

Eurogas position on key questions raised by the Sector Enquiry

Following its Board and General Assembly meetings which took place on June 22nd and 23rd, here is a detailed contribution of Eurogas on key questions raised by the Sector Enquiry.

Eurogas, the European Union of the Natural Gas Industry, welcomes the initiative of the Commission to organise an open consultation process on the preliminary findings of the competition sector enquiry. As an Association, Eurogas will limit itself to general issues and is not in a position to comment on specific questions concerning companies' behaviour.

Having considered the Preliminary Report, Eurogas would like to draw your particular attention to the following points, before going on to make some broader remarks concerning the current market situation:

1. The challenges Europe is facing today in terms of its energy policy are (i) a tight supply-demand balance for oil, gas and electricity, leading to high energy prices, (ii) security of supply, (iii) climate change and (iv) the completion of the internal market. Eurogas believes that sustainable, competitive and secure energy supplies will be best achieved through open and competitive energy markets
2. Market liberalisation is part of a dynamic process. In fact, in various Member States, the process of market opening is an ongoing one. **Eurogas considers the full implementation of the existing legislation as a priority and agrees that further significant progress is therefore needed in various areas to achieve the objective of a single, integrated European energy market.**
3. In its Energy Sector Enquiry Issues Paper dated 15 November 2005, the Commission states and acknowledges that **in the internal gas market**, "given high market concentration in EU Member States a **full assessment of the competitive conditions needs additionally to consider the very limited number of suppliers exporting gas to EU markets.**" Eurogas believes that this factor, and its impact on the internal European gas market, is very important but has, unfortunately, not been considered in full in the Preliminary Report.
4. The Preliminary Report views flexibility in gas import contracts "as a factor in the lack of hub liquidity". As off-take of gas can be varied to match demand, it is argued that importers do not have to resort to spot markets to the same extent as they would if import contracts had rigid off-take obligations.

However, it should be noted that:

- Flexibility in base load import contracts is limited and therefore not necessarily sufficient to cover all demand swings.
- Flexibility is often fully exploited to arbitrage between spot and long-term contracts, thereby precisely generating spot transactions.
- **Flexibility in supply contracts is not, therefore, a constraint on traded market liquidity and it can even be a source of liquidity on hubs.**

As indigenous production declines and Europe becomes more dependent on natural gas imports, additional imports will have to be transported over increasingly long distances under contracts which have a high load factor. This will result in greater demand for seasonal storage capacities in Europe, and flexibility in import contracts, although limited, will also be of high value, in order to accommodate fluctuations in European demand patterns.

5. Eurogas is concerned by the Commission's view on pre-liberalisation transit contracts. The Preliminary Report sees "sanctity of contract" and the long-term nature of capacity contracts as reasons for the malfunctioning of markets.

It must be recognised that purchase contracts are concluded on a "take or pay" basis in order to facilitate the huge investments involved in the production and transport of natural gas from well to market (including transit). In parallel with this, transit contracts are concluded for corresponding volumes and durations on a "ship or pay" basis, i.e. the booked capacity charge must be paid, whether or not the natural gas is actually shipped. This enables the exporter to get maximum value out of his product, since he sells "firm natural gas," i.e. natural gas with guaranteed availability. In turn, it enables the buyer to assure the supply to his customers. Transit contracts are thus a crucial part of a secure chain from wellhead to burner tip.

At the same time however, Eurogas recognises that these contracts must comply with the existing legislation, including the 2005 Gas Transmission Regulation, and not constrain the development of a truly competitive European gas market.

Eurogas also recognises the importance of maximizing the use of existing transport and transit capacities and fully supports effective congestion management rules, in particular use-it-or-lose-it procedures which aim to avoid contractual congestion preventing full use of existing physical capacities. Such congestion management rules can be applied whilst recognising the importance of certain types of long-term capacity reservation contracts in the overall supply chain.

6. The Preliminary Report analyses the existence of **gas swaps** (or the lack thereof) as a potential indicator for cross-border activity and hence for competition.

Gas swaps constitute a commercial instrument which can be used by market operators to freely determine the best allocation of resources. Gas swaps can be particularly useful to overcome short-term and incidental congestion problems.

If, however, **there are longer term structural congestion problems, they can only be resolved with investment in diversified supply lines and sources, which will in turn promote further improvements in competition and liquidity**. Once these diversified supply routes are established (and the fixed costs incurred), then gas swaps can be effectively used to economize on variable costs.

7. **Oil-price link: Eurogas members contract for new gas supplies using a variety of formulae and price benchmarks. We believe that the contracting parties (producers and buyers of natural gas) should be free at all times to negotiate and opt for the price formula that best suits their specific needs.** This freedom is indeed one of the cornerstones of free trade.
8. **The debate on long-term downstream contracts and their alleged negative effect on competition should be an open one between consumers, the gas industry and the Commission.** Discussions in the High Level Group on Energy, Competitiveness and the Environment have shown that energy intensive industrial

consumers of both electricity and natural gas attach great importance to competitive energy prices and predictable energy cost structures. Longer term supply contracts are one of the elements which could help respond to their needs. Gas consumers also wish to obtain guidance from the competent authorities as to what contract durations and structures are allowed and there seems to be considerable confusion among the different stakeholders about what kind of contract duration should be considered as *long-term*.

The duration of gas supply contracts is an important and well-considered choice of companies, based on their own business requirements, investment plans, price risk management policies as well as on their expectations of the gas market evolution. **Eurogas believes that, within the limits of what is allowed under competition law, both existing players and new entrants should to the largest extent possible be allowed to compete on their merits and conclude contracts which meet customers' legitimate business needs.**

Turning to the broader perspective, there seems to be a common agreement about a number of facts. Firstly, the EU is facing increasing import dependency with respect to natural gas. These imports will come from a handful of often state-controlled monopolies. Secondly, massive investments are needed not only to replace declining indigenous production, but also to meet future demand growth and to enhance liquidity in the gas market and avoid yet higher energy prices. These investments will need to be made all along the value chain, from reservoir to burner tip. Thirdly, Europe has to compete for energy resources with other energy consuming regions in the world, such as the US, Japan, China, India, Brazil, etc.

Finally, a strategic diversification of primary energy sources, including gas supplies, is a key for the EU to security of energy supply.

Within the global context as described above, Eurogas wishes to reiterate its full support for a competitive European gas market. Eurogas calls for a consistent approach taking into account (i) Europe's security of supply needs, (ii) a strategy to secure diversified gas supplies in a global competition for new sources, (iii) an external relations policy that will encourage properly functioning energy markets in neighbouring and producer countries, (iv) an overall sound and stable framework to encourage much needed investments and (v) the need to remove any remaining barriers to competition.

In this respect, **long-term commodity and capacity contracts will remain an important element to secure gas supplies and the development of spot markets and hubs is an important complement for a well functioning market.**

Consistency and coherence between policies and related legislative initiatives is essential. It is therefore very important that a dialogue continues to be promoted between the EU institutions, industry, relevant stakeholders and representatives of member state governments to come to a common understanding of the policy objectives and instruments which are needed to overcome the above-mentioned challenges. The Green Paper on Security of Supply, Sustainability and Competitiveness is certainly a timely and much needed initiative and Eurogas will continue to contribute to the ongoing consultation process.

In conclusion, Eurogas attaches high priority to the progress on a number of issues in areas that the Report identifies as still functioning imperfectly, and agrees that these are essential to ensure a properly functioning market:

- Non-discriminatory access to networks and other parts of the gas infrastructure.

- Capacity allocation and congestion management are important. The Report is right in identifying these issues as a matter of particular interest to the gas market. Maximizing the use of existing capacity is essential, and it is also necessary that the business and regulatory framework give timely signals to encourage necessary investment in the system and provide the proper inducements to invest.
- Transparency is very important too, and is necessary for a market to operate soundly. There should be a presumption towards publishing information on infrastructure use although legitimate concerns regarding confidentiality should be allowed to prevent inappropriate publication of commercially sensitive data.
- Improved compatibility of approaches and instruments in the different member states should be an overall objective as well – in which context Eurogas welcomes the regional gas market initiatives recently announced by ERGEG.

An important debate is ongoing in Europe on how to achieve a secure, sustainable and competitive European gas market. Eurogas will continue to contribute fully to this debate.