# EU Gas Market: Turning hopes into reality

The 1 July 2007 deadline for fully opening gas markets to competition has come and gone. Our Expert Panel believe that new sources of gas supply and voluntary measures to improve wholesale market liquidity will help, but legislation is needed to force the pace of change.

## Slow progress on liberalization

Directive 2003/J5/EC of 26 June 2003 requested full market opening by July 2007, but implementation is late or unsatisfactory in a number of EU states.

In Germany, (which is of crucial importance for the whole of Europe in terms of its volume, and the role it plays in transit and in price-setting), gas competition has scarcely developed and there is a lack of transparency in the market. This has serious consequences for the establishment of a liquid and transparent gas market in the EU. The European Energy Exchange (EEX) started trading gas on 2 July 2007, but believes that it will take up to three years in which to get a gas reference price, during which time the volume trading will increase only slowly. Liquidity in the European gas market is really only expected to improve if the dominance of the incumbents declines and there is easier access for new entrants.

Countries where gas has only been introduced relatively recently, such as Latvia, Portugal, Finland and Greece, have been allowed to derogate from the requirement to open their gas markets until 2010, in the case of the first two, and as soon as certain conditions are met, in the case of Finland and Greece. Gas Regulation 1775/2005 of 28 September 2005 sets minimum obligatory requirements for access to transmission systems. These must be offered in a non-discriminatory way on terms that may also suit new entrants, for example firm or interruptible capacity, long- or short-term contracts.

The energy sector enquiry by DG COMP and DG TREN, completed earlier this year, made a number of recommendations for further action to improve competition in the EU energy markets. These included ensuring non-discriminatory access to networks through unbundling, improving the regulation of network access at national and EU level, and coordination between TSOs. Other proposals covered reducing the scope for unfair competition and strengthening the enforcement of competition law, including rules governing market concentration and market integration.

## TSO unbundling is essential

Many of our expert panel **(see page 20)** believe that full unbundling of integrated companies is necessary if liquidity is to be developed in the wholesale market, as this will create more market players and increase transparency. There is also a tendency for capacity that could be used to be kept idle, and this practice could be ended if vertically integrated incumbents were required to separate out transmission and supply.

The European Commission is in favour of full ownership unbundling, but this idea is strongly opposed by the European gas industry and by some member states, principally France and Germany. Indeed, some energy companies, particularly in Germany, have threatened to challenge full unbundling in the courts if it goes ahead, and have warned that such a course of action could be construed as expropriation of assets, and therefore illegal.

The Commission has acknowledged that the gas market differs in certain ways from the power market, and that these differences need to be taken into consideration when addressing effective unbundling. These include the nature of gas flows, which allow the transmission system operators more power to choose where the gas goes, and the need to strengthen gas infrastructure, to diversify gas supplies and thereby provide more competition in the market.

## RSO may be an alternative

EFET, the European Federation of Energy Traders, while believing that ownership unbundling would be desirable, takes a fairly pragmatic approach. It believes that an alternative to ownership unbundling should be put forward to improve the current system for cross-border trade. This could be in the form of "regional system operators" or a system in which national TSOs could "transcend" boundaries to be involved in decisions concerning investment in cross-border transmission capacity. This could mean merging TSOs in many cases.

## Spot, capacity and cross-border trading

There was less agreement amongst our Expert Panel on the question of whether we would ever see a situation in the EU like in North America, where about 60% of contracts are for less than 12 months. Some panel members believed that political concerns over security of supply in Europe will make it difficult for short-term contracts to develop in the same way as in the US, while there was some doubt about whether a spot market could develop in Europe in the same way as in the USA, because of the small number of dominant incumbents in the EU. Conversely, others thought that with more flexibility in the market, there would no longer be the need for long-term contracts.

The issue of secondary gas capacity rights in the EU is also a key concern for the gas industry. The EU energy regulators group (ERGEG) believes that these markets are an important vehicle for capacity re-trading and therefore for providing access to gas markets within the EU. EFET **(see page 07)** produced a position paper on this subject on 29 March 2007 which states that the secondary market plays a vital role in

helping market participants manage and shape capacity needs to meet business requirements, where the price of traded capacity is determined by agreement between buyers and sellers. The paper set out a number of recommendations on how to promote greater secondary market activity, including "harmonised and timely platforms, coordination processes and information rights."

On the whole our Expert Panel thought that there would be an increase in the trading of secondary capacity rights, largely because a general increase in trading will result in an increase in all products, including secondary capacity rights, and that this should produce more liquidity in the market.

There was less of a consensus on whether, gas release programmes are the best way of facilitating wholesale gas trading. Although many of our panel believed that it was an effective mechanism, there was less agreement about whether this was the best way. In the same way, opinions were divided on whether long-term contracts made it impossible for third parties to access gas in upstream markets, although there was some agreement that these do indeed make it more difficult.

Cross-border trade in gas is a good way of improving liquidity in the market, but non-discriminatory access to cross-border capacity is an issue which still has to be resolved. New entrants are not able to compete on an equal footing with incumbents for access to cross-border transit capacity, and this acts as a barrier to competition. Coordination between national energy networks, in terms of technical standards, gas quality and congestion management mechanisms, is relatively low and needs to be improved if there is to be an integrated pan-European gas network. Such a network would facilitate investment in cross-border capacity, not only by the incumbents but also by new entrants. More investment in facilities and infrastructure would itself have the effect of improving liquidity in the market.

### Some signs of progress

In the meantime, liquidity on the European wholesale gas markets is likely to remain low, although there are some positive signs which could have an impact in the short-term.

Wingas's decision earlier this year to merge its three gas trading zones in Germany into one from 1 October 2007, following similar moves by RWE and E.ON, should help to strengthen liquidity. Plans for Wingas to merge their trading zones with other gas companies later this year should also help to make trading more liquid.

The increasing availability of LNG in the European market should also help to drive growth in wholesale gas liquidity in southern Europe, particularly as France develops more LNG terminals, and gas demand continues to grow in Spain and Portugal.

However, much will depend on the development of further EU legislation on the EU electricity and gas markets. The European Commission is expected to produce a third draft directive on energy liberalisation before the end of September 2007, and all market participants will await this document with interest. ■

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**August 2007**