Comment

POVL ASSERHØJ

Povl Asserhøj is Executive Vice President, Dansk Naturgas A/S

Discussions on the prospects for development of the natural gas market in Europe have recently been closely related to the possibilities for, and necessity of, creating a more competitive market structure. The predominant view, at least outside the natural gas industry itself, has been that once open access to the competitive paradise is attained, everybody will benefit from the blessings: end of price discrimination and consequently lower prices to consumers; liberation of gas prices from the ties to competing fuels, permitting gas prices to develop in parallel with gas costs; and the triumph of natural gas in terms of increased use and market penetration throughout Europe.

However, a close look at the present natural gas sector in Europe and the de facto situation of supply for Continental Europe raises some doubt as to whether gas to gas competition really is the wonder-tool that can solve all the problems of this particular market.

European Gas Prices Will Stay Competitive

The concept of competition in the natural gas market has been made virtually synonymous with open access or TPA to pipeline capacity. Thus the debate has focused on the role of the transmission companies and their monopolistic behaviour to the detriment of consumers. This view, however, relates only to one part of the natural gas chain, the middle one. On either side of the transmission pipelines reside the producers and the distribution companies respectively, neither one with obvious motives for changing their pricing strategies.

Eliminating the merchant function of the present European transmission companies thus may have little or no positive effect on consumer prices. The comparison between industrial end-user prices for energy, contained in Campbell Watkins paper (Figure 1) indicates that the gas/oil premium is about the same in Europe as in the United States. Hence, it is by no means clear that competition in Europe will diminish the existing natural gas premium. The point is reinforced by the observation that the premium is of the same order of magnitude in France, Germany and the UK, despite the fact that these countries' price regimes differ considerably.

The hopes of consumers in Europe for lower prices through a more competitive market may be further dampened by the fact that a substantial part of the market will still be served by non-competitive distribution companies. The residential and commercial sector will continue to rely exclusively on one supplier, the LDC. Although the residential consumers in the US appear to receive natural gas at a discount price compared to their European counterparts, such lower price is not a consequence of the opening of the North American gas market to competition, but quite the opposite.

Figure 2, again based on data in Watkins' paper, shows that the coming into force of NGPA in 1978 and FERC 436 in 1985, respectively, had no effect on the US price ratios. These ratios remained virtually unchanged compared to the period before the introduction of open access. In this market segment in Europe, regulation will definitely be part of the pricing formula, competition or not.

The above evidence suggests that TPA and elimination of the merchant function of transmission companies will have little or no effect on the pricing behaviour of the European gas sellers: gas prices will remain competitive with alternative fuels, providing for a natural gas premium when possible.

It appears that in the absence of competition between producers, no gains will be derived from fragmenting the downstream sector by an artificial liberalisation. At the same time, it is hard to perceive a truly competitive situation among the concentrated suppliers to Continental Europe, (Table 1) even in a longer-term perspective.

The fact that only a few producer countries supply a substantial part of Continental Europe's consumption leaves little incentive for competition at the producer end of the pipeline. The forecast increase in demand will not change this situation. Even if margins could be reduced in the downstream sector through the means of market regulation and TPA, the producers outside the EU rather than European consumers will pick up the benefit, by conducting a net-back pricing policy.

In short, the introduction of TPA will most likely lead to a transfer of excess margins, if any, to the producers rather than to an elimination of these margins.

I admit, however, that once a Continental spot market for natural gas is established, the ensuing spot price fluctuation might yield gains to large energy-consuming industries. Such gains are linked to risks as well.

Market Structure May Change but Market Value Remains

The decoupling of natural gas prices from the prices of alternative fuels, mainly oil products, is often regarded as the token of a competitive market. Through gas-to-gas competition, the price will reflect the cost of production and distribution only, rather than exhibit the often claimed habit of price discrimination. In this way, it is claimed, competition will lead to an optimal allocation and expansion of supplies.

Even if the present Continental European gas market may not fully live up to such competitive standards, the flaws do not appear to have had any major impact on the market penetration of natural gas. Neither is it obvious why the present market organization should be a deterrent to future expansion.

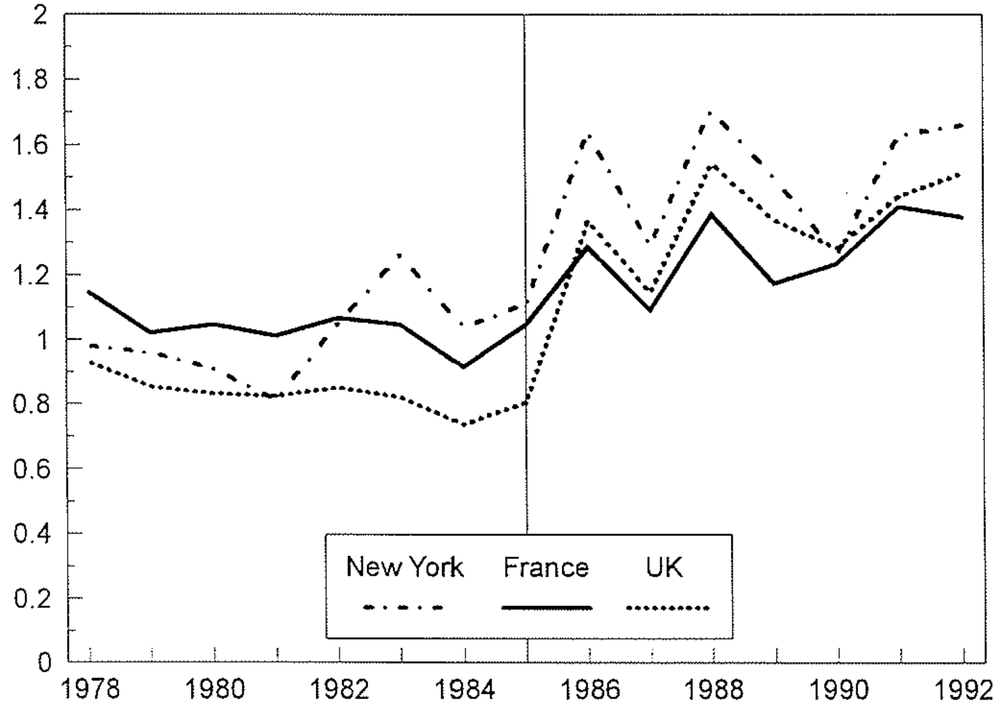

Figure 1: Price Ratios between Natural Gas and Oil Industry, 1978-1992
Source: G.C. Watkins

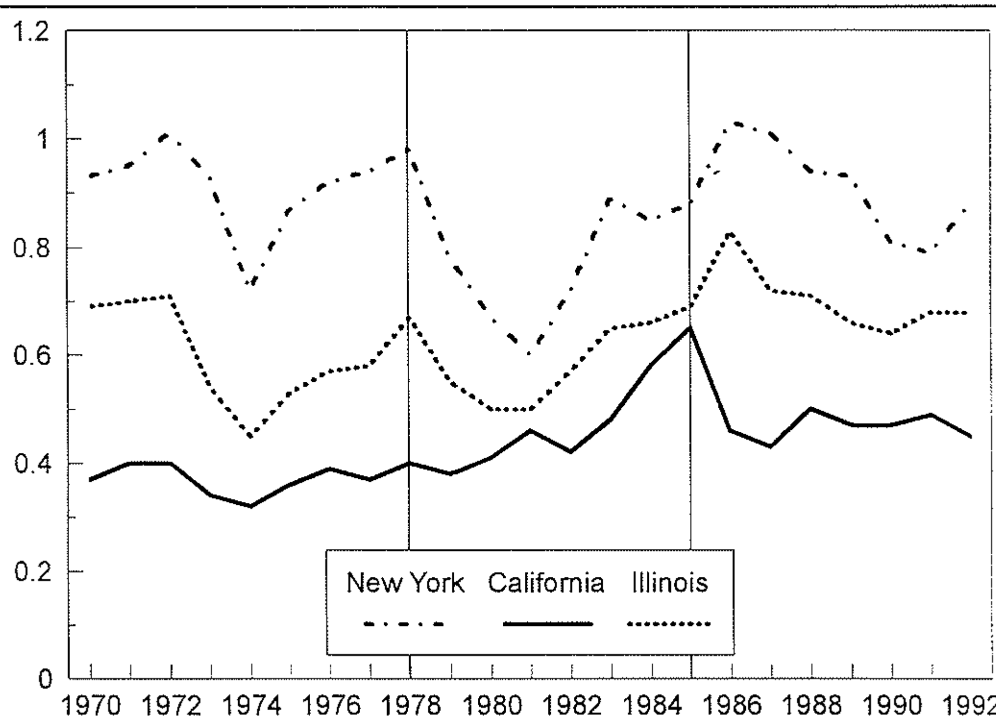

Figure 2: Price Ratios between Natural Gas and Oil for Residential Consumers, 1970-1992
Source: G.C. Watkins

Table 1: Proven Reserves in Supplier Countries to Europe, 1995 (BCM).

Outside EU	
FSU	57 000
of which: Russia	48 000
Algeria	3 600
Norway	2 800
Inside EU	
Netherlands	1 900
UK	630

The market value principle of gas pricing has been widely applied in a number of Continental European countries. The price of competing fuels has been, and remains, a vital element in the prevailing pricing system. The market value of natural gas has so far created the incentives necessary for attracting new supplies. The maintenance of such incentives is crucial in the present European situation where future supplies are to be delivered from new and increasingly costly sources.

Competition Will Not Create a Natural Gas Market

Building up a gas market demands stability and attractive long term prospects to suppliers, given the need for large irreversible investments. Competition in itself does not create the necessary environment for the further evolution of the still juvenile European gas market. The short-term price fluctuations and instabilities associated with gas-to-gas competition are not the most appropriate setting at this juncture of the market's evolution. Long term commitments, commercial as well as political, are necessary.

TPA, and gas-to-gas competition, all will be easier to apply after the market has reached maturity, when its infrastructure is fully in place and when a multiple of producers are available.

Conclusions

A close reading of Campbell Watkins' paper reveals a number of implicit arguments demonstrating why open access in the Continental European gas market may not warrant the euphoria otherwise common with believers, and I end my remarks by the following conclusions:

1. Continental Europe faces a situation where most of the future demand will be supplied by three producer countries outside the EU.
2. Introduction of TPA and gas-to-gas competition will lead to fragmentation of the present transmission and import structure and will place the price setting and the determination of profit distribution in the hands of producer countries.
3. Artificial and non-commercial regulation might result in higher, not lower consumer prices, caused by a less efficient transmission and import structure.