

# EU Gas Market Liberalisation

## EU Gas market liberalisation has been largely successful in Western Europe but how can it be squared with the need for security of supply?

The liberalisation of the gas market and the move towards a true market pricing model has been largely successful across Western Europe. But just as it has begun to bear fruit the European Commission and gas industry regulators are faced with a new problem – security of supply. How are regulators going to find a way of maintaining security of supply while not undoing the gains made from market liberalisation and integration over the last few years?

Liberalisation has had a profound impact on the development of the gas market across Europe.

The emergence of European hubs has allowed gas producers, suppliers, and traders to transact with each other and for a market-based gas price to emerge.

Prior to liberalisation, vertically integrated companies had a monopoly in the supply of gas in their national markets<sup>1</sup>. They owned the transport networks within their markets and bought gas from the producers in Netherlands (Gas Terra) Norway (Statoil), Russia (Gazprom) and North Africa (Sonatrach) to supply those customers. Producers sold gas via long-term contracts, in which prices were set based on oil products and buyers had to 'take-or-pay' minimum volumes but also had the flexibility to take additional volumes if required.

The liberalisation process in Europe focused on introducing competition by ensuring that energy companies are afforded effective fair and non-discriminatory access to the European gas transport networks. Unlike previous packages, the Third Energy Package sought to remove the incentives for the former incumbents to discriminate against new entrants. Hence the requirement to unbundle the operation of the transport networks from the supply and trading of gas. More detailed requirements were introduced to make the transport capacity available.

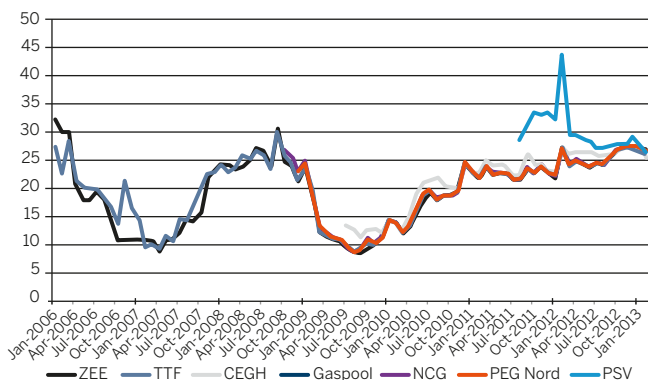
<sup>1</sup> Or in the case of Germany, there were several energy companies each with their own regional market.

To remove capacity hoarding, requirements were introduced for booked but unused network capacity to be offered to other market players. To ensure that gas suppliers could respond to price signals for gas, obligations were introduced for network operators to offer short-term capacity products and to hold regular auctions of network capacity. The new rules have been accompanied by active enforcement by the European Commission's DG Competition. It has opened a number of investigations into provisions in gas contracts, which prevented buyers from reselling gas bought from producers or hoarding of transport capacity by the incumbents.

## Liberalisation – a profound effect

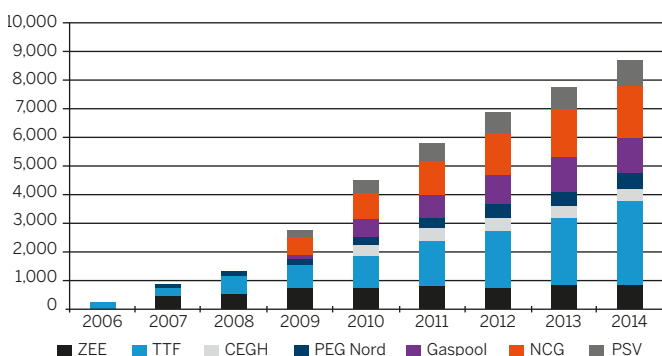
Liberalisation has had a profound impact on the development of the gas market across Europe. There has been an increase in gas trading at hubs. While the majority of the liquidity is still at Great Britain's NBP and the TTF in Netherlands, we have seen a significant increase since 2008 in trading at Germany's NCG & Gaspool, PEG Nord in France, PSV in Italy and CEGH in Austria – see figure 2. The emergence of European hubs has allowed gas producers, suppliers, and traders to transact with each other and for a market-based gas price to emerge. Furthermore, as set out in Figure 1 below we have seen increasing convergence of prices at these hubs, showing that gas suppliers are able to obtain the transport capacity and react to price signals.

**Figure 1: Monthly average prices at continental European hubs (€/MWh)**



Source: ICE Index, CEGH, Gaspool, NetConnect, Powernext, Bloomberg

**Figure 2: Liquidity at continental European hubs (TWh)**

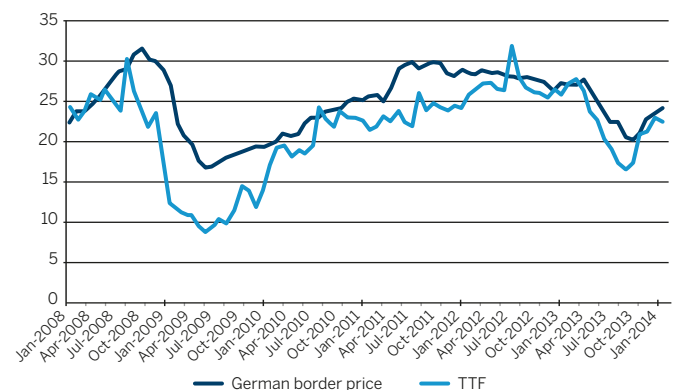


Source: Huberator, Gasunie, CEGH, GRTgaz, GASPOOL, NetConnect, Snam Rete

Note: These volumes are nominations at the hubs not total traded volumes, which would be greater but this information is not publically available.

Much of the success of the European liberalisation process is due to the fact that the measures coincided with reduced gas demand. Gas demand fell in Europe from 2009 because of the economic recession and the switching away from gas in electricity production to renewable sources, such as wind and solar or cheap coal. The drop in gas demand meant that gas buyers, supplying the gas in Europe, such as E.ON and ENI, reduced their demand to 'take-or-pay' levels and used the hubs to trade excess gas. It also led to renegotiations of gas prices in the long-term contracts and producers, particularly Statoil and Gastera<sup>2</sup>, agreeing to reference prices in the long-term contracts to the European gas hubs. This increase in gas trading led to a decoupling in the gas hub prices from the oil-indexed prices.

**Figure 3: Price of oil linked contracts (German border price) and TTF hub price (€/MWh)**



Source: BAFA, Bloomberg

Note: The German border price may be influenced by some contracts that have partial indexation to gas hub prices

## A reverse in the gas price reviews as gas producers try to increase prices

More recently, the dramatic fall in the oil price since late 2014 might reverse this trend if oil-indexed prices fall below gas hub prices. As long-term oil linked gas contracts tend to be based on a trailing average of oil prices, the fall in the price of these contracts lags behind the fall in oil prices, but the decline in oil prices is expected to feed through during 2015 into lower long-term gas contract prices.

This situation might prompt reviews followed by adjustments of the price of long-term gas contracts in the opposite direction, with gas producers attempting to increase prices. Producers might argue that with long-term oil-indexed gas contract prices below gas hub prices, buyers are able to sell gas from long-term contracts directly at the hub with no risk, and that such an outcome is not the intention of long-term contracts.

<sup>2</sup> Sonatrach and Gazprom have been publically less in favour of moving away from oil-indexation

The main consequence of the decoupling of the oil and gas price is likely to be the demise of long-term gas contracts. With liquidity at hubs growing and falling prices driving less need for new investments in gas production or infrastructure, we might see market players agreeing to shorter-term contracts rather than engaging in a continual cycle of price renegotiations. In the UK, for instance, where the liberalised market is longer established than in many other EU states, long term gas contracts are rare.

### Effects on transport and storage capacity

The same is likely to happen with transport and storage contracts. Gas suppliers holding capacity currently surplus to requirements are likely to seek renegotiations of these contracts. Furthermore, the liberalisation measures are encouraging transport operators to release unused capacity and provide short-term capacity reducing the value of long-term capacity contracts. We're now entering a "pay as you go" model for transport and storage capacity. This has important implications for the business models of infrastructure providers. With the price spread between winter peak demand and summer, when gas suppliers typically inject gas into storage, we're seeing declining demand for gas storage. A number of storage sites have been mothballed and operators are considering how to compete in a world of uncertain revenues and tight margins.

### Balancing free markets with security of supply

Long-term gas contracts provided security of supply in the old monopoly world. In a liberalised market, security of supply is met through prices signalling scarcity and the need for gas. The challenge for European policy-makers is whether to rely on the 'invisible hand' of the market or whether additional measures are required as the market will not sufficiently

price in the value of security of supply. We have seen different responses to this in electricity markets. The French and British Governments have introduced capacity markets and are required to remunerate generators to make their power plants available while others have opted to rely on the energy price. This divergence in approaches has created challenges for the single energy market, with the Commission recently announcing its intention to focus on revising a target model for electricity.

We see the same divergences in the gas markets with countries such as Italy opting for strategic reserves and others placing obligations on suppliers to store gas ahead of the winter. With Europe's domestic sources of conventional gas declining, the extent to which shale gas will develop remains uncertain given the concerns with fracking, it is likely that these divergences will persist and even grow. We are already seeing measures to support storage and secure supplies being considered in France and calls in Eastern Europe for collective bargaining of gas prices, which the Commission has said that it will consider. So just as market liberalisation has taken hold and markets have become more liquid as they hoped, the Commission and gas regulators across Europe are becoming concerned about supply and wondering whether there should be more not less market intervention.

The question for policy-makers is whether they can remain committed to markets while addressing concerns about security of supply. The Commission and regulators recognise the value of a liberalised market in securing gas supplies, the question is whether the 'security of supply' measures that are likely to emerge can be designed such that they work with the markets.

Balancing the benefits of the nascent free market in gas across the EU with the need for security of supply presents policy makers with a major challenge – and one that they must address sooner rather than later.

The views expressed in this article are those of the author(s) and not necessarily the views of FTI Consulting, Inc., its management, its subsidiaries, its affiliates, or its other professionals.

Pamela Taylor  
+44 (0)20 3727 1492  
pamela.taylor@fticonsulting.com

Suzanne Clifton  
+44 (0)20 3727 1098  
suzanne.clifton@fticonsulting.com



### About FTI Consulting

FTI Consulting LLP is a global business advisory firm dedicated to helping organisations protect and enhance enterprise value in an increasingly complex legal, regulatory and economic environment. FTI Consulting professionals, who are located in all major business centres throughout the world, work closely with clients to anticipate, illuminate and overcome complex business challenges in areas such as investigations, litigation, mergers and acquisitions, regulatory issues, reputation management and restructuring.

[www.fticonsulting.com](http://www.fticonsulting.com)

CRITICAL THINKING  
AT THE CRITICAL TIME™