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Impact of the "storage obligation" on trading and market development in Poland

Dear Mrs. Kaźmierska

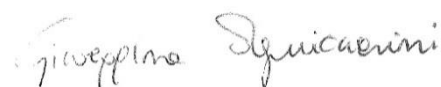
As agreed in the meeting on 15 January 2015 at your premises in Warsaw, we send you enclosed our analysis of the "storage obligation" on trading in Poland also in the light of what we experienced as traders in other European markets.

For further questions please do not hesitate to contact us.

Yours sincerely



Jan van Aken
Secretary General
European Federation of Energy Traders (EFET)



Giuseppina Squicciarini
Chairwoman TF CSEEG

Impact of the “storage obligation” on trading and market development in Poland

The Polish storage obligation

Article 24.1 of the Act on stocks of crude oil, petroleum product and natural gas of 16 February 2007 mandates every shipper importing gas into Poland to hold gas in store in a quantity corresponding to at least 30 days of the average daily amount of gas (“storage obligation”). This gas has to be stored for one year in Poland. It can also be stored in another EU country if the shipper holds firm transmission rights from the storage facility in the neighbouring country to Poland.

Art. 24.5 of the Act allows shippers to apply for an exemption from the storage obligation with the Ministry of Economy. However, players benefitting from an exemption will only be allowed to import a maximum of 100 million cubic meters (mcm) per year and are subject to quarterly reporting requirements to the Ministry. On the other hand, shippers importing for their own consumption such as large industrial consumers are automatically exempted from the storage obligation.

The storage obligation effectively acts as a cap on imports, reducing the amount of gas that new suppliers can bring in

EFET understands the importance of security of supply concerns, particularly in markets that significantly depend from a single gas source such as the Polish one (Poland imported 60% of its total gas consumption from Russia in 2013). However, we believe that the storage obligation has the opposite effect to the objective it was designed for: EFET believes that the obligation reduces the level of security of supply in Poland, prevents diversification of gas sources and acts a key obstacle to developing a well-functioning market.

The main reason for this is because market participants find the obligation costly, complex from an operational point of view and difficult to comply with. For these reasons the storage obligation acts as a disincentive to import gas into Poland in excess of the exemption threshold of 100 mcm. This disincentive reduces the ability of the Polish market to attract import from different sources and to become resilient to supply shortfalls by attracting additional supplies when needed. In addition to this the storage obligation failed to guarantee the subscription of full capacity in 2014. There are a number of reasons why storage capacity in Poland is not attractive for market participants despite the obligation:

- **Access to storage in Poland is expensive:** our analysis shows that storage prices in Poland are well above the ones for Germany and the Czech Republic (see ANNEX II);
- **The obligation imposes additional costs besides access.** In particular, the obligation effectively requires keeping in store for one year a volume of gas corresponding to about 10% of gas import. This imposes a commodity and financial costs on traders. For example, for a trader importing about 200 mcm we estimate additional capital and financial costs to be in the region of 6 million¹ euros per year;

¹ We have assumed a price of 24 euro/MWh for gas, a flat storage profile and a 6% cost of capital.

- **Fulfilling the storage obligation is a pure cost for traders with no benefits.** In a liberalised gas market traders book storage as a flexibility tool to balance their portfolio. Storage has therefore an intrinsic value (the price spread between the summer price of gas and the winter price of gas) and an extrinsic value (the additional value that a trader can achieve by using gas flexibly in the market). Traders tend to be prepared to pay more for storage the higher is the benefit they think they can achieve by holding storage (intrinsic and extrinsic value). In Poland traders will not be able to use the gas kept in storage to fulfil the obligation as a way to flexibly respond to demand variations. The gas kept in storage to fulfil the storage obligation has therefore no intrinsic value and no extrinsic value;
- **The Polish storage obligation is complex to fulfil and carries operational risks.** Whilst the legislation allows for fulfilling the obligation by storing the required volume of gas in a neighbouring country, traders face significant obstacles when trying to comply with the requirement in this way. In particular, there is mismatch between capacity bookings in Germany and in Poland: annual capacity needs to be booked in March in Germany and in July in Poland. Traders risk booking exit capacity on the German border and then being unable to get corresponding entry capacity in Poland². This issue could be mitigated by: **i)** adopting simultaneous auctions over PRISMA at either side of the interconnection point as mandated by the implementation of the EU Network Code on Capacity Allocation Mechanisms and **ii)** ensuring that capacity cannot be hoarded and is made available to the market (as mandated by the EU network Code on Congestion Management Procedures);
- **The Polish storage obligation distorts the market by discriminating between shippers importing for trading/reselling purposes and those importing for own consumption.** As industrial clients are fully exempted from the obligation, import costs are not equal for all shippers. Furthermore, shippers importing for own consumption exempted from the storage obligation are prevented from trading their import volumes in Poland, reducing activity on the exchange and limiting the potential for increased liquidity on the Polish gas market.

Market participants see the cost of complying with the storage obligation as an add-on to the cost of transmission between a neighbouring country and Poland. This may in some case make a difference in the decision of importing gas into Poland: shippers will not import if the cost of the commodity in the neighbouring country plus the transportation cost plus the cost of the storage obligation is below the price spreads between the two markets. So, effectively the extra cost from the storage obligation may make Poland a market which does not attract import.

EFET is of the view that the requirements imposed by the storage obligation are obsolete and no longer needed in a liberalised and integrated gas market. In such markets, participants react to price signals and a reduction in gas from one source or one company would trigger a small price increase on the wholesale market that would in turn lead other companies to schedule gas imports into Poland from either a foreign country connected with Poland via the pipeline system or through LNG cargoes.

² There is an additional operational risk on the Polish side where there are actually two transport capacity allocations taking place at the same time in July: entry Poland at Mallnow and then entry in the Polish system. A trader will need to be successful in both auctions to be able to fulfil the obligation.

The effectiveness and resilience of a market-based approach has been widely recognised in North West Europe where most markets just rely on well-functioning gas hubs and do not require market participants to hold stocks. These markets have been increasingly successful and have achieved security of supply without imposing extra costs to market participants and to consumers. The responsiveness of markets has also been demonstrated by the changes in flow patterns observed in recent years, particularly in Central and Eastern Europe where physical and virtual “reverse flows” allowed gas to be shipped in the opposite direction of the traditional east-west export route. From spring 2014, we have witnessed substantial flows from Slovakia, Hungary and Poland to the Ukraine. Even though these flows are being hampered by political and contractual issues, their cumulative volume now exceeds 50 mcm/day³ and is allowing the country to cope with the shortfall in Russian gas. This shows how markets are able to respond and provide gas where needed, even in less liquid and liberalised areas.

Conversely, in Poland the storage obligation – combined with the other obstacles which we mentioned in our letter of 20 November 2014 – does not allow to react quickly to changing market conditions and would prevent shippers from importing gas in case of a major supply shortfall or higher than expected gas consumption in the country.

EFET firmly believes that security of supply is best guaranteed by the development of a liberalised market able to attract gas from different sources.

EFET therefore believes that the storage obligation in Poland should be phased out as soon as possible.

We recognise that the Polish Authorities may consider necessary a gradual approach in phasing out of the existing obligation. In such a case, the current obligation could be replaced with interim solutions which have a less severe impact on the development of a well-functioning market. To support URE and the Ministry of Economy in developing a roadmap for phasing out the existing obligation, we offer in annex I examples of other EU countries. In Annex II we also include examples of how the cost of storage in Poland compares to neighbouring EU countries.

³ Source: ENTSOG transparency Platform.

ANNEX I: **Storage obligations in other European countries**

Most European gas markets do not impose on market players any obligation to keep stocks of gas in storage. For example market participants have no obligations to hold stocks in UK, Germany, Austria, the Netherlands, Slovakia, Hungary and Greece.

We believe that relying on markets provides the best guarantee to ensure security of supply. EFET therefore believes that Poland should phase out the obligation.

As you requested, we would like to provide examples of how storage obligations are dealt with in other European countries. In general, EFET is of the view that obligations on suppliers or traders that force certain booking behaviours or restrict certain types of access or usage of storage tend to reduce the value of storage and distort market behaviour to the detriment of supply security and market efficiency⁴. However, as explained in the main body of this paper, the current Polish storage obligation is particularly restrictive and therefore even more distortive of market functioning than the examples provided in this section.

Czech Republic

The storage obligation in the Czech Republic is limited to suppliers serving residential customers; as such it has a less distortive effect on import than the Polish obligation. Importers trading at the wholesale level and suppliers of business customers do not have the obligation to hold stocks. Importers can therefore quickly react to demand increases in the Czech market and support market resilience in case of supply shortfalls.

In particular, the Czech Gas Storage Obligation (344/2012) states following: gas suppliers are obliged to keep at least 20% of the gas supplied to protected customers in gas storages during period 30th Sept to 1st April. Gas storages shall be located in the European Union. Protected customers are defined as households and some prioritized off-takers such as hospitals, emergency etc.

Italy

Suppliers serving residential customers in Italy used to have a de facto obligation to hold storage capacity: suppliers serving residential customers used to have priority in storage capacity allocations and capacity was allocated pro quota based on demand.

Since 2014 the vast majority of storage capacity in Italy is auctioned off. Traders can use their storage stocks to provide flexibility. As traders can benefit from holding stocks, auctions worked well in Italy and storage stocks reached a record high in the 2014.

Italy maintains some "strategic stocks" of gas in its storage sites and, in a similar fashion to Poland, its costs are borne by importers. However, these stocks are managed in a centralised manner by the country's largest storage operator Stogit and financed through a levy on gas volumes injected into the grid from import points (pipelines and LNG terminals) and domestic production fields.

⁴ See also EFET response to CEER storage consultation for further reference:
http://www.efet.org/Cms_Data/Contents/EFET/Folders/Documents/EnergyMarkets/GasPosPprs/2005Today/~contents/4FM2LPB7WEYAB73D/EFET-response_CEER-storage-consultation_final.pdf

In 2014, the Italian strategic storage system still represented a cost to shippers of 0.09 euro/MWh (applied to import flows). The Italian strategic storage is a cost to shippers and the higher is this cost the lower the incentive to import into the country. However the Italian strategic storage has some operational advantages compared to the Polish storage obligation:

- the volume of strategic stocks is set annually and limited to what the Ministry considers necessary for that year, the rest of the capacity can be used commercially;
- the Italian system is administratively less complex than the Polish one and does not require to set up commercial relationships with storage operators;
- there are no operational risks as importers do not have to book capacity or storage capacity;
- market participants are allowed rapidly increase the planned amount of import to react to changing market scenario and are not constrained by the amount of gas they decided to put in store at the beginning of the gas year.

ANNEX II: Comparison of storage costs in Poland, Germany and Czech Republic

Figure 1 and 2 compare 2015 storage prices in Germany, Poland and the Czech Republic⁵. For Poland we have considered the storage sites which can be used to book firm capacity to fulfil the obligation according to the OMS⁶.

Figure 1: Comparison of storage prices: lowest, average and highest prices

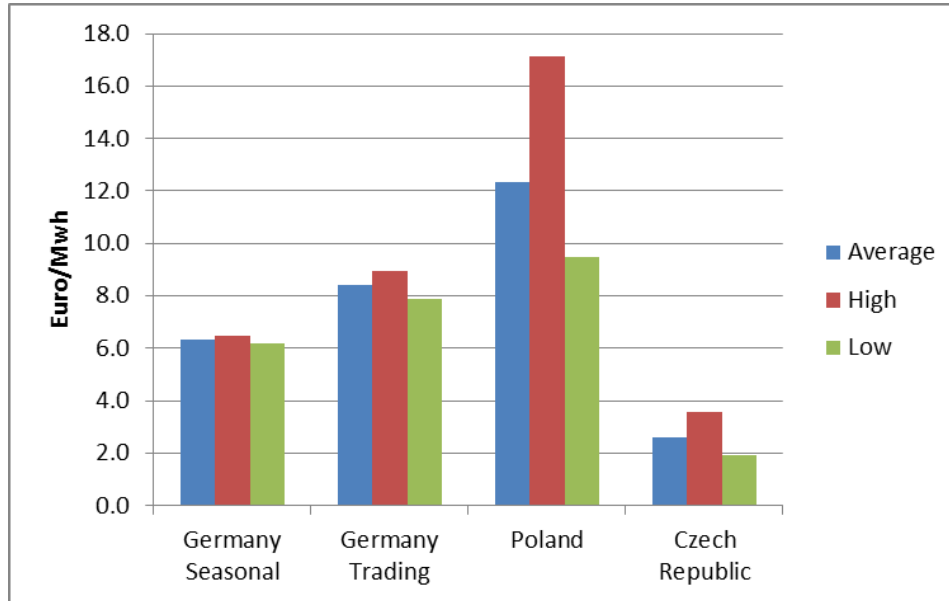
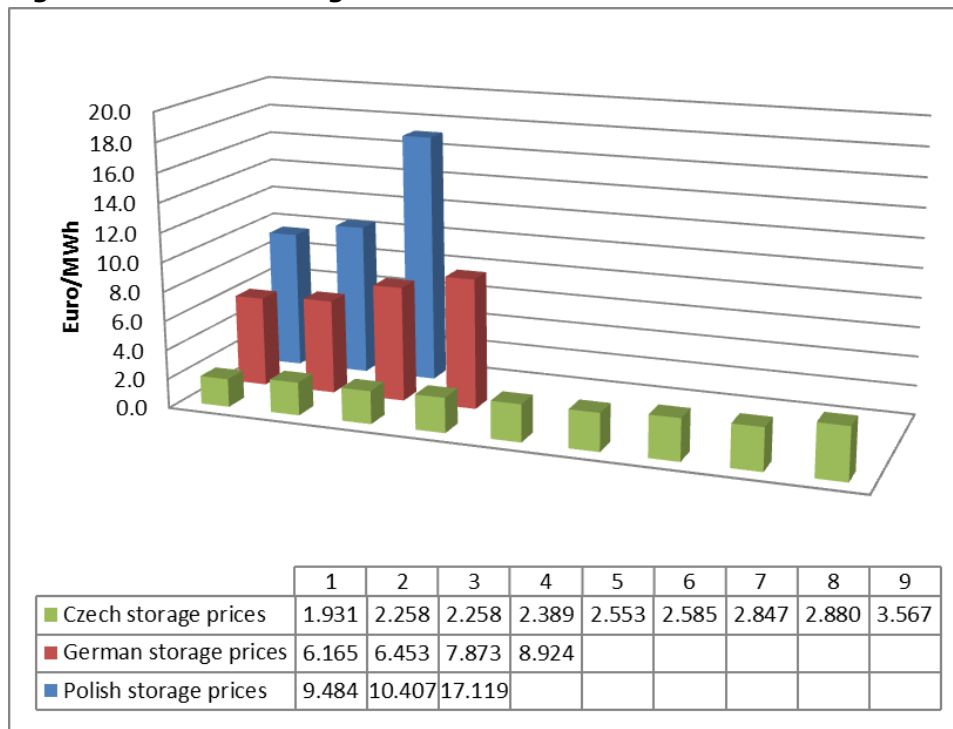


Figure 2: Prices of storage services



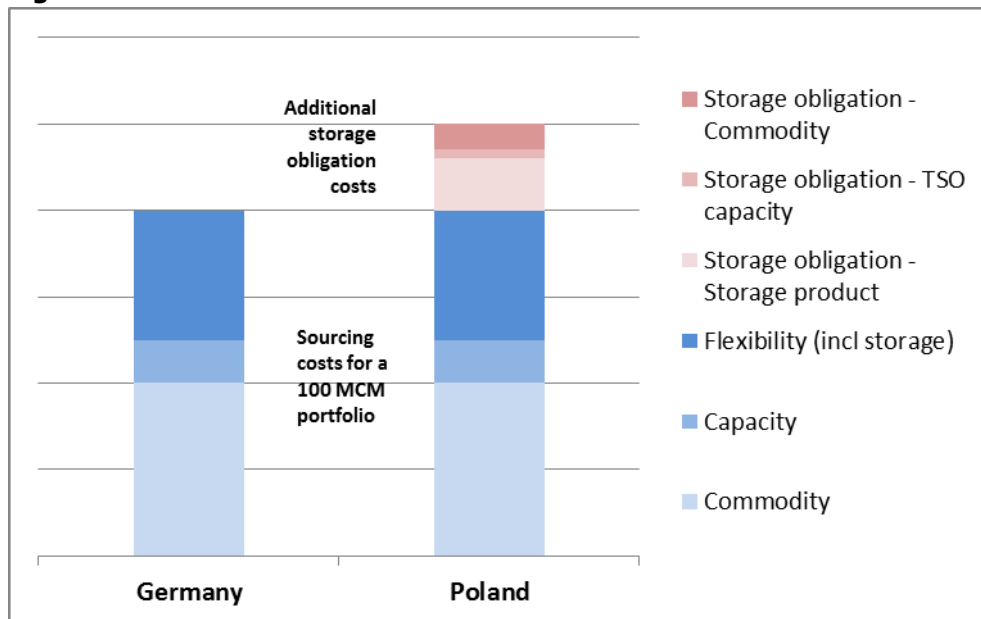
⁵ Please note that in the case of Czech Republic, the reported prices are the results of auction processes.

⁶ See: <https://www.osm.pgnig.pl/en/storage-services/mandatory-gas-stock>

As explained in the main body of the paper, in addition to the storage service, the storage obligation in Poland implies additional cost in terms of TSO capacity which needs to be booked, commodity costs and related financial costs. Even assuming that other costs in the two markets are the same, the storage obligation imposes extra costs which are not present in Germany (figure 3 represents this graphically).

In addition, German storage can be used by suppliers as source of flexibility for their portfolio. In Poland, the storage capacity must be held in stock for certain (rare) market conditions and flexibility must be purchased/booked additionally⁷.

Figure 3



⁷ All storage prices do not include transportation costs. All prices are in euro/MWh and based on publicly available tariffs.