EFET

EFET response to the proposal for a regulation amending the SofS and Gas Regulations

Summary

The European energy industry is facing exceptional challenges. We are in the midst of a global shortfall of gas and there is risk of further disruption to Russian gas supplies. Unusually low storage levels at the start of the heating season have prompted calls for rigid obligations to guarantee higher storage levels in future. These are intended to address the current crisis and to reduce the likelihood and impact of a future recurrence. However, the measures may also carry unintended consequences and it will be important to retain flexibility in their implementation to minimise adverse effects.

- Storage-filling obligations do not bring additional gas and will therefore not reduce the overall supply shortfall. Until incremental production is available, demand-side measures will still be necessary. Nevertheless, having gas in store can provide important cushioning for sudden supply disruption and to provide optionality around curtailment.
- Storage is necessary to manage system imbalances and to reduce price volatility. Multi-cycle facilities such as salt caverns should be largely excluded from the obligations as this would have a lesser impact on security but could significantly affect system operation and price stability.
- Different Member States have different exposures to security of gas supply. A one-size-fits-all model is unnecessary and inefficient. Member States should retain considerable discretion over how to set and apply obligations, including for example which forms of storage may contribute towards meeting a target.
- Market-based measures should be prioritised. Conversely, strict filling targets, trajectories and control points will remove optionality from the market and be more expensive and difficult to fulfil. They may also exacerbate price movements if they cannot flex to accommodate unforeseen events. As much flexibility as possible should be left in the hands of storage users to allow optimisation of injection and withdrawal.
- There is a risk that an increased focus on the use of storage may simply be compensated by a reduction in other security contributors such as forward purchase of LNG. As market parties commit more capital to one solution, there is less available for others. Broader measures of security across a range of tools should be considered.
- EFET supports a certification requirement that allows authorities to take action against unexplained behaviour that compromises supply security. We note that most market parties behaved rationally and economically during the storage injection season in 2021, but capacity that is unjustifiably left empty should be eligible for release.
- In the interests of proceeding quickly, the legislation was proposed without expert assistance, without an Impact Assessment and with limited stakeholder involvement. There are scenarios which were not fully considered where strong obligations could have a negative effect, such as accelerated demand destruction if supplies to customers must be cannibalised to meet injection obligations. Flexibility in implementation and opportunities to review the proposals would allow positive responses to such circumstances and should be built into the process.
- These measures are being introduced as a response to the current crisis. When circumstances improve, they should be removed as early as possible in order to avoid extended market distortion.

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1. Comments on the proposals

1.1 General comments

The current situation is one of a global gas shortfall: gas demand has continued to grow worldwide and significant new supply is not expected before 2025. Europe is in competition with Asia for scarce gas. Once wholesale prices reach a level whereby production is maximised in the short term, prices remain important to send a commercial signal to consumers to conserve gas and ultimately to switch off or defer consumption, whether in Europe or in Asia. By and large, this reflects what we have seen in practice to be successful in reducing demand both in Europe and Asia. However, this is still overshadowed by continued political uncertainty both on the supply side and the regulatory response.

The introduction of storage-filling obligations does not bring additional annual gas, though it does have other benefits, notably providing a cushion to manage the risk of a sudden worsening of supply, or to provide optionality over timing of curtailment. Until more supply becomes available, the only other way to match supply and demand is through demand reductions, whether commercially driven or imposed.

1.2 Context: What is security of supply?

Security of supply is not absolute. It is never the case that if an action is taken, all consumers will be 100% secure, and if the action is not taken they will be 0% secure. The question is more about what level of security is appropriate and how much consumers can afford and are willing to pay for. Does the benefit of increasing the security level justify the additional cost, or can a point be reached when the cost of the insurance is greater than the adverse effect of increased curtailment.

Markets are thought to undervalue low probability high impact events. Many consumers prefer to pay a lower price for their gas while accepting the remote risk of disruption. Similarly, there is a limit to the price consumers are willing to pay to avoid curtailment and that limit may not price in the actual economic loss incurred by the wider economy in the event of supply disruption. Current events have drawn attention to externalities that were not valued by the market, but which authorities wish to address at a macroeconomic level.

Governments may therefore wish to hold higher levels of insurance than would be delivered by the market alone. They may for example define a higher level of gas stocks, but carry an obligation to make sure that the additional security is provided at the most competitive rate, and must identify how the additional costs should be recovered.

It should be noted that while storage levels appears low at the start of the 2021/22 heating season, this was largely due to Russian-controlled storages not being filled. Other commercial parties

[1] The European Federation of Energy Traders (EFET) promotes and facilitates European energy trading in open, transparent, sustainable and liquid wholesale markets, unhindered by national borders or other undue obstacles. We currently represent more than 100 energy trading companies, active in over 27 European countries. For more information, visit our website at www.efet.org.

behaved rationally in response to market circumstances and reasonable filling levels were achieved without the need for obligations.

1.3 How security of supply is provided

Security of gas supply is provided in a number of ways: diversification of sources and import routes is more secure than reliance on a single exporter through a single pipeline. The ability to import LNG gives further access to diverse sources of gas.

Demand-side flexibility through the ability to switch to alternative fuels or to delay consumption is also an option. Finally, gas held in various forms of storage – both locally and further afield – provides further supply diversification, and which may be more directly controllable, closer to the point of consumption.

Insurance provided by the market consists not only of gas in storage, but also local production, imports via LNG and pipeline gas from diverse sources, and demand side management including fuel switching and self-interruption. A change in the value (or demand or supply) of one will have an impact on the market and therefore on other forms and all those variations are reflected in the price signals, provided that they are not distorted by different forms of market interventions.

1.4 The market helps to manage shortages

If there is an anticipated shortage, prices will rise in forward markets and parties will contract forward for more gas or put gas in store. Higher prices will make production from higher cost facilities economic, will divert gas from consumers who value it less to those who value it more, and will encourage demand reductions through fuel switching, fuel economy or delaying consumption.

Ultimately, there may be no additional short-term production available and the price of gas may be unable to reach the value of lost load (VOLL) where consumers self-interrupt. At this point, the only way to address a shortage is through curtailment of demand. In order to protect domestic consumers and essential facilities such as key public services, it may be necessary to require industrial and commercial consumers to reduce discretionary demand. (Some may be able to switch off entirely, others require a residual firm load to avoid serious damage to industrial equipment.) If this is not done, it will be down to TSOs and DSOs to carry out the necessary emergency measures in order to maintain a safe system and avoid danger to life and limb.

During the current shortage, the market has indeed ensured that supply and demand balance, through high prices leading to demand reductions in Europe, most notably in the chemicals industry, but also by exporting demand curtailment to Asia, by paying higher prices for cargoes than can be sustained by some Asian buyers.

1.5 The role of gas storage

Gas storage does not reduce overall dependence on imports over the year, but allows this dependence to be spread over a longer period. Filling storage to a higher level will in fact increase dependence on imports (and therefore demand) in the short term, by adding injection volumes to existing demand.

Together, these factors will influence what is the role of storage and its extent in providing security, how much storage can be available for insurance, and at what point the cost of this insurance is unaffordable compared to the costs of dealing with a gas shortage, e.g. by curtailing non-essential load.

One challenge that must be met is to ensure that an obligation to increase security measures of one sort (storage filling obligations) is not compensated by lower security measures in areas that are not measured. For example, in order to manage values held at risk within a party's acceptable range, an increase in storage holdings may need to be balanced by a reduction in exposure elsewhere, such as forward purchases of LNG. In this way the overall level of security does not change, it merely becomes more biased towards the sources of security that are measured (storage) and away from sources that are not.

1.6 Storage has many uses

Storage provides a number of functions, not limited to supply security. It helps to modulate imbalances in the system that stem from the variability of supply and demand for gas. Imbalances can arise because of weather deviations, changes in economic activity, planned and unplanned maintenance of production or transportation assets. Storage also dampens price volatility. When prices are low, commercial storage users will inject gas, to withdraw when prices are high. Storage that is close to consumer areas has locational value: it may substitute for transportation capacity. Finally, some localised storage may be required to help manage emergencies, should a controlled run down of the system become necessary.

Buyers of gas (which may be utilities, industrial consumers, power generators) may have seasonal consumption patterns. They have a choice whether to buy forward their gas needs for next winter (or longer durations), or to put gas in storage and hold it on their own account or leave open the physical position (leave unhedged or hedge with financial products).

Sellers may wish to hold gas in storage to cover production outages for example during maintenance periods, or to convert LNG cargoes into a tradable strip (including coverage of potential delays when selling forward), or exceptionally to hold storage capacity to manage volatile flows during a commissioning period.

Traders (who may also be buyers and sellers) behave on a merchant basis, injecting when prices are low in expectation of being able to sell at a higher price later. If winter prices do not justify summer injection plus storage costs, the commercial call may instead be to sell the summer and/or buy the winter.

1.7 Impact of regulations

In the absence of other regulatory interventions, the market would itself adjust for the previously low storage filling, and higher levels could be expected if the storage capacity price could reflect its actual value in the current market environment. That value is largely negative, since currently markets are illiquid, prices are volatile, being determined by thin levels of trading, forward prices show low and even negative summer/winter spreads. On that basis, there is no consistent incentive for commercial filling of storage. Negative storage prices to incentivize the subscription of storage capacity may be considered, especially when summer gas prices are higher than winter gas prices.

We note also that the threat of intervention could additionally affect the willingness of market parties to contract for storage that may attract new unexpected obligations during the contract period. Nevertheless, some injections have been made to take advantage of sudden market movements as Asian demand has fallen and LNG cargoes have been released as a result. It is important that markets can continue to respond as opportunity arises rather than be forced into storage-filling trajectories that may exacerbate price movements rather than allow parties to optimise around them.

The reservation of storage for supply security may also have unintended effects of removing sources of flexibility from the market. We note that salt caverns represent 18% of storage space in EU, but are used as multi-cycle facilities. To place a seasonal obligation on them would reduce their availability to provide flexibility to the market, which could in itself increase price volatility in-year. We recommend that they be excluded from the obligations.

How to demonstrate that conditions have been met? Current rules would not allow floating offshore storage in the form of parked LNG carriers, which has previously been used in EU in exceptional circumstances, though this is an expensive source. Increases in domestic production capacity are also not included, though they would reduce the level of imports required rather than redistribute them across the year; similarly increased LNG import capacity, though this in turn depends on available LNG production and shipping. Together, these signify differences between Member State circumstances, requiring a degree of flexibility rather than one-size-fits-all.

1.8 Objectives

The proposal must recognise that the use of storage does not exist in isolation. Incentives to increase the use of storage as a form of insurance may have a compensating reduction in other measures. If there is a perception that an overhang of storage will bear down on winter prices, this may affect positions that would otherwise be taken. Legislative change should consider every way - as described above - to provide security of supply, and not only measures related to storage.

At the same time the Regulation needs to recognize that different obligations have been imposed on the market participants already ahead of its adoption. Transitional arrangements may be necessary for sudden changes in obligations that could not be foreseen.

1.9 Consistency with policy provisions

From the trader viewpoint, we must also consider the risk of further policy measures and how they would impact a position. For example, market parties who committed to storage in advance of a filling obligation would value the product differently from those who were aware of the obligation and whether financial assistance is to be made available to those who take on obligations.

In this perspective, it is important to highlight that users with storage capacities contracted before the entry into force of an obligation regarding this facility (filling obligation as well as the UIOLI mechanism), will be saddled with a windfall loss that will deter future participation unless it is somehow neutralised. This could be in the form of compensation or an option to terminate their contracts. This is necessary because those rules were not applicable when the capacity was contracted, resulting in a significant change in the regulatory framework (with respect to the one in

force when the storage contract was signed) and, as a consequence, in the terms and conditions of the booked product.

Currently in EU member states, there have been suggestions of price capping, differential prices for gas used in power generation, national initiatives to accelerate storage filling prior to the EU regulation. There is also historical experience of obligations to maximise imports and that prevent exports. All these insinuations and past experiences directly impact the already volatile market situation and make it difficult for the market participants to manage their risks around forward positions. Furthermore, we have incomplete implementation of Regulation 1938/2017 and therefore a lack of certainty whether this will affect how gas in storage may be called upon by authorities or released and used as part of a commercial party's portfolio.

Ideally, transparency and advance notice of rules that are reliable will give traders an opportunity to evaluate storage products and to signal their estimation of the value in indications of interest or in auction bids. However, given the uncertainty of the situation, it may be advisable for EU (if not MS) to retain some flexibility. Under these circumstances, it is important that parties making commitments are protected against subsequent adverse intervention. Without such protection, the perception of risk may discourage or reduce further participation.

1.10 Additional points

We note that incentivizing gas storage utilization through tariff discounts might have negative consequences, particularly since these discounts will weigh on the cost of capacity at other network points. In order to limit the potential negative consequences such solution might bring, the potential reduced revenues of operators linked to tariff discounts should be recouped over an extended period of time in order to prevent major tariff changes over the course of an ongoing tariff period. National authorities already hold the right to apply discounts on storage exits/entries. When considering discounts on capacity-based transmission tariffs at entry points from and exit points to storage facilities, a careful analysis of the implications it may carry for other network points should be run.

EFET continues to support that forms of assistance may still need to be made available to those vulnerable consumers who would otherwise be unable to heat their homes. This should continue to be done through direct aid (as described in the EU toolbox) rather than intervention in the wholesale market, which may be more costly as it would also provide assistance to those who don't immediately need it, and have potentially damaging outcome on the functioning of the market.

If there is simply insufficient gas that can be brought on in the short term and there is a physical shortfall, then it will need to be rationed either on the basis of price (it reaches a level whereby industrial and commercial consumers self-interrupt), or authorities must take action to determine which sectors should be curtailed in order to protect residential load and key services such as hospitals. These demand-side actions are notably missing from the proposals, though we note that individual member states are now considering them. Coordinated guidance in this area does not appear to be included in these proposals and should be considered further.

To improve the security of supply, the implementation of demand response scheme should be encouraged through financial incentives.

Additionally, we note that significant price spreads have been developing in EU, which are indicative of transportation constraints between markets. We encourage ENTSOG members to remove bottlenecks arising from changes in gas flows via infrastructure investment where necessary, but

also through amendments to capacity allocation mechanisms that are not sufficiently flexible to allow markets to clear during times of high price spreads.

2. Legal Basis

No comments

3. Absence of Ex Post evaluations, stakeholder consultation and Impact Assessments

While we understand the urgency with which the Commission wishes to progress with this initiative, further analysis of the market should have been considered in order to understand the potential impact.

The REPowerEU communication lays out possibilities to replace the recent levels of gas import from Russia amounting to 155 bcma. In the short to medium terms, it suggests that 50 bcma could be replaced with additional LNG import and another 10 bcma from pipeline imports. Demand reduction and biomethane production increases are expected to take longer. Without further gas (and indeed if not all the additional gas supply arrives in Europe), Europe faces a stark choice of increasing consumption of high carbon sources of energy which would jeopardise further achievement of the Fit for 55 objectives, or continuing to buy high levels of Russian gas, or of greater levels of demand curtailment. **An obligation to fill storage could, in combination with any substantial interruption of supplies (whether for geopolitical or other reasons), raise short term prices above the value of lost load such that demand destruction is accelerated. Parties may cannibalise supplies to consumers or to power generation in summer in order to fulfil the storage injection obligations.**

The absence of an Impact Assessment may mean that such scenarios have not been fully considered. Under these circumstances, the EU – or at least Member States – may wish to retain some discretion between continued supplies and storage injection. Unless protective mechanisms can be put in place, this may add to the level of risk being borne by market participants and require authorities to put in place higher curtailment orders.

4. Budgetary implications

We note that 5 FTEs are proposed for the management of an LNG platform for joint purchases. Should the Commission decided to go ahead with this aspect of the proposal, EFET believes it would be better managed through a commercial platform, which would be contracted out and would not require this level of resource within the Commission.