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Response to the opening Consultation on the Quo Vadis Study

Eurogas is the association representing the European gas wholesale, retail and distribution sectors. Founded in 1990, its members are 43 companies and associations from 22 countries.

Eurogas represents the sectors towards the EU institutions and, as such, participates in the Madrid Gas Regulatory Forum, the Gas Coordination Group, the Citizens Energy Forum and other stakeholder groups.

Its members work together, analysing the impact of EU political and legislative initiatives on their business and communicating their findings and suggestions to the EU stakeholders.

The association also provides statistics and forecasts on gas consumption. For this, the association can draw on national data supplied by its member companies and associations.

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SUMMARY

Although the gas wholesale market is continuing to show steady improvement, Eurogas agrees it is timely to carrying out a study to assess the underlying model, to ensure it is capable of adapting to future developments. The study should focus on advice regarding the regulatory framework necessary to maximise EU welfare, addressing key questions such as, what underlying factors of the current market will change and to what extent will these require legislative amendments to future-proof the framework? This paper sets out generally positive views on the current framework, recalling, however, problems remaining to be addressed that would bring immediate welfare gains. The paper mainly raises questions about aspects which could inhibit progress in the future, especially with regard to tariffs. The study should consider how most effectively to future-proof tariffs as market conditions change, notably the impact of market mergers reducing the number of interconnection points in the grid and the expected shift from long-term to short-term bookings. It should analyse the costs/benefits of alternative approaches to today's tariffs-design, not only considering radical models of change but also if improvements to the current and foreseen problems could not be addressed through more discretionary, targeted, and incremental approaches.

Gas will remain essential to the energy market. The objective should be to achieve a well-functioning market to maximise EU welfare, with a supportive, well-designed regulatory framework reflecting real market needs, key aspects of which should ensure the appropriateness of monopoly operations, and protect the interests of customers.

INTRODUCTION

In December 2016, the EU launched a significant package affecting the market design of the electricity market, seeking to improve the framework to achieve a clean energy economy. Gas has an essential role to play in this transition, and the starting point for Eurogas in assessing gas market issues is that a well-functioning market will be the most effective means to support this.

The 2015 Markets Monitoring Report of ACER shows that the wholesale gas market is generally performing well, and offering improvements overall. Eurogas concurs in this assessment, but it has to be ensured that any model is sustainable.

It is therefore appropriate at this juncture to review the success to date of the current regulatory framework, and ask if it will support the continuing development of a well-functioning and transparent wholesale market operating in the interests of consumers and Europe's economic welfare, capable of adapting to future changes.

The most obvious remaining problems stem from inconsistent and weak implementation of the current rules, and barriers such as lack of diversified supplies and regulated prices. Eurogas has addressed these problems in earlier positions, calling for targeted solutions*. Even if some issues of market design and the current legislation are to be reconsidered, this should not be taken as a signal for defaulting on implementation. Progress has to be maintained, while any established imperfections in the regulatory framework are addressed. For Eurogas, the main

* Eurogas Position Papers can be found at www.eurogas.org

issue to be addressed in this respect concerns issues around network tariffs, and it is welcome that this topic has been highlighted in the Terms of Reference for the Quo Vadis study.

THE AIMS OF THE STUDY

The study should focus on assessing the regulatory framework necessary to deliver an effective market, but it is important, while addressing the highly technical questions, to identify more strategic aspects as parameters, notably security of supply but also investment considerations. Gas demand is also an important sensitivity for any model output. If the study recommends changes to the current regulatory framework, then it should consider any trade-offs with the more strategic aspects.

The study should clarify the assessment criteria for maximising EU welfare against which the modelling work will be set. In the view of Eurogas, these concern:

- meeting market needs for different categories of consumers. This should involve consideration of the interface of the wholesale market with retail, although the latter is outside the scope of the study;
- delivering competitive markets (and keeping gas competitive in the energy mix), to boost Europe's industrial competitiveness;
- supporting efficient infrastructure and new investment against a background of changing technological opportunities such as gas for maritime bunkering, for road transport, and renewable gas;
- keeping Europe attractive to external suppliers of gas.

Eurogas suggests the focus of the study should be on the following questions:

- Is the current regulatory design for tariffs adequate for market needs, including the goal of market-driven integration?
- What underlying factors of the current market will change, and to what extent will these require legislative amendments to future-proof the regulatory framework?
- What will be the impact on the more strategic objectives to which the gas sector has continued to contribute significantly as it adjusted to a more competitive, open and sustainable market?

The paper sets out our generally positive views on the current framework, but also raises questions about aspects which could inhibit progress in the future, mainly to do with the tariffs question. Eurogas looks forward to participating further in the consultation process, but urges that the winning consultant takes contact with gas businesses to reach a concrete and expert understanding of the complex issues.

ASSESSMENT OF THE CURRENT REGULATORY FRAMEWORK

Eurogas understands the current regulatory design as referring to the Gas Directive, the Access Regulation, the Regulation setting up ACER, and the rules and codes, including revisions, subsequently developed. Eurogas considers that most aspects of the current regulatory design work well. In particular, the principal common rules in the Directive. An effective governance

framework has developed, reflected in the growing role of ACER, and NRAs are stepping up to their responsibilities in line with the Third Package.

The view of Eurogas is broadly positive on the overall framework. The entry-exit system, the establishment of capacity markets and balancing, the rules on transparency, and the congestion management tools, coupled with interoperability improvements, have served the interests of the market, changing the dynamics in a positive way. Market participants have contributed to the design and delivery of the current framework. The transition to new ways of doing things has been challenging and there is still need for progress in a number of areas, for example operation of the congestion management and capacity allocation tools and transitional arrangements for existing contracts, e.g. bundling of current contracts. These issues are well flagged, and gradual progress is being made.

Increasingly harmonised approaches to operational rules across Europe were seen in ACER's 2015 revised Gas Target Model (GTM) as a bedrock of a further advocated stage of integration between national markets. The GTM recommended in the first place robust implementation of the regulatory framework, a recommendation particularly welcomed by Eurogas, and also the benefits of different approaches of subsequent market integration (market coupling, trading, merger, and satellite) for small markets reflecting national or regional considerations. In principle, Eurogas supports greater market integration, but this has to be pragmatic and economically determined following a bottom-up, market-driven approach. There should be careful analysis of the costs, both capital and transaction costs, involved in merging balancing or trading markets. A bigger market area might require more capacity to make it work, or involve cross-subsidies or unwelcome socialised costs. A complex series of questions needs to be addressed involving different perspectives. If it leads in turn to higher transport tariffs, it will damage liquidity. Even bilaterally between Belgium and Luxembourg a market merger was challenging.

The slowness of some small markets to develop may be a barrier to regional liquidity, but the priority remains the proper implementation of the current rules, especially in the balancing market, coupled with addressing problems they have with access to diversified supplies or access to liquid markets.

Market integration, therefore, should not be a target in itself. It requires full cost-benefit analyses, and should not be imposed top-down. The risk of too rigid a model is that it could undermine less costly market dynamics. Regulatory obstacles to market mergers should be removed, especially differences in regulatory regimes, and then the regulatory framework could support fully market signals driving more market progress, a virtuous cycle.

The number, location and roles of hubs should essentially be market-driven, not planned top-down. Eurogas considers that the ultimate model should involve significantly performing hubs (perhaps serving different market functions), driven by an increasing market liquidity. Whatever the model, liquidity achievement will require implementation of market rules, availability and diversification of supplies and supply routes, and opportunities for gas retailers to build efficient portfolios, determining contracts on the most appropriate commercial bases. Obstacles to market should be removed, and best practice trading facilitated which will lead to more efficient price discovery, and increased competitive pressures, notably on regional incumbents. A trading hub will not be necessary in every Member State, but nor should the number and location of hubs be prescribed.

The current principle that infrastructure development should be market-driven is supported by Eurogas. We recognise that in specifically justified circumstances a measure of socialisation may be justified, but this should be kept to a minimum.

The approach taken to the development of codes is a practical one. Generally there should not be different rules for different regions, as this could hinder not help progress towards greater integration. Making the codes too prescriptive, however, ignoring national or regional specificities, is not the way forward either. The code process has often seemed as an “art of the possible”. This correctly sets the goal of harmonisation, but allows a path of adjustment where justified. NRAs have a principal role in ensuring correct implementation. Therefore, the balance in the process is about right. There is a pause in new codes for now, and the opportunity should be taken of learning from experience what amendments may be necessary. Eurogas also supports pragmatic ways of encouraging the dynamic potential of regional cooperation along the lines of the proposal in the new draft ACER Regulation.

FUTURE-PROOFING ISSUES

At a time when market dynamics are working in many positive respects, caution is urged about radically changing these, especially if that would involve imposed artificial market mergers. Eurogas has, however, identified issues surrounding network tariffs that could, if not effectively addressed, cause problems in the future. The study has been asked to address the issue of the removal of tariffs from intra-EU interconnection points and moving these charges to EU entry points and/or domestic exit points. Eurogas and other stakeholders during the development of the Tariffs Code frequently said that, despite the Code, fundamental issues would remain to be addressed. It is important therefore to analyse these issues to establish the reasons for stakeholders’ voiced concerns and how any identified problems can be solved. There is a potential problem and the current approach should be analysed. It may be necessary at least to consider the operation of the current entry/exit model.

In the academic literature on the gas market, increasingly referenced in the debate, the issue of the impact of the current approach has been addressed.

- Reduced competition by protecting high market concentration on the supply side in certain market zones.
- Failure to correctly remunerate infrastructure, which is normally underutilised but crucial for security of supply for certain countries.
- Distortion of the efficient transport of gas.

ACER’s Market Monitoring Report for 2015 noted that although hub prices are converging, situations in which hub price spreads are lower than transmission charges are very frequent. Ideally, they should be higher, and then, if there are no capacity constraints, this will boost advantageous trade. ACER, however, did not see this situation, found mainly in the North West where the market is most liquid, but elsewhere too, as a significant problem. One of their observations is that capacities may be booked on a long-term basis and as such they are sunk costs. Eurogas agrees that long-term capacity contracts for now minimise the problem. It causes economic issues for shippers especially if their capacity is underutilised in the absence of a robust secondary market, but there is no evidence of strong negative impacts on EU welfare. However, in the east and south of Europe, where they conceal the reality of high

prices at certain IPs, which inhibit liquidity where it already struggles most, there is arguably an important welfare loss.

Other developments too could have an impact on tariffs. As market-driven integration makes progress, interconnection points will be fewer, affecting the current entry-exit structures.

Main questions to be addressed should be:

- What options would deliver the highest levels of welfare?
- What will be the advantages/disadvantages of the different solutions and what would be other impacts likely to affect EU welfare?
- What are the practical issues to be addressed in aiming for greater market integration?
- What will the implications be of uncertainties in gas demand?
- How can a more holistic approach to electricity and gas markets be achieved, while recognising the specificities of the sectors?

To model responses to these sort of questions the consultant will need to access a level of quantitative detail not appropriate to be discussed within Eurogas. Comments below are necessarily of a qualitative nature.

Within the gas chain, differing situations, interests, and perspectives will affect preferences. The two most talked-about alternative models have attractions for shippers, and could boost trading, but,

- The model pushing charges to the EU borders (EEE) could make Europe a less attractive destination for external suppliers (LNG and piped gas), unless their costs would be preferentially low or offset elsewhere in the system. Perhaps the model would need to be discussed with them. Its implementation could involve sensitivities. It could also imply greater political intervention in commercial relationships. Also, its impact on gas markets with differing supply patterns would have to be checked.
- The model transferring more costs to the exit points (EE) could, unless there is clear redistribution of costs among Member States (and even bilaterally this is a difficult point for infrastructure funding), would not seem to present a trouble-free path either and raises issues relevant to end-user interests, including power plants using gas. Among the overall considerations, the interests of Distribution System Operators would need to be consulted.
- If the entry/exit system is fundamentally changed, especially in the EEE, it should be clear from where the signals would come to drive gas flows.
- Furthermore, both these essentially top-down models imply a sense of central planning, and that could lead to an unacceptable level of socialisation. It is essential that any model still adheres to the principles of optimising use of existing assets and of market-driven infrastructure in response to efficient market signals.

Eurogas recognises that existing stranded assets have still to be paid for in some way, but the costs should not be exaggerated, especially where they are sunk and the assets are not considered to hold strategic value. The TSOs are beginning to recognise the possibility of using their networks for renewable gases, a shift in which suppliers are also interested in cooperating, and this should be encouraged by the regulatory framework.

Therefore, although there are problems to be addressed in the present approach, much work is required to assess the mentioned alternatives, identifying their advantages and disadvantages, including costs and political acceptability. Installing a new model radically different from the current one might turn out to be the way forward, but it would take time, and costs/benefits would have to be clearly established. Eurogas would also suggest considering more discretionary, targeted and incremental approaches in the analysis.

GAS DEMAND OUTLOOK

The study will not consider the essential role of gas in the energy market but should indeed think about how eventual gas demand will interrelate with issues discussed on the market evolution, notably, the avoidance of stranded assets. Eurogas continues to be concerned that policies are giving at best ambiguous messages on the role of gas in the future energy market. This is not conducive to investor or user confidence.

The study should consider sensitivities, using different available scenarios on gas demand to 2030 and then more tentative considerations on demand beyond. Most scenarios currently show a gas demand that remains stable until 2030, contributing to emissions reductions due to fuel switching and technological improvement. Looking beyond that to 2050, realistic scenario work foresees a continued role for gas in supporting growth of renewable energy.

After 2030 and towards 2050 innovative gas solutions permit much higher shares of renewable energy providing options for intensive decarbonisation. This need not mean less gas demand as a higher share of renewables goes hand in hand with a higher demand for gas.

The gas system will remain crucial for other decarbonisation pathways.

- The transmission and distribution gas grids are capable of efficiently carrying vast amounts of high-density energy that can be coupled with underground storage, an important seasonal flexibility tool. Replacing natural gas with electricity would have significant consequences for the grid requirements, such as during peak requirements, and in terms of energy losses. In addition to demand fluctuations within a year, there would likely be strong differences between years, which influence total energy and gas demand. Moreover, there is public resistance to the expansion of high-voltage power cables.
- The expansion of the electricity sector is often regarded as the key to success in decarbonising the energy system. Although electrification will make sense in some instances and locations, it is not a silver bullet. Its potential is limited, largely because of cost barriers. A broader diversification of the energy mix is more cost-efficient while decarbonisation continues, and this argues in favour of optimising existing assets.
- Moreover, as long as natural gas remains essential in the residential sector, maintaining an efficient network, including the gas distribution grid, will be key in order to maintain the benefits of an holistic energy system and its increasingly renewable content, i.e. synthetic gas generated through power-to-gas technology, bio-methane and bio substitute natural gas, as well as hydrogen.
- In addition there is further innovation potential in developing micro-CHP, fuel cells and gas heat pumps, among other technologies. Moreover, natural gas is an essential part of a smart energy system – especially as an all-electric system is not possible – gradually becoming renewable and offering convenience to the consumer.

Gas will in this way contribute to an energy system that can continue beyond 2050 as a sustainable zero-carbon system. An intensive decarbonisation combining CCS for industry and renewable gas could bring significant benefits.

CONCLUSIONS

This paper gives the first inputs of Europe to the consultation process on Quo Vadis. Eurogas looks forward to engaging with the winning consultant and will urge them to engage fully with market participants who can give them more concrete material for their models.

Gas will remain essential to the energy market for many years. The objective should be to achieve a well-functioning market to maximise EU welfare, with a supportive, well-designed regulatory framework reflecting real market needs, key aspects of which should ensure the appropriateness of monopoly operations, and protect the interests of customers.

A well-functioning market will be effective in delivering supply security, and support the essential role that gas plays in a sustainable energy transition.

The most obvious problems to be addressed that would bring the most immediate welfare gains are through improved implementation of the current framework.

Backward steps in market terms should be avoided, such as any weakening of the access system or easing of exemptions. Implementation of the current legislation should continue to be enforced while any problems in the current regulatory framework are debated.

An approach to investments involving more socialisation, leading to higher tariffs for excess capacity, to be carried by system users and ultimately end-users should also be avoided. This would damage the competitiveness of gas.

In view of the increasingly acknowledged problems caused by the current entry/exit and tariff systems at some IPs, the study should focus on analysing this issue, while keeping in mind more strategic considerations. It should examine how most effectively to future-proof the approach to tariffs as market conditions change, notably the impact of market mergers reducing the number of IPs and the consequences of the expected shift from long-term to short-term bookings, and what the consequences would be. It should analyse the costs/benefits of alternative approaches, and should not only consider radical models of change but also if improvements to current and foreseen problems could not be reached on more tailored bases.

While natural gas will continue flowing through the system for many years to come, it could be useful to consider among the wider parameters the readiness of networks, the assets in the ground, to be adapted to carry a range of renewable gases in the future, and how synergies between electricity and gas could be enhanced, also through the regulatory framework.