

EFET comments to the preliminary report under the Quo Vadis EU gas market regulatory framework study



EFET comments – 10 July 2017

EFET¹ welcomes the opportunity to comment on the Quo Vadis gas market study published on 20th June 2017. We highly appreciate the chance to contribute to this extensive study and we hope the Commission and the consultants will find our remarks useful. While we realize that the timeline for the report is short, we hope that all steps of the study will be consulted to the highest extent possible and we are eager to join the discussion at all times.

The preliminary report represents a good first step in the process of preparing a detailed model and a credible view of how the EU gas regulatory framework could evolve during the next decade. We highly appreciate the fact that the consultants have identified and recognized many of the obstacles and threats to the functioning of the internal gas market that we have highlighted in our intervention submitted when the study was commissioned. Our intervention included a number of points where we felt further analysis would be particularly insightful if they were considered as part of the scenario-based approach to modelling in order to uncover what market inefficiencies still need to be tackled. However, we have a number of concerns about the modelling assumptions that we would like to indicate before the study moves on to the quantitative phase.

First, the assumption of full, EU-wide implementation of the Network Codes and relevant EU gas market legislation as a starting point for the quantitative analysis in 2020 is unrealistic. As much as we understand the need to make assumptions and simplifications to the modelled reference point, such an approach may undermine the accuracy of the forecasts and lead to improper conclusions. It would be important to recognize that the Third Package and the NCs are at different stages of implementation across Europe. The Quo Vadis study should therefore start with an assessment of the existing shortcomings identifying those which are likely to be addressed by proper implementation of the existing regulatory framework as well as those which would remain outstanding and would therefore require additional intervention. The extent of such intervention is to be further analysed, since certain issues may be addressed by minor amendments into existing legislation (e.g. CMP rules), whereas others may require more substantial changes. This would avoid unnecessary changes at a time in which the industry is already adopting new rules. We also suggest to model the main features of the local market arrangements under

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their current form unless member states have signalled their intention to overhaul them significantly. Measures such as storage obligations, specific balancing mechanisms, regulated end-user prices and tariff peculiarities can have a large impact on gas flows and pricing and they should not be ignored. This would ensure that any welfare assessment is performed against a realistic counterfactual and ensure that the results of the modelling can really provide an indication of potential benefit.

Second, gas demand dynamics should be more thoroughly analysed, as they will have a substantial impact on potential changes in welfare. The base case should consider the impact of the EU Energy and Climate targets for 2030² even though it is not included in the PRIMES EU Reference Scenario 2016. For the same reason, sensitivity analyses in terms of the expected level of gas demand and supply would provide a more robust basis for decision-making.

Third, we note that any 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 as it will be one of the major determinants of welfare changes under the different scenarios. As previously stated, the use of assumptions and a degree of simplification is intrinsic to the nature of economic modelling; however, it is important to ensure that they are adequately reflective of actual market conditions.

Fourth, the welfare impact of the different scenarios and sensitivity analyses should be assessed at a regional and national level, as well as at the pan-EU level. Differentiated impacts and distributional consequences are important elements to determine the desirability of potential policy measures and their political feasibility.

Fifth, the potential impact of the infrastructure depreciation and its further removal from the regulated asset base on the cross-border transmission tariffs should be assessed. This is necessary within the analysis of the expiry of long-term capacity contracts and the consequences for location spreads.

In addition to our general remarks on the fundamental assumptions of the modelling task, we would also like to indicate some more detailed points that we believe should be covered in all the scenarios.

As indicated in our initial submission to the Quo Vadis study, we believe that **asset stranding upon expiry of the long-term contracts constitutes a key issue for the future of the internal gas market.** We would therefore like to understand how the model will address the issue of evaluating the need for maintaining and remunerating assets for security of supply purposes in the face of low utilization rates and revenue under-recovery. Similarly, we would again like to stress the fact that the requested number of PCI-rated projects would exacerbate this trend of low infrastructure utilization, substantially increasing the amount of revenues to be collected. This, in

² EUCO27², EUCO30², PRIMES²: https://ec.europa.eu/energy/sites/ener/files/documents/20170125_-_technical_report_on_euco_scenarios_primes_corrected.pdf

turn, may lead to the adverse effect of a reduction of welfare and an adverse effect on market integration.

Furthermore, the model should evaluate the impact of reducing IP tariffs to zero (either via a tariff reform or via market mergers) in particular for long-term capacity contracts. Main alternative policy options should be outlined and modelled. The study should at least contain one scenario where all long-term capacity contracts are terminated in the context of a tariff reform and one where long-term legacy capacity contract will remain.

Recognising the ambitious and comprehensive nature of the analysis suggested under the Quo Vadis study, EFET would support an approach where several of the proposed scenarios and sensitivity analyses are analysed simultaneously in order to designate the best solution to the gas market development in the future. At this stage EFET believes that scenarios 1, 2 and 3 should all be in scope.

Scenario 1 (Tariff Reform scenario) envisages setting (i) intra-EU cross-border tariffs to zero (reserve price); and (ii) gas storage entry/exit tariff to zero, although the merits of the mechanism should be explained in more detail and analysed, recognising the concerns we expressed earlier about the modelling assumptions. The study assumes stable domestic exit tariffs and unchanged TSO revenue. These assumptions mean that all changes to transmission tariffs are accumulated on the entry charges. We would like to see more policy options analysed than merely the allocation of all IP costs at entry points into the EU. Sub-scenarios looking at alternatives such as allocation at exit points to end users and DSOs or a 50-50 split must be developed and analysed with equal attention. No pricing approach should be ruled out at this stage.

The removal of tariffs at IPs is also a feature of Scenarios 2 (*Regional market merger*) and 3 (*Conditional market merger*) so the points above are equally valid in relation to these scenarios. Although worthy of further analysis, some of the market mergers identified under these scenarios are already under development and may possibly be delivering welfare benefits prior to timescales being considered under the study. While nothing in existing gas market legislation prevents market mergers, whether it be a regional or a conditional merger, realistically they present very significant challenges. It may just not be feasible to legislate to bring about all of the market merger possibilities envisaged under the study. The study will need to ensure that all related investment costs, possible reductions in firm technical capacity offered, and costs of potential flow-commitments mechanisms are taken into consideration when evaluating the feasibility and benefits of the mergers. Overall, we believe the most successful market mergers are likely to be those that occur organically on the back of market forces and the local political desire for it to be achieved.

Finally, we see little merit in pursuing the analyses under Scenario 4 (*LTC gas delivered at EU border*). This scenario displays significant legal challenges due to its major impact on existing contracts and the restriction of contractual freedom it would impose. We believe that a prohibition to conclude long-term gas contracts within the EU would severely damage the ability of players along the value chain (including end users) to buy and sell gas on a forward basis and hedge their exposure appropriately, resulting in a loss of welfare due to increased uncertainty.