



Implementation of Gas Release Programmes for European Gas Market Development

Introduction

The European Federation of Energy Traders, EFET, actively contributes to the development of a transparent and liquid wholesale gas market throughout Europe in which all consumers have a choice of energy supplier.

In October 2002 EFET set out some key principles for the development of the European gas market¹. One of the steps required to achieve a properly functioning wholesale market is enabling new entrants to have access to gas and capacity and reducing the dominant position of the companies controlling most of the gas supplies. These have been, or plan to be, implemented in several countries with varying degrees of success.

EFET believes that it is now timely to set out some additional guidance for those companies and authorities that are implementing gas release programmes, so that they will be successful in helping to achieve a competitive energy market. *EFET has prepared a similar paper on unbundling.*

EFET Position on Gas Release

EFET's basic position on release programmes is as follows:

Release programmes

Release programmes (of which there can be various types) can be designed to overcome the problem of inadequate access to supplies or capacity, particularly in the early stages of market opening. EFET encourages such schemes where they would have an important 'catalytic' role in the context of developing sustainable competition in gas markets.

In practice more detailed guidance is needed to ensure that gas release programmes are effective. The rest of this note seeks to provide this next level of practical guidance.

Gas Release and Capacity Release Programmes

Introduction

To establish a competitive market in gas supply, new entrants need to have fair and economic access to customers, delivery networks, gas supplies and flexibility services.

¹ *Principles for European Gas Market Development*, October 2002, available at <http://www.efet.org>

Release programmes (of which there can be various types) can be designed to overcome the problem of inadequate access to supplies or capacity, particularly in the early stages of market opening and therefore can have an important 'catalytic' role in the context of developing sustainable competition in gas markets. This was recognised by the European Parliament who proposed amendments to the gas directive at first reading, to ensure that there can be release of gas or capacity, where this is required for the development of sustainable competition.

Among the particular advantages of a release programme is that divestment of assets is not involved. Indeed a release programme need not change the counter parties or any terms or conditions of the long-term arrangements in place.

When is a release programme needed?

Freely traded gas markets, with diverse supply routes and many producers, are unlikely to require any form of release programme.

On the other hand, there might be few supply routes or deliveries might be under the control of an incumbent through long-term contracts (with no secondary trading). In such a case, it would be unlikely that a competitive market could develop until some form of release programme provided new entrants with initial access to energy and/or delivery capacity. A gas release programme was used in the early 1990s to successfully help to address this type of issue in the UK.

Release programmes for short duration supplies can have added advantages in facilitating the development of gas trading hubs, which then leads to greater price transparency and further stimulates competition and efficient use of resources.

Full separation of transportation and trading activities can reduce the need for gas release, because the commercial pressures on the trading company will tend to encourage it to market all energy or secondary capacity that is available. But, there may well still be circumstances of effective monopoly control (e.g. control of gas of a particular quality or via a particular import route in combination with the absence of a liquid traded market) that make a release programme necessary to create sufficient availability of gas supply. A properly thought out gas release programme can be used to kick start competition in countries and regions where there is a well-established monopoly or oligopoly.

The terms of a release programme must be appropriate

The release programme will only be successful if the price of the gas or capacity made available to new entrants is low enough for the competition to compete. As a guide, the price must not be higher than the average price paid by the incumbent (including contractual discounts), nor must it be higher than the average netback from the incumbents' eligible customers. If a release programme is also used as a remedy to balance an incumbent's market power, the price must not be higher than that offered in the wholesale market, even if this implies a financial loss to the incumbent.

To be effective, the release terms must consider what is appropriate for the markets in which it is intended to stimulate competition. For example, a release gas programme might include options for short duration supplies and for the swing that end-consumers will require, particularly if access to storage is not readily available or not offered at an economic price. The duration of the longest contracts offered should also reflect the duration of retail contracts, i.e. individual tranches of gas or capacity should not be offered for not more than 1 year.

The result of early gas release should be a market in which a fully traded market will emerge and supply companies are able to compete for supplies on a sustainable basis. Large, long duration release should be avoided as this risks perpetuating a supply monopoly, albeit at a slightly different point in the chain.

The terms of a gas release programme must include:

- Publication of the terms and conditions of the programme, simultaneously in the national language(s) and English. Market participants should have the opportunity to comment on the terms and conditions before they are finalised to ensure that the release programme will achieve its objectives.
- Credit terms must not unduly restrict participation of new entrants, especially smaller companies.
- Payment terms should reflect standard market procedures or the average terms of the incumbents' contracts. Payment in the month following delivery is standard. If tighter conditions are applied, such as shorter payment periods or even pre-payment, this should attract a discount.
- The volumes released need to be significant compared with the incumbent's portfolio size. Volumes must be offered in small enough tranches attract smaller companies.
- Gas should be made available at more than one entry point, in principle using the same entry points as where the incumbent brings in most of its gas. This reduces the possibility that the transportation regime constrains competition in any specific area or market segment. It also ensures that new entrants face the same physical and operational risks as the incumbent by sharing the same entry points. In deciding the delivery locations, consideration must also be given to the ease and cost to participants of onward transportation and/or trading.
- Transportation capacity for gas released must be made available simultaneously at the relevant points in the system. However, this must not result in network users being obliged to participate in the gas release programme to obtain transportation capacity, if they wish to input their own gas into the system. For gas release programmes to be effective, there needs to be properly implemented, regulated third party access downstream of the delivery point.
- The swing and take-or-pay levels of the release gas programme should reflect the overall portfolio of the incumbent. If only flat gas is made available, and access to storage or other flexibility tools is still difficult or at punitive prices, then competition in supply will not arise from the release programme. In particular, if WACOG is used as a pricing basis for release gas, then the swing of the release programme should reflect the level of swing in the portfolio from which WACOG is calculated. The incumbent should not be able to charge a "swing" price for a flat gas supply.
- The release gas should be based on the incumbent's portfolio, not related to specific fields or contracts. The incumbent is able to manage operational risk by moving gas between physical sources. There is a risk that if gas is assigned to a specific field or contract, then the incumbent is strongly incentivised to use the field or contract with the poorest operational performance, which would have the greatest adverse impact on new suppliers and their customers.

- The released gas should be on a firm basis and not subject to a likelihood of interruption for any reason, which is greater than the risk on the incumbents remaining contracts. Interruptible gas could be released in addition if requested by the market.
- In a successful release programme, a competitive price for the gas will tend to be around the lower of the WACOG, the wholesale market price or the average netback from the incumbents' eligible customers. In general, floor prices should be avoided.
- If the auction price relates to some WACOG, then it must take account of the financial discounts that are built into most long-term contracts that may not be reflected in published border prices. An independent audit should confirm the WACOG calculation. If the release programme has an additional objective of compensating for the incumbents' market power e.g. a merger remedy, the price should at least reflect the wholesale market price, if this is lower than the incumbent's WACOG, even if this results in a financial loss for the incumbent.
- If the net purchase price relates to factors that are not fixed at the time of bidding (e.g. indexation) there must be sufficient transparency to the pricing mechanism to allow successful bidders to hedge their purchase costs. Withholding this information gives the releasing company a competitive advantage and is critical if the price is based on a WACOG or border-price heavily influenced by oil-indexed contracts.
- Nomination procedures should allow purchasers of release gas to nominate directly to the TSO, acting as an agent for the incumbent, who must preserve confidentiality. Although the incumbent will still be able to work out the aggregate flows under the release programme, it will not be able to identify individual behaviour of successful purchasers, which they would be able to do if nominations were made through the releasing entity.
- The initial allocation method should exclude participation by any affiliate of the releasing company or its affiliates, even if the percentage holding is relatively small. Otherwise it would be possible to bias any auction mechanism. Additionally, if a price auction is to be used, some means of scaling back any over recovery would preserve the ability of purchasers to compete. A volume auction would be an alternative means to achieve a similar result. In any case, it is essential that the programme is well advertised and that allocation methods should be transparent and objective (i.e. a beauty parade or first come first served are unlikely to lead to a pro-competitive outcome).
- The released gas (and capacity) should be freely tradable on the secondary market. Procedures to ensure this should be put in place if they do not already exist.
- The regulatory authorities should review the success of each stage or tranche of the programme and take action to amend the terms and conditions to ensure that they actively contribute towards the development of sustainable gas competition.

Appendix 1

Summary of Terms and Conditions of Gas Release Programmes

This appendix summarises recent gas release programmes that took place in the UK and Spain. It also outlines the proposals for Gas Release in Germany and Austria starting in 2003.

Historical Gas Release Programmes

UK experience in the gas market

The UK government introduced a variety of measures to release gas to new entrants, resulting in the successful development of gas-to-gas competition and significantly lower prices on the wholesale market. These lower prices were fed through to end-consumers as they became eligible to choose their gas supplier.

- **90/10 rule** – this was a voluntary undertaking by the old British Gas to only contract 90% volume from new fields, leaving 10% to be bought as a supply contract by another company. The undertaking was met, but was less effective than hoped, partly because of the lead-time in bringing new fields into production, but more because the 10% contracts were snapped up for gas-fired power generation.
- **Time swaps** – British Gas plc sold gas back to the producer in exchange for purchasing the gas under the same terms and conditions at an agreed time in the future, such as 5 years time. Despite full compliance from British Gas, this was only partly successful because it maintained the net long-term gas-purchasing position of the incumbent and the gas was not directly available to new-entrants.
- **Release Gas Programme 1992 to 1995** – In March 1992 British Gas plc gave an undertaking to the Office of Fair Trading to release gas from its long-term contracts to speed access to gas supplies by independent traders. This was part of a set of undertakings by British Gas to secure the development of genuine self-sustaining competition for eligible customers. The gas release programme was administered by the regulator Ofgas.

British Gas agreed to make available for release the following volumes of gas in annual tranches:

1992/93	500 million therms
1993/94	500 million therms, plus 100 million therms agreed in 1993
1994/95	500 million therms, agreed December 1993
1995/96	250 million therms (minimum)

Gas traders were invited each year to bid for a share of a tranche of gas priced at WACOG, i.e. the weighted average cost of gas to be purchased by British Gas during the year, plus a wholesaling fee of 0.25 pence per therm. New-entrants were active bidders: in 1992/93 32 companies successfully applied for gas and an additional 70 companies in 1993/94, although these numbers are inflated due to multiple-bids. Tighter selection criteria were introduced in 1994 to prevent such actions in the following gas years. The 32 successful bidders in the first year had a contractual right to bid for gas in the subsequent tranches.

By the time of the 1994/95 release programme in the UK, spot gas market began to develop rapidly, industrial and commercial prices fell and the incumbent's market share dropped.

Spanish release gas programme 2001

Spain recently introduced a release gas programme for 25% of the gas supplies that Spain receives from Algeria through the Maghreb pipeline from 2001 to 2001. This totaled 1.4 bcm/year or 43.5 billion thermal units: 9% of total supplies to the Spanish market.

Gas was released for 3 years to avoid price-review complications. The programme was based on the fundamental principle of keeping the incumbent neutral (as was the case in the UK.) The average price paid by bidders is equivalent to Gas Natural's purchasing cost plus a fixed management fee.

Participation was conditional on the tender demonstrating plans for securing gas in another way once the release programme finished. The release was designed to give competitors to Gas Natural access to gas so customers in the large industrial market would receive offers from alternative suppliers. The total release equates to 19% of the eligible customer market.

The gas was awarded according to a) participants meeting the eligibility requirements to be short-listed and b) economic bids of the short-listed companies. Short-listing depended on companies showing evidence of the following:

- independent supplies from 2003
- a diversity of supply sources from 2003
- the distribution of customers in the Spain market
- the expected number of customers in 2004.

Traders that failed to reach the short list, expressed concerns that the qualifying requirements were too onerous for new-entrants. The unsuccessful companies that were Cepsa, Gaz de France, Gas de Euskadi, ICG, RWE, Ericsson, TXU and L Dreyfuss.

14 licensed gas traders submitted bids, of which 9 were short-listed and 6 were allocated volumes as follows in return for a total payment of \$273 million.

BP	25%
Iberdrola	25%
Union Fenosa	20%
Endesa	18%
Hidrocantabrico	10%
Shell	2%

In a recent feature in Spanish newspaper *El Pais*, the Spanish Association of Intensive Energy Users (Aege) was critical of the release programme for not releasing gas to new-entrants, especially suppliers from other states.²

Proposed Gas Release Programmes

Germany: Ruhrgas

Government approval of the acquisition of Ruhrgas by E.ON was subject to a number of obligations on Ruhrgas. One of these was to establish a gas release programme to release 200 billion kWh of gas from its long-term import contracts.

Programme summary

- 200 billion kWh of gas will be sold in six separate annual auctions, with the first tranche of gas offered at the end of July 2003 for a start date of 1 October 2003.
- A summary information memorandum has been published in English (and to be published in German) on the Ruhrgas web site at <http://grp.ruhrgas.de/englisch/grp/>
- 33.33 billion kWh over 3 years (11.11 billion kWh/year) will be offered in the first auction in 33 lots

² El Pais, 18 November 2001, *El sobreprecio de la apertura gasística*

- No single bidder may bid for more than 11 lots
- Delivery period is three years starting from 1 October 2003
- Minimum Annual Quantity (MAQ) 80%, minimum daily quantity 60%DCQ
- Gas will be delivered at the flange near the Emden-Bunde Hub where the Norpipe Terminal joins the Ruhrgas pipeline system
- Nominations have to be made D-1 at 11:00 hours
- The starting price for the auction is 95% of the published average border price (by the BAFA) for the delivery month concerned plus the premium set by the auction
- Monthly payment to be made 10 days after delivery, with a later adjustment payment based on the average gas import price
- Force Majeure provisions apply
- Companies wishing to bid must provide a bank guarantee for EUR 1 million per lot being bid for and a higher guarantee if their bid is successful
- Companies with more than a 10% holding by E.On and Ruhrgas are excluded

Austria: EconGas

Dominant gas supplier EconGas is a joint venture between the national oil and gas company OMV and regional gas suppliers Wiengas, Ferngas, EVN, Begas and Linz Gas/Warme. As a condition for the approval of this joint venture in 2002, EconGas agreed to implement a gas release programme.

Programme summary

- 250 million cubic metres of gas offered at auction on 17 July 2003 for delivery at the Baumgarten hub from 1 October 2003
- 25 lots of 10 million cubic metres (110.674 million kWh) each with a duration of 1 year
- Gas will be allocated via an internet-based ascending clock auction
- The price for the gas is set purely by the auction, but EconGas is not obliged to sell the gas if the price is below the cost it incurs in obtaining the gas
- The gas is sold without any swing
- Invoices for payment are issued in advance on a monthly basis
- EconGas will rate the credit of each participant and require a credit guarantee based on a fixed and a variable element (the latter linked to its credit rating)
- EconGas, its parent companies and affiliated companies are excluded from the auction