

LET'S GET TO THE **POINT.** ■



The impacts of market changes on the pricing of flexibility of supply of natural gas in Europe

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- 1. Overview of the most relevant changes in the Gas Storage Markets in Europe in the last few years**
- 2. Impacts of such changes on long term Gas Storage Agreements (GStA)**
- 3. Adjustment Tools in long term GStAs (?)**
- 4. Compare to traditional Adjustment Tools in long term Gas Sales Agreements**
- 5. Traditional Adjustment Tools have their limitations**
- 6. Extraordinary Adjustment Tools in long term GStAs**
- 7. Hardship Clauses**
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Some of the Major Changes influencing Gas Storage in Europe

Less demand for Storage

- Lehmann crisis reduces demand for gas in industry, consequently lower demand of industry for flexibility.
- Gas fired power production is substantially reduced due to
 - i. lower demand for electricity;
 - ii. lower electricity prices;
 - iii. coal becomes best alternative: low coal prices due to US shale gas substituting coal fired power production in US, make coal available on world market;
 - iv. subsidization of renewables makes gas fired power production inefficient.
- Summer-Winter spread is minimized – no seasonal arbitrage; seasonal storage becomes uneconomical.
- Reduced arbitrage possibilities between different national markets reduces demand for storage.



Some of the Major Changes influencing Gas Storage in Europe

More flexibility supply:

- More storage facilities become available (2007-2014 storage volume in German speaking markets increases by more than 80%).
- Reduced gas demand leads to importers under long term TOP obligation dump gas on hubs; hubs become liquid.
- Regulatory changes add liquidity to hubs (transit gas is available at hub) and make hubs accessible across borders (eg German NCG for Austrian demand).
- Liquidity of hubs becomes alternative for storage.



Impacts of such Changes on Storage Markets in Europe

- Duration of GStA becomes (much) shorter; security of supply has no value; buyers have less reason to accept Store-or-Pay.
- Long Term GSA and GStA become non-competitive.
- New GStA not longer than 3-5 years; prices of long term Storage lower than short term.
- Gas fired power plants (with traditionally high demand for flexibility) are out of the market.
- Secondary trading of Storage becomes reality adding to the fall of storage prices.



Net effect on Storage prices

Until a few years ago

- Flexibility essentially came out of storage and the number of accessible storage facilities was limited;
- Storage was agreed long term;
- Storage was priced based on cost of storage, not on market; indexation was on operating cost of storage, not on market development;
- Due to insufficient hub volumes, no sufficient reliable market data on prices for alternatives to storage was available;
- Whole sellers simply passed on prices for storage and end user had to and did accept for lack of alternatives.



Net effect on Storage prices

Today

- Flexibility comes out of storage and market liquidity;
- Sufficient winter liquidity of gas means summer-winter spread becomes small to nil;
- Pricing of flexibility is to market, not based on cost (storage market became competitive);
- Storage agreements are short term; no premium/need for long term commitment; security of supply becomes political issue only;
- Auctions and secondary market for storage developed.



Traditional Adjustment Tools in Long Term GStAs (?)

- **Traditional Gas Storage Agreements are long term (up to 40 years).**
- **Traditional Gas Storage Agreements are priced and indexed to the (errection and operating) cost of the storage provider.**
- **Traditional Gas Storage Agreements have no Price Review Clause.**
- **Traditional Gas Storage Agreements have 100% TOP (store or pay).**
- **Most GStA contain a hardship clause.**



Compare: Traditional Adjustment Tools in Long Term GSAs

- **Traditional Risk Distribution in long term GSA**
 - Seller bears the price
 - Buyer bears the volume risk

- **Traditional Adjustment Tools modify Pricing Provisions of the Contract**
 - TOP usually lower (around 70-80%)
 - Indexation is to alternative sources of energy
 - Price Review Clause
 - (Occasionally) Hardship Clause



Adjustment Tools in Long Term GSAs - A model for GStA adjustment also?

- **Leave volume risk for the Buyer, but shift price risk to the storage operator?**
- **Index to market (summer winter spread)**
- **Price review will tend to shift end user market risk to storage operator (undesired effect?).**
- **Can a reduction of TOP alternatively do the trick?**
- **In return for reduced TOP, storage providers could be released from having to provide flexibility out of a defined facility (and many are already today).**
- **Will shorter duration of contract (otherwise unchanged) result in a reasonable risk splitting?**
- **Regulated storage prices?**
- **What about security of supply?**



Traditional Adjustment Tools have their limitations

Indexation

- Does not reflect all changes of the relevant market;
- What may be the competitive primary energy source factored into the index may change over time;
- Price setting on liquid markets;
- Does not address all fluctuation of demand.

Price Review Clause

- Trigger (Significant Change)
- Periodicity
- Market value concept in the “market of the Buyer”
- Reflecting price changes of the end product of the buyer?
- Taking the past to define the future (always the wrong price?)
- No change of other contract terms (TOP; contract quantity; Term)



(Extraordinary) Adjustment Tools in long term GStAs

- **Hardship / Loyalty Clause**
 - **Competition Law**



Extraordinary Adjustment Tools in long term GStAs

Hardship Clauses

- **Trigger event:**
 - External, frustrating, fundamental, irreversible (excessively onerous)
 - Economic, regulatory and/or technical circumstances prevailing at time of contracting have changed
 - Unforeseeability
 - Will a claim lie if there is no hardship clause in the agreement?

- **Agreements to agree:**
 - **Enforceability?**
 - Depending on Jurisdiction (common/civil law) and specific wording
 - Adjustment criteria and adjustment objective should in any case be defined in “sufficient” clarity to allow application by court
 - “*ex aequo et bono*” clause – increases application options



Hardship Clauses

- Are the reasonable expectations of a party when contracting a prevailing circumstance at time of contracting, which, if unfulfilled, justifies adjustment?
- Is the change fundamental/reversible (look into future of agreement)?
- Was the change foreseeable?
- Is unconscionability of the situation for plaintiff a precondition for the claim?
- Must plaintiff prove this is a loss making agreement?
- What remedy? Adjust or rescind? Balance economic interest of the parties. Is the change requested acceptable for defendant? Is defendant's cost structure relevant?
- Adapt price to market? Adapt duration and/or TOP?



Extraordinary Adjustment Tools in long term GSAs

Competition Law Art 102 TFEU

- **Prohibits an abuse by one or more dominant undertakings affecting trade between member states;**
- **Abuse may, in particular, consist in**
 - Imposing unfair (purchase or) selling prices
 - Imposing other unfair trading conditions
 - Applying dissimilar conditions to similar/equivalent transactions



Extraordinary Adjustment Tools in long term GStAs

Competition Law

- Art 102 TFEU does NOT stipulate an express EU law legal consequence of a violation
- Legal consequences to be determined by applicable law
- **Recognized legal consequences**
 - Nullity of the abusive contract term
 - Potential adjustment of the abusive term
- **The effects on the remaining parts of the contract are to be determined under the applicable law that governs the GStA**



Extraordinary Adjustment Tools in long term GStAs

Competition Law Art 102

- **Establishing dominance at what point in time?**
- **Can a development of the market in effect be attributed to a dominant undertaking?**
 - Long term effects of the original contract (preserving dominance)
 - Refusal to adjust



Extraordinary Adjustment Tools in long term GStAs

Competition Law Art 101

- Long-Term GStA = a vertical agreement which has the object or effect of market partitioning/foreclosure and thereby directly or indirectly restricting competition
- Legal consequence: void partially or totally under applicable contract law
- 80% of demand, 5 years; 30% market share
- Bundling effect vs. obligation to treat equal



Extraordinary Adjustment Tools in long term GStAs

Competition Law Art 101

- Who bears the (competition law) risk of fluctuating demand of the buyer?
- Is a slipping of the seller's market share relevant?
- Can the seller argue no foreclosure if the buyer has no demand?



Extraordinary Adjustment Tools in long term GStAs

Competition Law In summary

- **May allow attack on price, indexation, but also on other contract terms eg. TOP and duration**
- **Has procedural beauties**
 - Challenge of award?
 - Jurisdiction of the competition courts despite arbitration clause



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