

Introduction

EFET¹ very much welcomes the Commission's decision to commission the "Quo Vadis" consultant's study on gas market design, looking into whether the current regulatory framework is most effective in order to achieve the objective of maximising overall EU welfare. Requiring each of the consultants tendering for the study to publish an initial discussion paper and sharing these with stakeholders, is a good way of highlighting a comprehensive range of ideas where improvements to the regulatory framework may be necessary in order to achieve this objective. It will also enable stakeholders and policymakers to form an initial opinion on the practicality of such ideas and to identify those worthy of further detailed consideration.

Whilst we recognise that our comments below will not influence the selection of the consultant, we hope they will serve as a helpful input into the Commission's decision making process.

EFET's perception of the problem

The third energy package has already made an impressive contribution towards improving EU welfare. The combined effect of the legislative measures, guidelines and EU network codes that comprise the third energy package have significantly improved and harmonised market arrangements, creating conditions where market participants are incentivised to optimise their gas portfolios and compete on a level playing field. Whilst implementation and compliance with EU network codes is not yet universal and the tariff network code still has to be implemented, realisation of the single energy market is undoubtedly closer now than it was ten years ago. This can be demonstrated by greater levels of price convergence and correlation across market areas, along with steadily increasing liquidity in nearly all markets (at least in the prompt).

The increasing levels of liquidity and price correlation/convergence we are currently experiencing, particularly in North West Europe, have come about because market participants have had to arbitrage flows between market areas and optimise their pan European supply and demand portfolios more efficiently, as markets are now more open to competition. However, to a large extent such activity is still fundamentally being underpinned by the existence of large numbers of long term legacy supply and capacity contracts. So liquidity is benefiting greatly from market participants selling and swapping surplus legacy contract volumes at virtual trading points. And price correlation/convergence is being driven by market participants continuing to flow gas as long as the price differential between market areas exceeds the short run marginal cost. Ironically however, whilst such long term contracts have proved to be particularly disadvantageous for the market participants holding them, as they are out-of-the-money, they have been hugely beneficial to market development as a whole.

¹ The European Federation of Energy Traders (EFET) promotes and facilitates European energy trading in open, transparent, sustainable and liquid wholesale markets, unhindered by national borders or other undue obstacles. We currently represent more than 100 energy trading companies, active in over 28 European countries. For more information, visit our website at www.efet.org

Increasing levels of competition and liquidity along with narrowing price spreads suggest that the current regulatory framework is working well and is benefitting large numbers of EU citizens. As such there is a temptation to conclude that, unlike in electricity, it's "job done" vis-à-vis the gas regulatory framework. And the only thing that still needs to be done is to ensure that it is implemented in a consistent and timely manner across all EU Member States, not just in those with the most developed markets, so that all EU citizens can enjoy welfare benefits. In our opinion, it is vitally important that the Quo Vadis study rigorously tests this conclusion and investigates whether the current regulatory framework is sufficient to maximise welfare benefit in light of future changes in gas supply and demand fundamentals, legacy contracts and gas infrastructure.

The effect of market participants using legacy contracts to swap gas and arbitrage between markets areas such that the price spreads between them are less than the cost of transportation, is to undermine the demand of non-legacy contract holders for available capacity. There is no financial incentive on such market participants to book capacity and incur a loss. Even where a financial incentive exists this can be put at risk through unforeseen tariff changes. As such, large swathes of available capacity will remain unbooked and what capacity is booked is likely to be concentrated in short term bookings, to minimise risk.

In the run up to 2020, and increasingly in the years beyond, long-term legacy capacity contracts will expire and are unlikely to be renewed. Whilst capacity will still be required in some way, shape or form, it is very unlikely that TSOs will enjoy the same degree of revenue certainty they currently do from existing long term legacy bookings. Market participants are likely to adapt their booking strategies to reflect general market uncertainties and the additional flexibility afforded them by the CAM network code. With gas demand projected to decline significantly across the EU over this time in order to achieve ambitious carbon reduction targets, there is a reasonable expectation that the overall level of capacity being booked will reduce too. So unless TSOs allowed revenues reduce commensurately as depreciated infrastructure is removed from the regulated asset base, transmission average tariffs can be expected to rise. Such increases, combined with the impact of any under recoveries resulting from continuing trends towards short term booking, could result in "vicious circles" of ever increasing tariffs, further disincentivising long term capacity bookings. This will also compound the financial burden of legacy contract holders, who will pay a disproportionately high share of TSOs' allowed revenues. And future investment in new capacity intended primarily to enhance security of supply and source diversity, which is not underwritten by market participants through long term bookings, will compound this problem further².

So whilst policymakers may look at the improving liquidity and narrowing well correlated price spreads between market with satisfaction and reassurance, EFET is concerned this situation may not be sustained in the medium to long term. As long term legacy contracts expire there is a risk that significant price spreads between market areas will once again become a prominent feature of EU gas markets and that competition and liquidity will stagnate, undoing a lot of the benefits achieved by the third energy package. Reduced capacity bookings, predominantly of short term duration, diminish TSO investment signals and create greater risks and challenges for TSOs in recovering revenue related to existing capacity investments, which have not fully depreciated. This added risk could potentially lead to increases in TSO's weighted average cost of capital and threaten security of supply.

² ENTSOG's TYNDP 2017 shows 86 projects with FID and Advanced Non-FID project status amounting to around €40bn of investment, the majority of which are to increase source diversity and enhance security of supply.

In our view this should be the principal focus of the Quo Vadis study and it is noticeable that seven of the consultants (Baringa, Frontier, CEPA, Ref4E, EWI, Sund Energy and EY) identify with these concerns, with varying degrees of conviction and clarity. This reinforces our view that they are, at least, worthy of more rigorous and detailed investigation.

EFET's proposed market model

EFET is optimistic that this problem can be avoided through a concerted effort by EU policy makers, supported by TSOs and stakeholders in general, to create bigger more liquid markets across the EU. As the Quo Vadis tender document points out, over the past years significant work has been undertaken in developing the Gas Target Model (GTM): a vision of well-functioning gas markets across the EU. The GTM identified a set of metrics against which EU markets can be assessed to establish whether they are capable of being a functioning market in their own right, or whether some form of market merger is necessary to achieve this objective. Informative though the GTM is, it is not legally binding and is entirely reliant on the current regulatory framework to achieve its aims. So unsurprisingly, little progress has been made achieving functioning market status in those Member States that currently fall short.

Of the three models of market merger referenced in the GTM full market merger and the trading region model present particular challenges from a TSO, political, legal, regulatory and accounting perspective. These make it difficult to envisage them being implemented in an effective and timely manner, even if legislation could be introduced at EU level to facilitate or mandate this. In contrast however, the satellite model referenced in the GTM appears to us to be realistically achievable in the medium and long term and, whilst not without its challenges, is worthy of further investigation as part of the Quo Vadis study.

Removing or significantly reducing transmission tariffs at the interconnection points (IPs) between market areas within the EU could be a very effective way of retaining high levels of liquidity at a small number of hubs (particularly along the forward curve), whilst at the same time encouraging gas flows and competition in connected satellite markets. Adopting such an approach should ensure the level of price correlation and convergence between market areas remains high despite the expiry of long term contracts, integrating markets through an EU wide highly liquid single price zone. Price spreads between markets will be determined solely by the prevailing demand and supply for capacity between the principal hub and its satellites, not by the need to recover past investment costs. And the absence of uncompetitive and unpredictable tariff barriers at IPs will also reduce risk for market participants, encouraging them take bigger positions.

Noticeably, eight of the consultants (Baringa, SEO Amsterdam Economics, Frontier, CEPA, EWI, Sund Energy, DNV .GL, and EY) identified removing or reducing tariffs at IPs as a policy option which should be explored further through the Quo Vadis study, with three of the consultants (CEPA, EWI and EY) appearing to indicate this should be the main, or sole, focus of the study.

Scope of the Quo Vadis study

EFET thinks the Quo Vadis study should be narrowly focused on the problem and market model referred to above, and contain a strong element of quantitative analysis.

We see little benefit in conducting a largely theoretical study which explores policy options that are likely to be highly contentious and difficult to achieve, or which turn back the regulatory clock. Similarly, studies which largely revisit the market merger analysis already undertaken as part of the development of the GTM, or which redraw the map of possible regional hubs, will have a limited contribution towards achieving the Quo Vadis objective of maximising overall EU welfare.

The discussion papers identify a number of other perceived problems, suggested policy options, inefficiencies and perceived failings in the regulatory framework. Our response is not intended to be a critique of these many varied points and we have not sought to comment on those we think may be worthy of further investigation in their own right (inter alia removing national barriers to secondary trading) or those we think are unnecessary (inter alia harmonising rules across LNG, storage and pipelines). What is clear however is that by far the most commonly identified problem and policy option are those we have identified above. So it seems logical that these should be explored further as part of the study and that it should not be diluted by having too wide a scope.

Points for analysis

As stated previously, EFET thinks the Quo Vadis should contain a strong element of quantitative analysis to complement and reinforce qualitative analysis of the problem and market model referred to above.

In particular, the following points are ones we think the Quo Vadis study should try and analyse in detail.

Quantitative analysis

- 1) A detailed profile of long term legacy capacity contract expiry dates throughout the EU out to 2035, disaggregated by country, TSO, IP (entry/exit), quantity (GWh) and value (€)
- 2) An estimate of the impact this loss of revenue from long term legacy contracts (see point 1 above) will have on capacity prices at individual IPs (entry/exit) if not rebooked, based on technical capacity and historic flows, along with aggregated average information by country and TSO.
- 3) An estimate of how the N-1 Infrastructure Standard (Article 6 of Regulation 994/2020) of each Member State would be affected if 100%, 66% and 33% of the capacity covered by expiring long term legacy contracts (see point 1 above) was decommissioned.
- 4) Analysis of the average quantity of gas flowing between IPs each month on days where the price spreads between market areas (day-ahead) is less than the reserve price of bundled capacity (day ahead), compared to the average capacity booked during the same month on PRISMA. Such analysis should include all IPs between those markets where dependable day-ahead price quotes are routinely published by one of the price reporting agencies (e.g. Heren, Platts, Argus).
- 5) An estimate of the revenue (€) currently recovered by TSOs at all IPs between Member States and the proportion this represents of their total allowed revenue, disaggregated by entry/exit, country and TSO.
- 6) A breakdown of the revenue currently recovered at IPs (see point 5) between that relating to intra-system use and that relating to cross-system use, calculated in accordance with article 5 of the tariff network code agreed in comitology.
- 7) An estimate of what the average capacity price increase (€/MWh) would be if the intra-system and cross-system use portions of the revenue currently recovered at IPs (see point 6 above) was instead recovered at all EU entry points (excluding storage) both separately and in aggregate, disaggregated by pipeline entry points and LNG entry points.
- 8) An estimate of what the average capacity price increase (€/MWh) would be if the intra-system and cross-system use portions of the revenue currently recovered at IPs (see point 6 above) was instead recovered at all EU exit points (excluding storage) both separately and in aggregate, disaggregated by DSO exits and large end user exits (e.g. power stations, industrials).
- 9) An estimate of the EU welfare gain (€bn/yr) arising from increasing competition and liquidity within and between EU wholesale markets as represented by a % reduction on the average bid/offer spread and/or the average price of gas at the hub.

Qualitative analysis

- 1) A critique of the EU inter-TSO compensation scheme that exists in electricity, including whether such a scheme might be appropriate in gas. Suggested adaptations and possible alternative arrangements which avoid an inter-TSO compensation scheme, whilst still removing tariffs at IPs, should also be evaluated.
- 2) An assessment of what the impact of transferring revenue recovered at IPs to EU entry points would be on the EU's continuing ability to attract gas from third countries.
- 3) What to do about unexpired long term legacy contracts if tariffs at IPs are removed across the EU.
- 4) Whether existing CAM and CMP arrangements remain appropriate if tariffs at IPs are removed across the EU.