SELF-EVALUATION OF AUSTRIA’S EASTERN MARKET AREA IN ACCORDANCE WITH AGTM METRICS AND ANALYSIS OF MARKET INTEGRATION OPTIONS

Summary of responses to the consultation and reaction

Vienna, 9 June 2017

BACKGROUND

During February and March 2017, E-Control Austria conducted a public consultation on the above topics based on a number of published studies.[1] Overall, 15 market players responded to the consultation and their responses are available on the E-Control website.[2]

The present document summarises these responses and provides a reaction by the regulatory authority.

The summary is qualitative in nature and focuses on the issues that were subject of the studies themselves and that were explicitly addressed in the consultation questions.

Responses reveal that the use and interpretation of the term "market integration" is far from uniform across respondents. To clarify the situation, E-Control provides the following baseline definition:

- *"Market integration in the wider sense":* creation of conditions for the availability of and access to cross-border infrastructure and establishment of regulatory and organisational measures etc. which lead to converging prices in adjacent but separate entry-exit zones, to efficient use of infrastructure through market-based price signals, and to easier cross-border market entry. This explicitly includes market connection tools as addressed in chapter 4 of annex 6 to the AGTM.[3]

- *"Market integration in the narrower sense" / "true" market integration:* merging of previously separate entry-exit systems and markets into an integrated (cross-border / regional) entry-exit system, leading, among others, to a concentration of supply and demand at a central virtual trading point and enabling significant improvements in market efficiency. This explicitly includes gas market integration tools as addressed in chapter 3 of annex 6 to the AGTM.

[1] Link to studies: https://www.e-control.at/en/regionale-perspektiven-fur-den-osterreichischen-gasmarkt
[2] Link to (non-confidential) consultation responses: https://www.e-control.at/documents/20903/388512/Stellungnahmen_Selbstevaluierung_und_regionale_Perspektiven.rar/ec05db b4-93d8-86af-4c16-140a63e3892f
[3] http://www.acer.europa.eu/Events/Presentation-of-ACER-Gas-Target-Model-/Documents/A14-AGTM-13-03d_GTM_Annex%206%20-%20Gas%20market%20integration%20and%20connection%20tools_final.pdf

SELF-EVALUATION IN ACCORDANCE WITH AGTM METRICS FOR AUSTRIA'S EASTERN MARKET AREA

Evaluation of the current situation in the eastern market area

Respondents largely share the study's assessment of the current situation in the eastern market area and the statement that wholesale market liquidity is still insufficient. In particular, they point towards a lack of liquidity on the forward market. There is general support for the consideration that a sufficiently liquid wholesale market in the eastern market area would benefit the entire CEE/SEE region, but respondents also share the assessment that the AGTM thresholds will most likely not be reached if the eastern market area were left to develop completely on its own. Responses do not offer up measures that could boost attainment of the AGTM metrics in the eastern market area while maintaining the current market structure.[4]

Two respondents enquire as to the validity of the AGTM metrics as the right measure, given the different directions and maturities of national markets. E-Control maintains that the AGTM metrics are fit for purpose; indeed, it is precisely the intention of the thresholds to define what traders consider a liquid wholesale market. Selectively reducing the requirements to accommodate the characteristics of individual markets (size, location, maturity) goes against the target of creating a liquid wholesale market. Rather, the metrics' purpose is to point out each market's particular shortcomings, i.e. in the case of the eastern market area the prompt and forward markets.

[4] While not targeted towards attainment of the AGTM metrics, there are suggestions for improving transparency (of particular relevance to the spot market), simplifying the balancing regime and enhancing market maker conditions. E-Control intends to address the first two of these points when adapting the gas market model. The third, market maker conditions, are primarily an issue for the operators of exchanges and trading venues, and therefore outside E-Control's competence.

Advantages and disadvantages of accessing a liquid forward market outside the entry-exit zone

With reference to the prompt and forward markets, a number of respondents comment that longer-term forward liquidity is exclusively found at TTF, which is where market players can hedge risks etc. Following up on this consideration, E-Control suggests further investigations into two areas:

- Austrian suppliers are turning to TTF to hedge market risks. Is this really the most cost efficient option for Austrian consumers (considering the involved transaction costs, remaining risks (correlation), in particular for regional / local suppliers etc.)?

- Is there an indirect negative impact on and risk for Austrian consumers that results from the lack of activity on the Austrian forward market, or its lack of attractiveness, thereby further consolidating the function of TTF and/or NCG as price references for all kinds of trades (supply contracts between producers and importers, supply contracts to/from suppliers etc.)?

Further responses

One respondent points to the need for considering a regional HHI because security of supply cannot be analysed at an exclusively national level. In this respect, the authority would like to clarify that the HHI is not an indicator for security of supply but for market concentration, measuring effectively the market power held by individual or few suppliers. The AGTM specifies that the market area is the relevant market for this indicator given that prices refer to these market areas and regional prices or price levels are not present everywhere. The study revealed market concentration to be one of the metrics where the eastern market area in Austria still lags behind the target.

MARKET INTEGRATION STUDY

Recommendations, possible next steps and assumptions

The recommendations put forward by respondents largely correspond to E-Control's own considerations. They can be summarised as follows:

- The authority shares the view that successful market integration must rely on active participation and involvement of the relevant stakeholders in each market; we will bear this in mind when planning and designing the next steps.
- The decision of whether and how to go forward with market integration must hinge on detailed analyses of the costs and benefits for each of the involved markets. The next step should only be taken if such analyses reveal that market integration would improve the current situation.
- This next step would be to agree on the possibilities for and sequence of measures towards market integration with potential neighbouring partner markets. A pilot project might be a good first step. If it delivers positive results, it could be expanded both in terms of integration depth and in terms of geographical scope.
- E-Control is convinced that a final cost-benefit evaluation must rely on a concrete, detailed implementation concept which recognises and reflects the characteristics of the participating markets and regulatory systems. This concept must be developed together with the stakeholders in each market. The basic principles of such a concept (including the principles of cost and benefit distribution) must be developed early on, putting the authority in a position to evaluate whether market integration initiatives should go ahead.

Geographical options

A number of responses indicate preference for the market integration options with NCG/TTF as these would likely lead to lower prices. Also, it seems unrealistic at the moment that the benefits from positive integration options with CZ and/or SK could be realised.[5] Other responses explicitly point towards the potentials of real market integration with Italy and other southern neighbours, suggesting that talks should be opened to pursue this option.

E-Control agrees with the overall statements in the responses in that:

- geographically, real market integration with Austria's southern neighbours is most attractive; this corresponds to the results of the study;

[5] Some responses consider that SK and HU should have been included in the analyses as well, while they do not assume that this would increase the resulting benefits.

- in particular for market integration options that do not seem feasible because they have significant interconnection deficits, full implementation of network codes could be complemented by market connection tools; analyses should be conducted to find out whether this could lead to a more efficient connection between existing markets and create benefits for market players and consumers.

Integration tools

E-Control is of the view that a full market merger should be the target of comprehensive market integration but recognises that particularly the trading region approach offers a positive cost-benefit ratio and is less complex in terms of implementation. Respondents share this view.

Results of the cost-benefit analysis: benefits

Respondents voice concerns with respect to how the study calculated the benefits of **wholesale market efficiency**. E-Control concedes that a comprehensive and reliable quantification would require a full set of data for all supply and demand in the relevant markets for the entire reference period. This data is not available in the required quality, which is why the study could only deliver estimations (as is pointed out in the study itself).

Responses also point to a concern that market integration could lead to a price-/volume-weighted average price which would in turn create results that fundamentally differ from what is suggested in the study. We do not share these concerns. Please consider that:

- prices in the “more expensive” market are determined by the marginal price of the offers in that market. Access to a “cheaper” market, even if only for limited volumes, can have a sustained effect on price formation in the “more expensive” market.[6] The study took a cautious approach to this effect and only factored in 50% of such price reductions.

- the above shows that increased demand from the previously “more expensive” market would not automatically pull up prices in the “cheaper” market. This effect rather depends on the volume of previously unsuccessful offers on the “cheaper” market.

- when we develop a detailed implementation concept for market integration, this will include measures to ensure that the integrated market has efficient access to cheap offers. At the same time, the situation of consumers in the individual markets must not deteriorate compared to now (this could e.g. be achieved via compensation mechanisms to siphon off individual cases where this could not otherwise be avoided).

[6] In concrete terms, the AT/IT combination shows a consumption ratio of 1:10 but a trade ratio of 1:2, i.e. confirms the Austrian market’s potential to offer relevant volumes.

One respondent states that an integrated market would not improve **retail market efficiency** due to the risks connected with expanding retail activities. E-Control does not share this concern. On the contrary: integrated markets enable suppliers to expand their retail activities while sticking with their portfolios, working through their balance group and employing (largely) the same market processes as before. This considerably reduces the risks involved. The benefit that can be expected will depend on the market integration tool chosen (reaching its maximum with a full market merger, materialising in reduced form within a trading region etc.). Details on this can be found in the study.

One response mentions **additional benefit elements**; the study offers a qualitative assessment of these aspects (in particular with a view to access to new sources, LNG etc.) but does not include them in the quantitative assessment for simplicity's sake. Instead, the study takes a conservative approach and only delivers numerical benefit evaluations for a small number of key benefits. In reality, the benefit from market integration might turn out to be larger than indicated in the study.

Results of the cost-benefit analysis: costs

One response criticises the study for not considering costs for maintaining or expanding capacity. In this context, E-Control would like to point out that the firm capacity considered in the calculations was reduced to the degree suggested by the interconnection deficit, thereby reducing also the resulting benefit. This corresponds to the costs for capacity maintenance that would otherwise be incurred.

One of the responses correctly explains that market integration would eliminate bookable interconnection points, which means that these costs would have to be allocated to other points or compensation payments would need to be introduced. The detailed implementation concept will address this aspect.

In concrete terms, one response assumes that there would have to be a compensation payment IT>AT (corresponding to the distribution of benefit from increased wholesale market efficiency). The purported amount of such compensation payment, even if it were to fully cover the missing revenues from eliminated IPs, would be significantly lower than the calculated overall benefit of market integration.

Treatment of capacity and possible results of market integration

The study generally relied on **existing capacity**. For the market integration options involving CZ, it assumed that BACI will be realised. E-Control considers this to be fair treatment given the ratio between these integration options' benefits and the BACI investment cost. The interconnection capacity assumed for IT>AT included an expansion project by the Italian TSO which is already under construction. At the same time, the study reduced the calculated benefit by the Italian TSO's "commodity charge", i.e. followed a conservative approach.

With reference to the responses relating to the calculation of the **theoretical interconnection deficit (TID)** and the **theoretical capacity restriction rate (TCRR)**, the authority would like to point out that the same methodology was applied to all market integration options. This methodology follows a number of basic assumptions:

- It looks at a worst-case situation in terms of nominations, i.e. possibly overestimates the resulting capacity restriction and underestimates the benefit by the same amount (even excluding interruptible capacity). One response expressly acknowledges this overestimation, referencing that chances of such a situation actually occurring are small. The methodology pursued a cautious line of thinking that is in line with the existing capacity model.

- A number of responses criticise that the study used average annual values instead of peaks for the interconnection deficit. While this is generally a valid argument, in particular in combination with the above-quoted worst-case nomination situation, seasonal consumption swings result in an actual interconnection deficit that can be higher during some intervals while being lower in others. The annual average should reflect overall realistic levels and is thus the most representative reference value.

Views on the effect of market integration on the **value of freely allocable capacity** differ between responses. While some underline that the quality of current capacity must not deteriorate, others clarify that market integration would increase the value of freely allocable capacity (by increasing the number of points that can be combined) and that even potential restrictions on capacity use or combination of points would not necessarily mean a reduction of current capacity rights. E-Control considers that both these aspects are relevant and points out that concrete handling of potential interconnection deficits must be part of the detailed integration concept. Even though they were mentioned by the study, usage/allocation restrictions are only one of several options.

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Consequences for tariffs and tariff models

Responses bring up the thought that transport costs were unreasonably treated as sunk costs. The authority rejects this view. The study started, for all market integration options, from the assumption that the costs of existing national infrastructure exist irrespective of market integration. If market integration is pursued, these costs need to be allocated differently in future (given that some of the interconnection points where they are collected at the moment would then no longer exist) or be compensated through a dedicated mechanism. This will be part of the detailed implementation concept (see also section "Results of the cost-benefit analysis: costs").

One response proffers an alternative to market integration, suggesting that the current market structure (separate entry/exit systems in neighbouring markets) should be kept and reference prices for interconnection capacities should be set to zero (for capacity to be allocated in future but also for existing capacity contracts). The authority would like to present the following two considerations in this context:

- While the measure suggested by the respondent would lead to a convergence of market prices and improve the use of interconnection capacity, the efficiency potentials identified by the study can only fully be reaped if entry/exit systems are actually merged and a common virtual trading point is created.

- The "quo vadis study", an exercise currently conducted in the name of the European Commission, indeed addresses the measure proposed by the respondent; it could represent an intermediate step on the way to integrated regional markets. E-Control would like to point out that the implementation effort involved is comparable to that of actual market integration, while the benefits are not.

Consequences for security of supply

Respondents voice differing views as to the effects of market integration on security of supply.

E-Control shares the view that liquid markets with robust price signals are the best measure that can be taken to prevent security of supply incidents. In addition, an integrated market requires close cooperation and coordination of market-based measures to prevent and mitigate supply interruptions. The authority points out that the revised Security of Supply Regulation introduces solidarity cooperation at a regional level regardless of market integration. Even so, security of supply remains a deeply national concern; in an actual emergency situation, it might become necessary to suspend market mechanisms and/or temporarily reverse market integration by applying national measures.

Storage issues

Storage system operators point towards the particular complexities that market integration holds for the storage regulatory system (access, regulation etc.). E-Control underlines that the creation of a level playing field across the entire value chain is one of the major goals of market integration. The detailed implementation concept needs to evaluate any national market characteristics that contradict this goal as to their effect on competition etc. Even so, we do not expect that the market integration tool chosen necessarily means harmonisation of all market aspects.