

## "HUB SERVICES" FROM THE PERSPECTIVE OF GAS SUPPLIERS

This paper sets out the views of Eurogas Members as suppliers about the operation of gas trading hubs and their value in a portfolio approach. Eurogas supports the development of gas trading hubs as a major feature of the competitive gas market.

### What is a Hub?

A "hub" is a point at which title to gas can be transferred between buyers and sellers<sup>1</sup>. It may be a physical point where several pipelines are connected or a virtual point within a pipeline system. A "trading hub" is a hub where the operator offers services that facilitate the buying, selling and physical transportation from/or into connected systems and within systems (e.g. TTF, NBP). At a trading hub participants can exchange gas under standard conditions that are designed to create liquidity. When a hub is sufficiently "liquid", physical delivery occurs after the gas has been traded many times seeking a market. The amount of re-trading prior to physical delivery by a supplier is called "churn".

### What hubs can bring

Trading hubs offer gas suppliers increased access to both short- medium- and long-term supplies, and access to numerous buyers and sellers of gas (including producers, other suppliers, large consumers and pure wholesale traders). This can add flexibility to a diversified gas supply portfolio. Hubs allow gas suppliers to adapt to changing supply and demand conditions, by being able easily to buy and sell gas in the short and medium term. The presence of short term sales and purchases also enables suppliers to diversify the pattern of their gas resources, both in terms of origin and of allocation between long, medium and short term.

Trading hubs lead to price transparency, which in turn leads to more effective market signals. The greater the "churn", the greater is the liquidity and therefore the greater the price transparency. It is only once the short-term price of gas is responsive to gas supply and gas demand that real efficiency gains can be made and the benefits of a competitive market fully realised.

### Pre-requisites for hubs

Development of gas hubs must be driven by market participants but is contingent upon a number of prerequisites, of various kinds: the presence of technical infrastructures of large capacities in the area, a large number and diversity of actors on the market, a regulatory framework ensuring the security and clearness of access to and from the hub via regulated transmission networks and to related services, and the presence of incentives for investment (in hub services and any associated infrastructure).

By ensuring open access together with transparent TPA rules and providing incentives for operators to realize new infrastructure, regulators and gas industries have a major role to play in facilitating the promotion of new hubs.

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<sup>1</sup> At some in-grid hubs, title to gas within the system may legally/technically remain with the TSO, but the transfer is recognised by the TSO via a change in the network users' gas account or balance.

## Limitations of hubs

It is useful to recall that hubs are often complementary to “take or pay” contracts which, during the last decades, have governed relations between producers and suppliers. Short-term trades at hubs will not replace long-term contracts, which will continue to be concluded. Hubs may become the preferred trading point for buyers under such long-term contracts in the future to allow suppliers to fine-tune their overall portfolio of shorter-term and longer term contracts. The fundamentals of the upstream (production) and midstream (transportation) parts of the gas chain remain. Thus an adequate coverage of the volume and flow risk should remain in place to underwrite the financial risks associated with these capital intensive activities.

## How hubs should work

In a hub, all participants must be treated on a non-discriminatory basis, providing that the same level of services at the same costs has to be performed by the operator. It is recommended that the hub operator be a separate legal entity to avoid potentially discriminatory treatment between participants. In this respect is important to emphasise that, in order to participate in the trading activity at the hub, all participants must first satisfy *appropriate* financial and industry standards.

The level of standardization should be maximized, recognising that each hub that is developed will be a separate commercial enterprise, and that third party arrangements may vary from country to country. To avoid market distortions, clear rules and responsibilities have to be fixed in case of Force Majeure, with clear identification of the liabilities of the various parties.

Tariffs for the different services have to be designed in such a way as to allocate the cost of the different services and provide a fair margin. The tariff should be structured so as to encourage hub customers to trade.

Each transaction at the hub has to remain strictly confidential and the nomination process has to be clear and simple, preferably facilitated by a suitable IT system. Validation of transactions at hubs is essential for all players.

Shippers/suppliers should be incentivised to balance and hubs will facilitate the potential for back-up supply.

## Value of hubs for suppliers

From the supplier’s perspective, the value of hubs can be summarised as follows:

- Both small and large suppliers can benefit from **services offered by hubs** to balance their supply and demand portfolios.
- Hubs can generate **transparent pricing** and make future price trends visible.
- **Liquidity** at hubs will be determined by the market via clearing houses or over-the-counter (OTC) trade mechanisms, so providing price transparency which is helpful for suppliers.
- Each supplier will make his own judgement on what **mix of spot, mid- and long-term contracts** he wants in order to minimize market risk both in price and quantities required.
- In all types of markets, the experience is that on average only a small portion of the physical sales are spot sales. The majority of the physical sales will remain over the counter trade (short and long to even very long term, based on spot indexation or other pricing systems). For the supplier, the mix between short and long, fixed and spot pricing etc. will be based on his expectations of the market. Suppliers can purchase shortages on hubs and resell surpluses.

- Hubs can serve as a back up for supply shortfalls up to the maximum existing production level. Beyond that, rising demand will be curtailed by rising prices. Wholesale price spikes are inevitable but by engaging in the forward market at hubs or concluding long term contracts with less volatile price indicators suppliers can reduce their exposure by making a commercial decision to contract a percentage of their portfolio in advance. Whilst short-term price spikes are needed to provide the correct signals in the wholesale market, the resulting retail prices need not be as volatile.
- Hubs do not serve as signals for initiating major long-term investments because the future market for contracts beyond a few years will for the foreseeable future be too thin and too short-term to underpin major projects. However, the short to medium-term prices generated at hubs can contribute to the longer-term economic analysis underlying major investments and the existence of a hub can make it easier for projects to be designed with some extra capacity.

Hubs facilitate the development of liquid and transparent spot markets to allocate short term gas in the most efficient way and allocate the last m<sup>3</sup> best. Hubs can also facilitate long-term (OTC) deals. With the right range of hub services, suppliers can source efficiently the balanced mix of short and long terms supplies they need to achieve a competitive supply portfolio.

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