

COMPETITION SPURS SHIFT IN ITALIAN GAS BUYING STRATEGIES

September 2015

ICIS would like to thank Gas Intensive Italy and its members for their input into the survey.

Increased competition on the Italian natural gas market has produced a dramatic shift in the way in which Italian industrial and commercial companies purchase gas. Gas procurement models, which used to be all inclusive packages with one main supplier, are progressively moving towards hub-based solutions with one or multiple suppliers, with shorter and more flexible contracts.

This ICIS study, which focuses on evolution of gas procurement models in Italy in recent years until present, illustrates the degree of this market transition and the increased competition which is transforming the Italian gas market.

After surveying industrial and commercial gas buyers in Italy and a range of suppliers, ICIS has identified a vast range of procurement models. Those vary from companies that still prefer the security of a fixed price, to an increasing number of buyers that have moved to index their gas supply contracts to wholesale hub-based prices.

This trend has underpinned a growth in over-the-counter (OTC) traded volumes on the Italian PSV hub, which more than doubled in the 12 months to the end of August 2015.

About this study

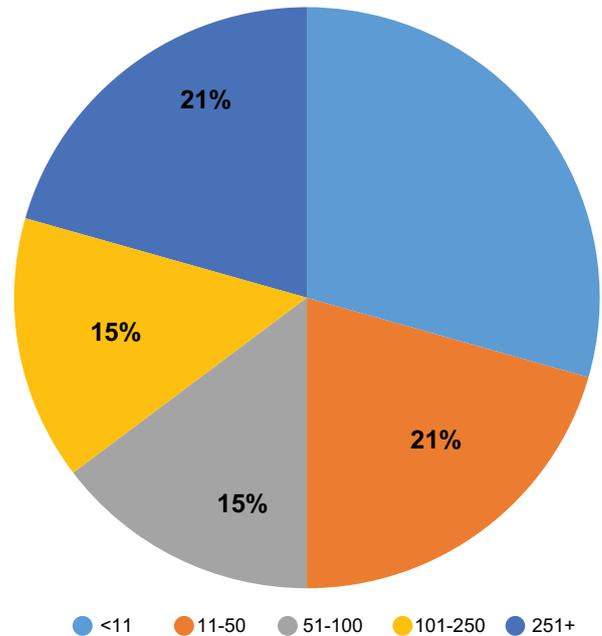
This significant change in purchase terms is having a huge impact on traded market dynamics, the area in which ICIS specialises, which is why it was relevant to conduct a study of Italian buyers about how exactly their procurement strategies are changing and what the future might hold.

In the first half of 2015, ICIS interviewed over 70 industrial and commercial gas consumers that operate in Italy. The interviewed companies' average consumption ranged between 50 million cubic metres (mcm)/year to 150mcm/year, although it included entities with demand as low as 1mcm/year to those who purchased over 800mcm/year. A breakdown of the demand portfolios of the interviewed companies is detailed in the chart on the right

The list of interviewed companies included paper, ceramic, fertiliser, glass, food and steel producers, as well as companies that supply industrial clients.

Among those, some companies procure gas for their own industrial production, while others purchase gas for a regional consortium of smaller industrial or commercial buyers. A smaller proportion also procures gas for onsite co-generation facilities.

Figure 1: Annual gas demand of Italian companies interviewed (million cubic metres/year)



Contract length

Industrial and commercial buyers in Italy traditionally purchased gas for several years ahead on an all-inclusive package. But the increased contract flexibility – combined with increased market volatility, and a general fall in wholesale price levels – has shortened the average contract length.

Over 60% of industrial gas consumers surveyed for this report purchase gas for a maximum of two years ahead, although most procure for one year (either the upcoming gas year or the next Calendar year). In several cases, the length of the contract has shortened further with companies buying part of their volumes on a yearly contract and part on a seasonal, quarterly, or even on a monthly contract.

Buying activity generally occurs during the so-called “commercial campaign”. This period has traditionally run between April and September ahead of the Gas Year (1 October to 30 September). However, in line with the market changes, this has become more flexible, with buyers afforded more choice over how and when they step into the market to meet their demand requirements.

There is an increasing trend for buyers not to purchase their entire annual gas volume at a single contract and a single point in time, but rather distributed in two or more

supply contracts, often done in different moments of the year. Over 25% of respondents said they were buying some gas volumes on monthly and quarterly basis.

Some respondents said their default position was to purchase a portion of their annual demand on a seasonal or quarterly contract ahead of the beginning of the Gas Year, and then to wait on market conditions before choosing how to procure the remaining volumes. Others indicated that they had adopted a more flexible approach and purchased gas on a quarterly or monthly contract with different price indexations, depending on price movements. This has caused an increase of deals with lower volumes on the wholesale markets.

Procurement strategy

Because of the increased competition, ahead of the “commercial campaign”, over 50% of the interviewed industrial gas buyers said they ask for quotes from up to ten different suppliers before committing. Some opted to sign contracts with four suppliers, but typically buyers signed deals with one or two suppliers for each commodity, i.e. one supplier for gas and two to supply power or vice-versa.

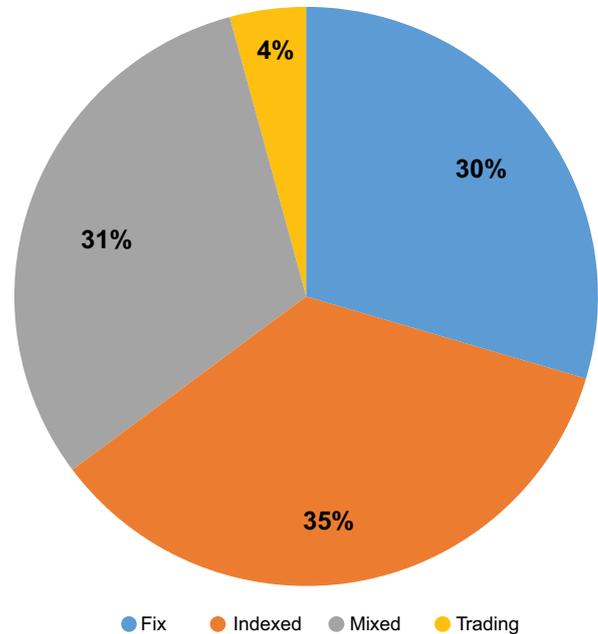
Over 50% of the interviewed companies signed a gas supply contracts for the entire year (either Gas Year or Calendar Year) with one or two suppliers, with gas delivery price being indexed to either the Dutch TTF hub or the Italian PSV hub.

Over three quarters of interviewed companies said that they had signed, or were planning to sign a contract for 2015 that included some degree of floating price indexation. This was exclusively indexed to either the PSV or TTF gas hubs rather than linkage to oil or oil products (see section below). There was also an equal split between companies that had elected or were going to opt for full indexation to either the PSV or TTF hubs (or a formula including the two hubs), and those that had a mixed formula, including both hub-indexed and fixed price elements.

The remaining 30% of respondees indicated that they would meet their 2015 demand requirements through a fixed priced contract.

For those companies with a mixed supply portfolio, the portion received through fixed price and floating price varied strongly from company to company. But a significant proportion of respondents said that their general strategy was to purchase their winter requirements on a fixed price formula, and summer volumes with a floating price, believing that winter prices are more likely to spike.

Figure 2: How much of your contracted gas was linked to hub prices in 2015?



Others had a mixed formula for the whole year, which included PSV, TTF and a fixed price by equal percentages.

Smaller companies or industry sectors where production has been severely hit by the recession (such as cement manufacturers), were generally content to have contracts with a fixed price. Respondents were aware that fixed priced contracts may be more expensive than floating, but they did not want, or did not have the ability, to manage the risk of a floating price contract.

Companies with fixed priced contracts generally procured gas from one large supplier, which can absorb the risk of clients not paying or paying with a delay. Volumes bought by these companies are also quite small, from less than 5mcm/year to about 40-60mcm/year for the largest companies in this sector.

Another supply model used by some industrial companies is to go through an “auction” process shortly before the end of their latest yearly supply contract, where suppliers submit an offer, in order to select a new supplier for the year ahead. In some cases, companies hold two or more “auctions” in different periods of the year.

While some interviewed companies were comfortable with the auction system, others noted that price differences between supplies were usually minimal, and it was the timing of the auction that was more important. Some companies suggested that they have moved from an auction process to purchasing gas progressively throughout the year.

Shift to floating price indices

While overall gas demand levels in the Italian industrial and commercial sectors has fallen over the past five years, the portion that is contracted to a floating price reference – either indexed to TTF, PSV or a mix of the two hubs – is growing.

That shift towards hub-indexation also appears to be gathering pace, with a number of respondents that currently have fixed priced contracts commenting that they are considering switching to a floating price mechanism over the next two years.

Moreover, those interviewed companies that adopted a floating price strategy were generally moving to more complex way of buying. For example, some larger industrial companies are monitoring market prices daily and are able to make their own buying decisions for short-term contracts through their supplier’s trading desk, buying for shorter period.

Most suppliers offer buyers total freedom to choose what index to use for their floating gas prices and charge a commission covering their fee.

Some suppliers also recommend indexation formulas to clients, depending on market trends and their analysis on procurement strategy. In certain cases, the formula might be PSV or TTF indexed or a mixed formula, which could include also a percentage of a fixed price.

ICIS noted that industrial and commercial companies are increasingly monitoring gas prices weekly or even daily in order to take supply decisions, as they realised that in this way they can better tailor their gas supply contracts.

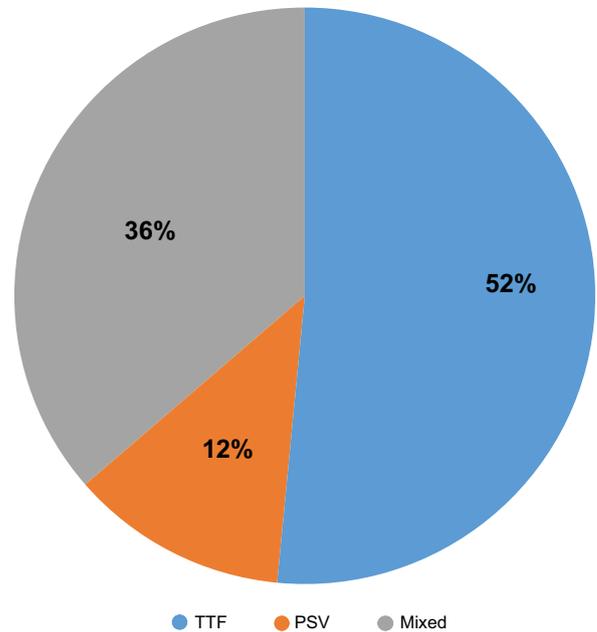
TTF ascendant in Italy – for now

The flexibility afforded to buyers has meant that there are a wide range of products available, with buyers given the option to index to the Italian PSV hub to the Dutch TTF, or a combination of the two. Indexation to Dutch TTF or PSV includes a range of products, from day-ahead, month ahead, to quarterly and seasonal contracts, out to Calendar Year or Gas Year.

Of the companies that had mixed or floating priced contracts, some 52% were indexed to the Dutch TTF hub, the most liquid gas market in Europe. The profile of those companies that referenced TTF prices varied, but international companies that had operations in Italy, or Italian companies that had operations in continental Europe almost exclusively had at least a portion of their supply indexed at the Dutch hub.

Generally, the interviewees noted that the deep liquidity provided by the TTF made it easier to manage price risk. Those respondents with operations outside Italy also noted that TTF was the pan-European hub of choice.

Figure 3: What European gas hubs are your supply contracts indexed to?



Buyers opting to index to the Dutch hub pay a premium (the premium is generally equal to the spread between the TTF price and the equivalent PSV contract price when the contract is executed), plus a commission fee charged by the supplier. Commission fees and spreads vary from contract to contract.

Less than 20% of interviewed companies were indexed to PSV exclusively, although this proportion has grown significantly over the past year in line with the overall growth in PSV market liquidity. Participants expected this proportion to grow over the coming year, and a number of respondents said that they had started to index to the PSV because it gives them a reference point that is ties to specifically to national price formation dynamics.

Some trading companies offer a mixed formula, which include both TTF and PSV prices (and in some cases also a fixed price component), and 18% of respondents preferred to have a balance of PSV and TTF indexation.

Volume flexibility

With the Italian market increasing opening to competition, the majority of framework contracts include a degree of volume flexibility. There is generally a charge applied in the event of a 10-20% variation of the annual contract quantity and this fee increases in proportion to amount of gas either above or below that threshold.

Several interviewed companies said that their gas supply contract did not include any penalty when lower or higher volumes were required, up to 100%, a trend which is prevalent in mature markets across northwest Europe.

Higher contracts flexibility has boosted the need for suppliers to balance their positions on the wholesale markets and this has contributed to the increase in liquidity on short-term products on the PSV market.

Italy is expected to implement the EU-wide balancing code in the next few months, which is designed to further increase the system's flexibility and to boost liquidity levels.

Buying directly on the wholesale market/trading

Less than 10% of interviewed industrial and commercial companies purchase volumes directly on the PSV or Dutch TTF hubs because of the heavy financial commitment associated to trading. A number of participants noted that the proportion of Italian industrial and commercial companies buying direct from the hub was similar to the situation in Germany about five years ago. Over the past five years the proportion of German industrial gas buyers procuring their yearly supply directly on the wholesale market either via brokers or on the exchange has grown significantly.

Some companies or regional consortia of smaller companies have begun to source their own volumes, usually via an energy procurement manager, directly on the wholesale market, but they still represent a small minority in the country. Those consortia or typically only buy PSV prompt volumes.

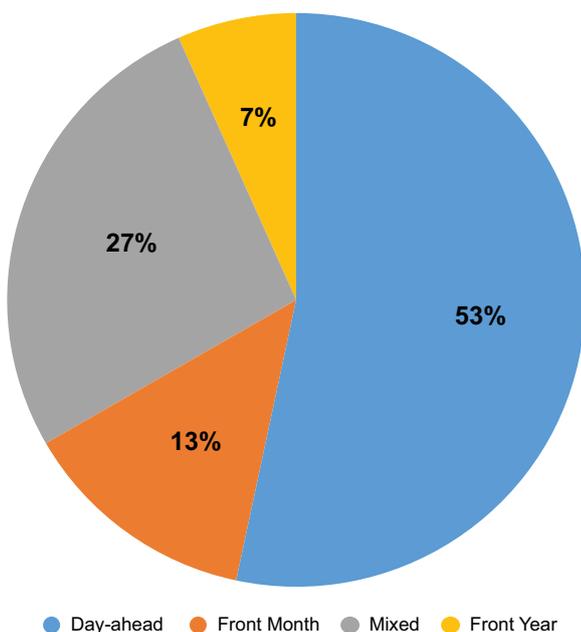
At the same time, a number of smaller buyers in this study have recently found ways to procure at the hubs without setting up their own trading desks. As the market is increasingly opening to competition, some suppliers now offer them framework contracts with high volume flexibility. Under these deals, customers are able to make their own buying decisions on the spot market, with the deals being executed through their supplier's trading desk.

For this reason, those industrial buyers monitor gas price movements at least once a day. In order to satisfy their customers' needs and more sophisticated requirements, some suppliers prepare daily or weekly reports with price information, outlooks and often give them the possibility to choose the preferred indexation, if they want so. However, compared with other more advanced European markets, i.e. the German market, this option remains still rarer in Italy.

Many of the interviewed industrial companies sign contracts that give them the possibility to change indexation for a period of supply, depending on market development or moving to a previously agreed fixed price.

Few of these buyers have access to an inactive broker screen or a supplier's live price platform, which cannot be used to execute deals but does show real-time price movements and enables them to react to short-term buying opportunities. Others rely on pricing information given to them by the supplier, while some follow price and market developments from independent providers such as ICIS, whose assessments and indices are used in reference prices across Europe and in Italy.

Figure 4: What period were your contracts indexed to in 2015?



Market Views

Moving away from oil-indexation

Generally, the interviewees were sceptical of the previously used concept of linking gas volumes to oil or oil products. The large Italian gas suppliers, which had oil-indexed gas supply contracts from a number of countries, i.e. Russia or Algeria, have been in process of renegotiating those contracts for the past few years.

For example, Italian incumbent Eni has indicated that it by 2016 it will fully align its gas supply costs to short-term market prices. All of the Italian industrial and commercial companies interviewed by ICIS had abandoned oil-indexation in their supply gas contracts already.

The sharp decrease in oil prices over the past 12 months has revived some interest among some interviewed companies, and while no companies polled by ICIS had a contract that was linked to oil, several suppliers said they would enter into an oil-indexed contract if requested by the client.

No supply worries

Security of supply – an argument used by producers who favoured long-term contracts – is not a big cause of concern for Italian gas buyers at present.

Italian gas and electricity demand has decrease in previous years, causing a bearish trend in Italian gas and electricity prices.

During 2014 gas consumption in Italy totalled 61.9 billion cubic meters (bcm), down 12% compared with 2013 as demand dropped from power plants, industrial plants and households.

However, according to forecasts from the country's transmission system operator, Snam Rete Gas, Italian gas demand is set to start rising again after a collapse over the past years or according to some suppliers' forecast Italian demand might remain stable. Snam predicted earlier this year that a recovering economy and more demand for gas to burn in the power generation sector will now push gas demand up again from this year to reach 76.6bcm in the next 10 years, rising about 2.1% every year until 2024. According to other views, gas demand in Italy might remain flat in the next few years.

Diversification of gas supply remains a priority both for Europe and the Italian government, which declared the Trans-Adriatic Pipeline (TAP), which will bring gas from Azerbaijan to Italy by 2020, as national priority. Italy, which also has pipelines to import gas from Algeria, Libya, Germany and Russia via Austria, aims to become a gas hub in the future, flowing gas to northern Europe.

Industrial gas buyers were generally happy about savings achieved so far because of price decrease and/or move to spot indexation in recent years and were not particularly worried about supply, although some of them noted that some tension between Russia and Ukraine last year boosted prices during 2014 commercial campaign. These residual concerns prompted some buyers to procure volumes for Winter '15 early, expecting that winter prices might rise again amid geopolitical tension. Ukraine said earlier this year that will buy gas from Europe rather than from Russia but at present is awaiting funding from international institutions to purchase its gas supply.

The regulator's aims to improve competition

According to the regulator, the decrease in gas demand and the progressive implementation of European legislation have changed Italian gas market dynamics. Availability of short-term transport capacity from northern Europe, changes to the balancing market and the reform to storage allocation method have so far contributed to the rise in PSV liquidity.

Italian energy regulator AEEGSI has singled out increasing PSV liquidity and improving flexibility of the Italian gas market as priorities in its 2015-2018 strategy.

The implementation of the European balancing network code in Italy (scheduled October 2015 but most likely subject to delays) will be a crucial factor for increasing PSV liquidity. The EU rules are expected to incentivise shippers to better balance their positions as well as improve quality and quantity of demand-supply information and expand gas system data forecasts.

Another reform implemented by the regulator for the increase in PSV liquidity was the reform of the variable component costs (CV) that the regulator can update in order to recover missing revenue, for example to repay local storage operator Stogit. Those fees used to apply to gas introduced into the network, including both imports and gas produced in Italy. The removal of some tariffs from entry points aimed to boost liquidity, as it would remove an additional cost of importing gas from northern Europe into Italy. The presence of those tariffs at entry points, especially when the CVs was raised to €0.85/MWh during winter 2014/2015, has been identified by participants as a deterrent from taking transport capacity and importing volumes into Italy from northern Europe as the PSV premium may not have been sufficient to cover all the tariffs at entry points plus entry point fee and transport costs. Moving some of those tariffs to exit points is expected to help avoid further wholesale price distortions and improve liquidity, as more shippers would try to flow gas from northern Europe into Italy.

According to the regulator, allowing exchanges other than GME offer physically-delivered gas futures will also improve liquidity and competition in the country's hub, as both ICE and PEGAS launched PSV physical products in September.

Outlook and conclusion

The interviewed companies were in solid agreement in seeing little or no future for oil-indexed contracts to return as the dominant procurement strategy among Italian buyers. Regarding their future procurement strategy, the majority of companies – over 50% – said they aim to focus on partial or total spot price-linked supply contracts from this or next year, which shows that spot indexation is an increasing dominant market trend.

The increasing reliance on wholesale gas prices suggests that the Italian trading hub will continue to grow. This study shows that gas buyers with direct access to the trading hubs are likely to increase the amount of gas procured at the hubs. However, it also suggests that those companies without direct access to the virtual trading points are currently unlikely to start implementing the necessary infrastructure, as suppliers offer framework contracts with little financial risk and high flexibility.

Regarding gas volumes tied into supply contracts, the results of this study clearly suggest that oil indexation will not have a future on the Italian gas market. Many companies aim to increase the percentage within their portfolio that is linked to hub prices. In this context, it can

be noted that confidence among participants in market liquidity at Italy's PSV trading point has been growing over the course of 2014 and 2015, and companies are increasingly linking their products to PSV rather than TTF prices, as the Italian hub's curve liquidity has risen.

Are you interested in more frequent gas price updates?

The ICIS European Spot Gas Markets (ESGM) report covers:



- The latest prices and expert analysis on the current day's trading
- Two decades of expertise in price reporting for natural gas
- Access the most widely traded and referenced prices across Europe's spot gas markets

For more Energy reports access www.icis.com/energy-reports



Join ICIS Tschach networking drinks on Tuesday, 10 November 2015

Sponsored by **eex**

ICIS Tschach Solutions is hosting a **training day** and **seminar** on the EU ETS. The two-day event takes place at the **Westin Palace in Milan, Italy** on **November 10-11**.

ICIS Tschach Training Day

Navigating through the noise - A practical framework to analyse carbon markets

Join the ICIS Tschach Solutions analyst team as they equip you with the insight you need to gain a competitive advantage in the carbon market. The training covers the key concepts and fundamentals to give you a more complete and incisive understanding of the EU ETS.

[Register your place today](#) ▶



ICIS Tschach Carbon Seminar

Post-2020 EU ETS - Business as usual or a brave new world?

Join the ICIS Tschach Solutions analyst team as they provide you with a 2015 market update and an insight into the Post-2020 EU ETS reform proposal. The key focus will be on the implications of the proposed legislation for Southern European EU ETS market participants.

[Register your place today](#) ▶



For more information visit: www.icis.com/energy-reports
 Contact: Stefan.Feuchtinger@icis.com | +49 (0) 721 205 96 29 28



Contacts

Ben Wetherall

Head of Gas, ICIS Energy

Email: ben.wetherall@icis.com

Tel: +44 20 7911 1786

Matilde Mereghetti

Senior Reporter, ICIS Energy

Email: matilde.mereghetti@icis.com

Tel: +44 (0)207 911 1890