Consultation paper on the self-evaluation of Austria’s eastern market area and analysis of market integration options

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About PEGAS

**PEGAS** is the central gas trading platform of EEX Group operated by Powernext. **PEGAS** provides its members with access to all products on one single platform and allows them to trade natural gas contracts in the Belgian, Dutch, French, German, Italian, Danish, and UK market areas. Since 2016, the CEGH spot and futures contracts have been part of the PEGAS platform. The **PEGAS** product range covers spot and derivatives contracts for the major European gas hubs as well as trading in location spread products between these market areas. This set-up enables market harmonisation and forms the leading pan-European natural gas market. For more information: [www.pegas-trading.com](http://www.pegas-trading.com)

PEGAS welcomes the opportunity to take part in the consultation process, initiated by the Austrian network agency E-Control concerning a study on the performance of the Austrian gas market and potential market area integrations. The self-evaluation of Austria’s gas market has been launched with the support of the independent consultant WECOM. The consultation process follows the ACER Gas Target Model II from 2015, which requires national regulators to evaluate their domestic markets. The aim of the gas target model is the realisation of a competitive European gas market consisting of well-functioning and well-connected market areas (entry-exit systems). The study aims to measure the cost-benefit ratio of potential market area mergers with the help of Market Health and Market Participant Metrics. In 2016, Bundesnetzagentur in Germany launched a similar study with the support of the same consultant.

The liberalisation of the European gas markets has been quite successful. So far, wholesale gas prices across the EU have been the lowest in a decade, and gas price differences have continued to decrease across the continent. Hence, market structures have proven to be an efficient tool for providing transparent pricing mechanisms and to ensure that gas is shipped freely to where it is needed. Wholesale prices are well correlated, especially, in Northwestern Europe. In addition, a reduction of the dependence on oil-indexed contracts could be achieved.

The **PEGAS** platform connects 11 European gas hubs and is an important driver for the integration of the European energy market and for enhanced energy security. As a reliable and liquid trading platform, **PEGAS** helps to provide natural gas at a fair price and to set clear price signals for investments. Spread products constitute another key tool for the European internal market connecting and combining spot trading on local hubs with derivative trading on larger central hubs. Such products enable hedging of price differences between the different hubs. In this way, the integration of different market areas does not appear necessary in most of the cases.
Thorough cost-benefit analysis required

Any integration of market areas induces additional challenges and costs, above all for the TSOs, which need to be considered. Cross-border market area integrations can become very complex - in spite of the successful implementation of the third EU energy package, there are still considerable differences in the regulation framework between countries. The merging of market areas requires the negotiation of a common, well-functioning regulatory framework.

Beside these transitional costs of integration, the effects on market efficiency and on the allocation of rents have to be analysed in detail. Understanding how an interconnector between two market areas is managed under the status quo and after a possible integration is of fundamental importance.

On one hand, if the market, and not the TSO, manages interconnector capacities, the resulting market equilibrium is closer to the welfare-maximising allocation. This is because the market takes into account and prices possibly scarce interconnector capacity. This argument therefore supports small market areas. On the other hand, larger market areas enable liquidity pooling, which increases welfare. The question of whether or not to integrate market areas is therefore about solving that trade-off.

Price effect induces mainly re-allocation of rents

If two market areas are integrated, prices change in general. However, the price of the integrated market areas is not equal to the lower price of the two separated market areas. The new equilibrium price of two integrated market areas will in general be in between the two prices of the formerly separated market areas.

In one of the markets, the price will therefore decrease. It is, however, questionable whether this decrease induces an increase in social welfare. It is rather likely that the price effect induces mainly a shifting of rents between producers and consumers.

In addition, the price effect does not fully correspond to a change of social welfare. Rather, it is likely that the price effect mainly induces a re-allocation of rents between consumers and producers and between both market areas. A similar effect has been identified during last year’s discussion in Germany regarding a possible integration of German market areas with the TTF in 2016.

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1 This reasoning that liquidity pooling increases welfare applies to spot markets. For derivative markets, hedging can be done cross-border, and market forces establish large liquidity pools themselves (NBP, TTF).
Finally, if the liquidity of a market is low and if it is not expected that the market will establish a critical liquidity level in the near future, market area integration can be considered. Here, the effect of bundling liquidity outperforms the welfare losses of the integration. If markets are sufficiently liquid, market area integration may not be beneficial.

**Bundling liquidity in the CEE region**

Some smaller markets in the Eastern and Central European area are still rather illiquid and still heavily rely on oil-indexed pricing. They usually have relatively low demand, and the number of trading participants can be limited, too. It is questionable whether countries like Slovenia, Slovakia or Croatia can develop a liquid and well-functioning market on their own in the foreseeable future, simply because liquidity might not reach a critical mass.

For this reason, the integration of the Central Eastern European market areas with the Austrian market, notably Slovenia, Slovakia and Croatia, can be considered, with Slovakia not covered in the study, with the aim to increase market activity in the respective countries and bundle liquidity in the region. Enhanced competition and transparent pricing could help to further de-couple the Central Eastern European markets from oil-indexed pricing. However, such integration is only feasible where the necessary physical, regulatory as well as operational conditions are fulfilled. In Slovakia, which is physically well connected to the Austrian market area, we see high potential for a market merger with the Austrian market area. Likewise, we would support integration with the Croatian market area.

**No welfare gains from integration of liquid market areas**

In Germany, the debate about a potential market merger between NCG, TTF and Gaspool took place last year. In the related consultation paper from November 2016, PEGAS highlighted the limited welfare gains compared to the costs incurred. In the case of a merger of the market areas, the costs would simply be re-allocated between market participants and would not result in any significant increase of welfare. We equally share this point of view regarding a potential market merger of the Austrian market area with other liquid market areas, such as the Italian or German market areas.

**Contact**

Dr Jan Richter  
Head of Regulatory Affairs & Communications  
Powernext SA  
Tel.: +33 173 03-7608  
j.richter@powernext.com