encourage primary holders to trade unwanted capacity.
16. The value of primary capacity holders’ rights can also be maintained by ensuring that any revenues that the TSO receives for the sale of UIOLI capacity are credited back to the primary holder who has “lost” capacity. This ensures that the TSO is not paid twice for the same capacity, once from the primary firm capacity holder and again from the user of the capacity under UIOLI. The pricing of such UIOLI capacity needs to be considered carefully. For example if the pricing of UIOLI capacity is set too low, there is a risk that shippers will be reluctant to underpin new investment in infrastructure with long term ship or pay contracts. The nature of competitive markets is such that no shipper can guarantee that it will require all the capacity it has signed for over the duration of a long term contract. If a shipper faces the risk that he will be forced to sell such capacity for much less than he paid for it, he will tend to book less capacity. However shippers will not face this problem, if the UIOLI price for capacity is set at a level close or at the price for which he bought the capacity. Of course, it is essential in these circumstances that shippers are not able to hoard capacity.
17. Whilst the above argument clearly applies to investment in new capacity, it is less clear that it applies where the original contracts have expired or the original investment has been recovered. In this case, lower UIOLI pricing may be justified, especially if this is part of a process to open up competition in the market by counteracting hoarding of capacity by incumbents. It should be noted that there is a clear difference between incumbents who are using their capacity rights to prevent the development of competition despite physical under-utilisation of capacity and new entrants underpinning new investment via ship or pay contracts. The Commission has itself recognised these through its approval of exemptions on certain new infrastructure projects.

Transparency.

18. BG agrees with the Commission that transparency is a necessary component of non-discriminatory access (Paragraph 52) on regulated infrastructure and that lack of transparency prevents new entry (Paragraph 226). In particular, it is essential to enable proper congestion management and UIOLI mechanisms to work by enabling market players to understand what capacity is available. Currently the level of transparency is too low and far below that in the UK market.

19. There are circumstances in which too much transparency can harm the legitimate commercial interests of market participants. However, this can be avoided by the publication of information at an aggregate level to avoid identifying individual companies' positions, and by scrutiny by the regulator where information is not published. More transparency is required on European pipelines because of the uncompetitive characteristics of the European gas market and because the system for making available unused capacity is not working.

Access to gas

20. BG agrees with the Report's assessment that lack of access to gas supplies is a major problem for new entrants. BG has found that incumbents in Northern Europe are reluctant to trade gas, even in circumstances where it is clear they have "spare" gas. At the moment, incumbents not only control the greater part of gas supplies into market but also the pipeline capacity and access to flexibility both by contractual flexibility and storage.

Consistent Regulation

21. As noted above consistent regulation is important where, for example, transit pipelines cross different regulatory jurisdictions. It is also important that there are not artificial impediments to the free flow of gas across, between and within markets due to different regulatory regimes. For example one country's exit point is another country's entry point and inconsistent treatment could hinder gas trade. Different treatment of imports and exports of gas by different regulatory regimes may also cause a problem. Investment issues include how costs are recovered for new capacity, and which set of network users pay the costs. For example there is the issue of where additional compression should be sited, and hence which set of network users pay the cost for such investment. There also needs to be regulatory certainty on tariff regimes where shippers are being asked to make long term capacity bookings in "open seasons" for new capacity.
22. Much work has been done to ensure such consistency via the Madrid Forum and the various Guidelines on good practice, as well as the Gas Regulation. However, it is also clear from the report that there is still inconsistency between Member States, as noted in the report, due to the incomplete implementation of unbundling measures in some states (e.g. lack of contracts between supply affiliates and TSOs) and the different treatment of transit pipelines.
23. Although superficially the idea of a European Regulator for cross border issues is attractive, BG believes that the Commission efforts would be better focussed on ensuring consistent implementation of existing legislation and on ensuring that national regulators have sufficient powers to enable competition. Continued work by ERGEG can ensure that best practice is applied by national regulators, whilst still leaving scope for national approaches to take into account country specific issues. In particular BG is supportive of the Regional Energy Market Initiatives recently launched by ERGEG to help resolve these issues.

Pricing.

24. BG notes the useful analysis within the Report on gas pricing, and the comparisons between gas pricing in a liberalised market such as the UK and the relatively illiberal markets in continental Europe. BG also notes the comparison that the report makes between gas prices on hubs and those in long term contracts which are indexed to other commodities. However, BG does not believe that the Commission should focus its efforts on the nature of gas pricing

at the wholesale level, other than as a potential indicator of the state of the development of competitive gas markets.

25. Where the Report notes that there is a strong similarity between the indexation contracts of different producers selling from the same field (Paragraphs 276 and 278), this often reflects that historically joint venture partners needed to agree terms and prices with a customer prior to sanctioning investment in a field. Even where negotiations did not take place jointly it is not surprising that the purchaser would not accept different prices from the same partners in a field.
26. Pricing of gas can be expected to change as a liquid liberalised wholesale market develops with a wider spread of buyers and sellers. For BG, the method of gas pricing is an outcome of the liberalisation process, not an input. For example, in the UK in the 1990s, the great majority of wholesale supply gas contracts were indexed to products such as oil, Producer Price Inflation, coal and electricity, reflecting the lack of a recognised and reliable traded gas price. However, once gas started trading, first at the beach and then at the newly formed NBP, prices to consumers quickly started to reflect traded gas prices even though the percentage of gas traded was very small. Even today, a substantial number of gas contracts are based on non gas indices, but the market fully reflects the fundamentals of gas supply and demand in the UK.
27. It is important that, in a competitive market, buyers and sellers are able to agree the pricing terms that suit them best. This will allow the market to decide on the most economically efficient solution. As the UK experience has shown, it is possible to have a competitive market even where a significant share of the gas is supplied on old pricing terms. Therefore, BG believes that regulators and the Commission should not be involved in the pricing and contracting strategies of market players, but concentrate on ensuring the conditions for competition are in place so that gas prices reflect gas market fundamentals. These conditions include effective access to capacity via rTPA of all gas pipelines; access to gas supplies; and access to flexibility via rTPA for storage.

Exemptions from rTPA under Article 22 of the Second Gas Directive.

28. The Report requests comments on the exemption provisions in the Second Gas Directive. BG believes Article 22 has been fundamental in enabling investment in new import capacity in the UK - both LNG terminals and pipeline capacity - without damaging the competitive nature of the UK market. The reasons for this are as follows.
29. First, the exemption criteria enable both national regulators and the Commission to scrutinise exemption requests to ensure that “(they) enhance competition in gas supply” and “the exemption is not detrimental to competition or the effective functioning of the internal gas market”. As BG knows from direct experience with the Dragon LNG exemption, this scrutiny is vigorous and, provided that this continues to be the case, BG does not see how or why exemptions which are detrimental to the aims of the internal gas market would be allowed to proceed.
30. Second, this approach has the advantage of enabling regulators and the Commission to judge exemption requests on their merits, both as individual projects and in the context of the relevant energy market. As a general principle BG does not believe that LNG terminals should be regulated so long as there are not issues of market power. The exemption process offers the opportunity for regulators to take account of the actual level of market power. BG does not

agree with the comments of the French regulator, made at the presentation on 16th February 2006, that exemptions should be subject to maximum limit, for example 80% of the capacity of a project. Such an approach is too 'dirigiste' and takes no account of the individual merits of an exemption request. In the case of the exemptions granted to LNG terminals and the BBL pipeline in the UK, the UK market has been fully competitive for a long time and the exemptions, as granted, do not undermine this. However, the situation could be very different in markets such as France or Germany, where an incumbent to apply for an exemption for a new infrastructure project. It would be hoped that such a request would not pass the scrutiny process described above.

31. Third, the approach enables regulators to impose conditions to ensure that an exemption meets the criteria described above. In the case of LNG terminals in the UK, these include measures to ensure that there is no hoarding of capacity. So long as there is a robust regulator, who follows fair and due process so that investors' and capacity holders' interests are taken into account whilst also ensuring that the competitive nature of the market is maintained, there should be no reason why exemptions might undermine the internal market.
32. Fourth, the exemption process allows for new investments to be financed by private investment because of the regulatory certainty they give investors. Investment in new capacity will be crucial as the internal gas market continues to develop. The key is to ensure that such investment does not undermine the competitive market. Application of the scrutiny process and conditions overseen by regulators enables this trade-off to be made.
33. Lastly, exemptions can enhance competition in a market. In the UK, the LNG terminals have enabled and will continue to support the entry of new sources of supply into the market. The nature of the LNG market is such that potentially supply could come from any of the current or future LNG producing countries. Exemptions in Europe offer the opportunity for new entrants to break the stranglehold that incumbents have on import capacity. For example, in Italy, the proposed new LNG terminals at Brindisi and Rovigo should end the situation whereby ENI dominates the current Panagaglia terminal.
34. For these reasons, BG believes not only that the current exemption regime should be maintained but that, properly applied, it offers the opportunity to help create a more competitive internal gas market.

Other comments.

35. The table on page 31 shows the incumbents' share of production for Great Britain in 2004 as between 40% and 50%. For the avoidance of doubt, BG Group, which is one of the successors to the old British Gas plc, supplied approximately 6% of the UK market in 2005 at the wholesale level. We believe, based on our own estimates, the shares quoted may be on the high side, even if you were referring to the production share of Centrica, the former incumbent distributor. Nonetheless, we do not view incumbents' market share as a problem in the UK market because competition at both the wholesale and retail level is vibrant, in stark contrast to the situation in many European markets. This view is supported by Ofgem which removed price controls from the incumbents' supply business several years ago. In BG's view, the necessary conditions for a competitive market - such as effective rTPA to pipelines, access to storage and flexibility, a liquid traded hub, ownership unbundling of the gas transmission and distribution network - all exist in the UK. This makes concerns over individual companies' market share less relevant, given that there are no signs of anti-

competitive behaviour. BG does not believe that the same can be said of European markets.

36. For the avoidance of doubt all BG's comments about access to pipeline capacity refer to transmission and distribution pipelines as defined in the Second Gas Directive, and including transit pipelines. BG believes that the current regulation of upstream pipelines as defined in Article 20 of the Second Gas Directive, is sufficient to enable competitive markets.