The importance of economic transit tariffs in creating trading hubs

Gas Trade and Transit Tariffs in Europe – Issues and Options

Round Table on Gas Tariffs and Investments
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THE ENERGY CHARTER TREATY
1994: Signature       1998: In Force

MAIN ELEMENTS
- Investment Protection
- Energy Trade based on WTO Rules
- Freedom Of Transit
- Energy Efficiency
- Dispute Settlement
Basic Givens in Gas Supply and Demand in EU and ECT Constituency

- EU a major gas market, but high and increasing import dependence
- Large gas resources (often in super giant fields) in pipeline reach to the EU market
- BUT: Substantial distance / investment fixed in transport infrastructure
- Need for transit in most cases

=> Issues:
1. Impact on cross border trade arrangements
2. Requirements for transport / transit arrangements and tariffs
3. Impact on market structure/ regulation in consuming countries (EU)
1. Impact on Cross-border Trade

1. Producing countries want to maximize resource rent (depletion premium) from export

2. The replacement value / net back concept is best to maximize resource rent / revenue for exporting countries:
   A price above => not marketable
   a price below => not maximising the resource rent

- In a deep and liquid market (like UK, US) either sell into the market, self contracting or an LTC linked to a gas-on-gas price indicator. Reference for replacement value defined by gas-on-gas competition
- A deep and liquid market requires a relative large number of (if possible domestic) suppliers not bound by their decisions by highly specific investment

- Otherwise LTCs are best instrument (Groningen Concept).
  Long term supply and payment (demand) obligation to secure investment into fixed infrastructure and commitment of large reserves

- In both cases: transportation costs reduce revenue of seller
1. Long Term Gas Contracts: Lasting Feature of Continental Cross-border Trade

- Concept for international gas trade developed by the Netherlands in 1961 (Groningen Concept)
- In place since 40 years for pipeline and LNG, remaining duration LTCs in place today: up to 2035
- Predominant share of world gas trade
- Review clause provided flexibility for LTCs to adopt to changes in the market:
  - from fixed price to pegging to heavy fuel oil, to more gas oil, inclusion of coal, power and gas to gas competition
  - Coped with oil price increases in 1973/74, 1979/80, 2008 as well as oil price slumps in 1985, 2009; fall of the Berlin Wall in 1989, major technological developments
1. Estimate of International Gas Trade: Pricing Mechanisms for Main Regions

Source: BP (2006)

(1) LNG to USA, UK and other spot LNG; arbitrage on the UK-Belgium Interconnector
(2) Pipeline Canada-USA, pipelines to UK (BBL, Langeled) and new Dutch exports
(3) All imports by Continental Europe (incl. accession countries) less spot LNG under (1)
(4) Trade with FSU now in transition from quasi-barter deals to LTCs, 2004 figures
2. Requirements for Transport / Transit Arrangements

Main issues: freedom of transit / no rent seeking

- No rent seeking from transit position (GATT Art. V):
  - Cost reflective (inclusive interest and risk premium) tariffs
  - No rent taking (taxes, fees etc) for transit beyond rent for comparable domestic transport, unless justified by special service (special pipeline protection)

- Possibility to create new transit capacity normally by new pipelines across the transit country; the transit country shall not be a hindrance to cross border trade!

- Non discriminatory access to existing pipelines or more important to pipeline in planning (open season): sharing economies of scale

- Non interruption of existing transit
2. Energy Transit: GATT V =>
ECT Article 7 => Draft Transit Protocol

- GATT Art. V: principle of “Freedom of Transit”
- ECT Article 7:
  - Specifying GATT V for energy materials and products using fixed infrastructure
  - Non-discrimination as to origin, destination, ownership or pricing

PLUS IMPORTANTLY

- No obstacles to the creation of new capacity
- Securing established transit flows, non-interruption of transit in case of dispute

- Draft Transit Protocol - further elaborate ECT Art. 7
  (tariffs: objective, reasonable, transparent, non-discriminatory, cost based)
- Dispute resolution procedures
  - ECT Art. 27 / dTP Art. 21: UNCITRAL state to state arbitration (any state can invoke),
  - ECT Art. 7.7 (conciliation, party to dispute can invoke)
2. Gas Transport Tariffs Design

• Calculation of allowable costs to determine total revenue requirement
  • Asset value
  • Depreciation
  • Rate of Return
• Allocation of costs among users
2. Types of Tariff Methodologies: Attribution to Users

- **Postal**: single fixed fee regardless of distance between entry and exit points (used for low-pres. distribution systems)

- **Point-to-Point**: quoted for every entry-exit pair within the system

- **Distance-Based**: commonly used for gas transit in one direction with few off-take points

- **Entry-Exit**: separate tariff for entry and exit points - suitable for highly meshed systems with many injection & delivery points (with an objective to create a market place) but
3. Creating Trading Places in Europe – Considerations on Tariffs

- Cost reflective tariffs necessary to avoid blocking access by excessive charges

- Using entry-exit system for a large geographical area will tend to include a larger number of players; given import dependence it might not increase the number of suppliers

- Reduction of transportation costs will increase the revenue at the well head (resource rent)
3. Creating Trading Places in Europe – Considerations on Access

- Hubs need several crossing pipelines
- Pools a highly meshed system of exit and above all entry points
- Above all to create a liquid market place a large enough number of players – mainly suppliers is needed
- Access to pipeline routes necessary condition for market place but not sufficient
3. Creating Trading Places in Europe – Considerations on Impact of Market Structures

- Do signals of trading places trigger reactions on the production side? Or only reaction on the demand side?
- Regulatory reform in consumer market has limited impact on upstream of important export countries.
- Even in markets with gas-to-gas competition price path still tracks fuel oil products.
- Liquid traded markets do not guarantee low prices (as seen in winter 2005-2006, or by oil market).
- Reluctance of producers to link the price to hubs (tying their income to unrepresentative local situations).
- Long-term commodity and capacity contracts remain the major option of European gas trade.
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