Europex feedback to Part 1 of the

“Quo vadis EU gas market” study

Brussels, 10 July 2017

1. Summary & Key Points

1.1. Europex considers that the current regulatory focus should be on ensuring a level playing field for all market actors and the consistent and comprehensive implementation and application of the 3rd Energy Package and the Network Codes throughout all Member States. There are still major deviations between Member States and the full and effective implementation across the EU-28, the EEA and the Energy Community is not yet foreseeable. Any study that only assumes the results of such full and effective implementation will remain a best guess, and will fall short of any precise evaluation. As the study may affect the design of future legislation, it should have been kicked-off only once concrete data becomes available and not before. If the built-in optionality of the 3rd 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.

1.2. In any case, we believe that stakeholders´ concerns regarding capacity contracts and capacity pricing should be directly and clearly addressed at face value. To this end, the situation should be assessed, taking into consideration the interest of all affected stakeholders, to find viable solutions for the gas industry, which also safeguard the interests of end-consumers. Therefore, it is worth exploring the possibility of opening up the study to address this topic in a separate chapter. As voiced in the last workshop, any evaluation of the regulatory framework conditions that combines the capacity issues with more general and far reaching market design topics could potentially create a lengthy dialogue that introduces further uncertainty and leads the discussion on to topics that are now premature, given the actual state of regulatory implementation.

1.3. Europex emphasises that the success of the North-West European gas hubs and the significant pick-up of liquidity in central Europe is current evidence that in Member States where the regulatory framework is vigorously implemented, the gas markets are working well and are already delivering tangible benefits for the end consumers. Therefore, we 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 current framework, market mergers are already possible in a “bottom-up” approach and do not need new regulation.

1.4. Currently, the internal market for gas is working well, as is recognised by the study and stakeholders. Therefore, additional regulatory intervention should be kept to a minimum. The modelling approach in Phase 2 of the study could help to provide and increased understanding of interdependencies of variables, but also has its limitations: it is difficult to define a metric that comprises both the results of a simplified model and factors like liquidity development and other trends.

2. General Remarks

2.1. The study should strongly rely on scientific standards including a sound factual base. It should clearly 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 relate to this base.

2.2. The study mixes different ideas and approaches: the first part does not provide a suitable assessment framework, while the modelling that will take place in phase 2 of the study is not a substitute for a sound and comprehensive methodological base that clearly and analytically analyses the (future) situation. Furthermore, it falls short in explaining the conceptual framework with which the welfare of the status quo and of potential changes are measured. It rather uses examples or case studies and generalises those to general conclusions. This approach is not suitable for comprehensively assessing shortfalls or upside potential. A comprehensive description of the applied methodology should be included in the study, as well as any assumptions behind the scenarios.

2.3. The scenarios proposed by the study each contain a key change, which is solely analysed regarding its capability to increase welfare, whereas the potential disruptions or other effects are not analysed. One example from page 9: “Easier gas flow between zones will increase the liquidity, allow for stronger price arbitrage and contribute to further price convergence.” Comment: it is unproven that liquidity increases, it is unclear what is meant by “stronger price arbitrage” and it is not an end in itself that prices converge). In our view, price differences between market areas do not necessarily constitute inefficiencies; if they correctly reflect a congestion between markets areas, price differences show that pricing works efficiently.

2.4. We consider the following elements applicable for the development of an efficient and liquid gas market that should be also incorporated / reflected by 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 is just “cheap” (page 31 line 7).

- **Justification / reason for market merger:**
  To determine whether the merger of two or more market areas is increasing welfare, a trade-off must be solved: this trade-off consists of 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 positive, does however not justify a merger in all cases and the creation of one large hub in Europe, which would certainly not be an efficient constellation.

- **Welfare gain / distribution:** the welfare of the internal market is distributed among all actors, not only the end consumers (page 32, last bullet point). 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 location spreads does not necessarily decrease consumer prices (page 33 second bullet line 7), if the elimination of location spreads induces an inefficient market outcome in which local prices are distorted. To optimise overall welfare, the goal should not be the minimisation of 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 with regard to 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.

2.5. We suggest that also the following is included in the study: natural gas as an attractive energy source and as a supplement to RES; more flexibility to gas fired power plants (and considering the special needs/requirements of power stations).

2.6. 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 jeopardise already achieved gains. 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.

3. Current Gas Market Functioning & Issues

3.1. The study acknowledges that:

- There are differences between countries in terms of developments (Part I, B. 6. local specifics in regulation and limited transparency – pages 24-25);
- The European gas market is in a good overall state even though the 3rd Energy Package is not yet fully implemented; 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 enter into effect.

3.2. 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) are only second-best solutions and should be only taken in case of clear and evidenced market failure. A detailed cost benefit analysis (detailing projected costs / benefits and responsibilities) should always be included in any discussion proposal.

4. Alternative Regulatory Scenarios

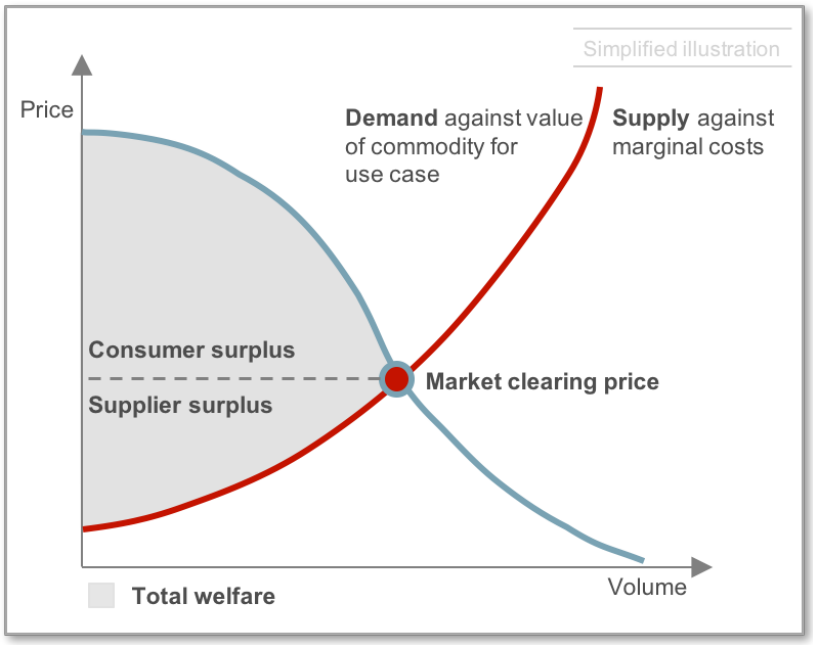
4.1. Scenario 1 – Tariff Reform Scenario

4.1.1. For traded markets, the correct price signals in the respective market areas is key to give 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.

4.1.2. Arbitrage possibilities on traded markets depend largely on the optimisation of the supply and demand situation (see Figure 1). In the case that the intra EU capacity tariffs will be set to zero and congestion pricing will apply, the EU gas market will continue to have different price zones depending on the congestion status. Therefore, by this measure, no single price zone will be created. In our view, it thus remains unclear which benefit to the traded market the suggested Tariff Reform Scenario could bring. If this scenario were designed to tackle the current situation of capacity pricing, then in our view it is questionable if this is the appropriate instrument; alternatively a substantial revision on the tariff network code could be more appropriate.

4.1.3. 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 below).

Figure 1: Exchanges increase social welfare



Source: Europex Market Vision Paper

4.1.4. Scarce capacity between markets should have a price, so 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. We do not agree with the study point that flexibility is “cheap” (page 31 line 7).

4.1.5. 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 wold be welcomed.

4.2. <u>Scenarios 2 & 3 – Trading zone merger (regional market merger) - conditional market merger</u>

4.2.1. Please see point: 2.4. 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 a considerate cost-benefit-analysis. In order to assess, if 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 a way that an efficient

equilibrium is reached. When merging market zones, costs might rather be re-allocated than inducing an increase of general welfare.

4.3. Scenario 5 – LTC gas delivered at EU border

4.3.1. 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 on a different location 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 the outside of the EU.

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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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