CONSULTATION RESPONSE

Response to ARERA Consultation 221/2024 on balancing and settlement

Brussels, 5 July 2024 – *Energy Traders Europe* welcome the opportunity to comment on the changes to the regulations for settlement and balancing in the natural gas sector (DCO 221/2024/R/GAS). Key points we wish to make regarding the consulted document are listed below, followed by more detailed reasoning. We remain available to continue the discussion and provide all required information or clarifications.

Key messages

1. We propose to value the $\Delta^{IO}_{UdB,m}$ using the same parameter that today is used to define C_{mem}, which is the **monthly average value of the PSV-DA** calculated by *ICIS Heren*, as it currently represents the reference value in the Italian retail market.
2. **Any change to the *small adjustment* (SA) and to the valorization of the *Delta in-out* should be postponed to at least to 1 October 2025**, to allow users to adapt their long-term contracts to the new balancing scenario.
3. The calculation of the SA should be simplified, for example by aligning with the common EU practice of **identifying the SA as a percentage of a reference price**.
4. We advise drafting a report on the operation of the balancing regime, analysing the performance of indicators p4 and p5.

Settlement

Q7: Si condividono le proposte in tema di valorizzazione del $\Delta^{IO}_{UdB,m}$? In caso contrario, per quali motivi?
Q8: Si ritiene opportuno modificare anche il comma 6.1 del TIVG sostituendo l'IG Index GME al prezzo PSV?

While we are willing to support the idea of unifying the valuation of $\Delta^{IO}_{UdB,m}$ and C_{mem} with a single reference index, we are concerned about ARERA's proposal to replace the PSV-DA with the IG Index calculated by the *Gestore dei Mercati Energetici* (GME) as the reference parameter for valorising the cost of supplying natural gas.

We believe that the PSV-DA ensures all the advantages attributed by ARERA to the IG Index, in terms of **liquidity**, **monitorability**, and **transparency.** Therefore, PSV price – that is, the C_{mem} value, which is monthly updated by ARERA – is already a long-established reference for the entire market and is widely used by various operators as a reference for the indexation of prices for their services, including volatility risk coverage and hedging.

In light of these considerations, *Energy Traders Europe* would like to seize this opportunity to draw ARERA's attention on some key observations:

- the entire gas market, not only in Italy but also in Europe, takes ICIS Heren indices as a reference; forcing Italian operators to use a new index could create a discontinuity from the current European market, with consequences that are difficult to predict nowadays;
- IG Index calculated by GME is too "young", potentially not representative, and uncorrelated from European markets; moreover, it is difficult to predict its reactions in case of market instability;
- there are no hedging products which are referred to this new index;
- the reference price of the Italian retail market was changed recently (October 1st, 2022); another change is not recommendable.

Finally, it is necessary to underline that in any case, the introduction of a new index requires time for operators to adapt contracts with final customers to the new conditions.
As we consider premature to utilise the IG Index to value $\Delta^{IO}_{UdB,m}$ and C_{mem}, **we suggest to value of $\Delta^{IO}_{UdB,m}$ using the same parameter that today is used to define C_{mem}, which is the monthly average value of the PSV DA calculated by ICIS Heren**, as it currently represents the reference value in the Italian retail market.

Improvement of shipper's role

Q9: Si condivide la previsione che l'UdB, già responsabile dei prelievi dei PdR nei confronti del servizio di trasporto e di bilanciamento, divenga anche UdD semplificando la filiera commerciale? In caso contrario, per quali motivi?

In the DCO, ARERA proposes to **change the role of the shipper nominating gas for withdrawals at city gates**, requiring that a separate distribution service agreement is also signed with the respective DSOs. The proposed solution seems to be inappropriate because:

- it imposes new tasks and responsibilities on the shipper, including the direct relation with the customers;
- it creates problems in managing city gate sales contracts.

In practice, **we believe that such change would be counterproductive, would make trading and settlement far more complex**, and eventually could negatively affect the number of companies interested in acting as suppliers in Italy. In our view, should the critical issues highlighted in the DCO be addressed, this should be done without affecting the existing business contracts and processes. In this spirit, **we would ask ARERA to further substantiate and consult on this proposal** – with an adequate level of detail – before any decisions are taken.

Balancing – Small Adjustment (SA)

Q12: Si condividono le modifiche ipotizzate in merito alla formulazione dello small adjustment? In caso contrario, indicare i motivi.

As *Energy Traders Europe* we understand, considering the increasing fluctuations to which the SAP price has been exposed in recent years, as well as the widening spread between the PSBbuy and the PSBsell vis-à-vis the daily value of the SAP, the *ratio* underlying the proposal – that is, discouraging opportunistic behaviour linked to the temporal deferral of payments.

However, while **we support the principle of transitioning from a fixed to a variable small adjustment**, we are concerned that the p**roposed formula exceeds the goal of neutralizing the incentive for such behaviour**. The result is an **excessive penalization** and a disproportionate response compared to the potential financial benefits.

In this respect, we would like to remind that, as per Article 22(7) of Regulation (EU) 312/2014 (BAL NC)[1], **the value of the small adjustment** may differ for determining the marginal buy price and the marginal sell price and **should not exceed ten percent of the weighted average price.**

[1] COMMISSION REGULATION (EU) No 312/2014 of 26 March 2014 establishing a Network Code on Gas Balancing of Transmission Networks

With regard to the formula proposed by ARERA, we believe that:

1) it is necessary to introduce a coefficient that re-proportions the interest rates from annual to a time horizon consistent with the 2-month risk of arbitrage outlined in the DCO, which could be done by dividing everything by six.
2) **the 2,93% rate**, used in resolution 274/2022 to calculate the "premio giacenza" incentive, at a time when liquidity and free cash availability were critical bottlenecks for traders and the security of supply of the EU systems, results arbitrary and is not explained in ARERA's consultation, nor it is justifiable in the current market context. Therefore, it **should be removed from the SA proposed new formula**.
3) Similarly, the "f" factor of 1.1, which increases the valuation of the financial burden by 10%, is not adequately justified. Combined with the other elements, it leads to an unjustified penalty for the Operators. Therefore, **it is advisable to also remove the "f" factor from the proposed new SA formula**.
4) The implementation of a **higher SA will have a greater impact on** final consumers, especially the industrial-size ones.
5) A **maximum value** for the SA should be set, and **mechanisms to prevent the penalisation of users who experience under-delivery from regasification terminals due to weather events**, or any other unpredictable supply modification (be it related to pipeline imports, regasification or national production), **should be in place**.
6) It is critical for any change to the SA to be postponed, at least, to 1 October 2025, as any shorter timeline would make it impossible for users to adapt their long-term contracts to the new balancing scenario.

Overall, we note that the proposed SA will generate higher costs for all the Users, diverging from ARERA's primary objective to encourage them to balance their own positions *ex-ante*, while avoiding excessively penalizing for the volumes of imbalance that are naturally generated by the Users themselves. It is also important to underline that, at the end of the day, the root of the issue appears to be the **extended time that the RdB requires to settle imbalances**, so much so that **a more expedited settlement process might effectively mitigate the "arbitrage" concerns raised by ARERA**.

In light of the issues encountered with the proposed formula and the unforeseeable consequences of its application in the calculation of the SA, we offer the following alternatives to the DCO proposal:

1. We suggest **simplifying the calculation**, as compared to the proposed formula, by **aligning with the common EU practice of identifying the SA as a percentage of a reference price.** This percentage value could be based on the **PSV day-ahead** quotation or the **SAP**, with the specific details to be evaluated during **a second consultation**. Setting the SA at approximately **1% of the gas price would likely ensure consistency** with the results of the updated formula and the purposes of the revision.
2. We invite ARERA to examine the option of identifying a "progressive cap" – yet to defined – on the SA value, so to avoid excessive costs in extreme market situations.
3. We encourage the consideration of a "dual application" of the SA associated with **mitigation measures for "innocent" imbalances**, applying the current value for users who help the system (helpers) by unbalancing in the opposite direction to the system imbalance, and the new SA value for users who imbalance in the same direction as the system (causers). Such measure should be complemented with the identification of specific cases in which a user providing physical supply to the country unbalances innocently (e.g., under-delivery due to bad weather or to technical problems at regasification terminals, natural production sites or at import pipelines), so that in these cases, the user is compensated from the imbalance price applied to such volumes.
4. We recommend **defining specific timelines for modifying the new parameters that will be adopted** (e.g., percentage value, allowance, etc.). For example, the update could be tied to the same timelines as the incentive period for the RdB, given that the two regulations are connected.
5. Given the increase in SA, it would also be considered appropriate to adopt measures aimed at allowing the **correct planning of consumption of the daily metered withdrawal points** connected to the distribution networks through the provision of the volumes, at least for the last 12 months, of redelivery points in case of switching as well as remote readings.

In any case, it is considered appropriate that any review of the small adjustment takes place following the neutralization of the imbalance also for the MMs as envisaged in the DCO.

Balancing – Performance Indicators

Energy Traders Europe praises ARERA about the initiative to undertake a revision of the performance indicators. In this regard, and all the more so, we wonder whether ARERA has also scrutinised the **performance of p1 indicator**, which is not object of revision, but has a relevant impact on the overall incentives seized by the RdB, resulting in a substantial financial benefit for the RdB over the years.

Indeed, the incentive has proven insufficiently challenging, as the RdB only showed negative performance in the first year following its introduction. Additionally, given that market participants have access to numerous reports from various professional and reputable providers, the forecasts made by the RdB on the daily quantities of gas withdrawn at the delivery points at 15:00 on the day preceding the gas day are not sensitive enough to justify the substantial financial benefits the RdB has accrued thus far. **In the light of above, we believe that the incentive number 1 should be abolished.**

Finally, and most importantly, before adopting any modifications to the current regime, for transparency purposes **we advise drafting a report similar to the one drafted in accordance with point 1, letter e) of resolution 554/2016/R/gas** ("Report on the first six months of operation of the new balancing regime"), **extending the analysis to at least the p4 and p5 and introducing a simulation of p6 results.**

Follow-up response on ARERA DCO 221/2024 – Performace Indicators

Performance Indicator 1

With reference to the p1 indicator, we question the rationale behind the Authority's decision to exclude it from the analysis.

While this indicator has **the most substantial impact on the overall value of the Annual Incentive (IA)** awarded to the RdB over the years, by analysing the trend in the average estimation error of the gas redelivered by RdB from 2016 to March 2024 we note that after a decrease between 2016-2018, the value has since then stabilized, remaining virtually **unchanged**.

This result is further confirmed by analysing the trend of the p1 indicator and the related I1 incentive as published by RdB on Jarvis.

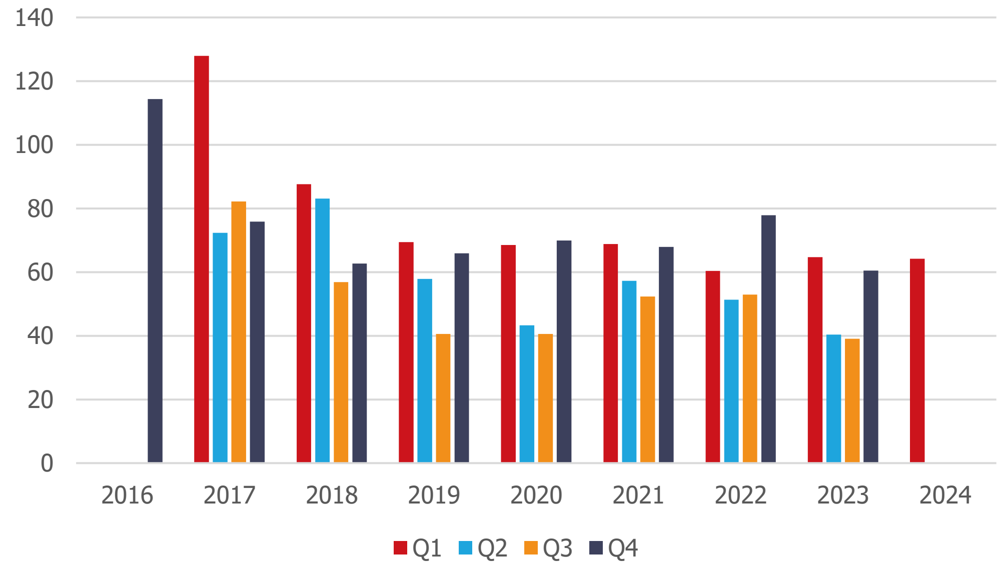

***Figure 1**: Average estimation error in MWh/day assessed on the gas redelivered (final balance) based on the p1 index published by RdB on Jarvis.*

The analysis of the data and the trend of the p1 performance indicator reveals the **ineffectiveness of the current incentive system, as it does not seem to adequately motivate RdB to improve its performance,** given that no significant improvements have occurred over time.

In light of the above, should ARERA not be willing to directly abolish incentive number 1, it would be appropriate to consider its revision, by reconsidering both the parameters used to assess the related I1 incentive and the Annual Incentive calculation formula, which currently only halves the I1 incentive beyond the threshold of 3 M€/year.

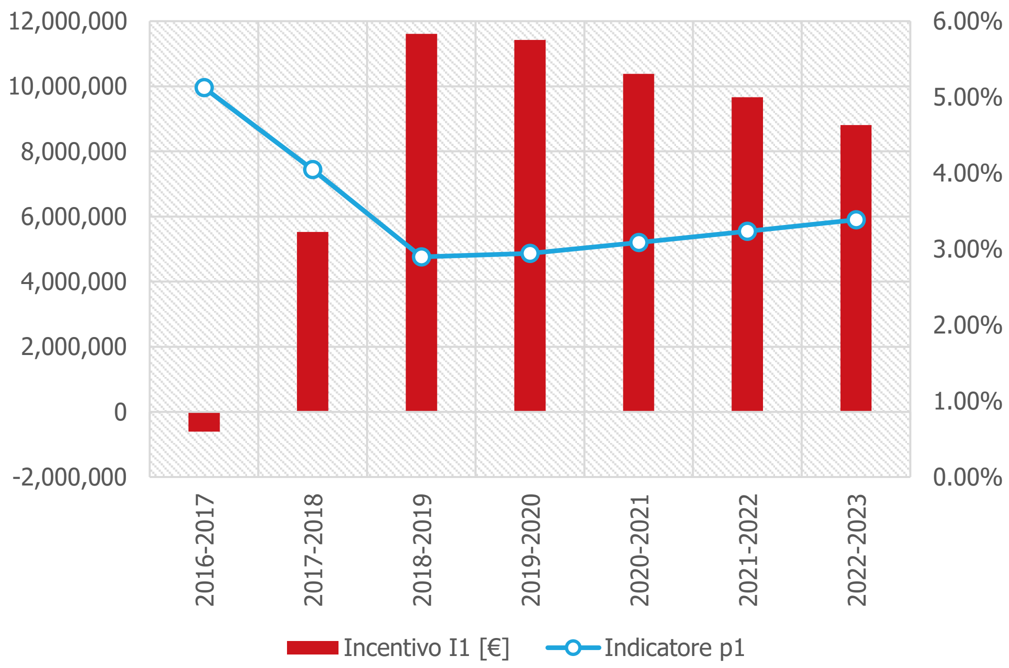

***Figure 2**: Valuation of the I1 incentive and the p1 performance indicator over time.*

Q13: Performance Indicator 2

Regarding the proposed modifications to the p2 indicator, it is observed that the proposed interventions, by limiting the scope of the penalty, **result in an increase of the I2 incentive without ensuring a clear benefit to the system** in terms of efficiency and/or optimization of balancing actions, as envisaged by Regulation (EU) 312/2014.

In particular, **it is unclear how introducing the proposed correction criterion for the value of p2**, based on identifying days of "excessive volatility," **would stimulate an improvement in RdB's operational performance, by *de facto* cancelling the penalty in cases where the volatility indicator exceeds 20%**.

We fear that the proposed revision would instead result in an "artificial" increase in RdB's performance and consequently the I2 incentive. This happens without prior discussion and evaluation of the most effective approach to reconcile the need to incentivize RdB for continuous improvement of its market interventions and the need to protect its operations in extraordinary situations, such as significant price drops or days characterized by "excessive volatility." Furthermore, **the DCO 221/24 does not exhaustively describe the criteria by which the Authority identified the floor at €20/MWh or the parameters for evaluating volatility** (i.e., the variability range of the volatility indicator from 0% to 20%, and the 12% threshold for identifying days of excessive volatility).

The chart below shows how incentives would change under the new rules. **With the newly introduced 20% threshold, incentives whose value would have been negative (=penalty)** under the current rules, **would now become positive**.

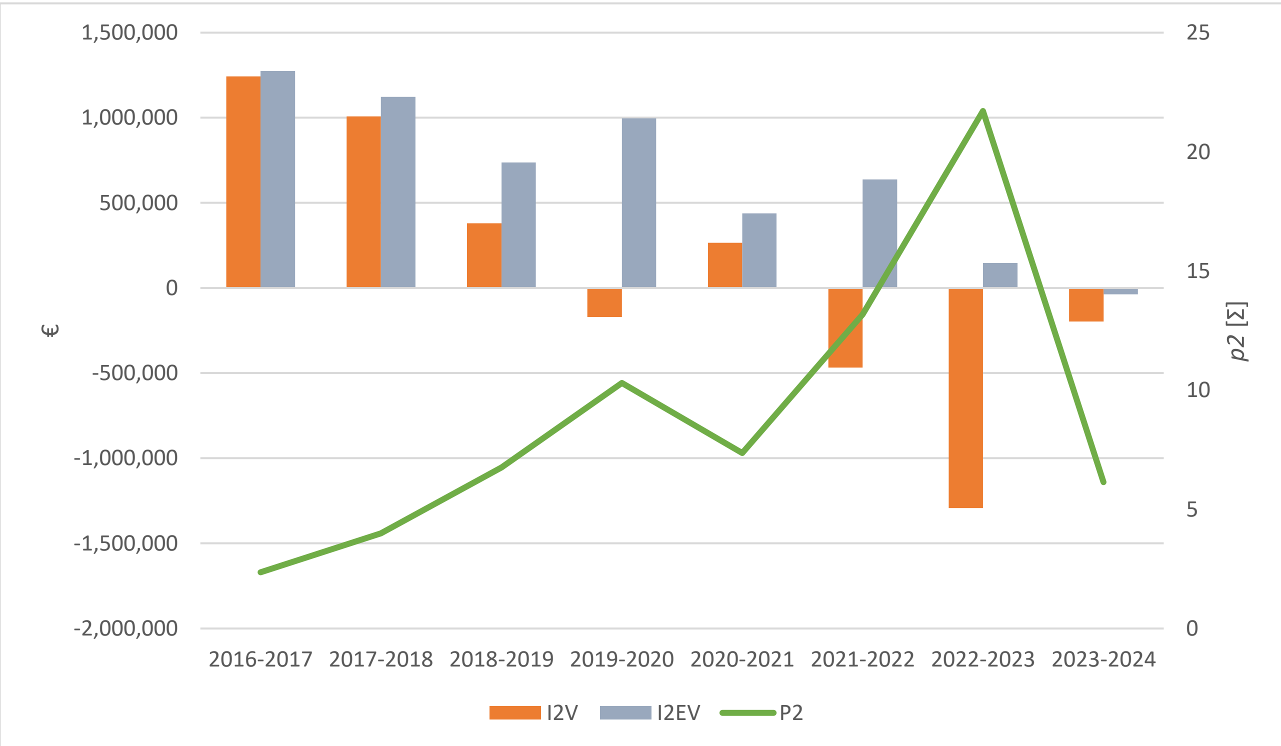

Figure 3: *Changes in I2 based on the new rules (grey) as compared to the existing rules, according to the performance*

Q14: Performance Indicator 3

Regarding the p3 indicator, its modification is deemed reasonable in principle, as clarified in point 3.21 of DCO 221/24. The volumes attributable to interconnection agreements (OBA) are generated physically in the operation of interconnected systems and have a limited impact on the overall result, as reported in DCO 221/24.

However, considering that:

- there is **insufficient information** available to allow for adequate evaluation; and
- shifting these volumes from the transport sphere to the balancing sphere could influence the calculation result of the p3 indicator, potentially leading to results showing an improvement in RdB's performance, without the RdB's performance actually changing (for better or worse);

it is proposed to consider these volumes only if their sign does not reduce the p3 value. This would prevent the hypothesized containment of balancing costs for users from resulting in an increased cost to fund the I3 incentive, thus nullifying or attenuating the savings derived from linepack variations.

In any case, **it is necessary for an analysis of the indicator to know the volumes attributable to OBAs**. Without knowing the actual weight of such volumes, it is impossible to evaluate proposed changes.

Finally, it is noted that:

- **Since the impact on RdB's actions resulting from the SA variation cannot be excluded a priori, it would be appropriate to evaluate the p2 and p3 variations only after the SA variation.**
- For more simplicity, effectiveness, and transparency of the Annual Incentive calculation methodology, **the proposal to eliminate the k_g parameter**, which is used to recognize an additional reward on days when the combined performance of p2 and p3 is positive, **should be reconsidered**. This intervention, proposed by ARERA in 2019, would allow for the financing of other incentive areas and prevent further increases in the I2+I3 incentive if the proposed modifications contained in DCO 221/24 are adopted.

Q15: Performance Indicator 4

Regarding the parameters of the I4 incentive, there are **no objections to the proposed modifications if evaluated under current conditions.** However, it would be prudent to postpone the **modifications due to the unpredictability of the results stemming from the**

reform of the settlement discipline. Specifically, their adoption should be deferred until the current seasonal trend is confirmed following the implementation of the aforementioned reforms.

Indeed, although the current proposal aims to encourage the RdB to improve its performance by containing the overall valuation of I4, it simultaneously results in a significant increase (approximately 80%) in the incentive during the winter period, without considering that:

- The **changes proposed could potentially alter the seasonal trend of the indicator compared to the past;**

The modification of the W_{kr} calculation, along with the introduction of other changes to the settlement discipline, could impact the calculation of the Δk term, potentially accentuating the aforementioned variation.

Q16: Performance Indicator 5

Since the value of the I5 incentive has been null on only 41 days between February 20, 2020, and March 31, 2024, it would be appropriate to consider its elimination, reallocating funds to other incentive areas without further burdening the system.

However, should ARERA not be willing to abolish the indicator, it would be desirable to **consider removing the floor level associated with the sum of I4 and I5 in the Annual Incentive calculation – in other words, introducing a penalty.**

The provision that the balance between rewards and penalties associated with I4+I5 could not be negative on an annual basis was introduced by the Authority considering the **experimental** nature of these incentives. Therefore, more than four years after their initial implementation, it is reasonable to consider the experimental phase concluded.

Finally, to ensure the balance between penalties and rewards mentioned in the response of July 5, 2024, **it would be appropriate to introduce a penalty for the p5 parameter, given that the I5 incentive has never been negative.**

Q17-19: Performance Indicator 6

We welcome the proposal to introduce a new indicator (p6) to stimulate and evaluate the RdB's performance in calculating expected withdrawals for redelivery points (PDR) with non-monthly measurement and daily detail. However, there are concerns regarding:

- The **methodology** for sizing the parameters of the incentive calculation;

- The **elimination of the penalty** for the p6 indicator in the first year of its application, while guaranteeing the RdB recognition of the related incentive.

On methodology, **it is not appropriate to use the period from 2020 to 2023 as the basis for calculating** the p6 performance level and the maximum I6 incentive. These years were influenced by extraordinary events that increased prices and market volatility, including MGAS, thereby also increasing the costs of both Δk and $\Delta^{IO}_{UdB,k}$. Using this period to value p6 based on the imprecision-related costs would lead to an **overestimation of the maximum daily incentive.**

Regarding the approach of **eliminating the penalty for the p6 indicator in its first year, this does not adequately uphold the balance between penalties and rewards.** As an alternative, to find a more balanced solution that protects the RdB without incurring additional system costs, the indicator could be monitored for the first year after its implementation.

We also **support a four-year duration for the 6PI**, provided that:

- The start and end of the incentive period coincide with the beginning of the reference gas year and the end of the fourth subsequent gas year, or alternatively, correspond to the beginning and end of each calendar year;
- An analysis of the outcomes of the introduced measures is performed before the conclusion of each incentive period, including the drafting of a specific report highlighting the actual performance of the RdB and the effectiveness of the incentives in promoting performance improvements over time;
- Any revisions to the discipline are evaluated following the presentation of the report mentioned above, involving all stakeholders.

Finally, regardless of the duration, the parameters for evaluating the RdB's performance and the related incentives should be reassessed every time the settlement/balancing discipline changes.

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