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POLICY BRIEF

From a Reactive to a Proactive EU Regulatory Framework for Long-term Gas Import Contracts

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Highlights

- In the context of the current revamping of the Regulation 994/2010 on the security of gas supply, this brief note from the Florence School of Regulation investigates ways to strengthen the existing EU regulatory framework for long-term import contracts (hereafter "LTCs") with extra-EU gas suppliers. The focus is exclusively on commercial contracts.
- The impact of LTCs on security of gas supply and competition is markedly different in hub-based Western markets and isolated Eastern markets.
- The existing EU regulatory framework follows a 'reactive' approach, pursuing two objectives: reacting to emergency situations or supply disruptions and tackling market abuse. It operates through three complementary but partly overlapping mechanisms: an *ex-ante* transparency mechanism structured by the Gas SoS Regulation, *ex-post* competition enforcement by the European Commission and a hybrid *ex-post* mechanism combining transparency and enforcement by national regulators through REMIT.
- EU competition law and REMIT work *ex-post* and mainly rely on hoped-for deterrence effects. They are not underpinned by a security of supply rationale and are unable to address the concerns of the most vulnerable Member States as regards the security of their gas supply. The Gas SoS transparency mechanism is a forward-looking instrument, but it only reaches its full effect in the so-called alert and emergency stages. It is also fundamentally limited by severe design flaws.
- In this context, it is possible to consider the introduction of a new mechanism allowing for regulatory control *ex-ante*, i.e. before LTCs are signed. If we were to follow that route, we would advocate the creation of a mechanism mirroring the one already established for merchant transmission investments, with the possible involvement of ACER or the Commission. In this case, notification of LTCs to the national regulator should be conditioned by a market share threshold.
- Transparency is paramount to enable a timely response, even in the presence of *ex-ante* control. Existing transparency mechanisms, although combined, are not satisfactory. We therefore call for an enhancement of the transparency framework, both in its national and European dimensions.

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1. Introduction

The issue of long-term import contracts (henceforth "LTCs") with extra-EU gas suppliers has been at the forefront of the EU energy policy debate for a considerable period of time. Back in 2003, the second liberalisation Directive had already acknowledged their necessity to ensure the security of gas supply in the EU, as long as they were compatible with the objectives of the Directive and with the rules of the Treaty.[4] At that time, LTCs were largely perceived as a competition problem, even though the preparatory documents leading to the Directive already provided evidence that EU institutions were divided on the impact of these contracts on security of gas supply. In a series of cases against Gazprom and Sonatrach in the early 2000s, DG Comp only partly tackled the problem through EU competition law by focusing on unlawful territorial restrictions and profit sharing mechanisms. In 2007, the DG Comp sector inquiry emphasised the potential anticompetitive effects of LTCs, particularly regarding access to upstream supply markets, market liquidity and customer foreclosure. The ongoing competition probe against Gazprom for the alleged abuse of dominance on Central and Eastern European gas supply markets shows that competition issues remain a serious source of concern to this day.

The successive Ukraine-Russia transit crises provided concrete evidence that LTCs may create an unwarranted level of dependency on a single supplier and thus endanger security of gas supply in some of the most vulnerable EU Member States. In this context, LTCs are always caught between law and politics. Externally, impinging on LTCs quickly heightens geopolitical tensions, in particular with Russia. Internally, Member States have always been reluctant to see the EU intervene in their external relations with foreign gas suppliers. Some progress has been made with the Council Decision of October 2012 establishing an information exchange mechanism for intergovernmental agreements (henceforth "IGAs") between Member States and third countries in the field of energy. However, a lot remains to be done in this field, as demonstrated by the public consultation launched by the Commission in July 2015.

The issue of the suitability of the existing EU regulatory framework for LTCs resurfaced recently in the Commission staff working document of 16 October 2014 (SWD(2014) 325 final) on the implementation of the Regulation 994/2010 on security of gas supply (hereafter the "Gas SoS Regulation"). In this paper, the Commission argued that the lack of transparency on these contracts was a source of concern for vulnerable Member States without supply diversification and gas hubs, and called for a strengthened transparency framework. The issue was raised again in the Council conclusions of 19 and 20 March 2015. The Council recalled that both IGAs and commercial contracts should be plainly in line with EU law, in particular with the SoS legislation, though safeguards for business secrets should be ensured.

In the context of the current revamping of the Gas SoS Regulation, this short note investigates ways to strengthen the existing EU regulatory framework for LTCs with foreign gas suppliers. We focus exclusively on commercial contracts.

2. LTCs and the Internal Market: Impact on SoS and Competition – Understanding the Issue

Despite the emergence of a competitive and integrated internal gas market in some parts of the EU, LTCs are far from becoming a residual instrument in the gas business. Indeed, "[…] *new long-term contracts are still being signed, although their duration (typically around 10-15 years) is lower than the average duration of legacy contracts (20-25 years)*"[5]. In addition, the trend towards shorter contracts only concerns the new contracts, whereas there are no signs of downward modifications to the contract duration in the process of renegotiation affecting existing LTCs. Besides, expired LTCs haven't been renewed only in a few exceptional cases.[6]

LTCs are based on complex long-term arrangements negotiated on a bilateral basis, sometimes at the inter-state level. Such contracts fall outside the scope of organised markets and hence make it difficult for regulators to draw a clear picture of overall gas trade. Firstly, the general framework of a LTC regularly lacks information or displays it in a non-typical way: not surprisingly, in the new REMIT Regulation, LTCs belong to the category of "non-standardised contracts". Secondly, the underlying deal may envisage different prices for the different time periods of delivery within the overall delivery time-range, based on pre-agreed indices, the nature of which tend to be complex and highly contract-specific. Therefore, it is often not possible to identify precise quantities or prices at the time of execution/delivery. Thirdly, the quantities to be delivered generally have a high degree of optionality: contrary to "standard contracts" where clear and precise rules tend to guarantee certainty of delivery, the amount of gas eventually delivered may be uncertain and subject to the discretion of one of the two contracting parties.

In order to have a complete and accurate overview of the European gas market, one cannot disregard the impact of LTCs on cross-border flows and the availability of capacity at the dif-

4. This position was reiterated in the third liberalisation Directive.

5. "Long-term gas contracts in Europe", CIEP 2014

6. See findings of the Commission in its staff working document of 16 October 2014, pages 18 and 19.

ferent points of delivery. This is true not only for monitoring security of supply, but also for efficient competition and for the effective identification of potential market abuses.[7] As ACER rightly pointed out; "*Reporting of records of transactions in non-standardised contracts is crucial to have a complete picture of the trading activities of market participants. Market abuse practices like ramping or cross-market manipulation could not or only hardly be detected without information on non-standardised contracts. For instance, a market participant being a seller in a long-term contract with price components depending on developments of spot market prices could influence the spot market prices by buying at artificial high prices to benefit from these higher prices as a seller in the long-term contract(s). If no information were available on the long-term contracts, the activity on the spot markets alone would not necessarily be sufficient to identify suspicious instances. Only with the knowledge about the long-term contracts the picture is complete.*"[8]

The presence of LTCs within the EU internal gas market greatly affects the competition dimension, particularly if we take a national perspective and analyse the considerable relevance of LTCs in certain Member States, where the national gas market is not yet "mature" or fully developed. If we take into account market variables like hub liquidity, number of market players, concentration, information transparency and so on, we realise the extent to which LTCs imply a different meaning for Western-European fully liquid markets or for some Eastern European markets (particularly in the so-called "transit countries"), which are substantially or entirely dependent on one external supplier. In a nutshell, the impact of LTCs on security of gas supply and competition is markedly different in hub-based Western markets and isolated Eastern markets once these LTCs are signed.

3. The Shortcomings of the Existing EU Regulatory Framework: the Limits of a 'Reactive' Approach

The existing EU regulatory framework for LTCs with foreign gas suppliers pursues two objectives: reacting to emergency supply crisis and tackling market abuse. It operates through three complementary but partly overlapping instruments: an *ex-ante* transparency mechanism structured by the Gas SoS Regulation, an *ex-post* EU competition enforcement by the Commission and a sort of hybrid *ex-post* mechanism combining transparency and enforcement by national regulators through REMIT.[9]

3.1 The limits of the Gas SoS Regulation transparency mechanism

Under Art 13(6)(b) of the Gas SoS Regulation, gas companies must notify the 'competent authority' (hence not necessarily the national regulator) of all LTCs signed for more than one year. However, the contracts themselves do not have to be reported. The transparency requirements only concern certain characteristics: contract length, forecast of total annual volume and average volume per month, delivery points and forecasted daily maximum volume in case of alert or emergency.[10]

The national emergency plans covered by Art (10)(1)(k) of the Gas SoS Regulation must detail the reporting obligations imposed on natural gas undertakings at alert and emergency levels. National emergency plans also establish a list of predefined actions to make gas available in the event of an emergency, including commercial agreements between the parties involved in such actions and the compensation mechanisms for natural gas undertakings where appropriate, taking due account of the confidentiality of sensitive data. Such actions may involve cross-border agreements between Member States and/or natural gas companies, under Art (10)(1)(i) of the Regulation.

The Commission has drafted a template that the competent authorities must fill-in. The competent authorities must then notify the Commission of these data under an aggregate form. On a regular basis, information must be updated. Of course, the Commission and the competent authority have a duty to ensure confidentiality. According to the Commission's staff working document of 16 October 2014, only 10 Member States had provided information using the template and five (mostly Eastern and Baltic) Member States provided non-aggregated data.

7. Additionally, the availability of certain gas capacities linked to LTCs, at present, could be detected through a specific legal instrument. This is the case, for example of the so-called "hanging capacities" which were originally linked to LTCs and terminated at a second stage.

8. ACER Recommendations on REMIT Records of Transactions, 23 October 2012.

9. The *ex-ante / ex-post* dichotomy refers here to the period either before, or after, a particular contract is signed or a particular trade takes place.

10. Art 10(3) of the Gas SoS Regulation foresees 3 steps:
"(a) early warning level (early warning): when there is concrete, serious and reliable information that an event may occur which is likely to result in the significant deterioration of the supply situation and is likely to lead to the alert or the emergency level being triggered; the early warning level may be activated by an early warning mechanism;
(b) alert level (alert): when a supply disruption or exceptionally high gas demand occurs which results in the significant deterioration of the supply situation, but the market is still able to manage that disruption or demand without the need to resort to non-market measures;
(c) emergency level (emergency): in the event of exceptionally high gas demand, a significant supply disruption or other significant deterioration of the supply situation, and in the event that all relevant market measures have been implemented, but the supply of gas is insufficient to meet the remaining gas demand, so that non-market measures have to be additionally introduced with a view, in particular, to safeguarding the supplies of gas to protected customers according to Article 8."

It follows from the above that the Gas SoS Regulation transparency mechanism suffers from severe shortcomings:

1. **"in case of alert or emergency only"**: some key information is either not communicated to the competent authority (in particular, the contracts themselves) or is communicated at a very late stage (daily max. volumes foreseen).

2. **the 'competent authority' problem**: the competent authority (e.g., a ministry) does not necessarily have the same sanction powers as those ensured by the third liberalisation package for regulators. They might not have either the same level of understanding or even information on market functioning.

3. **the 'data aggregation' problem**: the Commission is largely kept in the dark due to data aggregation. This might have an impact on the Commission assessment of national preventive and emergency plans and its ability to declare emergency situations at the EU and regional levels, even though the Commission can declare the existence of such a situation only when two competent authorities have asked for it. In addition, the Regulation does not specify any time frame for information updates.

4. **the 'lack of teeth' problem**: the mechanism does not specify clear sanction powers and to which entity such powers should be allocated when relevant data is not provided by gas companies.

5. **the 'one size fits all' problem**: the mechanism does not introduce differentiation in terms of transparency requirements according to the market situation (e.g. hub-based Western markets and isolated Eastern markets), creating both unnecessary regulatory costs and red tape.

6. **the 'Europeanisation' problem**: the mechanism does not allow for an information exchange mechanism across neighbouring Member States, whereas, as per Art 9 of the Gas SoS Regulation, competent authorities should do their national risk assessment with regards to real (projected) flows, including cross-border flows. The same problem occurs when competent authorities decide to build regional preventive plans (Art 4(3)).

3.2 The limits of EU competition enforcement

Up until now, EU competition law has been the main regulatory device used to address the negative effects of LTCs with foreign gas suppliers. The ongoing battle between the Commission and Gazprom shows that this tool remains reliable, even in a highly politicised context. Even though it can be used to gain leverage and obtain deterrence, it also suffers from serious shortcomings.

First, competition enforcement tends to be slow. It can take years to reach a decision and possibly a Court judgment. In addition, compliance with decisions and judgments cannot be taken for granted. Competition enforcement is thus not a suitable tool to address security of supply issues. Second, damages cannot always be quantified with accuracy, or at all, in the context of follow-on damage suits. Redress and compensation through private enforcement of competition law is therefore not reliable, in particular for household customers. Third, the ability of competition enforcers to suitably integrate in the analysis foreseeable issues pertinent to security of gas supply is yet to be proven.

3.3 The limits of the REMIT mechanism

According to Art 7(1) of REMIT, ACER shall collect the data for assessing and monitoring wholesale energy markets as provided for in Art 8 of REMIT.

The Commission's implementing acts set the deadline for eligible market participants to start reporting on wholesale energy contracts (over-the-counter standard and non-standard supply contracts, transportation contracts) and on the reportable fundamental data from Transmission, LNG and Storage System Operators. Non-OMP contracts, i.e. contracts that are not traded via brokers or on exchange platforms, must therefore be reported only as of 7 April 2016. LTCs with foreign gas suppliers fall into this category. Reporting takes place in case of execution, modification or early termination of a transaction.[11]

Often, LTCs (with optionality) have daily executions: this means that the commodity purchased under a LTC is delivered daily at an entry point and then re-traded (either bilaterally or via exchange). The long-term (framework) contract will then be reported as a non-standard contract (describing optionality and complex pricing formulas). Individual daily executions will also be reported, but as standard contracts because they will have an outright price and volume.

The limits of this way of reporting *ex-post* are obvious: while LTCs (framework) are reported in general terms and as non-standard contracts, the information (volumes, prices, etc.) on the daily deliveries or deals which are subsequent to the same framework contract are reported as standard contracts. This means that the two categories of data cannot be matched as belonging to the same agreement. As such, information collected under REMIT

11. According to the ACER Manual of Procedures on transaction and fundamental data reporting of 18 June 2015, non-standard supply contracts need to be reported following requirements of Table 2 of the Annex of the implementing acts: http://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=OJ:JOL_2014_363_R_0009&from=EN

only provides a partial overview of the underlying agreement of a transaction.

3.4 From a Reactive to a Proactive Approach

In essence, the EU regulatory framework for LTCs with foreign gas suppliers follows a 'reactive' approach, in the sense that it principally aims to react once a gas supply crisis or a market abuse has already occurred or is in the making. We can see that regulatory powers concerning security of supply are still (unsurprisingly) largely in the hands of national governments. In some countries, this reflects the national division of constitutional responsibilities on security of supply.

EU competition law and REMIT work *ex-post* and mainly, in the end, on hoped-for deterrence effects. They are not underpinned by a security of supply rationale and are thus unable to address the concerns of the most vulnerable Member States on this matter. It would be accurate to say that the Gas SoS transparency mechanism is a forward-looking instrument. However, it only reaches its real effect in the so-called alert and emergency stages. Furthermore, it is fundamentally limited by severe design flaws. This necessitates turning to a more 'proactive' approach.

In our view, a more proactive EU regulatory framework for LTCs with foreign gas suppliers should:

- ensure *effective* transparency, i.e. that the best placed public authority obtains, at the right moment, the most accurate picture of all the relevant gas flows in order to be able to act on time;
- make sure that both security of supply and competition concerns are taken into account concurrently;
- fine-tune the role of the different players (national regulators, competent authorities, Commission, ACER);
- refine the interaction of the available regulatory instruments;
- ensure that the EU and regional interests are well accounted for;
- ensure proportionality: regulatory costs and red tape should be kept to a minimum to account for the fact that hub-based Western markets and isolated Eastern markets are in different situations.

In this context, it is tempting to consider the introduction of a mechanism allowing for control of LTCs *ex-ante*, i.e. before they are signed. However, appealing as they may be, *ex-ante* control mechanisms are generally characterised by worryingly high regulatory costs and red tape. Once LTCs are signed, transparency is paramount to allow action on time, even in the presence of *ex-ante* control. Yet, existing transparency mechanisms (Gas SoS Regulation transparency mechanism and REMIT reporting obligations), appear to be unsatisfactory. We therefore call for an enhancement of the transparency framework, which might also be more politically acceptable.

4. *Ex-Ante* Control Mechanism: Do Not Use a Hatchet to Remove a Fly

A first solution (the *competition law* route) would be to strengthen the EU competition enforcement framework by introducing an *ex-ante* element in terms of assessment. Following the rationale of the former Regulation 17, pre-notification of LTCs to the Commission for an *ex-ante* compliance check with EU competition rules could be introduced. At the same time, the security of gas supply concerns might not be well accounted for, and the pre-notification may impose too high of an administrative burden on the Commission (DG Comp). These problems could partially be alleviated through strengthened internal cooperation between DG Comp and DG Energy. The Commission could also enact soft law guidelines on acceptable contract forms in order to provide guidance to operators. However, the non-binding character of such guidelines would largely undermine their concrete outcomes. A third option could be to introduce a safe harbour in the context of a block exemption regulation, i.e. to define criteria *ex-ante* in a piece of the EU legislation, the fulfilment of which would result in automatic compliance with the competition rules without the need for companies to notify contracts beforehand. This approach would have merit, as it would provide legal certainty to operators and limit the administrative burden on the Commission. It would, however, lack flexibility as no assessment of concrete situations would be carried out, as in the case of soft law guidelines. In addition, it remains difficult (but certainly not impossible) to define criteria that would be relevant for the whole Union due to the diversity of real-world gas market settings.

A second solution (the *Euratom* route) would be to implement a purchasing scheme inspired by the Euratom Treaty, which requires that the Euratom Supply Agency be involved in procurement and supply balance monitoring. ACER would be playing the role of the Euratom Supply Agency, in our case. Lighter and voluntary versions of such mechanisms are currently being discussed for emergency situations, following the usual 'reactive' approach described above. The idea of structuring a common buying scheme (aimed at regaining leverage on foreign gas suppliers) has been discussed for a long time but has lost strength recently with the development of more competitive and integrated markets in Western Europe. This trend is clear in the recent communication of the Commission on the Energy Union. On the positive side, such a scheme would allow for an assessment of each specific situation and wider EU/regional interests would be better taken into account. On the

Table 1: Preliminary comparative assessment

Options		Ability to tackle both SoS and competition issues	Regulatory costs	Red tape	EU/Regional interests	Tailor decisions
The *competition law* route	*Ex-ante* notification	-	---	---	++	++
	Soft law guidelines	--	+++	++	+	---
	Block exemption regulation	--	++	++	+	---
The *Euratom* route		+++	---	---	+++	++
The *national regulators* route		+++	-	--	++	+++

negative side, it would create high regulatory costs for ACER, a need to grant ACER access to the data gathered under the Gas SoS transparency mechanism and a host of fairly complicated EU law issues. Even more problematic, it would dramatically increase red tape for gas companies. Overall, this second solution, though interesting in theory, appears to overkill the problem at hand.

A third and more promising solution (the *national regulators* route) would be to introduce a lighter approval mechanism at the national level, such as the one foreseen for merchant transmission investments. In short, Art 36 of the third gas Directive organises a mechanism where national regulators can grant derogations from certain provisions of the Directive, in particular third-party access, to private investors in gas infrastructure, provided that certain criteria are met. In particular, such profit-motivated investment should strengthen *both* competition and security of gas supply. The first advantage in our case is to place national regulators at the centre of the game. Through their myriad interactions with gas operators and the information they can obtain under REMIT, they have a unique understanding of their own market. They are therefore the best placed to assess simultaneously both the security of gas supply and competition[12] issues. It is worth recalling that in its first reading of the second gas Directive, the European Parliament had already recommended that regulatory authorities be entrusted with the ability to call LTCs into question. Regulators are also used to cooperate with each other in different fora.

12. It is worth mentioning that they have often been involved in competition proceedings.

As national regulators would only be responsible for their own markets, regulatory costs would be manageable.

The two main challenges with the national regulators route are (i) to avoid an unnecessary burden on firms and (ii) make sure that regional and EU interests are taken into account.

(i) Given the differences between hub-based Western markets and isolated Eastern markets, the problem of red tape should be taken seriously. A way to solve the issue would be to define *ex-ante* contracts, which have to be notified. It should be done at EU level. A simple criterion, which would encompass both the security of supply and competition issues, would be to define a market share threshold. Indeed, security of supply and most competition issues emerge when too high a part of the demand is serviced by a single contract or supplier. This criterion has the advantage of being easy to administer.

(ii) In order to make sure that regional and EU interests are well accounted for, an obligation modelled on Art 36(8) and (9) of the Gas Directive to request an opinion from ACER or the Commission could be introduced. ACER or the Commission could then require the national regulator to amend or withdraw its decision.

5. Towards a Strengthened Transparency Framework: The Low Cost – High Reward Route

A strengthened transparency framework is all the more important if an *ex-ante* control mechanism does not exist. Both solutions should not be seen as substitutes but as complements. Indeed, once LTCs are signed, supply crises and market abuses can always occur.

We believe that amending the REMIT reporting regime is not the right course of action in this context, even if it provides useful (repeat) information on the market conditions (in particular, standard forward contracts) in a specific trading zone. The Gas SoS Regulation transparency mechanism is thus the best candidate for improvement.

We propose to proceed according to the following guiding principles:

- Data reporting to the Commission should be improved, in particular through data disaggregation, even though it can be presumed that vulnerable Member States might be more likely to voluntarily provide data in such a format. A binding reporting to the Commission on the daily maximum volumes at each delivery point, at least as soon as we enter the emergency stages, is important.
- The competent authority should be given the power to request data on daily forecasted volumes when a certain benchmark (e.g. a certain percentage of market demand is tied under a single contract or with a single supplier) is reached, without waiting to enter the alert or emergency 'zone'. EU legislation could require that national emergency plans contain strengthened reporting obligations in this regard.
- The competent authority should be able to jointly analyse REMIT data and data reported under the Gas SoS Regulation transparency mechanism. Provisions concerning (binding) cooperation between the national regulator and the competent authority should be introduced.
- A binding time frame for reporting by gas companies to the competent authority should be defined.
- EU legislation should require Member States to make sure that appropriate sanction measures are put in place (and thus powers suitably allocated) when relevant data is not provided.
- The competent authority should be given the power to request contracts themselves during the alert and emergency stages, but these contracts should not be made public to avoid breach of business secrets.
- The one-year period should not be amended. Contracts shorter than one-year cover a fairly marginal part of demand in Eastern markets, and Western markets are liquid enough so that such contracts are not crucial.
- Respecting business secrets and confidentiality issues is paramount. In this context, publishing even aggregated contract data gathered through the different reporting mechanisms is not a priority, even though it can provide a useful benchmark for the ongoing contracts negotiations.
- Limiting red tape and regulatory costs is crucial.

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The Florence School of Regulation

The Florence School of Regulation (FSR) was founded in 2004 as a partnership between the Council of the European Energy Regulators (CEER) and the European University Institute (EUI), and it works closely with the European Commission. The Florence School of Regulation, dealing with the main network industries, has developed a strong core of general regulatory topics and concepts as well as inter-sectoral discussion of regulatory practices and policies.

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