EFET response to Francois Lamoureux, DG TREN, on questions about progress in EU gas liberalisation and the state of the markets

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Introduction

The European Federation of Energy Traders www.EFET.org is a group of 75 companies from 19 European countries engaged in wholesale energy transactions. EFET is dedicated to stimulating and promoting energy trading throughout Europe.

Effective competition in the energy retail markets is only possible if there are robust traded wholesale markets. Traded markets only develop once the conditions exist for several buyers and sellers to participate on a fair basis.

The EFET Gas Committee has prepared this paper; the EFET Electricity Committee has written a companion paper dealing with the electricity market. Our focus in this paper is thus on the wholesale gas markets and the conditions necessary for gas trading to flourish.

1. Overview of the EU gas market

The conditions to sustain competition in continental European gas markets have not yet been established. Nearly all EFET Members are involved in electricity trading, but roughly only half are able to trade in gas. Whilst several traded power markets are now flourishing, the gas markets lag far behind.

EFET has set out in a separate paper[1] the basic principles that need to be followed in dealing with a wide range of issues across the gas market. Sadly, many of these basic principles have still not been implemented in some of continental Europe's largest gas markets.

In providing examples of the state of the gas markets and the improvements that are needed, EFET would like to point out that our members' experience of gas trading in continental Europe is concentrated on those few countries in which liberalisation is well advanced. In particular, the more detailed examples from the Netherlands are only possible, because progress in reforming the gas market structure and introducing information transparency are well ahead of most other continental European countries.

[1] *Key Principles for European Gas Market Development, update 2004*, 18 October 2005, available at www.efet.org

1.1 Current status

The prevailing situation in continental Europe is characterised by: a **lack of liquidity**, so that it is impossible to buy or sell a large quantity of gas in continental Europe at a traded market price, whether via a broker or on a gas exchange. The absence of a reliable, transparent spot gas price, results in difficulties in hedging and a lack of reliable financial instruments to manage risk. The lack of liquidity has a number of underlying causes, these include:

- A predominance of long-standing contacts or arrangements with **terms or different treatment, favouring the incumbent companies and related joint ventures on transit pipeline routes.** Some incumbent operators even purport to exempt their own **long-term arrangements** from the access and payment rules that apply to new entrants. Long-term capacity reservations that were obtained prior to the competitive market being established can be a barrier to new entry. They tend to distort competition and provide an unregulated monopoly role for those who obtained such long-term rights, without any allocation based on market mechanisms or an open season.
    - EFET observes that hardly any TSOs make efforts to determine (through a retroactive review of flow patterns on an annual or seasonal basis) unutilised long-term capacity. Such determination would be indispensable, in order to offer such capacity again to alternative users on a firm basis via market based mechanisms.
    - When capacity is not used on the day-ahead, EFET sees that such free capacity is mostly offered on an interruptible basis, with a prevailing right for the long-term owner to use the capacity again for within day nominations. As a consequence, the new players who buy such “free” capacity still bear a within-day risk of losing the capacity.
    - In general, and particularly in the presence of long-term capacity ownership, secondary markets are currently not very well developed or facilitated.
- Failure by infrastructure operators to ensure that the maximum capacity is offered to the market and that third parties have access to capacity that would otherwise remain unused. **Booking capacity is difficult**, time consuming and sometimes not possible. Problems in accessing capacity are a hindrance for trading and a stumbling block for newcomers to the market. In addition, the present way of allocating capacity results in a less efficient use of the grids.
- In particular there is **a lack of market-based mechanisms (auctions) for capacity allocation**. This is causing real problems at current bottlenecks.
- Very **little harmonisation** of access rules and procedures, with widespread concern that the processes and procedure for third parties are more onerous and less timely than for incumbents.
- A move towards improved network access systems, but with different and **inconsistent implementation of Entry/ Exit systems**, which are sometimes

little more than window-dressing, as they still require capacity booking along a route between entry and exit points and fail to provide a single balancing zone.

- System operators still fail to base balancing regimes on efficiently incurred costs. Many still constitute "**penalty balancing regimes**" and only a few operators are making some welcome progress towards market-based balancing.
- **Lack of effective unbundling**,
    - The system operator sometimes seems to operate according to the optimisation of the contract portfolio of its affiliate supply company, rather than be solely concerned with the physical optimisation of the pipeline system, in response to the needs of all network users. In certain countries, e.g. Germany and France, the **practical and financial separation** between grid operators and incumbent suppliers is very unclear.
    - Roles and **responsibilities of TSOs are unclear** or not harmonised, usually because the role of the incumbent supplier was not properly thought through at the time of separation. The following are some examples.
        - In the Netherlands the transportation services appear to have been designed with the historic operation of the system in mind and have the effect of protecting the position of the historical supplier.
        - In Belgium the transfer of transit capacity to an affiliate of the incumbent supply company before the implementation of separation has made it difficult for third parties to access that capacity. The transfer of primary capacity rights to the historic supplier causes regulatory confusion and can frustrate the ability of new entrants to access capacity.
    - **Failure to publish compliance reports** or even to appoint compliance officers, leaving network users with no confidence that compliance programmes are being properly implemented nor that discriminatory behaviour is being discouraged by the grid operators, nor that commercial information is properly held in confidence.
- Widespread **lack of information about the physical availability of the system and ancillary service facilities**, particularly a lack of transparency from the TSOs when facing the market. This ranges from simple non-publication of historical flows on the main pipeline interconnections and of daily system demand, through to the failure to provide information about how available capacities have been calculated. Transparent information is needed to allow a proper evaluation of allocation mechanisms, available gas quality conversion capacity, etc. TSOs should make available to the market all information in their possession, which does not relate to the commercially confidential aspects of an individual third party account.

- Regulators appear to have inconsistent powers or there is a **lack of regulatory or political will,** particularly to act against bundled companies. Concerns of protectionism are strongest in
    - Germany –(where the regulator has yet to exert any power and legislative proposals appear to be strongly influenced by the incumbents) and
    - France (where the Government regularly overrules the regulator to the benefit of the incumbents).

1.2 Likely future development

EFET would like to see the development of open, transparent and liquid wholesale gas markets throughout Europe. Traded gas markets are an essential aspect of effective competition in gas supply.

EFET is concerned that, without rapid and effective action to resolve the problems caused by non-implementation or ineffective implementation of the internal market directive, the supposedly newly open EU gas market will be foreclosed, before fresh competition has had a chance to develop.

Further concern arises from a number of other initiatives that could restrict the development of competition. Examples of these include:

- The January 2005 paper "Gas voor morgen" (Gas for tomorrow), prepared by the Dutch "Algemene Energieraad" (General Energy Council), pleads in its conclusions a limited number of strong players, without apparent heed for the detrimental consequences of correspondingly less liquid markets.
- Recently additional constraints on producers' freedom to provide flexibility have been imposed in the Netherlands.
- The recent GTE paper "Report on fostering investment in new gas infrastructures for Security of Supply": is strongly based on the "exemption" idea and appears to ignore the responsibilities of the regulated TSOs to develop their networks to satisfy future demand for capacity.

GTE have argued that investment in new transmission capacity is dependent on:

- Guarantees from regulators for non-intervention,
- Long term binding capacity contracts prior to investments, and
- Exemptions from TPA regulations.

If TSOs do not expand their systems unless all these conditions are achieved, then those who are not in favour of a liberalised market will have succeeded in creating a long-term barrier to competition.

Europe must act on its choice of efficient markets to deliver secure, sustainable and competitive gas supplies.

1.3 Interaction between the gas and electricity markets

The gas market in Continental Europe is lagging behind the power market in terms of progress towards achieving an internal market. Rather than concentrating on the acknowledged physical differences between the two fuels, perhaps gas market participants and regulators could learn from areas where electricity trading has developed successfully.

Without a concerted effort to remove the barriers to competition in all Member States, we risk seeing within Europe a further divide between mature gas markets like the UK, where competition in commercial services (covering also end-customers willing to switch suppliers) and gas markets dominated by traditional, vertically integrated suppliers and transporters, where end-customers do not switch because they find no real, attractive alternative.

There are both similarities and differences between the European gas and electricity markets. The gas and electricity sectors may face different obstacles to competition, not only because the markets are at different stages of development, but also because the two sectors have different production structures. For example, gas is obtained from a limited number of sources and electricity cannot be stored like gas.

However, it is important to bear in mind that, since a large part of Europe's electricity generation capacity uses gas as a fuel, competition problems in the wholesale gas markets and relevant gas transport anomalies can have a substantial impact on electricity markets. Overall, as gas is increasingly the marginal fuel for power generation, a failure to establish liquid wholesale gas markets, subject to pricing transparency, will impact both on investment in new power plant and on the optimal operation of existing plant (of various fuel types); either impact may lead to higher electricity prices than could be achieved in an efficient market structure.

For instance in the Netherlands:

- Peaking gas plants, which only produce power for a limited number of hours, need to contract for annual transport rights (e.g. exit capacity, and in some cases additional entry capacity); these annual costs (*)[2] have to be attributed to the marginal pricing of the peak plant, resulting in very high power prices. As a typical example, an exit fee of 2€/kWh/year for a peak-emergency plant (100 hours on year basis, efficiency 30%) will result in a markup of 66 €/MWh (power); this amount has to be doubled if additional entry capacity is required.
- Very high penalties up to about 3000€/MWh (gas) may be applied for highest daily imbalance between the physical entry and the physical exit of gas which exceeds the permitted tolerance. This incentivises market participants to flow more gas into the system than they need, i.e. go long. Thus, their reaction to the risk of incurring penalties for being short

[2] In many cases, it does not make sense to subscribe transport rights for shorter durations (like month or day) because the capacity has to be subscribed beforehand, and the capacity fee for a winter month is not 1/12th of the year capacity fee. (for instance, in the Netherlands, Belgium the subscription fee for a winter month is 70 % of the annual fee, while in the summer months this is 10 % and in the in between shoulder months it is 20 %).

reduces the availability of flexibility from gas-fired power plants to the market or results in the risk being passed through in the power price.

- Balancing penalties for daily excess or shortage of gas are not market-based and are in general higher than the prices on a balancing market. This does not create the right incentives and results in higher costs being passed through in the power prices.
- Ramp up notices for increases in power generation output are relatively short, while changes in nominations for gas require several hours to be implemented by the TSO. This means it is virtually impossible to meet the demands of the electricity generation market without incurring penalties and imbalances in the gas market.

2. Improvements to the market framework

In the following sections a number of improvements are suggested – at national level and at EU level.

2.1 National improvements

In this section we comment on some specific issues raised by EFET members arising from specific problems in some key gas markets. This is not a complete list and is not intended to rank market functioning in Member States.

France

- Traders and suppliers need **flexible access to storage facilities** and/or virtual storage products as opposed to the current framework where a user is forced to use storage for seasonal use.
- **Balancing zones** need to be unified to avoid fragmentation of the market damaging liquidity, in addition
    - The penalty-balancing regime needs to be removed.
    - Participation of the incumbents is required to create an active balancing market.
    - Information on line pack needs to be published
- Regulated **end-user tariffs** need to be removed or aligned with market prices. Regulated end-user tariffs currently remove any incentive to customers to switch supplier and therefore obstruct competition.

The Netherlands

- The balancing system needs to be redesigned to facilitate competition. An hourly balancing system is in place in the Netherlands. The balance position of the shippers is not transparent for the shippers themselves. Shippers have little opportunities to correct possible imbalances. Imbalance penalties are not cost-reflective. There is a great reluctance with shippers to start shipping activities in

the Netherlands which is hampering competition on wholesale and thus retail markets

- Action needs to be taken to allow new entrants fair access to flexibility. The historical supplier has a dominant position in the provision of flexibility and even reduced its offer on the market in 2005 with the abolition of the product "Load Conversion Factor".

- Fair access is needed to quality conversion capacity. There are two qualities of gas in the Netherlands. Quality conversion capacity can convert high-caloric gas into low-caloric gas. As this capacity is not abundant available and the quality conversion capacity is not a system service, two distinctive gas markets have developed. This is reducing liquidity in markets and thus hindering competition

- Auctions as allocation mechanism for transport capacity and quality conversion could provide a level playing field for all parties. Capacity is currently allocated on a first-come-first-serve basis. This allocation mechanism is discriminating against new entrants and/or market parties with smaller portfolios.

- The grid operator uses an 'open season' system for new investments in transport capacity. It is not yet clear that this process will ensure that all capacity efficiently required by the market will be built and made available.

Germany

- Regulation must make a clear distinction between areas of the gas market where competition is potentially achievable (e.g. supply) and areas where it is not (e.g. transmission including transit routes, distribution and monopoly storage). In particular access to transmission must be properly regulated to ensure non-discrimination and tariffs that are reflective of costs arising from only efficient actions by the TSO.

- True competition between TSOs is not the aim of liberalisation, is not feasible as such and therefore not a viable mechanism for tariff setting. TSOs can of course always 'compete' to reduce their operating cost by more than other pipeline companies. Efficient operation of the German pipeline network for the benefit of the market will only be achieved when the TSOs co-operate with each other to this end.

- New entrants need fair and equal access to flexibility. Balancing regimes need to reflect access to flexibility, as available to the majority of market participants including new entrants. The daily balancing and penalty regimes currently applied by TSO's in Germany strongly hamper competition. German incumbents established terms of business that in practice, can only be fulfilled by themselves. These business terms grant costless, not nominated (i.e. allocated as nominated) swing to all who have access to a swing source such as storage capacity. Since the new German Energy Act does not comprise access to storage and since the GGPSSO are not binding; nobody apart from the bundled incumbents can match such requirements.

- Stadtwerke long-term contracts with restrictive “one-supplier” clauses need to be addressed. According to most recent statement by Dr. Böge, president of the German Cartel Office (e/m/w- magazine 06/05) 75 % of natural gas demand of Stadtwerke is still not open to supply offers by new entrants due to historical long-standing contracts, which include “one supplier” clauses.

- Potential trading points are all illiquid due to the existence of the traditional supply chain. Action is needed to improve the accessibility and liquidity of spot markets, gas hubs and exchanges and even bilateral physical supply alternatives. The market access framework must be changed to make trading practical at these points and in particular encourage direct participation of producers and large consumers.

- Vertical integration, equity cross-holdings and predator actions must be addressed otherwise they will continue to foreclose the market to new entrants. Incumbents still gather many Stadtwerke under one umbrella.

- Even where Stadtwerke are relatively independent in terms of equity holdings, they are can still be influenced by the possibility of predatory retaliation activities against them in the retail market by the large incumbents if the Stadtwerke opts for a new wholesale supplier.

- Much improvement is needed on transparency, especially regarding levels of available capacity and communication of reasons for any capacity restrictions.

- Measures must be taken to address apparent capacity hoarding.

- Import obligations of TSO’s must not be allowed as an acceptable reason for TPA limitations, as supported by the recent the European Court of Justice judgment (EuGH C-17/03; decision June 7th 2005).

2.2 Improvements at European Union level

Further action is needed to ensure that all network users have easy and truly **non-discriminatory access** to the grids. Regulators must address legacy contracts involving long-term capacity bookings where these distort the market or prevent access.

The national examples show that evolution towards **effective balancing markets** is a must. This will require harmonised rules and pressure at EU level for incumbent suppliers to make any unused flexibility available to the market. The existing punitive balancing penalty regimes need to be removed in favour of charges which reflect actual TSO actions based on efficiently incurred costs and market-prices. Daily balancing should also be implemented as a standard in all Member States.

Wider and more effective implementation of **anti-hoarding mechanisms** is required, with an evolution from “use it or lend it” towards a more enforceable “use it or lose it”.

EFET advocated in earlier position papers firm and interruptible capacity rights through a use it or lose it principle (UIOLI)[3].

Regarding long-term unused capacity rights: There is a need to consider whether competition will be improved by recycling firm capacity through a market based release programme (which could possibly be linked to a gas release programme). Firm capacity sales handled through this process have the advantage of providing medium to long-term capacity that will encourage sustainable competition that perhaps could not be achieved under a short-term (D-1) approach alone. This also has the advantage of stimulating a secondary market as a value for capacity emerges that can be used as a basis for bilateral trades. (*See also recent EFET proposals for more clearly accommodating the development of secondary markets in power transmission capacity rights within the Congestion Management Guidelines, still to be finalised under Regulation EU 1228/2003).*

Regulators may consider the merits of firm UIOLI capacity recycling in the short-term, rather than relying solely on the sale of interruptible capacity. EFET will provide further guidance on how such a mechanism could be developed for the European gas market in a later paper.

EFET considers that the use of firm UIOLI on a short-term basis is best suited to those continental markets that suffer from a lack of effective competition.

Measures are needed to ensure and improve **co-operation between TSOs**. Because they have a duty to coordinate and optimise cross-border flows, and ultimately optimise the use of the whole European high-pressure transmission system, TSOs must be given regulatory incentives to avoid conflict with each other. Regulators must in turn collaborate to provide and harmonize these incentives.

Transmission must be fully regulated in all Member States. Competition between TSOs in the conventional sense is not workable in the new market framework. TSOs can of course compete to reduce their costs, however, and thus gain a better return than other TSOs.

Any system of third party charges (for balancing, transmission, storage, etc) should be cost-reflective, based **on transparent and efficiently incurred costs** and not on theoretical, non-transparent calculations.

Action needs to be taken to **reduce the number of Entry Exit zones**. In addition to Member States working to minimize the number of zones within each transmission system, work could be carried out at EU level to study measures to enhance connection and cooperation between Entry Exit zones. For example could a form of market coupling be a possible way forward in order to link together in the day-ahead operations Entry Exit zones together via market based mechanisms?

Establishment of **regional gas exchanges** should be supported

[3] See EFET position paper 2002 "Use it or Lose it principles for transmission capacity allocation" on the website www.efet.org; currently under review.

3. Reinforcement of measures to protect the interests of final customers

Transparent and liquid wholesale gas markets are needed to enable competing energy companies to offer retail customers a real choice of energy supply. The Gas Market Directive 2003/55/EC and the pending Gas Transmission Regulation COM (2003)741 together provide a framework in which the monopoly or 'near monopoly' infrastructure and related services are regulated by independent sector regulator, to enable fair and non-discriminatory third party access. Effective separation of the regulated infrastructure owners and operators from the competing users, who need access to the infrastructure, remains a fundamental prerequisite to achieving a fully functioning market.

The best way to protect consumer interests is to establish strong independent energy regulators, with a duty to promote competition in energy supply through ensuring fair and non-discriminatory access to pipelines and storage. Regulators need to be pro-active to ensure that the wholesale (and retail) markets can work, and assist in the transition to establishing fully competitive markets. Once competitive markets are established and price transparency is the norm, than Governments and Regulators must avoid undue interference in production and supply, as this would cause market uncertainty, increase risk and reduce liquidity.

Many of the problems identified in this paper would rapidly diminish, if the network operators were to behave as if they were truly unbundled. There is an inherent conflict of interest, where a company owns infrastructure that its competitors have to use. If companies and regulators cannot find a way to ensure that legal, financial, physical and management unbundling of the gas delivery infrastructure is fully effective, then ownership unbundling will need to be considered to ensure that third party access to infrastructure and ancillary services is both fair and non-discriminatory.

In the old integrated monopoly world, governments relied on national champions to deliver secure energy supplies and to look after consumers. The political decision has been made to regulate the delivery infrastructure and rely on competitive markets to secure supplies and protect the interests of the customers. A market that does not operate effectively will not serve the interests of consumers.

Lack of information transparency is a common problem across many parts of Europe and throughput the gas value chain. EFET has set out the basic information provision needed[4]. To help ensure that consumers, producers and suppliers can access each other in a competitive market, the markets must be fully open and gas exchanges must be allowed to develop with daily transparent bids and offers.

[4] *Gas Market Information Requirements* 6 May 2004 available at www.efet.org

4. In summary, the following implementing and enforcement measures are required:

- Removal of the market distortions and discrimination that arise from certain long-term contracts – i.e. ensuring that the same rules apply to all network users, that they are offered the same terms and have the same nomination rights etc.

- Specifically for long-term contracts signed before the market was opened, the current "use it or lend it" approach should be replaced by "use it or lose it" on a firm basis, as an important anti-hoarding mechanism

- Improved information transparency - particularly provided by the system operators

- Entry-exit systems that are designed to facilitate access by new entrants.

- Improved unbundling – with separate ownership if the current legislation proves ineffective.

- Obligations on TSOs to co-operate across borders – joint operation to maximise capacity offered to third parties, optimal development of cross-border links, equal access processes across borders.

- Sector Regulators who are independent of Government and have the power and the duty to promote competition in energy supply.

- Improved storage Guidelines, with better information provision and legislative force if they are not fully implemented.

- Encouragement for, or obligations on, incumbents to act as market makers – incumbents have most (sometimes all) of the initial flexibility.

- To establish market-based balancing there may need to be transitional measures that ensure that new entrants are not disadvantaged.