



POLICY PAPER

No. 8 (56), April 2013 © PISM

Editors: Marcin Zaborowski (Editor-in-Chief) ● Wojciech Lorenz (Managing Editor)
Jarosław Ćwiek-Karpowicz ● Artur Gradziuk ● Piotr Kościński
Roderick Parkes ● Marcin Terlikowski ● Beata Wojna

How the European Union Is Shaping the Gas Market in Poland

Aleksandra Gawlikowska-Fyk

Gas markets in the European Union are becoming more liberalised and integrated. But this model is rather typical only for North and Western Europe, while Poland significantly lags behind. Polish authorities only recently made some strategic decisions, but they constitute merely boundaries for a well functioning and liquid gas market in Poland integrated with the EU system. While the pace and scope of the necessary changes must be the subject of a reliable, expert debate, too much hesitation is already creating unnecessary uncertainty. Poland risks missing the opportunity to become an important player in Central and Eastern Europe.

Introduction

Poland's integration with the European Union has been a significant factor shaping the domestic gas market. Even before accession, Poland took necessary steps to adjust its market structure and legislation to the EU's requirements. An important milestone was the adoption the Energy Law Act in 1997. With accession to the EU, Poland committed itself to gradually creating a marketplace in which gas circulated freely and consumers could easily change supplier. Yet the current situation is far from that model. The pace of market reforms has been rather slow, and Poland is significantly behind schedule.

Due to a long-term contract,¹ regulation of prices, inadequate interconnections and the non-existence of an organised market (a hub or energy exchange), the wholesale gas segment in Poland has been monopolised by PGNiG, with only a limited market share of other companies (around 5%). A similar sales structure is present in the retail market. The situation is expected to change, though, as the EU is determined to create functioning energy markets in all Member States. In Poland, the first symptoms of real change can already be observed with such recent developments as the possibility to trade on the Polish Stock Exchange and the deregulation of wholesale prices.

Undeniably, the energy policy conducted by the EU is influencing the gas market in Poland. Looking at its current agenda, the country's most important factors are market, legal and infrastructural considerations, which require a solid basis in EU law, as well as EU climate policy. In 2013 and next years Polish gas market will certainly face a transition.

¹ In 2012, under a long-term contract, PGNiG bought 9 billion cubic metres of gas from Russia's Gazprom, which amounted to 82% of total imports, and acquired the rest (almost 2 bcm) from Germany and Czech Republic. Total domestic production amounted to 4.3 bcm, while consumption in Poland reached 15.4 bcm. Source: Urząd Regulacji Energetyki (Polish Energy Regulatory Office).

Market Considerations

The building of a competitive single gas market in the EU was undertaken in the 1990s. The uneven and rather slow development of national gas markets in the Member States resulted in numerous initiatives (legal and practical) aimed at designing a common model and speeded pace of integration. The momentum to create a more coherent approach came with two events. First, the Third Energy Package, which was adopted in 2009 and entered into force in early 2011, provided important policy and regulatory instruments. Second, the European Council in February 2011 set an ambitious deadline to complete the implementation of a functional and integrated gas market by 2014.

The idea of how this model should look like was incorporated in the “Vision for a European Gas Target Model,” prepared in late 2011 by the Council of European Energy Regulators (CEER), an association of national energy regulators cooperating closely with the Agency for the Cooperation of Energy Regulators (ACER) and the European Commission. As presented in the document, the Gas Target Model was built on previously conducted works among all relevant stakeholders—the Commission, regulators, associations of gas suppliers and traders and major industrial customers. It also included input from influential European think tanks. In March 2012 it was formally adopted.

In this vision of the market, CEER defined how the gas trade, transmission and other services should be organised. It would be based on three main pillars. The first would be the creation of a series of harmonised liquid and functional regional gas markets (hubs) with the possibility to merge smaller and illiquid zones (for example, national gas markets). An implementation of an entry/exit tariff model would be an indispensable condition as it allows for setting prices for every point of entry to and exit from one zone, regardless of the distance of a transit route. The second pillar would be coupling these functional wholesale gas markets through efficient interconnectors. The last element of the Gas Target Model would be that the markets within Europe need to be physically interconnected to achieve market integration and enhance the security of supply. The Gas Target Model is not binding, it is just an idea, a bold vision of how a truly integrated single gas market can be organised and operated in the European Union.

The possibility to achieve the final outcome is broadly contested. There might be too many obstacles and too high costs. Currently, there are 28 separate entry/exit zones (national or even smaller) at different stages of development. North and Western Europe are much more advanced, with eight gas hubs in existence (National Balancing Point in the UK and the Title Transfer Facility in the Netherlands are the most liquid and have the largest trading volumes), while there is none in Central and Eastern Europe (CEE). The CEE suffers also from insufficient and West-oriented cross-border capacity, poor diverse transport routes and insufficient storage facilities. The lack of LNG terminals is another obvious disadvantage.

With this backdrop, the situation in Poland is unsatisfactory. For many years Polish authorities were unable to introduce systemic solutions that followed from EU law and the practical experience of many more advanced countries, envisaged at the same time by the Gas Target Model. Only recently has Poland allowed for the entry/exit model with a virtual trading point and established gas trading on the Polish energy exchange. One step forward was the exemption from tariffs of trade in gas-related fuels on the wholesale natural gas market, which will finally allow competition among suppliers. Moreover, there will be a mandatory gas release programme in which PGNiG, the dominant market player, will be obliged to sell gas on the energy exchange. However, the draft gas law that forms the basis for this requirement is still subject to intensive debate as is the level of gas mandated to be sold on the exchange. With that much uncertainty and hesitation in play, Poland is delaying indispensable changes and causing unwanted risk for domestic gas companies while not attracting foreign players.

Legal Considerations

The Third Energy Package, a set of three regulations and two directives, entered into force on 3 March 2011. In the gas sector it provides common rules on the internal gas market (Directive 2009/73/EC)² and

² Directive 2009/73/EC of the European Parliament and of the Council of 13 July 2009 concerning common rules for the internal market in natural gas and repealing Directive 2003/55/EC, OJ L (EC) 211/94, 14.8.2009.

the conditions for access to cross-border gas transmission networks (Regulation 715/2009).³ As of today, Poland has not implemented these provisions. At the end of 2012, the Commission brought Poland to the EU Court of Justice for failing to fully transpose Directive 2009/73/EC regarding gas market. The Commission alleged, among other things, that Poland was regulating gas prices in a disproportionate manner (although the household tariff regulation was justified) and did not provide sufficient possibility to change supplier or means to protect vulnerable customers and did not require implement producers to certify as unbundled transmission system operators.

So far, the infringement procedure against Poland (with a possible daily fine of up to €88,800) has acted as a catalyst for the country to deregulate its gas prices in the wholesale segment of the market, which was actually not in line with the Second Energy Package. But it has not resulted in speeding up the legislative process. Three new acts covering separately electricity, gas and renewable energy sources and aiming to repeal the Energy Law Act (the so called three-pack) has reached an impasse. In seeking a solution, with the Commission's infringement procedure as a backdrop, necessary amendments to existing energy law were proposed. However, they are also a bone of contention. In the meantime, other detailed and binding regulations are about to enter into force. Network codes, for which the Third Energy Package is a legal basis, will shape national markets in a more explicit way. Those rules will be directly applicable to all Member States. The first network code in the gas sector (Network Code on Capacity Allocation Mechanisms) is at the moment in comitology procedure and may be expected to be approved late this year. Even earlier though, it will be implemented as a pilot project on certain interconnectors, including those on the Polish–German border.

The organisation and operation of energy markets in the EU are not only shaped by sector-specific directives and recommendations. The Commission has always proceeded with a dual strategy towards the energy sector, making good use of common competition rules. Poland has never been subjected to any gas competition case since major problems are handled at the national level. As an example, recently conducted research by the Polish Office of Competition and Consumer Protection (UOKiK) on gas agreements in the retail market. This analysis revealed serious detriments to competition and anticompetitive restrictions. Under EU competition rules, one particular ongoing proceeding may highly impact the Polish gas market, namely an infringement proceeding against the Russian monopoly Gazprom. It is said to be the landmark antitrust case of this decade, and one likely to reshape the European gas market.⁴ That infringement case may be very important for countries in the CEE region. For Poland, the re-export ban is no longer valid (from 2011), but the issues of long-term contracts and gas price indexation are of major concern. Together with increasing gas-to-gas competition in the European hubs, this ongoing case may lead to the dismantling of the current supply model. The issues raised by the Commission against Gazprom are regarded as very serious barriers to free gas trade in Europe.

Infrastructure

The fact that large volumes of gas have always been imported from external suppliers has resulted in quite well-developed cross-border links amongst Member States. But it does not mean that they have created a single gas network in the EU. Further investments are needed. National systems, especially, in Central and Eastern Europe are not sufficiently interconnected, and in many cases allow only for uni-directional flow. The accession of the CEE states to the EU brought the necessity for new cross-border connections and incentives for all other investments (LNG terminals, storage capacities). The gas supply crises of 2006 and 2009 increased the consciousness of the EU institutions that these countries are too vulnerable and inadequately linked. An explicit result of the crisis was a new regulation on security of gas supply (Regulation 994/2010⁵), which required Member States to diversify routes and sources of supply. According to that regulation, transmission system operators should enable permanent bi-directional capacity on all cross-border interconnections between Member States as early as possible but no later than 3 December

³ Regulation (EC) No. 715/2009 of the European Parliament and of the Council of 13 July 2009 on conditions for access to natural gas transmission networks and repealing Regulation (EC) 1775/2003, OJ L 21 1/36, 14.8.2009.

⁴ A. Riley, "Commission v. Gazprom: The Antitrust Clash of the Decade?," *CEPS Policy Brief*, no. 285, 31 October 2012.

⁵ Regulation (EU) No. 994/2010 of the European Parliament and of the Council of 20 October 2010 concerning measures to safeguard security of gas supply and repealing Council Directive 2004/67/EC, OJ L 295, 12.11.2010.

2013. At the same time, the North-South Gas Corridor and the Baltic Energy Market Interconnection Plan (BEMIP), which further enhance links amongst Member States, have become priority corridors in the EU.

The liberalisation process of gas markets in the EU has changed the responsibilities for and roles in securing adequate gas supplies and investments. The Third Party Access (TAP) and unbundling regime broke up vertically integrated monopolies and allowed for competition in trade. Transmission system operators are now solely responsible for security of gas supply and infrastructure development, but since they do not perform production and trade activities, they cannot be certain that the new capacity will be utilised. In other words, there is no guarantee that a transmission system operator will get a return on investment. Ultimately, a transmission company bears the entire risk of the project. Such a situation decreases its ability to obtain financing from private banks. This is a significant barrier to investment, but there are some solutions to it.

The first solution involved what regulators defined as a so called open-season procedure, in which a first step allows for market screening for potential demand for new capacity. The second step enables interested parties to conclude an agreement with a transmission system operator for an allocation of the planned capacity. The open-season procedure was used in the cases of the Polish–Czech and Polish–German interconnectors.

A second solution involves exempting under strict conditions new interconnectors, LNG terminals and storage capacity from certain provisions of the Third Energy Package (TPA, unbundling, tariffs regulation) so as to decrease risk and increase the profitability of the projects. The aim of the exemption is to create conditions in which an unprofitable project, but a socially desirable one, will become cost-effective and be implemented by a private investor in an optimal amount of time. Such an exemption was granted, for example, to the owners of the Gazelle and OPAL pipelines linking the Czech and German grids to Nord Stream.

A third solution is to use the means of the EU's trans-European network policy in the field of energy (TEN-E) to promote projects regarded as the most important from a common point of view. Such projects can receive additional funding. However, TEN-E policy instruments have turned out to be rather ineffective. In 2011, the EC proposed a revision of TEN-E policy. It included a new regulation on TEN-E guidelines and a new financial instrument—the Connecting Europe Facility. Currently, both proposals are being discussed. The new TEN-E regulation will define priority corridors in the EU. Within these corridors, certain projects of European interest (PCI) will be chosen. Those concrete projects will benefit from a faster permission procedure and will also be eligible for financial support from the Connecting Europe Facility. Although initially, the energy part of the Connecting Europe Facility was €9.12 billion, it was recently cut in budget negotiations to €5 billion. From a total number of four gas priority corridors, two directly include Poland (the Baltic Energy Market Interconnection Plan and the North-South Gas Corridor). It is recognised that of the projects promoted by Poland, a vast majority will be granted PCI status.

In the last couple of years, building new infrastructure and increasing cross-border capacity has significantly progressed in Poland. In 2011, Gaz System SA completed construction of the Polish-Czech interconnector (0.5 bcm), the development of the Lasów Hub with Germany (another 0.5 bcm) and achieved virtual reverse flow on the Yamal pipeline (2.3 bcm). Those investments allowed for gas imports from new sources amounting to 30% of the current import level. Gaz System SA is making good use of co-financing from EU funds, as all investments and projects have received or are expecting to receive support.

Climate Policy Context

The EU actions against climate change will also trigger changes on the Polish gas market. The EU wants to reduce fossil fuels' impact on the environment. Nevertheless hydrocarbons will remain a big part of energy supply, and gas in particular, the cleanest source, is expected to be the fuel of choice. Although currently there is a slight drop in gas demand, the overall outlook is rather positive due not only to climate change mitigation goals but also to expected demand recovery and unconventional gas production. Adjusting the Polish energy sector to low-emission standards and a diversified structure requires an increase in the role of gas in the long-term perspective. The dynamic development of renewable energy sources, incentivised by EU policy, might also positively impact the usage of gas. Generation of electricity from renewables is difficult to predict, and such intermittent supply requires back-up gas reserves. According to the prognosis

for the Polish Ministry of Economy, the share of gas in electricity production will rise in Poland from 3% in 2010 to 10% in 2030.⁶ Poland, which will soon have to update its energy policy, should design a strategy towards an enlarged gas market.

Conclusions

It seems that market liberalisation and transformation of the still monopolistic structure of the country's gas market has been a distinct goal for Polish authorities. Only recently can one observe indispensable changes, but for the time being they have resulted in minimum conditions for a free market to function. Polish actions to defend the monopolistic status quo are at odds with the expectations of foreign market players. The situation works to the detriment of the Polish market and its position in the region. This is somehow contradictory with stated ambitions to create a gas hub for Poland, or maybe even a regional one. It is worth mentioning that in the Baltic region Lithuania has already established a gas exchange, while for Poland's southern neighbours their proximity to the Central European Gas Hub in Baumgarten has created a natural opportunity to join the Austrian hub. Hungary has its own ambitions, too. And, one should not forget about Germany, which is one of the biggest and most developed gas markets in Europe. If Poland is truly committed to becoming a gas-trading centre, condition *sine qua non* is to open up the domestic market to attract new entrants.

Although EU legislation is already regulating the gas market, it seems that it is not a high priority in Poland. Even though energy regulations and directive are highly complicated, often technical acts of law, it takes too much time to properly implement them in Poland. In the meantime, some necessary provisions of regulation 715/2009 were introduced by the Polish Energy Regulatory Office without a basis in Polish legislation (entry/exit model). But this situation cannot continue. The Commission addressed the issue of not fully transposing the gas directive, and further delays exacerbate the risk of Poland being fined by the EU Court of Justice. Stability and predictability of law is necessary for domestic energy companies and for attracting foreign investors.

In contrast, one should assess as positive the progress of infrastructure development in Poland. Poland enhances diversification and has enabled gas supplies from new sources. This will also allow for real market integration, meaning free trade in gas. Polish membership in the EU has forced the need to properly develop gas transmission infrastructure. With new projects coming online—an LNG terminal and interconnectors with its south and western neighbours, Poland will significantly diversify its supply of this fuel. There are also good chances to expect the Polish project will be granted PCI status under the new TEN-E regulation. Nevertheless Polish authorities should carefully monitor the whole legislative process, especially since the new regulation on TEN-E guidelines is regarded as a very difficult and complicated piece of law. The Connecting Europe Facility will be an important, yet supplementary source of funding. Irrespective of negotiations on CEF, Poland should put much effort on securing funding from the Cohesion Fund and Regional Development Fund, which so far has been essential for Poland.

Nevertheless, the investment needs are still vast and include modernisation and development of the internal grid, additional storage facilities, new interconnectors with EU Member States, and completion of the LNG re-gasification terminal. As for unconventional gas production, Poland would also need to build new networks that would allow it to be distributed. If Poland is truly committed to further integration with the EU market and the creation of a region-wide trading place, new infrastructure investments are indispensable, though at present, insufficient.

⁶ Agencja Rynku Energii, "Aktualizacja prognozy zapotrzebowania na paliwa i energię do roku 2030" [Actual forecasted demand for gas and energy to 2030], Warsaw, 2011, www.mg.gov.pl/files/upload/11099/ARE%20MG_2011_Raport_koncowy_01_09_2011.pdf.