

Europex Feedback to Phase II of the Study “Quo Vadis, EU Gas Market”

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1. Executive summary and main implications

Executive summary

- 1.1 As a point of departure, the study names the “*alleged*” main weaknesses of the European gas market, pointing to price differences between countries/zones. These are explained as being a result of existing long-term supply contracts and an increasing dependency on extra-EU supplies. We are convinced that the goal of any future market design should not be to focus on price levels or to artificially align gas prices by regulatory intervention, but rather to design the market in such a way that an efficient price equilibrium is reached throughout the EU. And in such an equilibrium, prices between market areas can differ.
- 1.2 As Europex we believe in traded markets and market price signals that orchestrate activities within a well-functioning framework. It is evident that the share of long-term contracts is already decreasing and that short-term activities on exchanges are continuously growing. In addition, market mechanisms provide alternative options for market participants to hedge their portfolio risks along the curve and long-term contracts are increasingly hub indexed.
- 1.3 The current regulatory framework and market mechanisms provide efficient tools for the connection of European gas markets towards a Single European Energy Market. In this regard, we currently do not see a need for additional regulation on the EU gas market, because the market will itself ultimately define liquid pan-European trading areas where such stable and level conditions are consistently applied. Any fine-tuning that could be required given local differences should be done on a local level in line with network codes. Furthermore, under the framework of the Third Energy Package, market mergers or other measures are already possible within a “bottom-up” approach and do not require new regulation.
- 1.4 We emphasise that in our view the present study does not constitute a “final” result” or concrete policy recommendations. At this stage, it appears to sketch a very theoretical and only partial picture of the EU gas market as well as possible future scenarios. At the same

time, it lacks clear and feasible policy recommendations that are based on a thorough analysis taking into consideration all relevant factors. The limitations of the modelling and complexity of the gas market should be fully recognised.

Main implications for the study

- 1.5 Focus should not be lost on the consistent and comprehensive implementation and application of the Third Energy Package and the network codes in all Member States, and ensuring a level playing field to allow existing market mechanisms to work.
- 1.6 An assessment of market efficiency should be based on multiple indicators rather than only using price convergence as a proxy. Correct price differences reflect market realities and do not constitute inefficiencies. Indeed, price convergence is neither a consequence of nor a precondition for market integration.
- 1.7 The study should consider options to increase the attractiveness of the European market for extra-EU producers and retailers, with a view to increasing competition and the subsequent beneficial impact on prices. The importance of stability of European gas indices in this regard, for example in order to attract LNG imports, cannot be overestimated.
- 1.8 The optimisation of infrastructure use only appears as a side effect of the proposed scenarios. We recommend that the study explores optimisation measures in their own right, as the efficient use of infrastructure is a vital part of a welfare maximising outcome. Aspects that should be explored include how further development of infrastructure should be designed, how investments can be attracted or how stranded assets could be avoided.
- 1.9 It is important to explore how the gas market design can best support the ongoing energy transition, given the EU Energy Union priorities. The study can explore, for example, measures to increase the flexibility of the gas sector.

2. Key Points

- 2.1 The results presented in the study so far do not show a significant impact of the alternative regulatory scenarios on the improvement of general welfare. Any market design study should however take into account the goals of competitiveness, security of supply as well as affordable prices for end consumers. The far-reaching changes that would be associated with the suggested alternative regulatory scenarios would require a thorough analysis in terms of costs and benefits. In this regard, we believe that the study falls short of establishing a solid baseline and corresponding evaluation of the scenarios that considers both costs and effects. The remedies suggested by the study fail to convincingly address those issues. Therefore, we conclude that the benefits of reviewing the current EU regulatory framework in the proposed ways would not outweigh the costs and address the underlying concerns in terms of supply structure or declining indigenous production / import dependency.

- 2.2 Europex emphasises that the data available for European gas hubs shows that, where the Third Energy Package has been vigorously implemented, the gas markets are working well and are delivering benefits for end consumers within the current regulatory framework. As indicated in the study, natural gas prices have dropped by 27% in 2016. Furthermore, as a result of the emergence of gas exchanges in Europe, natural gas prices have been increasingly decoupled from oil-indexation.
- 2.3 Europex advises against any additional regulatory interventions as long as the Third Energy Package is not entirely rolled out within the EU. The Third Report on the State of the Energy Union indicates that for wholesale gas markets, many Member States have not yet fully implemented the necessary rules that allow for competitive and liquid markets.¹ If the built-in optionality of the Third Energy Package exacerbates certain inefficiencies, tailor-made solutions should be put forward, rather than addressing those inefficiencies by overhauling the entire EU gas wholesale market framework. A revision of the regulatory framework is only necessary when significant market failures can be identified, if the benefits of the intervention can be clearly shown and if these benefits outweigh the costs.

3. General Methodological Remarks

- 3.1 The study should strongly rely on scientific standards, including a sound factual base. In this regard, it should disclose all sources and provide information on how qualified estimates of the expected future market situation are made. The distinction between assumptions and conclusions should be clearly identified and should refer to this evidence base.
- 3.2 Regarding the use of quantitative models, the study should include some consideration of the pitfalls inherent in the modelling: For instance, there can be a lack of realistic behaviour of market participants. This can be due to uncertainty, imperfect information, imperfect foresight and lack of coordination between actors. It is also difficult to reflect those aspects adequately in a quantitative model. Assumptions made with respect to demand and supply elasticities will have a significant impact on welfare and therefore an analysis of differences in elasticity of supply and demand for gas in different parts of Europe should be carried out. We acknowledge that some structural changes have been taken into account through the addition of the proposed sensitivity scenarios.
- 3.3 It should be recognised in the study that welfare of the internal market is distributed among all actors, not only the end consumers. The goal should thus not be to minimise end consumer prices; the goal should rather be to design the market in such a way that an efficient equilibrium is reached. It should also be noted that EU domestic production currently accounts for only one third of Europe's gas supply. That means that a significant part of any producer surplus would be generated for non-EU gas suppliers, therefore not directly contributing to EU welfare.

¹ COM(2017) 688 final, Annex 2 to the Third Report on the State of the Energy Union.

- 3.4 In order to demonstrate inefficiencies in the EU gas market, the study draws a comparison between the US gas market and the EU gas market. We believe that comparing US and European prices provides no added value when examining the efficiency of the European internal market design. Firstly, the differing geographic situation means that it is not appropriate to make a direct comparison between the two markets. Secondly, this constitutes a very outdated view on global gas market trends since it omits any consideration of the Asian market. We also note that the price gap shown between the US and the EU market notably starts in 2009. This is when the shale gas revolution in the US started to show its first impacts. Since the export ban has been lifted in the US the prices have started to narrow again. When comparing US gas market prices to European prices, the price at which US LNG could be available in Europe should also be assessed.
- 3.5 Furthermore, the study presents the convergence of prices as the most important measure of a well-functioning and integrated market. It is stated that the price difference between intra-EU gas zones is an indication of market failures and that the integration of the European gas market is far from complete. We would like to emphasise that the existence of price convergence is not an appropriate indicator of the efficiency of the European gas market. It is in fact neither a precondition for nor a consequence of the European internal market working efficiently. Price convergence is therefore by no means a goal in itself, as price differences simply reflect scarce transportation capacity or transportation costs. If prices reflect these elements between market areas, then this proves that pricing mechanisms work effectively.
- 3.6 We consider that the following elements are applicable for the development of an efficient and liquid gas market and should be incorporated or reflected in the study:
- **Scarce capacity & flexibility:** Scarce capacity between markets should have a price, so that congestion is revealed and seen by the market. Only correct prices for scarce transportation and interconnection capacity lead to correct prices in the respective market areas. Correct prices for transportation capacity and on local hubs induce the correct infrastructure investments and reflect infrastructure needs; flexibility should be priced based on market mechanisms. It is therefore not the goal that flexibility be merely “cheap” (page 143, Second Preliminary Report, Dec 2017).
 - **Transportation costs should be reflected:** Transportation costs should incentivise an efficient use of given transport capacities, incentivise investment into new transport capacities and amplify supply capacity close to consumers. We acknowledge that the relevant price signal for efficient gas routing through existing infrastructure should usually equal short-term marginal costs, meaning the cost resulting from shipping the next unit of gas.
 - **Justification for market merger:** To determine whether the merger of two or more market areas has a positive impact on welfare, a trade-off must be solved: this trade-off is between i) higher liquidity in the larger area and ii) less local prices, less

regional transportation pricing and less regional asset pricing. Therefore, the added value of merging two market areas that are already liquid is low.

The fact that in some cases a merger might be a positive step forward, does however not justify a merger in all cases or the creation of one large hub in Europe, which would certainly not be an efficient constellation. Lastly, initiatives to merge market areas undermine the establishment of a reliable European reference market, such as the TTF, which can attract gas imports via LNG.

- **Welfare gain / distribution:** the welfare of the internal market is distributed among all actors, not only the end consumers. The goal should not be to minimise end consumer prices, the goal should rather be to design the market in such a way that an efficient equilibrium is reached. If required in a second step, rents could be distributed where needed.
- **Location Spreads:** the elimination of spreads between two markets does not necessarily decrease consumer prices (page 132, Second Preliminary Report, December 2017), but only in one of the two markets concerned, whereas consumer prices increase in the other market. Having said that, to optimise overall welfare, the goal should not be to minimise end consumer prices, but rather to design the market in such a way that an efficient equilibrium is reached, and then distribute any rents (*inter partes*) if needed.
- **Global supply trends:** in view of the global gas supply trends, and particularly regarding shale gas production from the United States, the study should include a short analysis of the current and future international export situation and the different sources available. The study should clearly indicate how European security of supply is affected by these trends.

3.7 We suggest that also the following is included in the study: natural gas as an attractive energy source and as a supplement to RES; options to increase flexibility for gas fired power plants, while considering the specific requirements of power stations.

3.8 The goal of the study should be to show potential ways to increase the overall welfare in the EU, but at the same time not to jeopardise the gains already achieved. In our view, such welfare maximisation is induced by an efficient allocation of resources and an efficient utilisation of infrastructures. To assess the status quo and evaluate measures to improve it, a welfare-maximising outcome analysis needs to be applied in the study, against which the status quo should be tested.

4. Current Gas Market Functioning & Issues

4.1 The study acknowledges that:

- There are differences between countries in terms of developments (Section 5.3, local specifics in regulation and limited transparency, pages 93-99, Second Preliminary Report, December 2017);
- The European gas market is in a good overall state even though the 3rd Energy Package is not yet fully implemented everywhere and;
- Inefficiencies are attributable to local factors.

In our view, it remains therefore unclear why the study should suggest new EU wide solutions to local issues when the current solutions are not yet in place or have not had a chance to prove effective.

- 4.2 Market liquidity: as market liquidity is first and foremost a result of market participants having trust in a market environment and in trading venues, regulatory steps to increase market liquidity (page 25, Preliminary Report, June 2017) are only second-best solutions and should be only taken in case of clear and evidenced market failure. A detailed and comprehensive cost benefit analysis (including projected costs, benefits and responsibilities) should always be included in any discussion proposal.

5. Alternative Regulatory Scenarios

5.1 Scenario 1 – Tariff Reform Scenario

- 5.1.1 The modelled outcome in this scenario does not provide a significant change in general welfare.

- 5.1.2 The abolition of fees risks leading to hoarding of capacity and a change of gas flows, which could lead to new congestions in the system requiring additional CMP measures. The implementation of an international compensation fund (“TCF”) is in our view, for various reasons, not feasible and would lead to severe additional complications that have been entirely left out of the analysis. Possible implications and risks associated with the establishment of an EU wide TCF should be fully assessed following stakeholder involvement and consultation.

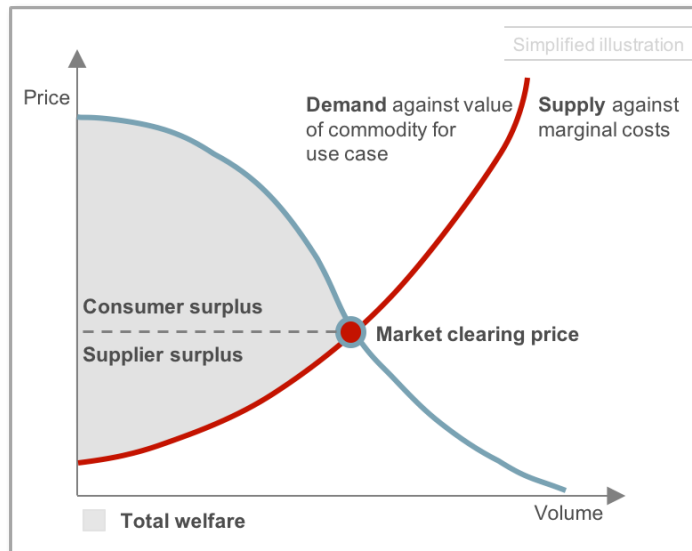
- 5.1.3 For traded markets, correct price signals in the respective market areas are vital to allow buyers and sellers the opportunity to optimise their portfolio and organise the supply for their customers. Therefore, the correct pricing of transportation scarcities and the existence of price zones is inevitable.

- 5.1.4 Arbitrage possibilities on traded markets depend largely on the optimisation of the supply and demand situation (see Figure 1). In a case where the intra-EU capacity tariffs would be set to zero and congestion pricing would apply, the EU gas market would continue to have different price zones depending on the congestion status. Therefore, by this measure, no single price zone would be created. In our view, it thus remains unclear what benefits the suggested Tariff Reform Scenario could bring to the traded market. If this scenario was designed to tackle the current situation of capacity pricing, then in our view it is questionable

as to whether this is the appropriate instrument; alternatively, a substantial revision of the tariff network code could be more appropriate.

5.1.5 The process exchanges manage is designed to maximise overall welfare. Market principles need to be put first as they ensure efficient price formation (see Figure 1).

Figure 1: The process exchanges manage is designed to maximise overall welfare



Source: Europex Market Vision Paper

5.1.6 Scarce capacity between markets should have a price, such that congestion is revealed and seen by the market. Only correct prices for scarce transportation capacity lead to correct prices in the respective market areas. Only correct prices for transportation capacity and commodity prices induce the correct infrastructure investments and reflect infrastructure needs. In our view, flexibility needs to be priced based on market mechanisms.

5.1.7 The cost implications of tariff reform should be included in the scenario, particularly in terms of implementation costs for different market actors, as compared to the expected benefits. In this respect, further quantitative analysis would be welcomed.

5.1.8 Instead of reshaping the tariff structure entirely, providing more transparency on how tariffs are being composed could be a first step to tackle the issue of “tariff pancaking”.

5.2 Scenarios 2 & 3 – Trading zone merger (regional market merger) - conditional market merger

5.2.1 Please see point: 3.6. The suggested market area mergers by the study should be critically reviewed.

- Price differences between market areas do not necessarily constitute inefficiencies. On the contrary, if they reflect a congestion between market areas correctly, price differences show that pricing works efficiently. Scarce capacity should have a price, so that congestion can be revealed and is visible to the market.

- A merger of trading zones should only follow an appropriate and comprehensive cost-benefit analysis. To assess whether general welfare can be increased, the trade-off between achieving higher liquidity in a larger area and less local pricing has to be solved. The goal should be to design the market in such a way that an efficient equilibrium is reached. When merging market zones, there is a risk that costs might be reallocated rather than inducing an increase of general welfare.
- The results of the study come to the same conclusion. With the exception of the Baltic area, the evidence indicates that the additional costs would outweigh the benefits of integrating market areas. We therefore largely share the conclusion “small is beautiful” given by the consultants. Market integration should not be the target in itself. The number of hubs should essentially be market driven, not planned from the top down by the regulatory framework. The assumption that market integration leads to lower prices mainly because larger areas are less likely to be exposed to dominant suppliers is not based on economic facts.

5.3 Scenario 5 – LTC gas delivered at EU border

- 5.3.1 In our view, this scenario should not be further pursued, since its implementation is, from our perspective, unlikely and could potentially lead to a disruption of trading activities whereby long-term contracts have to be fulfilled due to regulatory intervention in a location other than on the points foreseen in the contracts. We believe that EU competition law already provides for a suitable framework that also applies to gas supply coming from outside the EU.
- 5.3.2 The largest possible welfare increase has been associated with the creation of a **strategic partnership** with external suppliers such as Russia. One condition of such as strategic partnership would be a full liberalisation and application of EU principles in this market. With this proposal of a strategic partnership, the study risks entering into the wider debate on the application of EU policy principles and EU energy diplomacy. Such a partnership would require a cooperative approach instead of a competitive approach (which includes the increase of LNG supply and the roll-out of renewable energies). This is an issue which in our view is outside the scope of the study as it goes beyond what can be expected from an economic study / evaluation.

6. Important market design questions not currently addressed by the study

- 6.1 The study does not provide any suggestion as to how the attractiveness of the European market to extra-EU producers and retailers could be increased, with a view to increasing competition and the subsequent beneficial impact on prices. The importance of stability of European gas indices in this regard, for example in order to attract LNG imports, cannot be overestimated.
- 6.2 A lack of interconnection between neighbouring markets zones has been identified as one of the main barriers to market integration (especially in the Baltics and the Balkans). The study provides no answer how the further development of infrastructure should be

designed, how investments can be attracted or how stranded assets could be avoided. The optimisation of infrastructure use only appears as a side effect of the proposed scenarios.

- 6.3 The study takes into account various changes in market dynamics and external factors. However, one of the main projects of the EU Energy Union is the realisation of the energy transition. The study should therefore analyse how EU gas market design should be shaped to support the ongoing energy transition and address the question of how the flexibility of the gas sector could be increased.

About

Europex is a not-for-profit association of European energy exchanges with currently 27 members. It represents the interests of exchange-based wholesale electricity, gas and environmental markets, focuses on developments of the European regulatory framework for wholesale energy trading and provides a discussion platform at European level.

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