

EU Gas Market – Trading & Infrastructure Development

Wholesale gas trading in Europe continues to develop, but at a slower pace than many traders and new market entrants would like. The only truly liquid trading markets are in the UK and Benelux.

By Nigel Harris

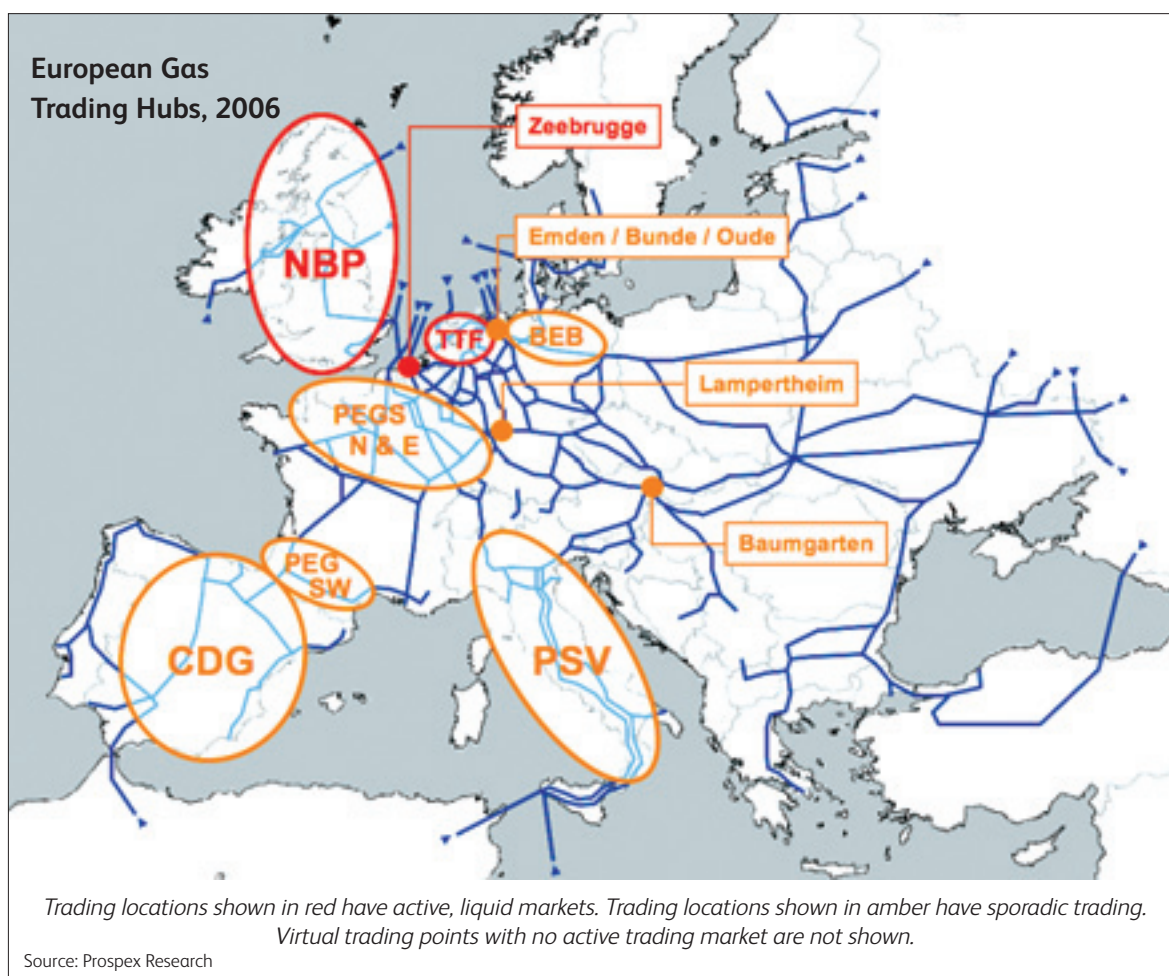
THE PAST YEAR has been an eventful one for the European gas markets. Wholesale trading in Europe continues to develop, but at a slower pace than many traders and new market entrants would like. The only truly liquid trading markets are in the UK and Benelux.

Gas is traded at a number of key international border crossing points and at major junctions between pipeline systems. Trading based on virtual balancing points has also developed in a number of national markets. A virtual balancing point allows gas to be exchanged at a notional location at a single price, irrespective of where it is actually injected into the network or withdrawn from it.

This creates a larger liquidity pool for trading than when gas is traded at a specific physical location. Gas is traded both bilaterally in the over the counter (OTC) market and at a growing number of organised exchanges. Deals range from very short-term (day ahead) balancing trades to forward trades, mainly for gas to be delivered within the next year. Trading liquidity grew in all areas except for forward trading in the UK market during 2005.

The only truly liquid trading markets are in the UK and Benelux

The UK has the most actively traded gas market in Europe, with OTC spot and forward trading based on the virtual balancing point, NBP, at beach terminals, and at the interconnector to Belgium. NBP is also the basis for very short-term trading in the balancing market and for longer-term trading in the ICE futures contract. Derivative contracts including swaps, options and virtual storage contracts are also traded up to five years forward.

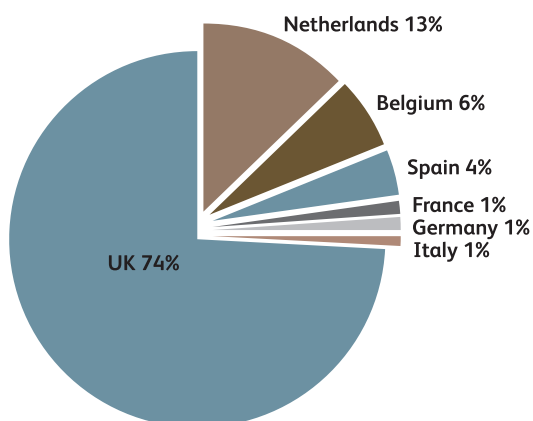


European Gas Markets

- In November 2005, the European Commission published its first major review of the market liberalisation process, and was highly critical of the slow progress towards open, competitive markets shown by many member states. At the same time, the EC competition authorities launched an enquiry into the energy sector, publishing scathing observations on the lack of real competition in the gas market, and identifying enormous barriers to entry for new gas suppliers. These reports will give new resolve to the enforcement of competition rules by both European and national regulators. We expect that some of the key barriers faced by new market entrants will now be removed, giving an enormous boost to the development of gas trading, especially in the key German market.
- In January 2006, the Russian gas exporter Gazprom temporarily curtailed supplies on one of the main export routes to Europe. This action dramatically highlighted Europe's growing dependence on imported gas supplies, and on Russian gas in particular. New pipeline infrastructure projects that will provide new routes and sources are being pursued with increased urgency.
- In March 2006, the UK market saw record high prices of over 250 pence per therm for day-ahead gas. [The average day-ahead price during 2005 had been below 40 p/th.] The price shock occurred when cold weather increased the demand for gas while the UK's main gas storage facility was out of action. But it also highlighted the UK's fundamental shortage of gas, caused by rapidly falling production of gas from the UK sector of the North Sea. In early October 2006, the UK market went to the opposite extreme, setting record low prices, with traders in short-term balancing markets even offering to pay up to 5 p/th to have gas taken off their hands. The reason: the new Langeled pipeline bringing Norwegian gas to the UK was being tested at full capacity and the UK found itself temporarily flooded with gas.

In continental Europe, the most liquid gas markets are in Belgium and the Netherlands. In Belgium, Zeebrugge is a major physical trading hub, supporting both bilateral and exchange-based trading. Because of the physical linkage between the two markets through the interconnector pipeline, the Zeebrugge market functions largely as an offshoot of the UK market. In the Netherlands, trading at the Title Transfer Facility (TTF)

Figure 1: European Gas Trading Volumes by Country, 2005



Sources: Industry Sources/Exchanges/Prospex Research

provides the balancing market for the Dutch network, as well as a virtual trading point for participants in the Dutch and German markets.

Elsewhere, trading is more sporadic. Germany is one of the biggest gas markets in Europe but network access issues have hampered trading. Currently, only a limited amount of OTC trading occurs at various border-crossing points, on the BEB network in northern Germany and at Lampertheim. Italy, France and Spain all have small but growing trading markets based around a combination of virtual trading points, border crossing locations and LNG terminal trading.

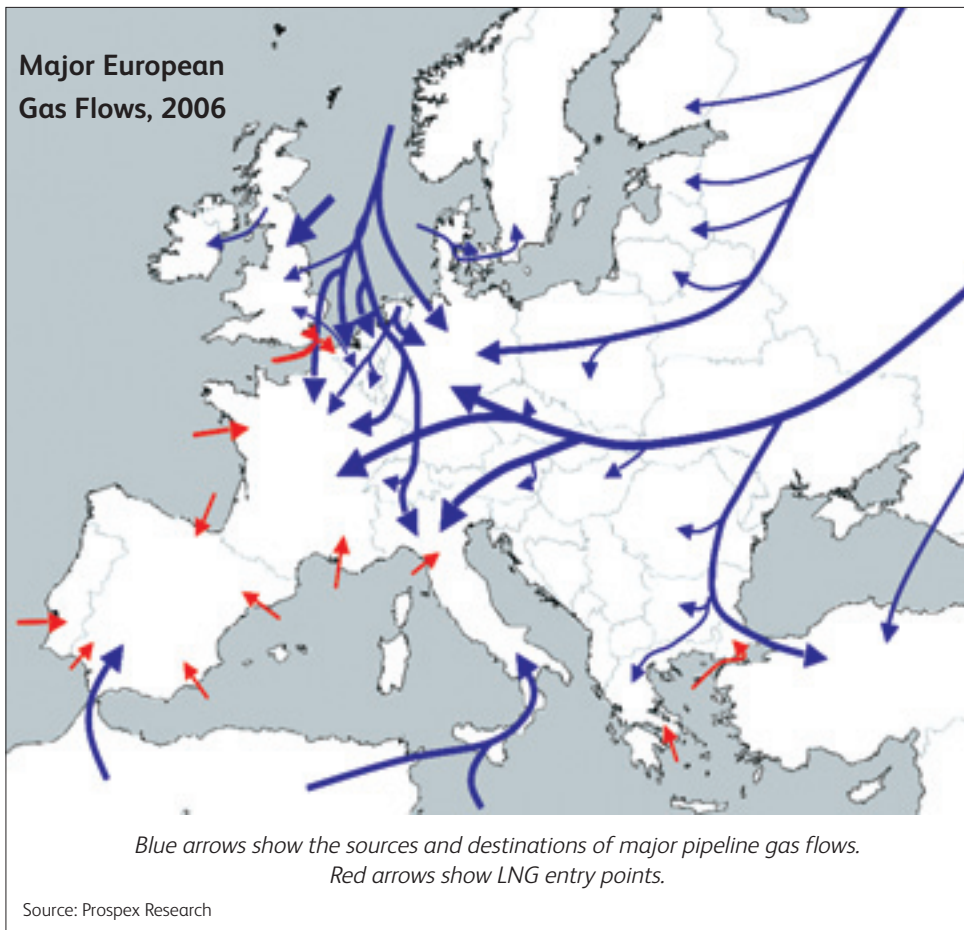


SUNGARD ENTEGRATE

More than 200 major energy traders, marketers, producers, and distributors rely on SunGard energy solutions to help them optimize business decision making, gain an enterprise view of both risks and opportunities, and effectively manage their energy assets. To learn more, please visit www.sungard.com/energy or contact us by phone at 713-210-8044 or toll-free 888-296-1906.

www.sungard.com/entegrate

SunGard and the SunGard logo are trademarks or registered trademarks of SunGard Data Systems Inc. or its subsidiaries in the U.S. and other countries. All other trade names are trademarks or registered trademarks of their respective holders.



In the UK, the price of gas responds strongly to supply and demand signals, and the trading market sets the price for short-term gas and is used as the basis for a substantial proportion of long-term gas supply contracts. On the continent, most gas is imported or obtained from producers under long-term contracts, with prices that are set by reference to oil product prices. The spot gas markets set the marginal price for short-term gas, but prices are strongly influenced by the availability of gas at oil indexed prices, which most of the large market players (but not all new market entrants) have access to.

In the past year, gas prices have been dominated by two factors: the rising price of oil, and the declining production of gas in the UK. Against a backdrop of continuing growth in gas demand, these factors have caused prices to be higher and more volatile than ever before.

Infrastructure Development

Major international pipelines currently under construction include North European Gas Pipeline (NEGP), Balgzand Bacton Line (BBL) and Langeled (which opened in October). The most significant for European import capacity is the

NEGP, which will link Russia and Germany via the Baltic Sea, increasing the transit capacity for Russian gas to western Europe by 25% from 2010. The UK is benefiting – not a moment too soon – from the Langeled project, which is now be able to supply Norwegian gas to meet up to 20% of UK demand. As far as trading is concerned, the most important development is the BBL pipeline, as it will provide a physical link between the active trading markets in the UK and the Netherlands from the end of this year.

A number of other pipeline projects are under consideration. Construction on the Medgaz pipeline, which will link Algeria to Spain, is due to begin before the end of 2006. Galsi is a proposed pipeline from Algeria to Italy via Sardinia and Corsica. The Nabucco pipeline, linking Turkey with Austria, is probably the most strategically important

project, as it would allow gas to flow into Southern and Western Europe from Russia, Middle East and Caspian region via Turkey.

Many of Europe’s existing LNG terminals are being expanded and a number of new terminals are being built or planned. An additional 789 TWh/y of LNG capacity is under construction, representing a massive 75% increase in LNG import capacity.

In the past year, gas prices have been dominated by two factors: the rising price of oil, and the declining production of gas in the UK

In the short-term, there will be more capacity to bring gas into some parts of Europe – the UK, Spain, and possibly Italy – than is required. October’s collapse in the UK gas price in response to the completion and testing of the Langeled pipeline was an extreme case, but oversupply of gas may be a feature of some European markets for the next five years, particularly in the summer months. But gas consumption, fuelled by economic growth, expansion of gas distribution networks, and by the continued adoption of gas-fired power generation, will grow to match the new import capacity, by which time Europe will have to be looking to new large projects to bring yet more gas from Russia, Algeria and sources across the EU’s borders ●

Nigel Harris
E: nigel.harris@kingstonenergy.com

European Gas Trading: The 187-page report is a comprehensive study of the markets, the players, the energy policy issues, the liberalisation programme, new infrastructure development and much more.
www.prospex.co.uk