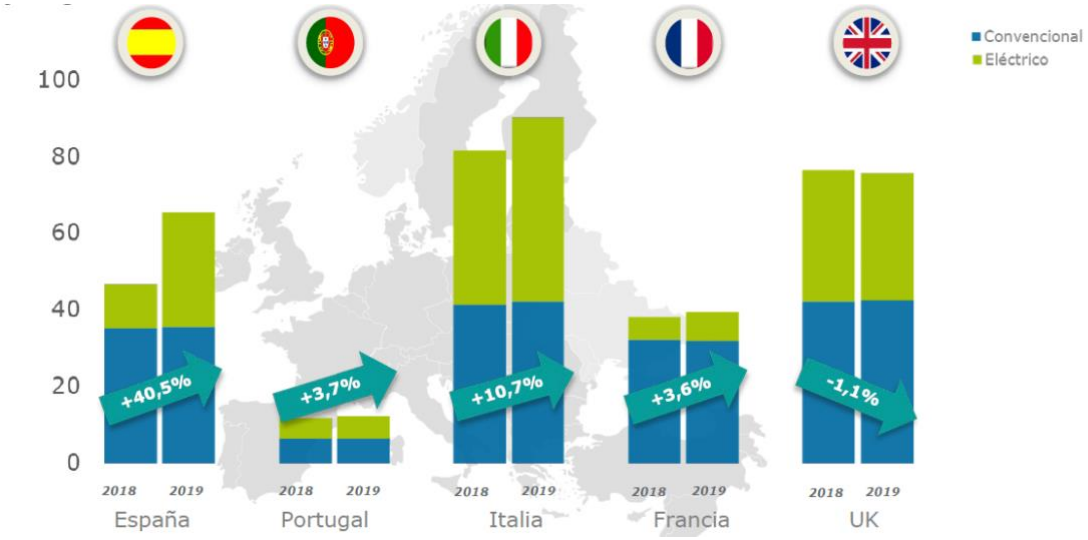
Position Paper on the Gas Market Reform

April 2020

The role of gas will be key in the energy transition in order to meet the climate targets, as a backup to renewables in the electricity generation mix and as a low carbon emission fuel in a power-based energy system including power-to-gas, hydrogen and synthetic methane produced with renewable energies (renewable gas) and biomethane/green gas. Furthermore, renewable gas can be an alternative fuel in transport in the context of the energy transition, in particular for maritime transport but also heavy-duty vehicles. All regulatory initiatives to be implemented should take this into consideration.

To mention some examples of the general increase on the natural gas demand in Europe, this figure shows the related values evolution from 2018 to 2019 in some European countries:

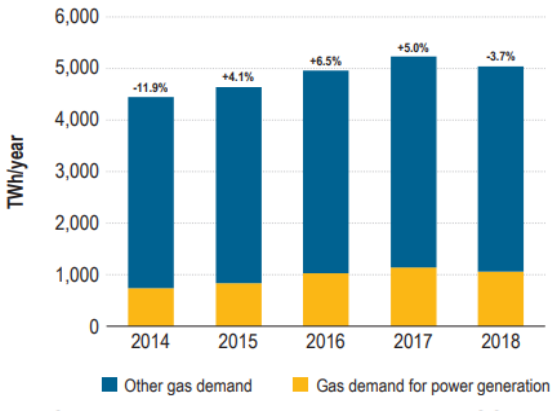
Fig. 1: Total demand of natural gas on the European framework (July-August 2018 vs July-August 2019)



Source: ENAGAS – Spanish Gas TSO
** "Conventional gas demand": Domestic, SME, industrial and LNG trucks.*
"Electrical demand": gas demand for electricity generation.

Furthermore, according to ACER, the gas demand development is overall positive year-on-year and over the last five years has been increasing, with the only decrease by 3.7% in 2018, mainly due to weather conditions and lower gas-fired power generation.

Fig. 2: EU gross inland gas consumption - TWh/year and % variation yoy



Source: ACER calculation based on Eurostat and ENTSO-E data

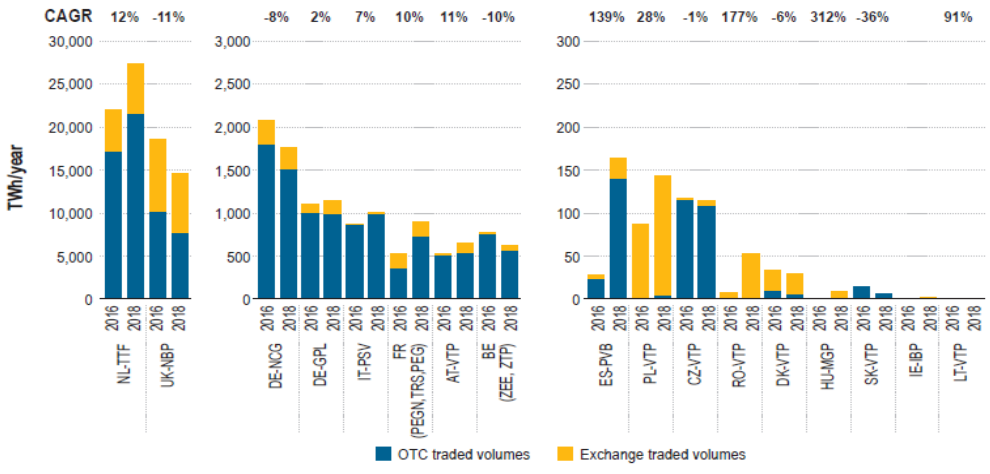
In general terms, the major issue that the gas regulation is facing is the lack of a true internal gas market in the European Union, compared to the development of the electricity market, due mainly to the following problems covered in three areas: i) competition, ii) market design and iii) infrastructures, which should be tackled in the upcoming gas package and are discussed in further detail in this paper:

I. COMPETITION - ENTRY BARRIERS AT WHOLESALE AND RETAIL LEVEL

1. **Barriers that hinder competition.** The main barriers that hinder competition in some Member States, are the low levels of liquidity at their hubs, particularly low trading activity in the forward markets, as well as the high cost of entry tariffs, LNG system costs and/or too expensive storage access. Lack of liquidity is a barrier as long as the interconnection capacity/international transport tariffs prevent operators from using a few continental hubs as a benchmark.

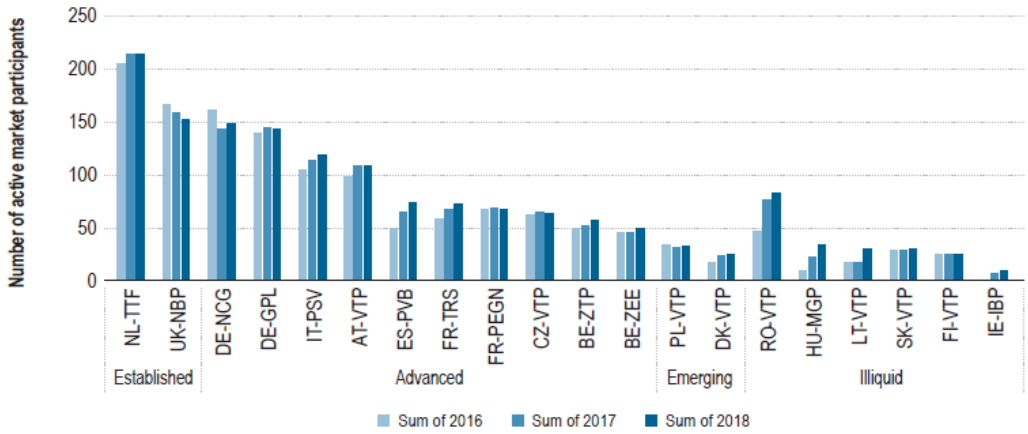
ACER's annual report on market monitoring in 2018 evaluates these factors by comparing them for all EU gas hubs:

Fig. 3: Traded volumes at EU hubs (ACER)



Gas traded at TTF and NBP is larger by a factor of 10 with respect the volumes traded at German (H-gas), French or Italian hubs and by a factor of 100 with respect to the volumes traded at the Spanish hub.

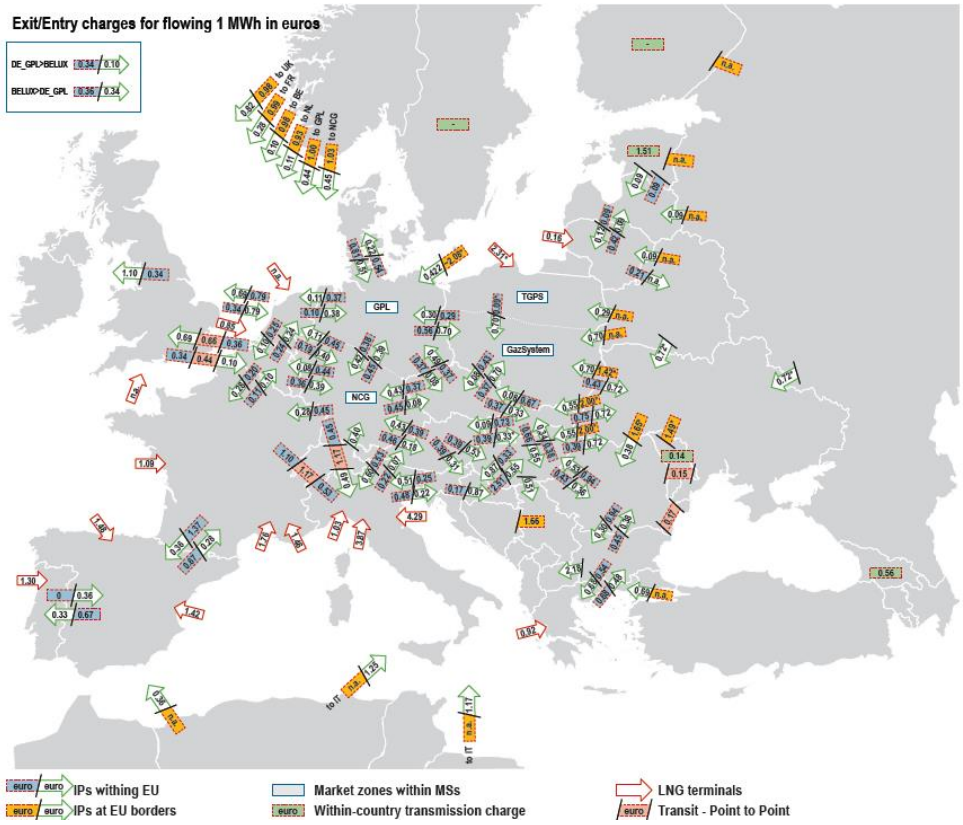
Fig. 4: Number of active market participants



The hub with the largest number of participants is TTF, followed by NBP and German hubs.

Fig. 5: Cross border transportation tariffs

Figure 36: Comparison of average gas cross-border transportation tariffs and LNG system access costs – 2019 – euros/MWh



As expected, EU hubs with high levels of trading activity are those for which entry costs are lower.

The abovementioned entry barriers benefit those market players with a dominant market share due to a former monopoly position, in consequence, any measure taken in order to eliminate/reduce these barriers is key to promote the competition between market players.

In addition, it is also beneficial to the EU having hubs with liquid forward markets in the absence of a recognized LNG price benchmark.

2. **Unbundling**: The lack of a clear distinction of activities and subsidiaries in vertically integrated gas supply companies is negatively affecting the competitive dynamics of the gas retail market.

Main obstacles facing the new entrants/non-incumbent players are detailed here below.

- **Vertical integration of supply and infrastructure**
  DSOs remaining as a company vertically integrated with the supply activity have the largest market share. For example, in Spain, the DSO Nedgia, owned by Naturgy (formerly Gas Natural Fenosa) has 69% supply points of the Spanish market. In Germany there are over 700 gas network operators, of which more than 90% have fewer than 100,000 connected consumers and thus benefit from the de-minimis regulation for unbundling. In other words, around 650 DSOs in Germany are not required to implement neither operational unbundling nor full brand unbundling.

  Additionally, an unclear brand distinction between regulated and liberalized activities contributes to customer confusion.

- **Supply of last resort pricing (SOLR)**
  In general terms, EER strongly rejects the existence of regulated prices for end customers and believes in full market liberalization. If any, this tariff should be applicable in a residual way to a very limited group of customers that meet specific criteria.

- **Consumption data of hourly metered costumers**: The data must be transmitted immediately to the suppliers and additional charges for hourly transmission of hourly measured values shall be prohibited. Today, e.g. more than half of all gas network operators in Germany charge additional fees between 100 and 3.000 EUR p.a. (in addition to the metering charges) for the transmission of hourly measured values. Furthermore, in Germany it is the network operators themselves, and not the regulators, who determine the deadline within which they transmit the intraday balancing data - with the result that in the German gas market this information is made available with a time delay of 4 hours.

- **Smart metering: Non-discriminatory data access on real time for all suppliers.** In the end, the legal framework and regulation must promote the obligation of effective measures to avoid the abovementioned distortions of competition.

- **Balancing markets:** According to the EU Network Code on Gas Balancing (Regulation EU No 312/2014), the TSOs are entitled to buy gas on the gas market to undertake balancing actions. This activity is difficult to forecast for market players, as such transactions are typically based on undisclosed information, leading, for example, to sudden price hikes in less liquid gas hubs (e.g. in Spain). Such balancing actions should therefore be procured by the TSO in in a way that does not lead to negative consequences for other market participants, through a transparent and no-discriminatory procedure and at the lowest possible cost for all players.

II. MARKET DESIGN

1. **Cross-border tariffs**: The current methodology for cross-border tariffs (entry-exit) allows some TSOs to charge very high tariffs, as in the case of Spain where the cross-border tariff reaches 3 €/MWh, discouraging the use of interconnections and placing the country in a position of disadvantage compared to players in other Member States. Many Member States implement hidden export fees. As an example, the French regulator initially proposed to apply the capacity weighted distance tariff methodology in a wrong way which could have resulted in Swiss and Spanish exit cost being more than double and treble the level of general entry cost. Finally, the French regulator followed ACER's opinion and slightly reduced French cross-border tariffs. While this is a step in the right direction, cross-border tariffs will need to be gradually reduced in the coming years.

The cross-border tariffs methodology therefore hinders the internal gas market development. Contrary to what happened in the electricity market, where interconnection tariffs were removed to promote the development of the internal market, the current methodology makes these tariffs more expensive, increasing the spread between the different wholesale gas market prices.

Consequently, any upstream cost optimization will result in a reduction to the downstream cost, which means a direct benefit for the end consumer.

Network tariffs for the use of gas storages: Today, network charges are levied for both injection and withdrawal. Removing this double burden should be examined.

2. **Liquidity of organized markets**. Liquidity at some hubs remains low if compared to other European wholesale trading hubs. For instance, in Spain more than half of the liquidity in the overall Spanish market is from volume swaps at LNG terminals where no price is disclosed making this index only partially reliable. Efficient and liquid wholesale markets are essential to competition and risk management in the energy markets. Also, the reliability of market signals impacts directly on the end customers.[1]

[1] A positive case of rising liquidity is Italy where the day ahead gas market has significantly gained transactions' volume recently. See http://mercatoelettrico.org/En/default.aspx

Gas release can be a good solution to gain market liquidity and price convergence between Member States. The Commission shall therefore foster Gas release programs for Member States in "energy islands" which lack a significant level of interconnection or are subject to high LNG/natural gas source dependency, such as Iberia and the Baltics, on which the price spread compared to the adjacent virtual trading hub(s) is significant. It could increase liquidity to the national markets as well as increase competitiveness capacity of new entrants.

3. **EU´s internal energy market**: In order to harmonize the EU´s internal energy market, the scope and main policy defined by the Commission should be targeted to increase:

- **The coordination between the natural gas and electricity markets**
  As we have seen over the last five years, natural gas is being used increasingly in electricity generation. This trend appears likely to accelerate as coal-powered generation is faced out, renewable energy resources require more backup by gas-powered plants, and competitive natural gas prices encourage more use of gas. The role of renewable gases, such as biomethane, bio-LNG, hydrogen and synthetic natural gas, as an energy carrier towards a low carbon energy future should also be considered.

  On the basis of the above, it is suggested that more resources must be allocated, planning for the increased use of natural gas to generate electricity.

  Some historically grown rules such as the gas day and gas year still hamper an alignment of the electricity and gas markets. In any case, they cause unnecessary additional costs in operations and capacity booking. For example, gas sales for calendar years are discriminated in capacity booking because the yearly capacity product refers to the gas year (October – September). Only this kind of yearly capacity can be purchased without a surcharge while quarterly, monthly and daily capacity are regarded as short-term products which could be sold by TSO with surcharges (e.g. in Germany between 10 to 40 %). In order to improve the harmonization and eliminate the discrimination of annual bookings which do not correspond to the gas year, TSOs should be allowed to sell quarterly products only at no extra cost .

- **The harmonization of the gas market in order for all market participants to be able to compete on equal conditions**, especially in terms of:
  - Tariff structure on network tariffs, switching and billing processes with network tariffs
  - NRA standardized final general terms and conditions, respective contracts for network access and network connection
  - Economical guarantees to market access
  - Access to LNG terminals and standardization of products
  - Congestion management and anti-hoarding mechanisms

III. INFRASTRUCTURES

Building new infrastructures should be guided by the following principles

- **Infrastructures should allow to achieve a fair level of interconnection throughout Europe and with energy islands in particular**. Only once a 10% level of interconnection of natural gas consumption in a Member State is reached, authorities shall employ the cost-benefit analysis for each new additional project. The promotion of infrastructures should be previously approved by national regulators. Once they are approved, the promotion and construction of transmission infrastructure projects should be subject to a competitive bidding process, guaranteeing the smallest possible costs for the system and the participation of new players, other than TSOs.
- European institutions shall give priority to small and medium sized projects on interconnections and infrastructures. The "pharaonic size" of many interconnection projects is in fact becoming a barrier for their development.
- First and foremost, it is the task of TSOs to guarantee capacity and adequate levels of interconnection and it's up to the NRAs to enforce it. In order to guarantee gas supply, new cross-border infrastructures should also be considered under TPA exemption of merchant schemes. Internalizing investment cost in tariffs would cause a negative impact, passing the cost on to end consumers and can ultimately lead to the underutilization of such infrastructures.

IV. NEW BUSINESS MODELS

Retailers and DSOs are confronted regarding their role in new business opportunities. However, in line with the unbundling principles, gas filling stations and gas tank storages may be considered as free-market competition activities and not as regulated ones. Even if that means certain delays into deploying such infrastructures. Member States may guarantee that suppliers act as promotors of such projects avoiding an increase of regulated costs for natural gas systems.

Also, decarbonisation in many transport modes is at least in the medium term not going to be based on electrification. Maritime transport, for example, will to a large extend not be fuelled by electricity in the next 30 years. A certain number of consumers are buying gas-powered vehicles, too. For such reason, LNG terrestrial storage shall be promoted, where appropriate, in Europe. There is a notorious lack of such infrastructures which is going to have an impact on the energy transition. Furthermore, bunkering activities in harbours and filling stations on motorways shall not be provided by DSOs but under free-market competition.

V. SECTOR COUPLING AND POWER-TO-GAS

The further development and market integration of power-to-gas and hydrogen is essential for the future of the gas sector in a power-based energy system. However, this development must not be taken as an opportunity to dissolve or even reverse the unbundling regulation between grid operation and other business areas that has been achieved to date. We therefore support ACER in its statement that TSO and DSO should be excluded from investments in power-to-gas projects.

It is true that no major projects have yet been developed by market players. However, power-to-gas, hydrogen and green gas have so far played a subordinate role, because their use in the energy market often encounters restrictions (e.g. recognition as a renewable energy source for heat supply, recognition as a long-term energy storage instead of devaluation due to efficiency losses in production) or is considerably disadvantaged by other regulation (e.g. levies). This must first be corrected in the legal and regulatory framework. In addition, a political decision is always required first as to the extent to which alternative gas should play a role in the future energy system and the prerequisites must be created for the development of a market for carbon-free gas. The decision as to how much power-to-gas or hydrogen is to be integrated into the gas system and when must under no circumstances be left to the TSOs or DSOs. On the other hand, the development of an own hydrogen network at an industrial site, can be implemented without regulatory requirements.