EFMA RESPONSE TO THE EUROPEAN COMMISSION, DG COMPETITITON, GAS SECTOR STUDY PRELIMINARY FINDINGS, 16th February 2006.

28th April 2006

The European nitrogen fertilizer industry is the single largest manufacturing sector user of natural gas in the European Union. Natural gas, in fact, is used as a raw material feedstock accounting for between 40 to 60% (and even higher) of a finished nitrogen fertilizer. It is imperative for this industry, therefore, that real progress to a truly competitive, free, transparent and integrated EU gas market is achieved quickly.

Indeed, it is vital faced with the prospect of another winter period 2006/2007 of unprecedented high gas prices, that the Commission, Member States and national regulators prepare to take on short-term action programmes as well as a more longer-term strategic programme.

We therefore look forward to the completion of the analysis phase represented by the Gas Sector Study; and then the activation of short-term and long-term action programmes to address the unacceptably exaggerated prices for gas in Europe today.

Firstly, hereunder is submitted as Part I of the EFMA response is the Executive Summary / Introduction to our forthcoming publication on our vision for a competitive world-class gas market.

This Executive Summary/Introduction highlights the five strategic factors, which we believe must be addressed in order to establish a competitive EU, indeed Pan-European gas market.

Secondly, as Part II we submit our Buyers Wish List arising from a Survey done in year 2005. It is noteworthy that our buyers in the nitrogen fertilizer industry are individually responsible for typically and 1 to 1.5 Billion Cubic Metres of natural gas per annum.

Thirdly, as Part III, we submit our specific response to the Sector Report giving special attention to priorities set out in Part I; and special attention to the urgent need, over a short –term period of time, to secure effective regulatory and action.

PART I - THE FIVE KEY STRATEGIC FACTORS

To achieve the now imperative completion of a fully inter-connected, transparent and free market requires bold strategic actions focused on the following five strategic factors.

The five strategic factors are:

1. **The expansion of BIG INFRASTRUCTURE, i.e. new pipelines, LNG terminals, storage and conversion facilities as well as the true development of European physical and financial trading hubs;**

2. **The allied expansion of physical and organisational SMALL INFRASTRUCTURE to guarantee and improve the interconnections and storage facilities comprising an efficient Pan-European network. There is a need for the ACCELERATED INTRODUCTION OF TECHNICAL REFORMS and BUSINESS DEVELOPMENT especially those facilitating cross border trading and inter-connectivity.**

3. **The encouragement of VOLUNTARY ENERGY EFFICIENCY SCHEMES promoting best available techniques and practices.**

4. **CONCERTED REGULATORY ACTION FULLY LEVERAGING THE EXISTING GAS DIRECTIVE together with more enhanced vigorous ENFORCEMENT OF EU COMPETITION LAWS. The on-going take-over and consolidation on the supply side is an increasing concern.**

   The EU and national institutions should devote their efforts towards establishing a regulatory environment which assures the creation of a truly free transparent demonopolised marketplace. This effort should include:

   - **Capping the EU market share of national incumbents by a 30% reduction over three years;**
   - **Further consideration of capping the EU market share of the national incumbents by 50% over eight years if this is considered appropriate to free up the market further:**
   - **EU competition law and practice should be applied with rigour especially with regard to dominant positions. The convention here is that no supplier should be permitted to reach a dominant 40% market share position – in EU market terms.**

5. **EU AND INTERNATIONAL AGREEMENT AND ACTION TO PROMOTE THE FREE AND FAIR PRICING of gas and its transit from producer / supplier sources. In particular the EU should enhance the authority of Energy Charter and the application of free and fair trading practices therein. Russia must be persuaded to finally sign up to the Transit Protocol. Longer – term, an international level playing field for gas / energy supply could lead to the**

development within the WTO of 'Trade related Rules-for-Energy-supply (TRES)'.

The recent announcement of a potential EU-Russia and EU-Ukraine Free Trade Areas with energy chapters included should be taken as an opportunity to secure a Pan-European infrastructure allowing for security of supply and demand; and predictability and transparency of energy trade backed by market economy instruments and energy exchanges. Equal and non – discriminatory access to pipeline transportation in Russia and EU should also be secured.

Over recent years, the European fertilizer industry has been forced to use anti-dumping actions as a short-term correction to dual-pricing practices, which include supporting unfair artificially low gas prices to local industry. Russia is the most classic example. The real correction, to a significant degree, involves the prevalence of non-discriminatory market prices built on true market structures in all countries – whether a producer and / or consumer country.

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PART II - THE BUYERS' WISHLIST – EFMA SURVEY 2005

Encourage new infrastructure using legitimate private/government finance;

Place significant restrictions on the national and EU market share of the oligopolistic/monopoly incumbents;

Enforce full unbundling of integrated oligopolistic incumbents;

Reduce control and reservation of pipeline capacity at borders and key points by the incumbents;

Propose daily rather than hourly balancing network codes and the transfer mechanisms between systems.

Encourage trading hubs promoting transparency and liquidity to match the emergence of physical hubs

Create EU or Member State statistical bureaux to act as clearing house / reporter on production, imports, storage and hub contract activity.

PART III - SPECIFIC RESPONSE TO GAS SECTOR STUDY

(Paragraph references to the Report are cited to assist understanding and relevance.)

INTRODUCTION

Para 4 - **There is most certainly a real imperative for energy policy to be put at the heart of the Commission s macro-economic policy strategy, i.e. the Lisbon agenda addressing Growth and Jobs.** Economic growth and employment prospects are going to be challenged in European energy intensive industries by the dramatic price increases in oil and gas in 2005:2006. This is especially true when many of our competitors operate of subsidised and / or rigid state fixed oil and gas prices. Most notable here are nearby neighbours such as Russia and several North African countries.

Political leadership and leverages will be required to overcome traditional interests and force market liberalisation and integration. In effect, the Sector Study suggests that all are 5 main barriers to a fully functioning internal energy market are due to or relate to the behaviour of traditional national monopolies.

The Single European Market deadline was 1992. As far as energy market liberalisation and integration are concerned – and especially on de-monopolisation - there now needs to be an end to such missed deadlines. Deadlines agreed in the Second Gas Directive and in the Gas Regulation must be met on time.

<u>*Para 10*</u> - The Preliminary Report, February 2006 as with the Issues Paper, November 2005 does correctly **identify five key barriers to a fully functioning Internal Energy Market**; i.e. market concentration; vertical foreclosure; lack of market integration; lack of transparency; price formation.

However, even more correctly the Green Paper on European Energy Policy adopts a less restricted EU – centric view. In particular the need to develop **a Pan – European integrated regulatory framework including Russia and Ukraine is meeting a vital strategic market and integration need.** Algeria also attracts special mention but all the North African oil and gas suppliers represent competitive threats and opportunities best handled in a co-operative truly market economy based framework.

<u>*Para 68*</u> - Thus while we appreciate that the Sector Study is based on the competition law competence of the European Union, nevertheless the **external dimension** especially with regard to **Russia and North Africa** must be accounted for to **reflect current business and trading realities.**

The prevailance of dual-pricing practices by such countries is a particular concern to the European fertilizer industry. DG Trade (anti-dumping and WTO Accessions) and DG Enterprise (industry dialogues) are the lead Commission services on this subject.

ISSUES: BARRIERS AFFECTING THE GAS MARKET

II. 1. CONCENTRATION

Para 69 - It is a vital strategic necessity as expressed in Part I of this submission that **new international sources of gas supply to Europe are encouraged by EU authorities and industry**. There is significant LNG supply potential from many African countries; and the potential for new pipelines from the Caspian Sea and North Africa are credible. Over-reliance on the traditional suppliers has evident political and economic risks.

Para 70 - EFMA agrees that the **EU liberalisation process has not changed market structure** or concentrations. In general, the old national incumbents remain dominant within Member States national territories; as cited *in Para 99* the activity of the larger incumbents has been surprisingly small outside their traditional markets; there is very limited liquidity on wholesale markets; and traded markets – with the exception of the UK – have far too limited a number of players.

The incumbents are the major players on most of the gas hubs. Only with significant freeing up of gas supply, transit; storage and flexibility of supply to the customer will new entrants be encouraged to enter and compete on the hubs. This is recognised by the Preliminary report, *Para 93,94,95,96.* The final report must address how, in practical terms, the Commission competition or regulatory powers or those of the national regulators can be applied to assist this combination of factors. A vital starting point is addressed hereunder.

Para 81 - the breakthrough in the UK on **establishing liquidity** – and competition - was the forced capping of the incumbent suppliers supply to the market. Hence the set of EFMA market share capping recommendations made in Part I of this submission.

Para 103 – **Major Barriers to New Entrants.** Lack of conversion capacity; - *Para 104*, lack of available network capacity; the complexity of the process for booking capacity; *Para 105* – poor transparency; storage problems etc all do add up – in the experience of our buyers – to **major barriers to new entrants.**

Conclusion: EFMA agrees with the Preliminary Report's conclusion that the incumbents have maintained their national dominance and that this has impeded the development of competition.

The short-term solution is: -

- **The solution Capping the EU market share of national incumbents by a 30% reduction over three years;**

II. 2. VERTICAL FORECLOSURE

Para 108 correctly describes a de facto system of vertical foreclosure. The incumbents effectively operate at all levels of the supply chain; long-term contracts effectively dominate the available capacity on the transport system; and it is difficult for free gas players or gas to break – in.

Para 114 to 127 shows up the value of the Sector Study approach. Most revealing is that flexibility is confined to the producer supplier – national incumbent relationship.

As the largest industrial user it is critical that major consumers can have access to producer suppliers on the wholesale market or on liquid hubs. This requires the access to transport capacity; Para *156* this is turn – as the Report indicates – probably requires full ownership unbundling.

It is critical for energy intensive industries that they can access producer suppliers directly on a transparent market basis. The Final Report should address the option of full ownership unbundling or alternative means of guarantying large users access to the main suppliers.

Para 144 - Discriminatory behaviour of vertically integrated operators in favour of their own upstream or downstream arms to the disadvantage of others or new entrants should be addressed by competition authorities. If such cases are an abuse of dominant position under Article 82, then the appropriate legal procedures should be applied.

Para 170 – Investment in new storage facilities is increasingly necessary. Local and regional authorities must be encouraged by central governments to give proper account of the economic advantages in terms of employment and growth etc.

Foreclosure by long-term reservations is a serious constraint on competition and therefore should be controlled; and the take it or lose it principle must apply on storage.

II. 3 MARKET INTEGRATION

Para 172 to Para 225 clearly describes a lack of market – especially cross-border – integration in the EU. The traditional long-term contract scene does effectively promote contractual congestion; and release on a secondary market basis can only be on a very short term and interruptible basis *(Para 187).*

The Report findings reported in *Para 188* that there are several examples of no mechanisms in place to manage congestion; and the statement that UIOLI principles do not apply to transit pipelines are issues of significant concern. *Para 187.*

Access to major transit pipelines and the very existence and then transparency over congestion management are vital to a open free market situation. In *Para 186* the Report highlights that competition law; ie the "essential facilities doctrine" and Article 5 of the Gas Directive are not being fully respected by the incumbents. These leverages or re-inforced or new leverages must be used to ensure freedom of trade in gas over the major pipelines.

Equally under-utilised LNG facilities in Europe must be freed up under the Use It or Lose It Principle.

The whole gas supply and network apparatus must be put on a pro-competitive pro-competition basis. Para 197 explains findings showing that pipelines on the Benelux Italy axis are booked, in terms of primary capacity until 2022. Not until 2015 is primary capacity made available. This vertical foreclosure or rather closed shop must be addressed by the Commission s competition powers.

While the Report does not overtly address the current wave of merger proposals in the energy sector, again the obvious role of the authorities must be to truly enforce a pro-competitive pro-competition corporate scene;

North – West Europe Market Integration

In many respects the North West European region represents a sub-region where true market integration should take place on open competitive grounds. Hereunder problems and solutions are addressed.

The underlying problem of the NBP/ZEE gas market is the consumer uncertainty driven by lack of clarity and transparency across the marketplace, and gas not flowing to where demand is greatest.

Some potential solutions are as follows:

1/Common commercial terms: Gas suppliers operating in the EU must offer equivalent contract terms across all Member States, subject to reasonable cost related transport charges as defined by national regulators. Major customers for gas need to have total freedom of choice with regard to available price mechanisms or indices for agreeing gas supply deals;

2/Transit tariffs: These tariffs should be regulated and based on cost reflective prices.

3/Access to and usage of infrastructure: Third party access must be enforced using effective "use it or lose it" mechanisms.

4/Gas storage: The price of access to storage facilities should be set at cost reflective levels as determined by national regulators, and transparency on stock flows and levels must be established.

5/Information: Ensure access to market information already shared between producers and shippers, such as physical stocks, interconnector and LNG terminal capacity reservations, and all terminal gas flows (which must be made available to all parties in real time).

We are approaching an integrated NWE gas market from an infrastructure point of view with BBL and Sleipner pipes being put in service by end 2006, beginning 2007; but if transparency and access to infrastructure are not improved the gas will not flow effectively to meet demand, leading to an inefficient market and artificially inflated prices.

Real/actual market limits must no longer be defined by Member States' borders. Therefore we will need closely coordinated measures at EU level to ensure a Single Market – the principal means to achieve the objectives of competitive, secure and sustainable supplies.

Industry in UK, Belgium and north of France cannot afford a second winter with gas prices levels experienced this winter. While appreciative of the Commission's relative speed on the Sector Study it is nevertheless imperative to improve the gas market as suggested above as soon as possible. The consequences of delay could include the closure of industrial energy intensive plants in Europe.

EFMA's senior gas managers and experts are immediately ready to share our concerns and confidential information with the Commission. Indeed we would be delighted to combine this with an industry plant site visit in the nearby Benelux region. Of course this proposal should in no way prejudice analysis of other regions in the EU or visits to plants in other EU regions.

II. 4. TRANSPARENCY

Para 226 to Para 255 of the Report address the serious lack of transparency on the gas markets. The Report correctly expresses the wish of users to have information/statistics on transit capacity, storage and access to networks.

> EFMA's major users wish that the Commission and Member States should establish a statistical bureau – such as the AEI (Agency for Energy Information in the USA) to supply transit, storage and turnover per hub information.
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> Such a bureau could greatly enhance transparency at key hubs by:
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> "creating an index reflecting the weighted average of all contracts realised via the hub trading platform".

II. 5. PRICE ISSUES

EFMA finds the Commission's analysis here a useful reference point for discussion. It is notable that the study on pricing does not address the dual-pricing dimension and its impact upon major buyers. Moreover, it does not address Russia's more overt policy now of forcing market prices upon near neighbours such as Ukraine, Moldova, Georgia as well as Romania and Bulgaria. It is ironic that Russian pricing policy rather than adoption of the acquis communautaire is the price setting force in the Eastern European Union gas markets .

The absolute necessity, however, for large buyers is the ability to use freedom of choice in terms of type of contract, type of supplier, and negotiable terms and conditions of supply.

CONCLUSION – EFMA on behalf of the EU industry request an Oral Hearing with the Commission's investigation team. We feel this is the best means by which to put our arguments forward and assist the Final Report and its Recommendations.