

# **The implementation of the single market in natural gas**

## **EFET Position Paper**

**September 1999**

### **Introduction**

The European Federation of Energy Traders (EFET) was set up in 1999. The group represents 29 companies across Europe. Each company in EFET supports liberalised markets, in electricity and gas, in each country of Europe.

### **General**

The EU gas market is characterised by a variety of structures. EFET wishes to ensure that the natural development of the internal market is not distorted or constrained by barriers to competition, which result from undue application of subsidiarity in Gas Directive implementation. In addition, in EFET's view, it is important to avoid the imposition of unnecessary bureaucracy in the European gas market. That is, while EFET supports the need for an independent regulator in each country, care should be taken that this does not result in a substantial increase in administration, particularly for new entrants.

The Commission has produced several documents including Gas Directive guidelines, the harmonisation report and the interoperability study. These documents represent helpful explanation and clarification of the Gas Directive requirements as well as a warning of some potential detrimental effects of a minimalist approach to implementation. EFET welcomes the pro-active stance taken by the Commission in identifying issues. We hope to see more of this transparency, as well as some of the identified problems being addressed.

**The guiding principle for implementing the Gas Directive must be the goal of achieving a fully competitive energy market. EFET believes that failure to achieve a competitive gas market will also have consequences for the implementation of the Electricity Directive. There are several steps that need to be taken, with respect to gas, in order to deliver a fully competitive energy market -**

### ***Effective unbundling***

EFET believes that effective unbundling is one of the most important steps in achieving a competitive market. Effective unbundling will remove much of the work of the Governments and regulators (where they exist). This is because an independent pipeline company will have different incentives than a pipeline company that is affiliated with a supply company. An independent pipeline company should have no need to discriminate against one party as opposed to another. An integrated company, unless properly separated, is likely to have an incentive to use its pipeline monopoly to favour its affiliated supply function. This can be demonstrated from the early days of most liberalised markets.

The Directive requires the preservation of confidentiality of information, together with accounting unbundling of transportation and trading activities. These two requirements of the Directive do not sit easily together. That is, in practice, clear administrative separation or 'Chinese Walls' (that is, more than accounting separation) will be required in order to prevent commercial information from a third party reaching the supply arm of a transportation company. Only in this way is it possible to ensure that third party suppliers and marketing affiliates of a transportation company are treated on an equal basis. In EFET's view, accounting unbundling alone will not prevent commercial information being passed from the pipeline business to the trading business.

It appears that much of the potential conflict regarding Gas Directive implementation is caused by the incumbent monopoly transportation companies continuing to think of themselves as integrated transportation and supply businesses. If their intention were truly not to discriminate between third party traders and their own trading businesses then they should have no material concern in going further than the minimum recommendations of the Gas Directive with respect to internal separation. In order to demonstrate that confidential information given to transporters remains confidential (as required by the Directive), and given the implausibility of accounting unbundling alone allowing this to be achieved, EFET suggests that Member States should require integrated companies to explain the mechanisms by which confidentiality of information will be ensured.

A further point here is the role of Transmission System Operators (TSOs). The role of TSOs has become significant in the implementation of the Electricity Directive. For example, the European Transmission System Operators (ETSO) is in dialogue with the Commission on issues related to cross-border trading. EFET suggests that there would be a similar role for gas transmission system operators. Such an organisation could helpfully seek solutions to the issues identified in the Commission's inter-operability report and other issues associated with pan-European trading.

### *Pipeline access*

Transparent and non-discriminatory tariffs for access to gas pipelines and services throughout the EU are also essential for the achievement of the competition in the energy markets. Such tariffs also put pressure on monopoly transportation companies to cut costs and improve services to customers. The Commission's emphasis on this aspect is appropriate and EFET fully supports it.

It is only through price transparency (together with proper separation of transportation and trading businesses) that it can be demonstrated that a network or storage undertaking is giving access to a third party under the same terms as their own subsidiary or trading arm. This is a requirement of article 7.2 of the Directive.

De-facto there is a wide range both of transportation charging mechanisms and of commercial and technical rules for network access in different parts of the EU. A reduction of these differences would undoubtedly improve the workings on the internal gas market. The minimum requirement must be price transparency, to enable cost comparisons, thereby revealing cross-border distortions. Simplicity in the design of transportation charging is also necessary to facilitate the development of gas exchanges (or trading hubs) that may well transcend national boundaries. There are, however, dangers in trying to impose a single system and EFET would advise that the best solution is rather to encourage the natural

evolution of trading centres. . Lessons can be learned from the Electricity Directive. The most successful new trading centre is in the Netherlands, a country that already has transparent transportation tariffs (together with regulated third party access).

The rules of access to pipelines (and storage and related services) also need to recognise that a customer will not be able to benefit from a new competitive supply if the new supplier cannot get access to the pipeline because the incumbent supplier has a long term capacity booking that freezes out competitive activity. This 'first-come-others-refused' approach would be anti-competitive and must not be allowed to occur. Any such refusal of access must be demonstrated, as the Commission recognises, to be objective and non-discriminatory.

Finally, EFET recognises that the Gas Directive allows NTPA, rather than RTPA. However, EFET has several comments on RTPA vs NTPA

- NTPA will lead to an increasing, not decreasing, regulatory burden
- It can already be demonstrated that negotiated prices in liberalising markets are being set at what the market will bear, rather than being related to actual costs, a clear sign of discriminatory pricing
- In Germany, NTPA will take the form of the gas Verbändevereinbarung ("VV"). EFET has concluded that this, as drafted, will not lead to market entry. There are several reasons for this, which we would be happy to elaborate further upon.
- Any access arrangement must include all the services necessary for TPA - quality conversion and access to storage / balancing tools for example are not included in the gas VV in Germany
- Any access arrangement must not result in unnecessary technical obstacles - the hourly balancing regime of Gasunie is clear example of this

EFET agrees with the Commission that "the two approaches to system access laid down in the Directive must lead to equivalent economic results in the Member States, and hence to a directly comparable level of market opening up of markets and to a directly comparable degree of access to natural gas markets." EFET suggests that each Member State that chooses NTPA, rather than RTPA, ask gas undertakings to demonstrate that its negotiated prices have actually resulted in non-discriminatory, cost-reflective services.

### ***Access to storage***

It is a feature of liberalised markets that as the thresholds for competition reduce, end-users have a greater need for flexible services. EFET believes that access to storage is therefore essential for the development of competition. Access to storage must be on a non-discriminatory basis between third parties and the storage undertaking's own supply arm: this is clearly stated in article 7.2 of the Directive. The Commission has rightly concluded in their guidance notes that "availability of storage ... is crucial for an efficient operation of the gas system". Also, the Commission has said that access to storage is only necessary when such access is "technically necessary for providing efficient access to transmission and distribution networks".

EFET is concerned that some Member States appear to wish to limit access to storage. If accepted this could force eligible customers to use the bundled services offered by the incumbent monopolies and ensure that competing suppliers are at a disadvantage to the

monopoly transporter's own supply arm. Such disadvantages for customers have clearly been seen in the existing liberalised markets. That is, integrated companies were able to offer "full requirements" contracts to customers. Competitors to the integrated companies were not able to offer such flexible services, as access to storage was denied, or over-priced. Competition, as a result, was hindered in its development.

In principle, whatever rules or guidelines are put in place should enable eligible customers and competing suppliers to access storage services without having to buy gas, transportation or any other services from the incumbent monopoly. The goal should be for the prices of storage services to be set by the market. The initial step would be for all storage services to be unbundled from transportation and supply businesses. Until this is achieved it will be necessary for the prices of storage services to be set in a transparent and non-discriminatory way.

The importance of access to storage is demonstrated by the way Member States are proposing to implement the Gas Directive. For example, Gasunie in the Netherlands has proposed hourly balancing. Many believe that these arrangements are unduly onerous. However, if such arrangements are to be put in place, it is only fair that access, at reasonable prices, to storage is allowed.

Member States should demonstrate their commitment to successful implementation of the Gas Directive by aiming to provide full access to storage, as well as other balancing services for all eligible customers and competing suppliers.

### ***Refusal of access on grounds of take or pay contracts***

Europe's security of gas supply will be enhanced by the development of an internal market in which there are well-established spot markets. Special protection for companies who own pipelines and enter into contracts that keep gas and capacity dedicated to themselves would lead to market distortions at the cost of customers.

EFET fully supports the view that the primary criterion in judging the merits of a refusal of access to a pipeline on grounds of take or pay commitments should be the development of a competitive market. In addition, EFET agrees with the Commission that such refusal should be demonstrated to be directly related to "severe economic and financial consequences". EFET also notes that in the UK, where take or pay problems occurred through the rapid liberalisation of the gas market, the solution was found through commercial negotiation not through refusal of access to pipelines or markets. Also, the cost of this re-negotiation was achieved at a significantly lower figure than had been estimated by the regulator or the government.

In the Gas Directive, the process of derogation on grounds of take or pay difficulties is the same for old and new contracts. It is evident, however, that there is a distinction between old contracts that were necessary for financing the development of infrastructure in a developing market and contracts entered into since the move towards liberalisation started. The Commission's assertion that the date of the take or pay agreement is important is well made. EFET believes that there are strong grounds for suggesting an early date. As has been pointed out by the Commission, the concept of the Gas Directive was known for several years prior to

its actual introduction and could have been reflected in contracts signed prior to its implementation. This would point to a date some years earlier than, for example, the implementation date of the Directive.

Liberalisation will lead to greater choice, greater market efficiency and, on average, lower prices whilst maintaining (arguably whilst enhancing) supply availability (as reflected in the Commission's own report on this issue). Some companies may have sought to freeze out competition by agreeing new long-term take or pay contracts, thus making access to new supplies by third parties more difficult and leaving the pipeline company with the option of using the Gas Directive to refuse access to their transmission network. The Commission should be rigorous in scrutinising any refusal of access on these grounds.

Related to this issue is the nature of contracts that exist on mainland Europe. That is, most of the existing contracts are long term, inflexible, take or pay contracts. In a competitive market, such forms of contracts are not appropriate. For example, it would not be reasonable for a producer to insist that any gas that is sold cannot then be resold. This kind of inflexibility in contracts inhibits trading, and thereby the successful implementation of a single energy market. Such contract inflexibility only reinforces the importance of the Commission and Member States delivering transparent, non-discriminatory third party access.

### ***Public Service Obligations***

The application of Public Service Obligations (PSOs) in the context of the Gas Directive is potentially a complex matter. It is important that there is clarity and transparency in the approaches taken by Member States and the Commission.

While we see the list of PSOs included in the Gas Directive, we believe that some Member States may be considering imposing PSOs beyond the types of PSOs mentioned in the Gas Directive. There may also be regional as well as national PSOs that give rise to concern that a multiplicity of obligations might impose unjustifiable constraints on achieving a single market.

EFET suggests that it is important to stick to the list included in the Gas Directive. The Commission's suggestion that there is one single document per Member State is eminently sensible. It is also important that PSOs, and the associated costs, are predominantly targeted at suppliers of residential customers, since larger customers are less likely to need such protection. In this context, it seems unreasonable, for example, that free customers in Spain are required to book storage.

We note the Commission's view that derogation from the Gas Directive is unlikely under normal circumstances. In this regard, EFET welcomes the fact that the burden of proof for using a PSO as a reason for refusing access must lie with the party refusing access.

### **Role of the Commission**

EFET welcomes the publication by the Commission of guidance notes for interpretation of the Gas Directive. It has been argued that the Commission should not add to the wording of the Directive itself. However, EFET believes that the Gas Directive represents only a minimum target for Member States. Of course, the Commission should ensure that each Member State passes into legislation the minimum requirements of the Gas Directive. In this respect, we

would hope that the Commission will be more active on gas than it has been on electricity (where France / EdF are successfully resisting the implementation of the Electricity Directive). It is also important that legislation is not only introduced by the Member States, but is implemented via any necessary regulatory appointments or governmental decrees.

In addition to ensuring the implementation of the Directive, it is a legitimate role of the Commission to offer guidance and clarification as to those areas where it would be particularly helpful for the implementation of the Gas Directive to be improved. That is, the purpose of the Directive is to deliver a single energy market. With that goal in mind, the Commission should, where practicable, offer advice as to areas in which it would be possible for the goal of a single market to be achieved faster than the Directive envisages. In this light, EFET welcomes the guidance notes issued by the Commission as a positive contribution towards the overall goal of achieving a single energy market. We would suggest that the Commission should review these notes on a regular basis. In particular, there may be the need for further guidance notes following the first meeting of the European gas regulators and the Commission (in Madrid in September / October 1999). We would also suggest that the Commission places these guidance notes on the DGXVII website.

### **Summary**

This paper outlines some important points that EFET believes are necessary for the achievement of competition in the European gas market. We suggest actions that could be taken by the Commission and Member States better to achieve the aims of the Gas Directive. EFET would welcome any comments on the views contained in this paper, and would be happy to provide more detailed views on any particular aspect. EFET would welcome further dialogue and discussion with any part of the European energy industry.

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