IEA paper on Gas Market Regulation

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1. A global gas market is emerging. Gas demand is growing rapidly, mainly driven by the power sector. Not only in OECD countries but also in new economies like China, India and Brazil. LNG is playing an increasingly important role in connecting what were previously regional gas markets (North America, Europe, Asia).

2. Consumer markets across the globe are competing for supplies of gas as domestic supplies in OECD countries are depleted and transportation of gas becomes cheaper. As a response to this opportunity, both consumers and producers are seeking diversification of their trade partners. This has started to create a global gas market, although views may differ as to how quickly regional markets will converge.

3. Due to strong demand and the long lead times for major new projects, the global gas market currently seems to be a "sellers" market with major players increasingly dominating production and wholesale markets. Governments of consuming regions which are all facing rapidly increasing import dependence are well advised to build more attractive markets in the light of diminishing local resources. Regions with more flexible gas markets will be more able to attract gas supply when it is needed.

4. Regulatory frameworks in regional markets aimed at creating a competitive market for natural gas should give the necessary incentives for investors to attract sufficient timely supplies. This requires energy policies and subsequent regulatory measures that lead to competitive market outcomes and long term objectives. We are experiencing a new phase in which investment in order to ensure security of supply is taking centre stage. There is reason to have serious concern on whether sufficient investment is coming forward in a timely manner, both in OECD countries and in the countries that have the largest gas reserves (Russia and the Middle East).

5. Energy policy should recognise the structural features of a region, and provide for suitable market design. Lack of timely long-term investment is a by-product of uncertain energy policy, and/or poor implementation of that policy.

6. In order to make sure that the market works well, regulators must be given the responsibility to monitor the market and propose necessary changes if policy outcomes are not being realised. Whilst stable regulation is desirable, the dynamics of energy markets make this impossible within all aspects of the market all the time. Dynamic regulation takes into account the feedback mechanisms from the market. A good example is the way in which the US regulator FERC adapted its regulation of LNG terminals in order to provide a clear incentive to get more investment in LNG terminals (Hackberry decision). Similar changes were made by FERC to get more investment in commercial storage capacity. Other jurisdictions may benefit from taking a close look at these examples.

7. Infrastructure investments in the gas industry often involve large front-end costs with long-term revenues. Naturally, some of these investments should be financed by long-term contracts for the use of those newly-created assets. However, more competitive assets are generally better matched to equity investments and short term contracts. One challenge of regulatory design is to match the long-term investments to suitable contracts whilst enabling flexibility in the competitive market. The key issue for regulation is to create a level playing field and a good framework for competition.

8. While many markets continue to price long-term gas contracts on oil products, there may also be a place for long-term gas contracts on gas pricing. In markets with more gas-to-gas competition and excess supply, we see gas prices more decoupled from oil prices but also more volatile. However, even in those markets gas prices tend to show a strong correlation with oil prices again when markets are tight. In a functioning gas market, consumers are free to choose from many viable pricing alternatives.

9. Coordination of the regulatory regimes along the gas chain crossing different legal systems, is a major challenge to support coordinated investments in infrastructure to maintain supply. The Energy Charter Treaty, WTO rules and bi-lateral arrangements are designed to support investment initiatives and to resolve disputes. Energy policy should in addition be a major element in foreign policies securing long term dialogue between producers and consumers recognising mutual dependency. With OECD countries becoming increasingly dependent on gas supplies from a limited number of countries in the Middle East and Russia, this dialogue will obviously be more important in the future.

10. The market is a tool to deliver security of supply objectives and flexibility. Within the gas market there are opportunities to value security of supply, and to assign responsibilities to parties best placed to manage it. It is increasingly realised that even the more-developed liberalised markets may not provide all the investment signals required for a timely response by investors or valuing security-of-supply. Unless policy makers design markets which value security, this may tend to be under delivered, noting that long term contracting of supply and vertical-integration provide (or are assumed to provide) this in many cases. Within interconnected markets there is a strong case to promote more coordination and harmonization of regulation in order to have gas cross borders much more easily.

11. There is reason to be sceptical of current moves to organise strategic gas stocks as a policy response to supply disruptions on several grounds. Gas emergency stocks would be 10 times more expensive than oil, and their effectiveness in terms of being able to deliver the gas when and where it is needed is questionable. Furthermore there is evidence to suggest that companies' plans to develop commercial stocks might be delayed or modified if there was a perception that "strategic" stocks were providing a buffer for some market conditions. Non-commercial gas stocks may be useful in exceptional cases, but these are much more limited than for oil because the gas delivery system is so much less flexible. Most countries might prefer a suite of other measures tailored to their circumstances and needs, for example demand flexibility or fuel switching.

12. Global and regional gas markets have a variety of complex and specific characteristics. Awareness and understanding of this by policy makers and the public at large is of major importance if long term investment is to be attracted in the right place, at the right time and in adequate amounts. Even in markets with the right set of incentives we see increasing problems with approval procedures for LNG terminals, pipelines etcetera. This so-called problem of NIMBY (Not In My Back Yard) is causing unacceptable delays in getting new infrastructure in place and thus slowing down the supply reaction to price signals. Governments around the world are called upon to start attacking this problem aggressively by substantially reducing the time and effort it takes to get approvals for new infrastructure investments, since Governments will tend to be blamed if inadequate infrastructure leads to supply shortages.