Gas Trading in Central/Eastern Europe: Are there still obstacles?

“Why do CEE gas markets lack behind in liquidity?”

Bucharest, June 2016

The energy to lead

Content

- A selection of countries looked at, with general observations and impressions
  - Poland
  - Hungary
  - Romania/Bulgaria
  - Ukraine
- Drawn conclusions and summary
  - Tendency for isolation instead of integration
  - National solutions' approach
  - Delay of the 3rd Energy package
  - Significant entry hurdles (administration, non-standard reporting requirements, language barriers)
  - Low liquidity with limited number of active players or pretended liquidity between affiliates => higher risk in case of supply shocks
  - In those illiquid gas markets a physical portfolio is crucial (even partially enforced by different regulatory obligations), but the variety and structure of TSO rules & tariffs are not supportive or even hindering such portfolio built-up
  - Extremely slow developments towards efficient markets

Poland

- Import volume cap 100 million m³/year
  - Higher than 100m m³/yr import needs to be backed by storage capacity for Security of Supply
  - Storage can be located in Poland (=> *very limited storage capacity available)* or in an EU country connected to Poland with firm transport capacity (=> *timing issue with capacity auctions, expensive and unrealistic due to "either-or-use" of capacity)*
  - This is an artificial high entry hurdle and hinders new entrants to enter the polish market commercially, and it does not deliver its intention, i.e. does not increase the level of security of supply
  - It merely protects the market share of the incumbent
- Diversification rule (non-European gas, i.e. Russian gas)
  - For the current period 2015 to 2018 the share of non-European gas shall not exceed 59%
  - In theory rather an issue for PGNIG only, <u>but</u> with an insufficient definition, of what exactly is considered to be non-European gas, the Regulator is challenging flows from Germany via Mallnow as being non-European and threatening shippers with fines (Result for deliveries in 2013still pending , having the 'origin of gas molecules' in mind…)
- Transport capacities, grid rules
  - High short term capacity tariffs (DA) and seasonal multipliers, which neither support market entry of newcomers nor appropriate reactions to market changes of market players
- Still a Market dominant incumbent
  - Estimated market share of 90% (and potentially increasing with LNG arriving by 2016)
  - Gas Release Program did not help: PGNIG supposed to sell 50% of volume via exchange, but the Program is missing the 'affiliated rule' (i.e. PGNIG Trading selling to PGNIG Retail)
- Numerous and non-standardized reporting requirements
  - 'Well meant' reporting requirements will not lead to transparency in that sense that competition kicks in
  - It just leads to high admin cost, especially as all communication requires polish language

Hungary

Transport capacities, grid rules

- High short term capacity tariffs (DA) and seasonal multipliers, which neither support market entry of newcomers nor appropriate reactions to market changes of market players
- Offered on own IT Platform “Regional Booking Platform” (RBP), which is not very user-friendly compared to Prisma for instance

Reporting & License

- Finally, after many years, it is possible to apply for a Limited Wholesale Gas Trading license. But still significant admin work required before it is finally granted
- The Supply License offering the full market access is in contrast overloaded with requirements to be fullfilled (*which is by the way an issue in most CEE countries*)
- Numerous, absolutely <u>non</u>-standardised reporting requirements

The political dimension

- Don’t forget that faith in a market place is crucial
- In summer 2014 several shippers started reverse flows to Ukraine. On 26th September the reverse flows were stopped by the TSO FGSZ, stating the entry nominations from Ukraine into Hungary went up significantly.
  - In Hungary the same physical rules apply as in rest of Europe – netting of flows
  - 22nd September a delegation from Russia met in Budapest with Hungarian officials

  All coincidence?
- Recap how many international companies sold their Hungarian affiliates to MOL Group: a signal of an attempt to create a National Champion? This does not support efficient markets nor Security of Supply

Taxation

- ‘robin hood tax’…a looming risk or really off the table completely?

Romania, Bulgaria

- Transport system
  - Entry/Exit System only on paper, but de facto still point-to-point (we see some signs of change for later the year)
  - No Virtual Trading Point (TSO facilitate a ‘kind of’-Title Transfer, but it bears several risks as the legal basis is not explicit), which simply means no market, no liquidity, no competition
  - Even more of a problem: separation of domestic entry/exit and ‘transit’ systems
    - Only by combining the two a gas markets can evolve where demand meets supply
    - Domestic entry/exit system isolated from the ‘rest of the world’
  - Export from Romania still not possible, although by production figures it could export.
    - Historically, the domestic gas production is connected to the medium pressure grid and is therefore missing compressors to connect to European’s high pressure grid…a missing willingness to invest?
    - Liquidity will only be attracted once not only imports but also exports are possible within well-connected markets
  - Cross-border point Negru Voda for 3rd Party access?
    - Would be more than welcome, as geographically both countries could form a very important bridge to connect the Turkish gas market with CEE / Northwest Europe – a true solution is still pending
    - Recently the European Union has approved funds to expand pipelines to flow gas from Giurgiu (BG/RO) to Csanadpalota (RO/HU) – a sign for hope?
- Romanian Commodities Exchange (RCE), OPCOM
  - 25% of portfolio needs to be traded mandatory on this platform. In principle a good thought, but the current set-up is counterproductive, as it is missing the main element of an Exchange: CCP (Central Clearing Party)
- Gas Price Regulation
  - Can limit a countries ability to fully participate in the benefits of integrated European gas industry: price regulation tends to be slow, i.e. inflexible to react on price signals from outside the country , effectively creating an “isolated price region” (e.g. hinders gas exports for the benefit of the economy)

Ukraine….slowly catching up

- A Promising market from its supply & demand figures and its geographical location
- But unfortunately a poor and challenging financial and political situation
  - Both the country and its industry suffer from financial constraints
  - Very strict foreign exchange rule, i.e. creating difficulties for buyers to pay in hard currency
  - Furthermore we observe a reluctance for reforms in the energy sector, which hinders international investments => *too much influence of politics in economy?*
- Still doubts of mid-term political stability
- Gas Market:
  - Liberalisation still at a very early stage, break-up of Naftogaz's dominant position and its link to politics still outstanding
  - Discretionary actions, e.g. end of November 2014 the decrees 596/599 and 647 came into force (as per decision of the Cabinet of Ministers)
    - For the period 1st Dec 2014 until 1st March 2015 a number of 152 gas customers were obliged to buy exclusively from Naftogaz (note: the remaining gas customers in our view were insolvent anyway…)
    - A de facto monopolisation of the market, alternative suppliers squeezed out with stranded business cases
    - Such measures can have a very destructive effect on market => *see above: faith in a market place*
  - Transportation & storage => unbundling again recently postponed
    - An entry/exit system is introduced, but still at very early stages and very immature. But: unbundling again postponed
    - Ukraine's huge storage capacities are underutilized, and could form an important part of EU's Security of Supply package. But: concern about commercial and political reliability
    - Exit points for utilisation into EU => so far very limited possibilities and formalistic difficulties to flow from Ukraine to EU countries, work in progress

Summary

- We are concerned about a tendency towards isolation rather than integration on EU-level
  - Under the headline of ‘Security of Supply’, we see a realisation of a variety different national targets/goals
  - Questionable concepts of defining entry/exit tariffs:
    - Cheap entry cost/ expensive exit cost <u>plus</u> high multipliers for short term or seasonal capacity booking
    - This hinders markets to react on supply and demand imbalances, and rather risks pushing it even deeper into imbalances
  - ‘Impressive’ hurdles to acquire a license, language barriers, extensive non-standardised reporting

- We are concerned that we see only a very slow and hesitant willingness to implement the 3rd Energy package
  - But why? Potentially to protect…whom?
    - Price regulation rather than competition
    - Incumbents are safeguarded as well as their profitability (are they really profitable?)
    - Impression: ‘small step policy’ to full-fill the minimum requirements of EU regulation … i.e. buying time

- We are concerned about weak liquidity
  - No new entrants (either supplier or trader) => no price signals for competition
  - Low/no liquidity and a small number of active market participants => countries <u>more</u> vulnerable to supply shocks
  - Exchanges as a stand alone solution are not ‘the key to a functioning competition’, they are not self-fulfilling. In fact they are an instrument when all other conditions are prepared

Thank you for your attention

RWE

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