

General

The Commission has ascertained that the internal energy market in Europe currently does not function sufficiently well. The Commission attributes this to a number of shortcomings within the current structure of the internal market. The Commission has also defined five main issues in which these shortcomings are manifested: concentration, vertical exclusion, a lack of market integration, a lack of transparency and price issues. The Commission also indicates the manner in which it thinks the structure of the internal market should be adapted, with the aim of achieving a fully functioning, open and competitive internal energy market.

(1) In Gasunie Trade & Supply's opinion, good progress has been made in general in the creation of the internal energy market, but that more will have to be done to complete the process. The development towards a free market is a complicated process in which existing agreements reached in the past cannot simply be set aside. Consequently, it will take a certain amount of time to complete such a transition. The current European Gas Directive has only been in effect in the Netherlands since 1 July 2004. In other Member States its implementation has not yet been completed. Regulation (EC) No 1775/2005 on conditions for access to the natural gas transmission networks has not even become effective. Despite this, Gasunie Trade & Supply thinks that numerous encouraging steps have been taken in recent years towards achieving the preferred market structure (especially in North-west Europe), although a somewhat more balanced pace of change in the individual EU countries would be preferred. It is not realistic to assume that a market which, due to the highly sensitive nature of the product concerned as a prime source of energy and heating, must provide for stable supplies, could or should change fundamentally within a period of just a few years.

(2) The Commission has found that the existing directives for unbundling transport and trade interests and for non-discriminatory access to transport networks are not being followed throughout Europe. Gasunie Trade & Supply supports the resolution of the Commission to force the Member States concerned to implement the legislation in question and thus achieve compliance. Gasunie Trade & Supply hopes that this will create a real 'level playing field' in Europe. Gasunie Trade & Supply wants to reiterate the importance of an actual non-discriminatory access regime. This means banning the advantages that gas transport companies give to affiliated trading companies and all other forms of discrimination. In the Netherlands, for instance, there is the danger of discrimination occurring according to the size of the shipper's transport portfolio, to the detriment of larger shippers.

(3) In light of the increasing dependence on imported gas in Europe and the extremely large investments that are required to bring sufficient volumes of gas to Europe, Gasunie Trade & Supply would like to emphasize that the Commission should proceed cautiously in taking any further measures to promote the internal energy market. Such measures should first be analysed thoroughly for their possible effects, particularly on the investment climate.

(4) Gasunie Trade & Supply does not support the formal centralisation of the activities of national regulators under the European flag. This would have an overly inhibitive effect on the developments in North-west Europe. Gasunie Trade & Supply does however welcome far-reaching collaboration and cooperation between national transmission system operators and national regulators, as it does the harmonisation of the different network codes where it is possible. It would also be good for there to be greater uniformity in the respective powers of the individual national regulators. This would promote international cross-border trade and the creation of a 'level playing field'. Gasunie Trade & Supply believes that the Commission has an important role to play in stimulating and coordinating cooperation between national regulators. At this stage, in Gasunie Trade & Supply's perception such cooperation is still highly insufficient.

(5) From the aforementioned perspective, Gasunie Trade & Supply wishes to make a number of comments on the preliminary conclusions drawn by the Commission as a result of its findings. First, we would like to discuss the preferred structure and the degree of concentration on the internal gas market, partly in relation to the external energy policy of Europe. Secondly, the current state of affairs and limitations will be explained with respect to the development of new gas hubs and the position of the traditional large parties in relation to this development. Here, also several comments will be made with respect to the formation of prices on the gas market. Next, the markets for gas transport and storage services will be discussed, focusing among other things on the necessity of long-term contracts in relation to the investment climate for new gas infrastructure facilities. Finally, the necessity of and limitations to the improvement of transparency within the internal gas market will be discussed.

Market Structure and Concentration

The Commission has found that the traditional large players continue to dominate the national gas markets concerned because they have access to long-term gas import contracts and production licences. As a result, it would be very difficult for newcomers to acquire a substantial position within an existing market due to their dependence on the established large players in the area of gas supply, transport and storage capacity. The continuing dominant position of the established large players is seriously undermining the development of competition on the market according to the Commission.

(6) Gasunie Trade & Supply is convinced that the European gas market, in general terms, would benefit most from a market structure in which there are a number of financially strong market parties. These parties should be large enough to act as a sufficient counterweight to, on one side, the limited number of suppliers (Russia, North Africa and the Middle East) and, on the other, the powerful competition from other regions (the US and Asia). In view of the specific characteristics of the gas market, such as the geo-political determination of the supply, the large social significance of the product and the high investments in infrastructure, it is in Europe's interest to ensure that its gas market does not become too fragmented.

(7) In this context, we would like to refer to the report: *Gas for Tomorrow* by the Dutch General Energy Council (Algemene Energieraad or AER), an independent advisory body for the Dutch government and parliament that focuses on issues in the area of energy policy. A summary of this report is attached as an appendix. The entire report can be found at www.energieraad.nl. The aforementioned summary includes the following paragraph: "As mentioned above, competition between gas providers is expected to consist of buyers' competition in the world gas market and, within the EU, will remain limited to sellers' competition in the area of gas services. The EU and Dutch gas policies will have to take thorough account of these aspects. The advantages of competition for gas services within the EU must be combined to the best extent possible with sufficient space for major players within the EU gas market in order to maintain a strong position in the world gas market. The quality of the proper 'balancing act' between competition and concentration will be a determining factor for a successful gas policy in the coming years."

(8) In addition to this report from the Dutch General Energy Council, we would also like to refer to the study: *The Future of the Dutch Natural Gas Market: Regulatory Policy, Market Form and International Competition in a Turbulent Europe* by professor Van Witteloostuijn et al from the University of Groningen. In this report, the specific characteristics of the Dutch and European energy market are described and confronted with a number of economic theories on market structure and market mechanisms. The conclusion drawn in this study is that a structure that has fierce competition between a relatively limited number of players (oligopoly) within the EU is the most preferable one. An effective regulatory framework should guarantee fair competition within Europe. The summary of this study, too, is enclosed with this document as an appendix. On request, we would be happy to send the entire report to you.

The Commission considers gas (or contract) release programmes as an effective way in which to reduce market concentration if there are new market parties that are also able to absorb the risks of existing contracts. The Commission encourages Member States to consider using this instrument.

(9) In general, in the opinion of Gasunie Trade & Supply, gas (or contract) release programmes, if applied outside the framework of concentration control, are a serious breach of the principle of legal certainty. Gasunie Trade & Supply can, of course, well imagine that gas (or contract) release programmes are used in the context of certain mergers and takeovers if, without such a programme, these mergers or takeovers would lead to a concentration that violates the competition law.

Development of Gas Hubs

The Commission attributes the unsatisfactory performance of the wholesale market for gas, among other things, to the dominance of a number of market parties in their traditional home markets and the vertical integration of these parties. As a result, new players can scarcely gain access to the gas infrastructure (transport networks and storage facilities). According to the Commission, this leads to a lack of liquidity at the gas hubs under development, also because the established large market parties only trade a small portion of their gas at these hubs. In this respect, the Commission also points to the fact that some characteristics of long-term supply contracts provide little stimulus to achieve greater liquidity on the trade markets; this refers to contracts that offer a flexible off take possibility. The Commission thinks that liquid gas hubs are not only important in the context of effective gas pricing, they can also ensure there are price signals with respect to investments in transport and gas storage.

(10) Gasunie Trade & Supply recognises the importance of developing new trade centres where gas can be made available in the short term under standardised conditions. Such gas hubs are a valuable addition to the existing possibilities for market parties to adjust their supply portfolio to the needs of their clients. Gasunie Trade & Supply is also using them now.

(11) Gasunie Trade & Supply is also convinced that the presence of sufficient transport capacity between the different gas hubs is by far the most important condition for the proper performance of such hubs. Currently this is often not the case. The redistribution of scarce transport capacity is not a realistic option because, as a result, the basis of the supply contracts linked to this contractual transport capacity would disappear. Consequently there is a great need for the construction of new transport capacity between the various member countries, in part due also to the continuing growth in the demand for gas in Europe. Gasunie Trade & Supply enthusiastically supports the non-discriminatory supply of this capacity under reasonable conditions. This will give new players the chance to manifest themselves on markets that otherwise would largely remain inaccessible to them.

(12) Gasunie Trade & Supply recognises, however, that the investing transport companies need long-term security in order to recover their often large investments. Gasunie Trade & Supply does not share the faith of the Commission in the indicative effect of gas hubs with respect to investments in gas infrastructure. The new gas hubs are much too short-term oriented for this. The large volatility of these markets would be more likely to discourage such investments rather than to encourage them. For this reason, market parties (both new and existing players) that want to utilise the new capacity to be built must be willing to assume a part of the investment risk by entering into transport obligations for the long term. Gasunie Trade & Supply has the impression that new players often fail to go along with this. This could have something to do with the size and financial strength of these players, but also with the willingness to share responsibility for the expansion of the European gas infrastructure for the market of tomorrow and the day after

Reaction of Gasunie Trade & Supply to the Draft Preliminary Report on the Energy Sector Inquiry

tomorrow. If this is the case, new players are letting an opportunity slip by to promote the development of the different gas hubs and to increase competition on the market further.

(13) In the meantime, Gasunie Trade & Supply wants to point out that some gas hubs, such as the TTF in the Netherlands, are currently experiencing sharp growth which, particularly since the beginning of this year, is approaching the growth of the early years of the NBP in Great Britain. See figure 1, which shows the percentage of the physically supplied volume via the NBP and the TTF in comparison with the total volume of the relevant market in the first three years after the rise of the spot market.

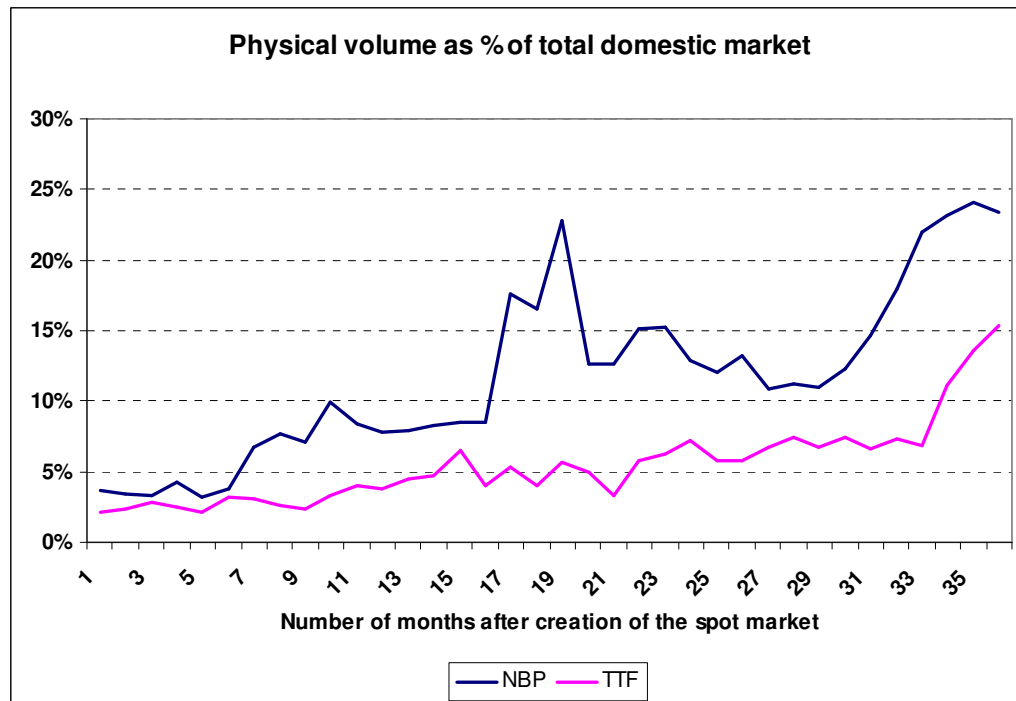


Figure 1: Development of spot markets NBP and TTF

(14) Gasunie Trade & Supply has found that there is a high level of ambition among market parties, policy makers and regulators with respect to the development of gas hubs and the spot and forward markets established there. The question that arises is 'to what extent is this a realistic expectation?' It is useful to review other (non-energy-related) product markets in this context. If we do, it becomes apparent that each of these markets has reached its own balance with respect to the volume of product that finds its way to consumers via spot markets and other short-term oriented markets or via long-term contracts. For the aluminium market, for instance, the share of spot markets worldwide is limited to approximately 25% of the supplied product. In a free gas market, too, market parties are very well able to make a suitable choice on their own between the various contract forms and sales channels by which they think they can best serve their clients. Here, too, a market-linked balance between spot markets and long-term contracts could be achieved, provided there are sufficient possibilities to transport gas to and from the marketplace.

(15) In connection to this, Gasunie Trade & Supply would like to point out that a forced development of gas spot markets in which market parties are obliged to trade their product (in part) via this market channel could lead to a situation in which the established players will also have a prevailing position on these markets. In such a case, other players could be discouraged from trading via that market channel, which would nip the natural development of gas hubs towards an international marketplace in the bud.

(16) In this connection, Gasunie Trade & Supply also points to the fact that gas that is supplied on liquid markets has other product characteristics - and is actually another product - than gas that is

supplied to consumers. Supply on liquid markets needs to be standardised in a number of respects for the sake of marketability. Consumers, on the other hand, often appreciate flexible gas which optimally meets their specific energy needs. In Gasunie Trade & Supply's opinion this product variation (on one side, standardised products for trade and, on the other, products tailored to the individual consumer) is a valuable characteristic of the modern gas market. This should not be lost due to the forced development of the new gas hubs to the detriment of a gas supply that is directly tailored to the needs of consumers.

(17) Gasunie Trade & Supply rejects the Commission's criticism, in this context, of (long-term) supply contracts with a flexible character. As already mentioned, these contracts meet the wishes of many market parties and consumers. Market parties should have the freedom to trade with one another under conditions that they have agreed to themselves, particularly with respect to the duration of the contract, the supply location, off take rights/obligations and pricing. Flexible long-term supply contracts are an important element in the variation of products found on the gas market. Next to these flexible long term contracts there is also room for products that are offered on spot markets and short-term markets, in order to match the balance between supply and demand.

Pricing

The Commission has found that the way in which prices are established on the European gas market is an obstacle to the development of healthy market mechanisms. The Commission questions the tenability of linking the price of gas to the price of oil, which is still the basis of most long-term contracts, both upstream and downstream.

(18) In the opinion of Gasunie Trade & Supply the choice of price indexes in long-term gas-supply contracts should be left to the marketplace. In practice, such contracts currently contain the prices of oil, oil derivatives, coal, spot gas and electricity as indicators in proportion to the need of the contract parties. It leaves no doubt that the need for various forms of price indexation will develop further in the future, depending on the manner in which the energy market evolves.

(19) Historically gas prices have always been strongly linked to the prices of oil and oil products. This is the case even to the present day. At the global level in many cases, natural gas is competing with oil products, making the price of oil (products) a good reference point for the price of natural gas in situations in which there is no oversupply on the natural gas market. The (certainty of the) link between the price of natural gas and the price of oil provides an important impetus to the development of burgeoning natural gas markets. It also gives consumers the guarantee that the investments that they are making to make the transition from oil to gas will be recovered, while producers can create security of demand for themselves in this manner.

(20) It also seems that natural gas prices set at the gas hubs are clearly linked to the price of oil, apart from short-term fluctuations. This link between natural gas spot prices and the price of oil (Brent) is shown in figure 2 for the period 1993 up to and including March 2006. Here it can be seen that the trends of the price movements are roughly similar in the long term.

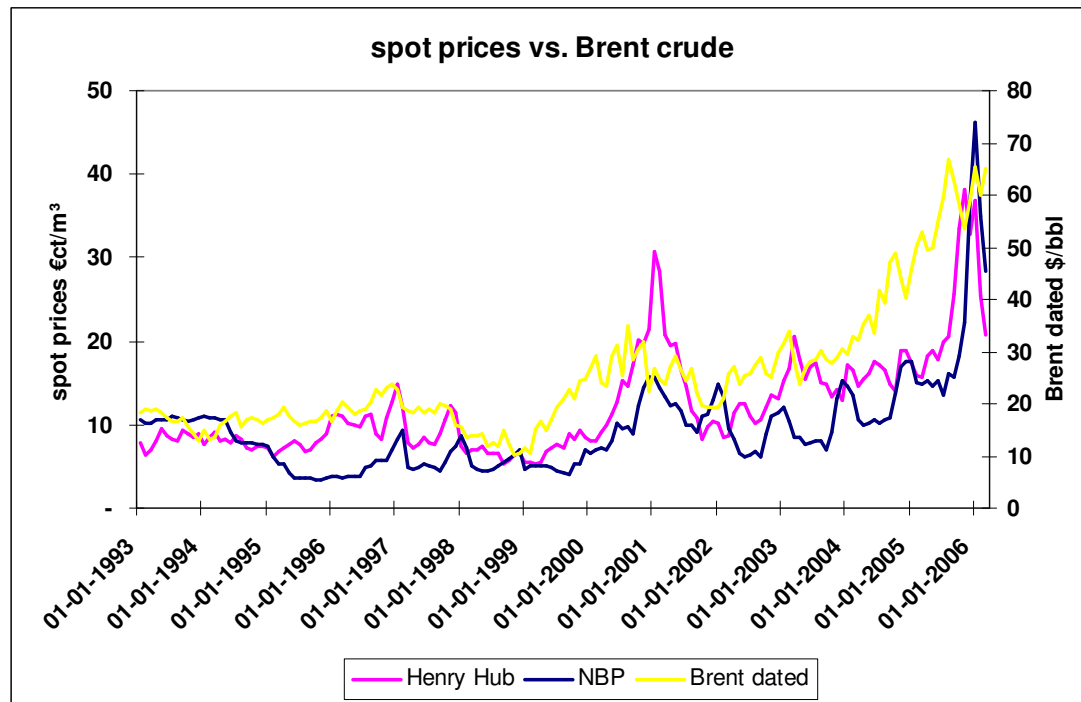


Figure 2: spot prices for gas vs. Brent crude

(21) Only when there is more than an incidental oversupply on the natural gas market it can be expected that the gas prices will move independently from the price of oil due to 'gas-to-gas-competition'. Just such a situation occurred for a while in the United Kingdom during the time when the British gas market was still isolated from the rest of the European market area. Up to the present on the European continent as a whole, no substantial situation of oversupply has occurred under the established link to oil prices. Market analysts also think that, in the near future, such a 'buyers market' is unlikely to develop. On the contrary, it is very possible that Europe is on its way to a 'sellers market'.

(22) Gasunie Trade & Supply also wishes to point out another important consideration for market parties to make when choosing price indicators in the contracts they conclude: the parties do not want to accept that indicators are possibly influenced by the other party. In the case of a (local) spot price for gas as an indicator, such a danger could currently be very real. This possibility does not exist, for instance, when there is a link to the more liquid oil market. It is therefore not surprising that in continental Europe there is still no large-scale trend towards more gas-market-related contract prices.

(23) The Commission points out that the link of the natural gas price to oil prices ensures that the gas prices do not react to changes in supply and demand and that such oil related prices therefore are not market-linked. Gasunie Trade & Supply would like to make several comments on this. The other side of the Commission's observation is that oil-related natural gas prices show a much more stable trend than spot prices do. There is practically no other spot market that has such a large volatility as the spot market for natural gas. The British spot market during the previous winter is a perfect example of this. This volatility is entirely related to the limited price elasticity of both supply and demand. A decrease in this volatility would serve the interests of consumers. Practical experience shows that the buyers of natural gas would gladly trade in this (market-linked) volatility for the relative stability of oil-linked prices or for fixed prices during a certain period.

(24) The preliminary findings of the Commission also make it necessary to think about the interpretation of price fluctuations between the seasons. These fluctuations are the result of the difference in the need for capacity between the summer and winter seasons. In the gas prices that

are formed at a gas hub, the costs of these distinct needs for capacity are expressed directly in the price of natural gas. So a large difference can be observed between summer and winter prices, corresponding to the laws of supply and demand. For oil-linked gas prices it is often the case that, apart from the price per unit of energy, a specific capacity component is agreed to. In the so-called 'all-in' gas price this capacity component is then often spread out over the entire year. In this way, no clear seasonal trend can be observed in the movement of such an 'all-in' price. But if the capacity component were specifically attributed to the winter period during which the capacity is used, then a strong summer-winter differential would be observed that is comparable to the pattern seen in the European spot prices for natural gas. It is therefore not the case that spot prices for gas are more efficient in showing the difference in value between summer gas and winter gas.

Market for Gas Transport

The Commission has observed that new players are hardly able to obtain transport capacity to and from important markets. A large part of the existing capacity is in the hands of established market parties and the transport contracts involved often still have a long contract period remaining. According to the Commission, there are also ineffective congestion mechanisms and a poorly functioning secondary market for transport capacity associated with these contracts.

(25) In its assessment of these findings, Gasunie Trade & Supply points to what has already been said in this response. Gasunie Trade & Supply finds it disconcerting that the Commission does not give long-term transport contracts the recognition that is given to long-term supply contracts from the standpoint of security of supply – even though the one type of contract cannot exist without the other. The same applies to long-term gas storage contracts. The sanctity of the combination of all of these contracts is essential to providing consumers 'security of supply' and producers 'security of demand'. The Commission would undermine the trust of consumers and producers if it were to leave any doubt about this sanctity.

(26) Gasunie Trade & Supply would like to make a specific comment with respect to the possibility of obtaining an exemption in regard to the regulation framework for the transport infrastructure. Gasunie Trade & Supply thinks that such an exemption can be a good way to protect an investor against regulatory risks (the intervention of a regulator in rates and conditions for transport services retrospectively, after the investment in infrastructure has become a 'sunk cost').

(27) Gasunie Trade & Supply supports the advisability of a better functioning secondary market for transport capacity and, in consultation with transmission system operators and other shippers, is willing to make this a reality. Gasunie Trade & Supply shares the view that a properly operating secondary capacity market is preferable to the application of use-it-or-lose-it mechanisms by the transmission system operators. But a properly operating secondary market cannot remove the fact that, in the view of Gasunie Trade & Supply, many problems can only be effectively solved if more transport capacity is built.

(28) With respect to the unused transport capacity, Gasunie Trade & Supply would like to point out that, in many cases, this nevertheless has a substantial function to fill in the context of security of supply. This unused capacity serves as a buffer in the event that, due to extreme temperature effects or other unforeseen events (interruptions in the network or in the supply of gas), there appears to be an incidental need for extra transport capacity. To illustrate this, the following example: In a relatively warm year, it will subsequently appear that the realised capacity utilisation of the pipelines is relatively low. But even in such a warm year, capacity should be reserved in advance for the possibility that it might have been a cold year. In the Netherlands, the transmission system operator reserves capacity to cover a temperature of -17°C in order to guarantee security of supply to residential consumers. Statistically, this temperature occurs in the Netherlands once every 50 years. This means that in the majority of years capacity is reserved that

is not actually used. As an indication: analysis of the Dutch demand for natural gas in the year 2004 shows that for each °C that it was colder, the demand for gas increased by 2.66%. In the year mentioned, the lowest mean daytime temperature in the Netherlands was -5°C; the demand for gas at the stated temperature of -17°C would then be approximately 30% greater than it was at the actual lowest temperature. Figure 3 below shows this in diagram. In this context, it is logical that the Commission's analysis of the degree of capacity utilisation for the transport pipelines in Europe shows that there are often substantial amounts of capacity that are not actually used since the period under consideration was relatively warm. If during the same period there would have been (almost) full utilisation of capacity, this would mean that in a cold period there would be too little capacity available, which would put the security of supply at risk.

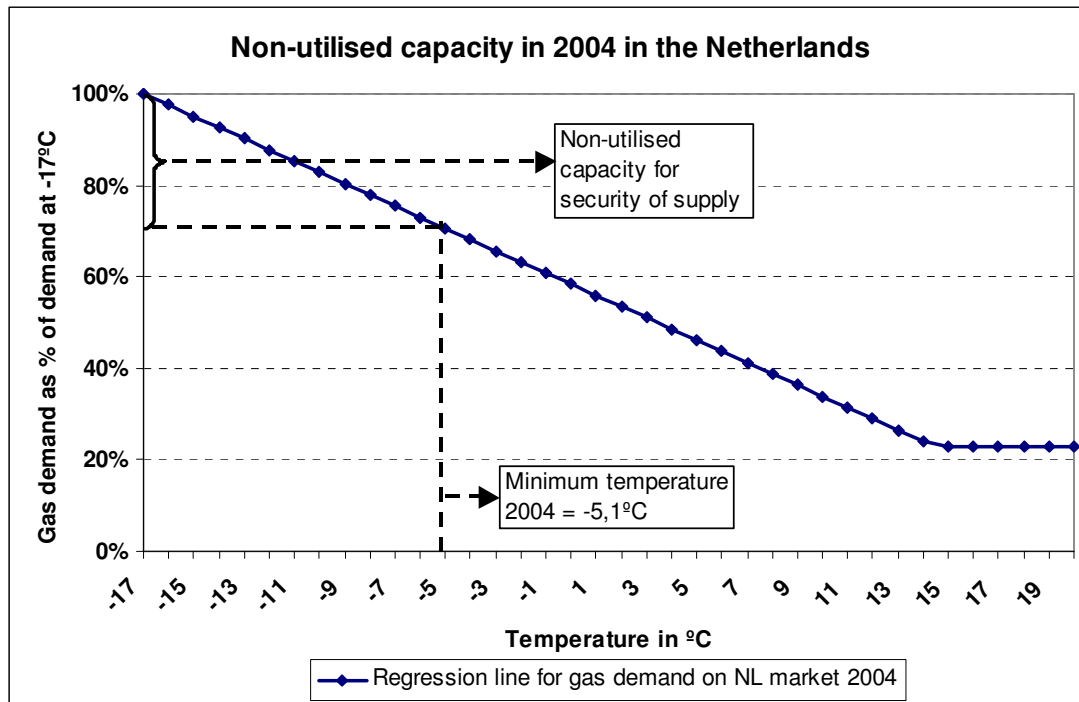


Figure 3: Non-utilised capacity in 2004 in the Netherlands

(29) In view of the points given above, Gasunie Trade & Supply agrees that, in the event of an insufficiently functioning secondary market, the use-it-or-lose-it principle can be applied to unused transport capacity, but the transfer of transport capacity should only take place on an interruptible basis in order not to compromise the security of supply.

Underground Storage

The Commission has found that, for underground storage as well, capacity is often contracted for the long term, so that newcomers are excluded from this market. The role of underground storage is, according to the Commission, critically important for both security of supply and the development of market mechanisms within the European gas market. In the development of the market for underground storage, the Commission thinks that a strong focus on an effective system of third party access is required.

(30) With the growing dependence on baseload supplies from outside the EU, the importance of the availability of capacity provided by underground storage within the EU is increasing more than proportionally compared with the growth of the demand for gas. To be able to meet the demand for gas storage services, massive investments will have to be made. What is generally true for large investments in gas infrastructure, also applies to the expansion of facilities for underground storage: the market profits from financially strong parties. These parties should be put in a position

Reaction of Gasunie Trade & Supply to the Draft Preliminary Report on the Energy Sector Inquiry

to invest in the necessary infrastructure, whereas avoidable uncertainties should be kept to a minimum. The role of the national governments and the European Commission in this should be to bring about a stable regulatory regime in the short term with the right incentives for investments. This particularly applies to underground storage facilities used to cover the seasonal variations. Such storage facilities require large investments not only in installations and wells, but also in cushion gas. Gasunie Trade & Supply also refers to the discussion paper: *The European Market for Seasonal Storage* of the Clingendael International Energy Programme (CIEP). This document can be found at www.clingendael.nl/ciep/. The Dutch Minister of Economic Affairs also recently sent a letter to parliament that contains passages on this subject that are worthy of consideration here. According to this letter “*Visie op de gasmarkt*”, the Minister shares the opinion that the gas storage market would profit from a stable regulatory framework in which a regime of negotiated third party access would effectively limit the uncertainties for investors.

(31) Furthermore, it should be said that from a competition perspective as well, it can be argued that limited regulation for storage facilities would be sufficient because the relevant market for storage services is relatively large. As a result, the market climate is often competitive. Competition takes place on the international market between different storage facilities, and with other capacity sources. It is therefore unnecessary and undesirable to force artificial competition within an individual storage installation, particularly because the risk of regulation can lead to new investments never getting off the ground.

(32) Gasunie Trade & Supply would like to stress here that the application of the use-it-or-lose-it mechanism to capacity from underground storage cannot, as a matter of principle, be up for discussion. Application of use-it-or-lose-it would not only include the transfer of non-used capacity, but also the transfer of physical volumes. If these volumes are produced from seasonal storages, there is no opportunity left to refill the storage during the same winter period and this would be detrimental to parties who deliberately chose to secure their gas supply by reserving storage capacity and volume. The relatively cold months of March 2005 and March 2006 indicate that at the end of the winter too still sufficient volume should be left in storages.

Transparency

The Commission has observed that the transparency in different areas of the gas market should be improved. This primarily concerns transparency in the availability of transport capacity, secondary trade of unused capacity and access to capacity from underground storage. Here the Commission considers the ‘three or more rule’ often to be an obstacle to achieving the desired transparency.

(33) Gasunie Trade & Supply supports transparency on the part of system operators vis-à-vis system users. But of course the confidentiality of individual data should be taken into consideration. In contrast to what the Commission seems to suggest in its preliminary findings, the so-called ‘three shipper rule’ is in practice a well-considered way to take this confidentiality into account. One should note that if two or less system users are active on a certain point or line, the publication of data concerning contracted and/or used capacities would unavoidably lead to the revelation of commercially sensitive information to competitors. This could never be the intention of any intervention from the perspective of competition law. Gasunie Trade & Supply is however open to suggestions to consider alternative information systems if they would improve transparency without compromising the required confidentiality.

Way forward/Conclusion

Gasunie Trade & Supply would like to stress that it does not favour additional legislative action on the part of the Commission. As mentioned above, the current European Gas Directive has only been in effect in the Netherlands since 1 July 2004 while several other Member States have yet to complete the implementation of this Directive. Other relevant legislation such as Regulation (EC) No 1775/2005 on conditions for access to the natural gas transmission networks has not even

Reaction of Gasunie Trade & Supply to the Draft Preliminary Report on the Energy Sector Inquiry

become effective yet. Evidently, the implementation of this legislation requires time. It is too early therefore to draw any conclusions on the effectiveness of the legislation. Consequently, it is also too early to conclude that additional legislation is needed to complement the existing legislation.

Instead of initiating additional legislation, Gasunie Trade & Supply takes the view that the Commission should focus on positive action, fostering initiatives to enhance investments - in particular - in cross border infrastructure and storage facilities and improvement of the investment climate in the gas sector generally. In addition, Gasunie Trade & Supply believes that the Commission has an important role to play in stimulating and orchestrating effective cooperation between national regulators.

Finally, the approach by the Commission in its preliminary report appears unbalanced: the interest of increasing competition is not in equilibrium with the fundamental interest of maintaining security of supply and enhancing the long term stability of the gas market.