



Statement regarding the process for adjustment of the conversion system in quality-overlapping market areas

Leipzig/Paris, 22nd April 2016

Introduction

In 2012, the German gas industry largely agreed on a phase-out of the fee for converting H-Gas into L-Gas and vice versa within the framework of Konni Gas. After a gradual reduction, the conversion fee was to be abolished on 1st October 2016. At present, a possible extension to end of March 2017 and beyond that date is being discussed. Stakeholders have been invited to discuss this question during a workshop in which PEGAS took part on 6th April 2016. Additionally, we have been invited to participate in the consultation on this matter, and we are grateful for this opportunity and happy to respond. Our previous statement made during the workshop is available on the BNetzA website.

Trigger for discussions about an extension of conversion fees beyond September 2016

Since January 2016, Market Area Managers (MAM) and, especially, NetConnect Germany (NCG), have observed an increase in the demand for and costs of the commercial conversion from H-Gas to L-Gas. These costs have not been covered sufficiently by revenues from the conversion fee and the conversion neutrality charge, as ruled out in Konni Gas. Based on information published by MAM and aggregated data available at PEGAS, the following two reasons are mainly responsible for the non-coverage of the commercial conversion costs:

1. Much stronger usage of quality conversion by shippers → higher conversion volumes
2. Wide price spreads between L-Gas procurement and H-Gas sales for commercial conversion by NCG inside the own market area → higher costs for conversion

In the GASPOOL market area the problems have not occurred to the same extent as in the NCG market area. This is due to a higher availability of L-Gas through production in the own market area, the possibility to sell H-Gas without unexpected operational risk in the non-quality-specific order book of PEGAS and a higher conversion fee than MAM NCG, which obviously prevents shippers from using the commercial conversion service offered by MAM GASPOOL to a higher extent.

The table below provides a short summary of the monthly numbers of active members, trading volumes and average prices in quality-specific gas trading with MAM at PEGAS, which underlines our statements above.

The role of the production cap in Groningen

In the workshop held on 6th April, the cap on the gas production of the Groningen field has been cited as a factor driving this increase of costs. It has been argued that, as a result, a market shortage or an expected future market shortage may drive up prices. To PEGAS, it does not appear that there is a shortage in L-Gas in the German market areas at present. It is, however, possible that the expectation of a further decrease in production has a certain effect on L-Gas prices. On the other hand, further facilities for converting H-Gas into L-Gas are being constructed, thus decreasing pressure on the L-Gas market. However, it seems possible that a production cap on the Groningen field might c.p. increase prices for L-Gas and, thus, increase the overall costs for covering the demand for L-Gas - be it only slightly.

NetConnect Germany		2014			2015									2016				
(traded with MAM NCG)		Okt	Nov	Dez	Jan	Feb	Mrz	Apr	Mai	Jun	Jul	Aug	Sep	Okt	Nov	Dez	Jan	Feb
L-Gas	# Member	[REDACTED]																
	Volume	GWh	58	91	233	158	145	567	832	1.016	555	559	211	604	1.283	[REDACTED]		
	Ø Price	€/MWh	22,8	24,0	30,4	23,4	25,4	24,2	24,8	22,2	22,0	22,0	21,0	20,1	19,7	[REDACTED]		
H-Gas	# Member	[REDACTED]																
	Volume	GWh	11	9	12	15	15	15	18	19	17	17	18	20	17	[REDACTED]		
	Ø Price	€/MWh	18,9	23,7	22,3	21,4	22,8	20,2	20,3	19,5	20,2	20,5	19,4	18,9	17,2	[REDACTED]		
Δ Prices	L-Gas - H-Gas	€/MWh	3,9	0,3	8,1	2,0	2,6	4,0	4,5	2,7	1,8	1,5	1,5	1,2	2,4	[REDACTED]		
GASPOOL		2014			2015									2016				
(traded with MAM GPL)		Okt	Nov	Dez	Jan	Feb	Mrz	Apr	Mai	Jun	Jul	Aug	Sep	Okt	Nov	Dez	Jan	Feb
L-Gas	# Member	[REDACTED]																
	Volume	GWh	34	26	28	21	72	62	195	43	61	19	9	13	118	[REDACTED]		
	Ø Price	€/MWh	21,3	21,9	21,8	20,8	20,9	20,7	20,2	18,8	19,6	20,6	17,1	19,9	18,9	[REDACTED]		
TTF		2014			2015									2016				
(traded with MAM GPL & NCG)		Okt	Nov	Dez	Jan	Feb	Mrz	Apr	Mai	Jun	Jul	Aug	Sep	Okt	Nov	Dez	Jan	Feb
Gas	# Member	[REDACTED]																
	Volume	GWh	392	235	772	815	258	880	1.249	972	566	346	331	507	581	[REDACTED]		
	Ø Price	€/MWh	21,2	22,8	22,7	19,7	22,7	21,8	22,2	20,5	20,5	20,9	19,6	19,2	18,2	[REDACTED]		
Δ Prices	NCG L - TTF	€/MWh	1,6	1,2	7,8	3,6	2,7	2,5	2,6	1,7	1,5	1,1	1,4	0,9	1,5	[REDACTED]		
	NCG H - TTF	€/MWh	-2,3	0,9	-0,4	1,7	0,1	-1,6	-1,8	-1,0	-0,3	-0,4	-0,1	-0,3	-1,0	[REDACTED]		
	GPL L - TTF	€/MWh	0,0	-1,0	-0,8	1,0	-1,8	-1,1	-2,0	-1,7	-0,9	-0,3	-2,4	0,7	0,7	[REDACTED]		

In light of increasing costs for MAMs, it has been argued that a mechanism is required to allocate the additional costs incurred to Germany's market participants. The extension of the conversion fee forms one such mechanism since the increased conversion costs for MAMs are passed on solely to market participants who use the commercial conversion services offered by German MAM.

The conversion fee and security of supply

Another argument that has been put forth to extend the conversion fee is related to the security of the L-Gas supply. It has been argued that a conversion fee increases the value of long-term contracts, with which market participants import L-Gas from the Netherlands. Therefore, it would be less likely that market participants holding such contracts would terminate them, which would increase security of supply. However, we perceive two arguments against that:

- 1) Firstly, if, for several reasons, we have an unplanned undersupply in the Netherlands as the main producer for L-Gas, at that very moment we would also expect an undersupply in Germany. If we assume, that, in this case, long-term contracts could prevent an undersupply of L-Gas in Germany, then this would obviously imply an under-supply in the Netherlands because the same L-Gas cannot be sold twice, in the Netherlands or Germany. Hence, the long-term contracts would only shift a physical shortage from Germany to the Netherlands. It is questionable if that is a stable or desirable solution.
- 2) Secondly, and more importantly: The value of the long-term contract but equally also that of L-Gas traded at the VTP, derives from the overall demand for and supply of L-Gas in the Dutch and German market area. If the conversion fee is high, the market participants themselves demand L-Gas; if the conversion fee is low, it is the Market Area Managers. The overall demand for L-Gas remains unchanged regardless of the application of a conversion fee.

Irrespective of argument 1), long-term contracts can equally increase the security of supply for trading L-Gas at the VTP, because VTP trading in long-, mid and short-term contracts can ensure the same physical effect and thereby contribute to the security of supply to the same extent. However, the conversion fee does not have the desired impact on the contractual relationships.

Implications for positions in derivatives and cost allocation to consumers and utilities

An unexpected change in the market rules generally induces a change in the value of the portfolio of market participants in derivatives. For example, the owner of a gas-fired power plant that burns L-Gas may have entered a position in future with delivery beyond September 2016 and may, hence, have procured gas of the H-Gas quality on the derivatives markets in trust of Konni Gas and a conversion fee of € 0 per MWh. Therefore, H-Gas will be delivered to the owner of the plant. Now, the re-introduction of the conversion fee can affect the owner's business case. On the other hand, there might also be market participants whose portfolio value increases due to that measure.

The described effect on the value of positions in derivatives is a non-recurring effect related to the decision to extend the conversion fee. Any positions entered after such a decision are not affected. In the medium term, it can therefore be expected that additional costs are solely borne by end consumers of L-Gas or their utilities, in case these cannot pass on the additional costs to end consumers.

Proposals to achieve full conversion cost coverage and continuation with Konni Gas as planned

However, instead of re-allocating additional costs, all market-based measures that might reduce these costs should be discussed.

Please find below some first proposals for discussions, which may enable German MAM to cover completely the conversion costs without the application of a conversion fee and simple usage of the conversion neutrality charge at the current or a slightly higher level.

1) Tightening of the price spread between buy and sell trades for quality conversion

The general concept comprises the possibility that the German MAM have access to quality-overlapping, market based prices on the TTF VTP and transport capacities between the Netherlands and Germany on a Day-Ahead/Within-Day base. If - and only if - quality-specific prices in the own market area are worse than the sum of TTF prices and transport costs, MAM are allowed to access TTF and transport capacities. Upon the implementation of this measure, quality-specific gas prices and, therefore, conversion costs for buying L-Gas/selling H-Gas are capped at the prices of TTF +/- transport cost for MAM benefit. In order to respect EU NC Bal. Art 9 (3) and GaBi Gas 2.0 the MAM would need to be allowed to book transport capacities for the purpose of conversion.

2) Increase in the number of market participants in quality-specific gas trading

Enabling Within-Day transport capacity bookings on gas storage facilities in Germany for the use of intraday gas storage flexibilities according to gas prices in quality-specific order books; storage users can then also participate

3) *Allowing the gas industry to adapt to the new GABi Gas 2.0 without hasty regulatory interventions*

All market participants, incl. traders, Market Area Managers as well as regulators are still on a learning curve following the introduction of GABi Gas 2.0 in October 2015. Even today, some market participants are able to adapt the new balancing trading model for MAM in their own trading processes and portfolio but a lot of them are still working on it and were deeply surprised and incentivised by the strong price signals, which occurred constantly throughout the last winter and open further business opportunities. There is almost a trend with an increasing number of active members trading with MAM in view.

Conclusion

Conversion costs for MAMs have increased, and these costs clearly need to be covered or reduced. The conversion fee can effectively cover the additional costs since it allows MAMs to pass on these costs solely to market participants who use the conversion services. In the short-term, this will have a re-distributional effect on market participants who hold positions in futures on H-Gas and are short in L-Gas. In the medium term, the additional costs will be borne by L-Gas end consumers or their utilities.

Following the discussion above, the impact of the conversion fee on existing long-term contracts and thus on security of supply seems at least questionable.

Considering these two aspects, we are convinced that the conversion fee is one mechanism to re-allocate additional costs to consumers of L-Gas. Additionally, this measure can be implemented relatively easily from a regulatory point of view.

However, before taking such a strong measure as a last resort, alternatives for a mechanism to re-allocate conversion costs or even better market-based solutions for avoiding uncovered conversion costs and thereby continuing with Konni Gas as planned initially should be considered and discussed openly with the gas industry.

Lastly, we recommend that any changes of the market rules should be prepared carefully and a smooth phase-in or phase-out should be provided for. Such a phase-out has been granted regarding the abolishment of the conversion fee in the first place in order to enable market participants to prepare for that change, and a re-introduction has to be established with the same level of care. In the wake of abrupt changes, market participants lose trust in the market mechanisms that are supposed to be of fundamental importance for a successful development of the German gas markets in competition with the adjacent ones.

Based on our considerations as outlined above, we are happy to continue the debate with regulatory authorities, market participants and stakeholders. Furthermore, we are at your disposal should you have any additional questions.



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About PEGAS

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