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Discussion Papers

A Complementarity Model for the European Natural Gas Market

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A Complementarity Model for the European Natural Gas Market *

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Abstract:
In this paper, we present a detailed and comprehensive complementarity model for
computing market equilibrium values in the European natural gas system. Market play-
ners include producers and their marketing arms which we call "transmitters", pipeline
and storage operators, marketers, LNG liquefiers, regasifiers, tankers, and three end-use
consumption sectors. The economic behavior of producers, transmitters, pipeline and
storage operators, liquefiers and regasifiers is modeled via optimization problems whose
Karush-Kuhn-Tucker (KKT) optimality conditions in combination with market-clearing
conditions form the complementarity system. The LNG tankers, marketers and con-
sumption sectors are modeled implicitly via appropriate cost functions, aggregate demand
curves, and ex-post calculations, respectively. The model is run on several case studies
that highlight its capabilities, including a simulation of a disruption of Russian supplies
via Ukraine.

Keywords: European Natural Gas Market, Global LNG market, Mixed Complement-
arity Problem
JEL Code: C61, L95

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1. Introduction

Many European countries have only limited domestic reserves of natural gas, and are therefore dependent on a small number of pipeline exporters to secure their supplies via pipeline. This situation enables strategic producers to exert market power resulting in higher prices for a variety of consumers downstream, as was already analyzed in [51]. The dependence of importing countries on one or a few suppliers was in evidence in January of 2006 when Gazprom, the large Russian gas and oil company shut down gas owing to Ukraine due to contractual disputes ([52]-[62]; [68] provide an in-depth analysis).

By no means is strategic power of the producers limited to Gazprom. Other examples include the Algerian Sonatrach that supplies a large share of natural gas to Southern Europe (Italy, Spain), and the Norwegian gas export consortium Petoro (selling the gas produced by Statoil and Hydro) that supplies large parts of Northern Europe including Germany, France, Belgium and the UK. In addition to issues of supply security for the EU there are questions of power sector environmental constraints which generally favor natural gas over other fossil fuels, such as coal or oil.

The situation in the European natural gas market has changed considerably over the last few years with the advent of the technology of liquefaction of natural gas and the possibility to import large amounts of Liquefied Natural Gas (LNG) by tanker to Europe. Although LNG has been used since the 1960s as a way to transport natural gas over long distances to isolated marketplaces, its utilization until the end of the 1990s was mainly limited to supply Japan and South Korea. Several reasons explain the recent strong development of LNG in the Atlantic basin. Political and economic considerations of supply security favor diversification to decrease dependency on single (or few) external suppliers. Importing LNG is a way to diversify gas supplies away from pipelines and create more supply options. Another reason for the attractiveness of LNG are the still increasing economies of scale for LNG equipment ([8], [18]) that allow for increasingly cheaper long-distance transports. LNG also is an alternative to domestic production and pipeline imports in times of growing demand for natural gas and anticipated depletion of domestic resources either voluntarily (e.g., the Netherlands) or involuntarily (e.g., Canada). In the former case, the Netherlands has voluntarily chosen a production cap that sustains domestic independence for a longer period but limits the possibility for neighboring countries to import. Thus, while natural gas markets previously were continental (Europe, North America) due to accessibility of pipelines, the rise of LNG is creating one global market with, for example, the East Coast of the United States and Europe competing for LNG in the Atlantic Basin.

Consistent with the trend towards increasing reliance on LNG, many countries have policies in place which should stimulate the development of LNG infrastructure. Several of the European Commission’s (EC) priority projects in the Trans-European Energy Networks are LNG-related [14], [16], [17]. Figure 1 shows the anticipated increase in LNG import capacity by country expressed in billions of cubic meters (bcm) per year.¹ Major

¹The current five year horizon is 2006-2011. Aggregate capacity is shown for terminals for which con-
expected new regasification capacity (2011)
existing regasification capacity (2005)

+17.5
35
+16.5
15.5
+4.5
4.5
+8
+6
+20
6
+39
6.2
2.7
5.5

[bcm/y]

Figure 1. Existing and anticipated LNG import capacities in Europe [bcm/year]

increases will be seen in the United Kingdom (+39 bcm), Italy (+20 bcm), Spain (+17.5 bcm) and France (+16.5 bcm).

The United States has traditionally relied on natural gas imports by pipeline from Canada, in addition to its domestic production. But LNG constitutes an increasing share. The U.S. imported 17.87 bcm of LNG in 2005, almost three times as much as the LNG imports in 2000 ([5], [7]). Declining domestic production in the United States and Canada will need to be replaced, and the U.S. will increasingly rely on LNG to fill the gap [19]. With several provisions in the Energy Policy Act of 2005 [21] the United States aims to encourage the development of the domestic infrastructure for importing LNG. Currently, the U.S. has five regasification terminals in place with total regasification capacity of 52 bcm/year; soon there will be eight. According to the U.S. Federal Energy Regulatory Commission (FERC) [24], there are plans for 31 more, not all of which may be built though due to strong societal opposition.

Besides natural gas importing countries, exporting countries also have clear incentives to increase the share of LNG in their natural gas portfolio, seeking demand security and benefiting from the potential high profits in the LNG supply chains [18]. Between 1997 and 2002 the number of LNG exporting countries rose from nine to 12, and total shipped volumes increased by more than 40% in that period. Egypt started LNG exports in 2002, Norway and Russia are expected to start exporting LNG exports in short term, possibly soon making a total of 15 LNG exporting countries.

construction has started, or is expected to begin by 2008. Data are from several sources, including [47], [65].
Figure 2. Global natural gas consumption and trade in 2000 and 2005 [bcm/year]

Figure 2 shows that between 2000 and 2005 world wide natural gas consumption increased by 13% ([5], [7]). In the same period, the share of internationally traded gas in total consumption rose from 21.6% to 26.2%. Natural gas trade by pipeline increased by 37%, LNG trade by 38%. In the years to come, LNG is expected to outpace the growth in pipeline trade by far, accounting for possibly more than half of interregional gas trade by 2030 [46].

In this paper, we present a new, detailed model of the European natural gas market which accounts for the issues of market power of exporters and of globalizing natural gas markets with LNG trade. Besides a disaggregated representation of the European market, we cover all relevant pipeline exporters to Europe (Russia, Caspian Region, North Africa, Middle East) and all LNG exporters globally (North and Sub-Saharan Africa, Middle East, South-East Asia, Australia and Latin America) as well as all other LNG importing regions in the world. This allows us to analyze possible substitution effects between pipeline and LNG exporters on the one hand, and competition of demand between different LNG importing countries on the other hand.

The market participants being modeled include: producers and their marketing and trading arms which we call "transmitters," ² pipeline and storage operators, LNG liquefiers, regasifiers, tankers, marketers (implicitly), and consumers in three sectors (residential/commercial, industrial, and power generation) via their aggregate inverse demand functions. These players, except for LNG tankers, marketers and consumers, are modeled via convex optimization problems, whose Karush-Kuhn-Tucker (KKT) optimality conditions [2] are both necessary and sufficient for global optimality. Necessity follows.

²Transmitters do not take care of pipeline or other gas transportation issues. Their function is to market the gas produced by their production company counterparts.
due to the polyhedrality of the feasible regions and sufficiency due to the convexity of the objective functions and the polyhedral feasible regions. Collecting these KKT conditions for all the players and combining them with market-clearing conditions constitutes an instance of a nonlinear complementarity problem (NCP) or variational inequality problem (VI) referred to as complementarity problem [23]. The optimization problems of the players are typically profit maximization objectives subject to operational constraints, e.g., production rates. In all cases, except for the transmitters, players are price-takers in the production, transportation, LNG, and storage markets.

Only the transmitters, being the pipeline sales end of the production companies that interface with downstream markets, can exert market power. They are modeled as being able to behave strategically in multiple countries accessible by pipeline from the producing country (possibly via transit countries). Modeling the transmitters as separate entities can be seen as anticipating European Commission decisions striving for legal unbundling of the various parts in the natural gas supply chain. This is a change compared to [13] where the production companies were modeled as vertically integrated comprising both production and sales functions. However, it is important to note that the model set-up presented allows for representing vertically integrated production and trading companies where the latter are (legally) unbundled from the former. Lastly, the transmitters are a convenient mechanism that allows for proper accounting of transportation charges instead of using aggregate pipelines between production and consumption markets with no transit nodes as was the case in [29]. LNG tankers and consumers are modeled implicitly by cost and aggregate inverse demand functions, respectively.

To our knowledge, the concept of international traders (the transmitters) operating separately from producers has not been used in other natural gas market models. Modeling transmitters as separate players increases model transparency by clearly separating the production and the sales/export operations via pipeline of the production companies which are characterized by different operational costs and constraints. These players can be seen in the actual market: for example, the trading business of gas companies like Gazprom or GasTerra (Netherlands) is done by separate affiliates from the production companies; by Gazexport in the Russian case, by GasTerra in the Dutch case. Especially in the European Union, legal requirements have led to the separation ( unbundling) of production and trade operations of companies. Although these separate units may still belong to the same holding company, each affiliate has its own operations and optimization problem under different constraints. We take account of the fact that the production and the trade operations could be part of the same company by not modeling any strategic behavior or bargaining between these two operations. The producer sells natural gas to the transmitter at a competitive (marginal cost) price. On the other hand the transmitter, the player operating in international natural gas markets, may behave strategically vis-à-vis its competitors, the other transmitters.

A similar rationale of modeling an activity separately that may be executed within the same company is generally applied to the pipeline operation that is done by an indepen-

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3 Other major changes are the detailed representation of all agents in the LNG supply chain, the incorporation of all countries in the world involved in LNG imports and exports and a thorough update of the input database.
dent but perfectly competitive pipeline operator. Traditionally, in Europe the pipeline grid belonged to integrated production or wholesale trade companies. But the recent liberalization efforts of the European Commission have led to separation (unbundling) of the pipeline operation from production and/or trade. The interaction between the transmitters and the pipeline operators is such that the pipeline operators allocate transport capacity to transmitters that need to transport gas to their consumer markets.

While complementarity models of natural gas markets have been formulated and developed with real or realistic data before, e.g., [13], [37], [34], [1], [26], [29], [4], [50], [38], the one presented in this paper distinguishes itself by its level of detail relative to the number and variety of players, the number of seasons (three seasons: low demand, high demand, and peak), as well as the number of countries modeled (52). In this respect, the model we present is approaching the level of detail of the Rice University World Gas Trade model [36], or the Gas Systems Analysis Model (GSAM) for North America ([28], [27]). This level of detail with a representation of the global LNG market and combined with the strategic behavior of the producers (via their transmitters) is unique and represents the main contribution of this work. The second contribution is the use of this model to analyze a series of geopolitical and market-based cases. One scenario involves the curtailment of gas supplies to Ukraine by Gazprom motivated by actual events in January, 2006. The other cases include: a perfect competition relaxation for the producers (transmitters), a shut-off of the relatively inexpensive gas that comes from Algeria, and a case relating to capacity expansions in LNG and pipeline capacity corresponding approximately to the year 2011. 4 Lastly, the base year of the simulations was taken as 2004.

The rest of this paper is organized as follows: in Section 2 we describe the complementarity model derived from the optimization problems and market-clearing conditions; in Section 3 we discuss the numerical results of the case studies, Section 4 provides conclusions, and lastly, an Appendix provides key data and modeling details.

2. Model Formulation

The economic behavior of the market participants in the natural gas sector is modeled by optimization problems for each of the players and market-clearing conditions linking them. The players are: producers, transmitters, liquefiers, regasifiers, storage operators, marketer/shippers (hereafter referred to as marketers and implicitly modeled), and consumers in three sectors (residential/commercial, industrial, and electric power generation). A schematic overview of the gas network and market participants is depicted in Figure 3. The countries (or nodes) are the ovals surrounding the players for that node. Also, the consumption sectors are shown as a triangle. In this figure, the following players can be distinguished:

- Producers \((C_1, C_3)\) located at a production node (could be more than one per country)

4The scenarios involving disruptions for Ukraine or Algeria have also been analyzed in [70], for the year 2030. However, the current model has a greater level of detail and includes seasonality aspects, in comparison with [70].
Transmitters ($T_1, T_3$) operating at production, transit and consumption nodes (one per producer)

- LNG Liquefiers ($L_1$) (could be more than one per country)

The following players are active at the consumption nodes only:

- LNG Regasifiers ($R_3$) (could be more than one per country)
- Storage operators ($S_1, S_3$) (could be more than one per country)
- Marketers ($M_1, M_3$) (one per country)
- Consumers ($K_1, K_2, K_3$) respectively, for the residential/commercial, industrial, and electric power sectors.

International pipeline flows are depicted via inter-country arcs whereas LNG tankers routes are described by arcs between liquefiers and regasifiers. At the production nodes, there is local gas transport from the producers to their transmitter and, possibly, to any liquefier. For example, in Figure 3, all flows originating from C1 are depicted as solid lines, flows from C3 as dashed lines. At the consumption nodes, gas flows from the transmitters to the storage operators and marketers, where transportation is defined.
to be on the local (i.e., national grid). Flows into and from storage are indicated with a diamond shape at the start of the arrow. The marketers are the only interface with the three consumption sectors and receive gas from producers via the transmitters (using pipelines) or via the regasifiers in each of the three seasons, and from the storage operators in the withdrawal seasons (2 and 3, for high and peak demand, respectively). Flows to final consumption sectors are indicated with an oval shape at the start of the arrow. Transmitters or regasifiers supply storage operators in the low demand season (1) when there is injection into storage. In what follows, volumes are generally denoted in kcm, or $1000 \, m^3$, and prices are in €/kcm. The general notation with respect to nodes and time periods is:

- $Y$ is the set of years, $y \in Y$
- $D$ is the set of seasons, $d \in D$
- $days_d$ is the number of days in season $d$
- $N$ is the set of nodes, $n \in N$

where $|Y| = 1$ for this paper unless otherwise stated. The number of days per season and set of seasons are user-defined (see Appendix C), and the set of nodes includes all countries of the European pipeline and the global LNG market (see Appendix A). We next describe the specific optimization problems faced by the market participants and the complementarity problem that results.

2.1. Producers

Each production company located at a node is modeled as choosing gas production rates so as to maximize its net profit over the time horizon. The net profit is the difference between seasonal revenue and seasonal costs, summed over all seasons and years. This objective is subject to constraints on production rates, total production volume, and nonnegativity of the quantity produced. This is an approximation to the very complicated spatial and temporal dependencies that can exist. In particular, as described in [27] and [28], one would need to take into account reservoir variables such as porosity, permeability, thickness, production in previous time periods, rig movements between regions, etc.; see [9] for a discussion of relevant petroleum engineering principles. The total cost function takes into account all the expenses associated with producing at a given rate. As producing at a higher rate should require more resources (machines, personnel, etc.) it is reasonable to assume this function to be non-decreasing and convex. The producers are modeled as price-takers in a perfectly competitive environment. The complete optimization problem for producer $p$ is thus:
\[
\max_{\text{SALES}_{\text{pdy}}} \sum_{d \in D} \sum_{y \in Y} \text{days}_d \left[ (\pi_{n(p)dy})^P \cdot \text{SALES}_{\text{pdy}}^P - c_p^P \left( \text{SALES}_{\text{pdy}}^P \right) \right] 
\]
\[\text{s.t.} \quad \text{SALES}_{\text{pdy}}^P \leq PR_{p}^P \quad \forall d, y \quad (\alpha_{\text{pdy}}^P) \]
\[\sum_{d \in D} \sum_{y \in Y} \text{days}_d \cdot \text{SALES}_{\text{pdy}}^P \leq PROD_p \quad (\beta_p) \]
\[\text{SALES}_{\text{pdy}}^P \geq 0 \quad \forall d, y \quad (4)\]

where

- the “P” superscript means for all producers, not for a specific one (similar notational concepts for other players)
- \(P\) is the set of all producers in the network, \(p \in P\)
- \(P(n)\) is the set of producers located at node \(n\)
- \(n(p)\) is the node where producer \(p\) is located
- \(c_p^P(\text{SALES}_{\text{pdy}}^P)\) is the production cost function for producer \(p\), following [34],[4], and [13] (€/volume/day)
- \(PR_{p}^P\) is the upper bound on the production rate for producer \(p\) (volume/day)
- \(PROD_p\) is the total production forecast for the time horizon (volume)
- \(\pi_{n(p)dy}^P\) is the selling price of gas for producer \(p\) in season \(d\) and year \(y\) (€/volume) (exogenous to producers but a variable in the overall complementarity system)
- \(\text{SALES}_{\text{pdy}}^P\) is the decision variable for the rate of gas sold by producer \(p\) to the transmitter at the same node in season \(d\) and year \(y\) (volume/day)\(^5\)

Note that the Greek letters shown in parentheses besides the constraints are the associated dual variables (Lagrange multipliers). The dual variables associated with inequalities (hence nonnegative in sign) will be \(\alpha, \beta,\) or \(\gamma\) with appropriate super- and subscripts. By contrast, free variables associated with equality constraints to an objective function (see for example in the transmitters problem in (10)) will be denoted as \(\phi\) with appropriate super- and subscripts. Lastly, all prices that are determined by market-clearing conditions outside of the individual optimization problems (hence, exogenous to these problems) will be denoted as \(\pi\) with appropriate super- and subscripts except for the inverse demand function \(\pi_{n(p)dy}^W\), which is under the strategic influence of the transmitters. Since the wellhead prices are exogenous to the producers, the producer problem (1)-(4) is a convex program as long as the cost function is convex, which, as stated above is a reasonable

\(^5\)Note that LNG liquefiers buy directly from the producers and that the market-clearing condition for production includes a term denoting the purchases by the liquefier from the producer at the same node.
approximation to reality. As such, the KKT conditions are both necessary and sufficient
for optimality.

These conditions are shown below but for ease of presentation have been divided by
period lengths \((\text{days}_d)\), resulting in a more compact formulation but not affecting the
numerical results, except for a scaling factor for the duals in question. For example,
consider the following two inequalities providing the same restriction on the daily sales
rate, but with different scales for the dual variable \(\alpha_{pdy}\).

Consider first what is stated
above, i.e., \(\text{SALES}^{P}_{pdy} \leq \text{PR}^{P}_{p}\). This constraint, scaled with the period lengths becomes
\((\text{days}_d)\left(\text{SALES}^{P}_{pdy}\right) \leq (\text{days}_d)\left(\text{PR}^{P}_{p}\right)\). The dual variable \(\alpha_{pdy}\) for this latter equation
expresses the marginal value of an extra unit in production rate for the whole period,
whereas the dual variable \(\alpha_{pdy}\) of the previous expression gives the marginal value of an
extra unit in production rate for every day in the period. A similar reasoning applies to
the KKT conditions for the other parts of the overall complementarity system. Thus, the
KKT conditions for the producers are the following:

\[
0 \leq \left[ -\left(\pi_{n(p)dy}^{P}\right) + \frac{dc^{P}_{p}}{d\text{SALES}^{P}_{pdy}} + \alpha^{P}_{pdy} + \beta^{P}_{p} \right] \perp \text{SALES}^{P}_{pdy} \geq 0 \ \forall d, y \tag{5}
\]

\[
0 \leq \text{PR}^{P}_{p} - \text{SALES}^{P}_{pdy} \perp \alpha^{P}_{pdy} \geq 0 \ \forall d, y \tag{6}
\]

\[
0 \leq \text{PROD}^{P}_{p} - \sum_{y \in Y} \sum_{d \in D} \text{days}_d \text{SALES}^{P}_{pdy} \perp \beta^{P}_{p} \geq 0 \tag{7}
\]

In addition, one must consider market-clearing conditions that state that the supply
of gas for a production region equals the demand for gas being sent to the transmitter
and/or the LNG liquefier. The associated dual variables are the wellhead prices.

\[
0 = \text{SALES}^{P}_{pdy} - \text{PURCH}^{T\rightarrow P}_{(p)n(p)dy} - \sum_{l \in L(p)} \text{PURCH}^{L\rightarrow P}_{ldy}, \pi^{P}_{pdy}(\text{free}) \ \forall d, p, y \tag{8}
\]

where

- \(\text{PURCH}^{T\rightarrow P}_{(p)n(p)dy}\) is the is the decision variable for purchases by the transmitter from
  the producer (volume/day)

- \(\text{PURCH}^{L\rightarrow P}_{ldy}\) is the is the decision variable for purchases by the liquefiers from their
  producer (volume/day)

2.2. Transmitters

A transmitter operates for one producer and represents the gas trading arm of the
production company. This approach is consistent with having production and trading
carried out by separate parts of the same overall organization or by legally separate
entities. In any event, each transmitter is dedicated to a producer and a transmitter
purchases gas only from its own producer and then sells the gas, possibly by exporting
the gas to other countries. We distinguish two types of transmitters:
1. Transmitters operating only at the domestic node of the producer, in case it is a small producer and doesn’t export any gas. Previous papers usually refer to this production as exogenous production, e.g., [4].

2. Transmitters that can operate at any consumption node that can be reached via pipelines through transit nodes from their own producer’s node. An example is Norway, both a gas producing and exporting country. The transmitter associated with the Norwegian producer will be present in European consuming countries such as the Netherlands, the United Kingdom, Belgium, France, Germany, Poland, Austria, Italy, etc., but will not be present in:
   a. Algeria, because Algeria is not a consumption node in the model
   b. Japan, because Japan can’t be reached by pipeline from Norway
   c. Tunisia, because Tunisia is only a relevant transit country from Algeria into Europe.

The transmitter is modeled as maximizing its net profit subject to balance equations (flow conservation constraints in each node) as well as nonnegativity constraints on its variables. The revenues are derived from the sales to marketers \(SALES^{T \rightarrow M}_{ndy}\) and to storage operators \(SALES^{T \rightarrow S}_{ndy}\). To determine the revenues, the sales to the storage operators are multiplied by the market-clearing price \(\pi^{T}_{ndy}\). The sales to the marketers are multiplied by a convex combination of the price determined by the inverse demand function \(\Pi^{W(T)}_{ndy}(\cdot)\) or by the market-clearing wholesale price \(\pi^{W}_{ndy}\) if no market power is exerted.

This convex combination of the price is determined by the market power constant for the transmitter \(t\), \(\delta^{C}_{t} \in [0, 1]\) where \(\delta^{C}_{t} = 0\) means no market power and \(\delta^{C}_{t} = 1\) means that the transmitter is a full Cournot player. Since traders in the natural gas market can and may exert different levels of market power, not captured by the theoretical concepts of perfect competition or Cournot behavior, other values for \(\delta^{C}_{t}\) are allowed. Although market power values between 0 and 1 have been used before (in [71] it is called degree of competition) there is no literature describing the precise meaning of other values than 0 or 1 for the market power constant. To prevent discussion about arbitrary values with several digits, we limited ourselves to a small yet representative set of values: \(\{0, 0.25, 0.5, 0.75, 1\}\) and determined the actual values during the model calibration.

The costs to the transmitter include purchasing the gas from the producer \((\pi_{p(t)}^{P}_{ndy}PURCH^{T \rightarrow P}_{ndy})\) as well as the transportation charges given by \(\sum_{(n,m) \in A(t)}(\tau^{A}_{nmdy} + \tau^{Reg}_{nmdy})\) where

- \(FLOW^{T}_{nmdy}\) is the decision variable for the rate of gas transported by transmitter \(t\) from node \(n\) to neighboring node \(m\) in season \(d\) and year \(y\) (volume/day)
- \(\tau^{A}_{nmdy}\) is the congestion fee of the arc \((n, m)\) in season \(d\) and year \(y\) (\(\mathbb{E}/\)volume), determined by the pipeline operator’s problem
- \(\tau^{Reg}_{nmdy}\) is the regulated pipeline transportation costs for the arc \(a\) from \(n\) to \(m\) in season \(d\) and year \(y\) (\(\mathbb{E}/\)volume)
A(t) is the set of arcs \((n, m)\) that transmitter \(t\) could use. \(A(t) := \{(n, m) : t \in T(n, m)\}\)  

\(loss_{nm}\) is the loss factor for the arc \(a\) from \(n\) to \(m\)

Anticipating EU regulations, we assume complete Third Party Access to the international pipeline network. Hence, any transmitter can contract transmission capacity with any pipeline. To introduce seasonality of storage use, an indicator \(\text{low}_d\) is used.

\[\text{low}_d = 1\] if \(d = 1\), the low-demand season (injection into storage), and 0 otherwise.

Thus, the optimization problem for transmitter \(t\) is as follows:

\[
\max \sum_{y \in Y} \sum_{d \in D} \sum_{n \in N(t)} \text{days}_d \left[ \sum_{(n,m) \in A(t)} \left( \tau^a_{nm\text{dy}} + \tau^{\text{Reg}}_{nm\text{dy}} \right) FLOW^T_{tnm\text{dy}} \right]
\]

s.t.

\[
\left[ \delta^{\text{low}}_d \cdot \text{SALES}^T_{tn\text{dy}} - \text{SALES}^T_{tn\text{dy}} - \text{FLOW}^T_{tnm\text{dy}} \right] - \sum_{m \in N} \left( 1 - loss_{mn} \right) FLOW^T_{tnm\text{dy}} = 0 \quad \forall n \in N(t), d, y \quad (\phi^T_{tn\text{dy}})
\]

\[
\text{SALES}^T_{tn\text{dy}} \geq 0 \quad \forall n, d, y \quad (11)
\]

\[
\text{SALES}^T_{tn\text{dy}} \geq 0 \quad \forall n, y \quad (12)
\]

\[
\text{PURCH}^T_{tn\text{dy}} \geq 0 \quad \forall n = n(p(t)), d, y \quad (13)
\]

\[
\text{FLOW}^T_{tnm\text{dy}} \geq 0 \quad \forall (n, m) \in A(t), d, y \quad (14)
\]

with the additional definitions that:

- \(T\) is the set of transmitters, \(t \in T\)
- \(p(t)\) is the producer for which transmitter \(t\) is the trading agent
- \(N(t)\) is the set of nodes where transmitter \(t\) is present
- \(T(n)\) is the set of transmitters \(t\) present at node \(n\)
- \(T(n, m)\) is the set of transmitters \(t\) that can use arc \((n, m)\), \(T(n, m) := \{ t \in (T(n) \cap T(m)) \}\)

\(^6\)Here, arc \((n, m)\) is the unique link between one node and another one, for notational simplicity, we use \(a\) to denote arcs when interpretation is unambiguous.
• \( PURCH^{T-P}_{n_{dy}} \) is the decision variable for the rate of gas bought by transmitter \( t \) from its producer \( p(t) \) located at node \( n \in (N(t) \cap N(p)) \) in season \( d \) and year \( y \) (volume/day)

By influencing the inverse demand function \( \Pi^W_{n_{dy}}(\cdot) \) the producer via its transmitter, can exert market power by withholding supplies to downstream customers. In particular, we posit that this inverse demand function is linear and has the following form:

\[
\Pi^W_{n_{dy}} = INT^M_{n_{dy}} - SLP^M_{n_{dy}} - \sum_{t' \in T(n): t' \neq t} \text{SALES}^{T-M}_{n_{dy}} + \left( 1 - \delta^\text{low}_d \right) \sum_{s \in S(n)} \text{SALES}^{S-M}_{n_{dy}} + \text{SALES}^{R-M}_{n_{dy}} + \left( 1 - \delta^\text{low}_d \right) \sum_{s \in S(n)} \text{SALES}^{S-M}_{n_{dy}}
\]

where \( INT^M_{n_{dy}} \) and \( SLP^M_{n_{dy}} \) are the intercept and slope constants for this linear function and \( \text{SALES}^{T-M}_{n_{dy}}, \text{SALES}^{R-M}_{n_{dy}} \) represents the total sales from the transmitter and other transmitters to the marketers as well as sales coming from the regasifiers and storage operators, respectively. Only the sales from the transmitter, \( \text{SALES}^{T-M}_{n_{dy}} \), are variables in the transmitter’s optimization problem above. The other variables are treated as exogenous by the transmitter.

The KKT conditions for the transmitter’s problem as well as for the other players are presented in Appendix B. To determine the price \( \pi^T_{n_{dy}} \), market-clearing conditions are also included. It is only the storage operators in the low demand season that require a market-clearing condition (with the transmitters having market power over the marketers). For the storage market, in the low demand season, these market-clearing conditions take the form:

\[
0 = \sum_{t \in T(n)} \text{SALES}^{T-S}_{n_{dy}} - \sum_{s \in S(n)} PURCH^{S-T}_{n_{dy}} + \pi^T_{n_{dy}} \text{ (free) } \forall n \in N(t), y
\]

### 2.3. LNG Liquefiers

LNG liquefiers receive natural gas from the producers, liquefy the gas and then send it to downstream regasifiers by LNG tankers. The liquefiers maximize their net revenue by deciding on how much to sell to regasifiers \( \text{SALES}^L_{n_{dy}} \) and how much to purchase from the producers \( PURCH^L_{n_{dy}} \). For a particular season and year, their revenue is given by the term \( \text{days}_d \left( \frac{\pi^L_{n(1)dy}}{\pi^L_{n(1)dy}} \right) \text{SALES}^L_{n_{dy}} \) from which is subtracted their purchasing costs \( \pi^P_{n(1)dy} PURCH^L_{n_{dy}} \), distribution costs \( \text{days}_d \mu^L_{dy} PURCH^L_{n_{dy}} \), and transmission costs using the tankers \( c^T_i(\text{SALES}^L_{n_{dy}}) \) where

- \( L \) is the set of LNG liquefiers, \( l \in L \)
\( L(n) \) is the set of LNG liquefiers located at node \( n \)
\( L(p) \) is the set of LNG liquefiers buying from producer \( p \)
\( n(l) \) is the node where LNG liquefier \( l \) is located
\( p(l) \) is the producer \( p \) from which LNG liquefier \( l \) can buy
\( c^L_l(\text{SALES}^L_{ldy}) \) is the liquefaction cost function of LNG liquefier \( l \) (\( \text{\euro}/\text{volume/day} \))
\( u^L_{P-l} \) are the unit distribution costs for producer \( p \) to LNG liquefier \( l \) (\( \text{\euro}/\text{volume/day} \))

Note that both the selling price of gas, \( \pi^L_{n(l)dy} \) as well as the buying price from the producer \( \pi^P_{n(p(l))dy} \), are exogenous to the price-taking liquefier but are variables in the overall complementarity problem. \( \text{SALES}^L_{ldy} \) and \( \text{PURCH}^L_{ldy} \) are the decision variables of the LNG liquefier. The optimization of net revenues is subject to liquefaction capacity constraints as well as balancing and nonnegativity restrictions. Consequently, the full problem can be stated as follows:

\[
\max_{\text{SALES}^L_{ldy}, \text{PURCH}^L_{ldy}} \sum_{y \in Y} \sum_{d \in D} \text{days}_d \left[ (\pi^L_{n(l)dy}) \text{SALES}^L_{ldy} - \pi^P_{n(p(l))dy} \text{PURCH}^L_{ldy} \right] \\
- \sum_{y \in Y} \sum_{d \in D} \text{days}_d u^L_{P-l} \text{PURCH}^L_{ldy} + c^L_l(\text{SALES}^L_{ldy}) \\
\text{s.t.} \quad \text{SALES}^L_{ldy} \leq \text{LQF}^L_l \quad (\alpha^L_{ldy}) \quad \forall d, y \\
(1 - \text{loss}_l) \text{PURCH}^L_{ldy} - \text{SALES}^L_{ldy} = 0 \quad (\phi^L_{ldy}) \quad \forall d, y \\
\text{SALES}^L_{ldy} \geq 0 \quad \forall d, y \\
\text{PURCH}^L_{ldy} \geq 0 \quad \forall d, y 
\]

where

\( \text{LQF}^L_l \) is the upper bound on the LNG liquefaction rate for LNG liquefier \( l \) (volume/day)
\( \text{loss}_l \) is the liquefaction loss factor for LNG liquefier \( l \) (\%)

In the liquefaction market, the total supply of liquefied gas at a node match the total demand by all regasifiers. This market-clearing condition is:

\[
0 = \sum_{l \in L(n(l))} \text{SALES}^L_{ldy} - \sum_{b : n(b) = n(l)} (1 - \text{loss}_b) \text{PURCH}^R_{b-l} \pi^L_{n(l)dy}(\text{free}) \quad \forall d, y
\]
2.4. LNG Regasifiers

The modeling of the regasifiers is similar to the concept of the peak gas operator in the North American market as presented in [26] and [29]. There, the peak gas operators are modeled with production bounds and are active only in the peak demand season. We now take account of the new situation on the global natural gas markets where LNG has become part of the gas supply mix throughout the year. Hence, we model the regasifiers as being active in every season. They are the downstream interface with the liquefiers and are a new player compared to previous models ([26],[29],[4],[13],[38]). Modeling both types of players allows us to represent the entire LNG value chain, with the LNG tankers activity represented by the arcs between the liquefiers and the regasifiers.

The regasifiers maximize their net revenue by deciding how much re-gasified natural gas to sell to the storage operators $SALES_{rdy}^{R-S}$ (in the low-demand season) and to the marketers $SALES_{rdy}^{R-M}$ (in all seasons), and how much to purchase and transport from the liquefiers $PURCH_{bdy}^{R-L}$. The regasifiers problem implicitly includes the LNG transportation problem of tanker utilization, which is subject to tanker operation costs ($u_{b}^{R-L}$) ($PURCH_{bdy}^{R-L}$) and losses ($loss_{b}$) ($PURCH_{bdy}^{R-L}$). These and the other costs incurred from the LNG purchases \((\pi_{n(b)dy}^{L})\) ($PURCH_{bdy}^{R-L}$) and regasification operations \((r_{r}^{R}(SALES_{rdy}^{R}))\) are subtracted from the regasifier’s revenue. We assume the regasification cost function to be convex, based on a somewhat similar argument made for the producers. The regasification operations are constrained by a limited regasification rate per day ($REG_{r}^{R}$), and is subject to losses ($loss_{r}$). The sets and indices in this optimization problem are the following:

- $B$ the set of boats (arcs), $b \in B$ [unlimited marine capacity and fixed distribution charges are assumed]
- $B(n)$ the set of boats shipping to node $n$
- $n_{e}(b)$ the destination (end) node of boat (arc) $b$
- $n_{s}(b)$ the origin (source) node of boat (arc) $b$
- $n(r)$ the node where LNG regasifier $r$ is located;
- $R$ the set of LNG regasifiers, $r \in R$
- $R(n)$ the set of LNG regasifiers located at node $n$.

Note that, here again, the selling prices of natural gas ($\pi_{n(r)dy}^{W}$ for the wholesale price and $\pi_{n(r)dy}^{R}$ for the price of sales to storage) as well as the buying price from the liquefiers ($\pi_{n(b)dy}^{L}$) are exogenous to the regasifiers optimization problems because they are determined in the market-clearing conditions with the players from the "adjacent" markets. The optimization problem for regasifier $r$ involves choosing the values for $SALES_{rdy}^{R-M}$,
SALES_{rd_y}^{R-S}$ and PURCH_{bd_y}^{R-L}$ to maximize net profits subject to regasification rates, material balance, and nonnegativity constraint, that is:

$$\max \sum_{y \in Y} \sum_{d \in D} \text{days}_d \left[ - \sum_{\text{bcn}_n(b)=n(r)} \pi_{n(b)dy}^L \left( \pi_{n(b)dy}^L + u_{b}^{R-L} \right) \text{PURCH}_{bdy}^{R-L} - c_r^{R} \left( \text{SALES}_{rd_y}^{R-M} + \text{SALES}_{rd_y}^{R-S} \right) \right]$$

s.t. $\text{SALES}_{rd_y}^{R-M} + \text{SALES}_{rd_y}^{R-S} \leq \text{REG}_{r}^{R} \forall d, y \left( \phi_{rdy}^R \right)$ (23)

$$\sum_{\text{bcn}_n(b)=n(r)} \left( 1 - \text{loss}_r \right) \left( 1 - \text{loss}_b \right) \text{PURCH}_{bdy}^{R-L}$$

$$\text{SALES}_{rd_y}^{R-M} \geq 0 \forall d, y \left( \phi_{rdy}^R \right)$$ (24)

$$\text{SALES}_{rd_y}^{R-S} \geq 0 \forall d = 1, y$$ (25)

$$\text{PURCH}_{bd_y}^{R-L} \geq 0 \forall b : n_e(b) = n(r), d, y$$ (26)

The total supply for regasified natural gas must match the demand for it at each node. This equality is enforced by market-clearing conditions. As far as sales to marketers are concerned, this is taken care of in the inverse demand functions of the marketers. The market-clearing conditions between the regasifier and the storage operator in the low demand injection season are:

$$0 = \sum_{\text{rR}_{ry}} \text{SALES}_{rd_y}^{R-S} - \sum_{\text{sS}_{sy}} \text{PURCH}_{sy}^{S-R} \pi_{n1y}^R \text{(free)} \forall n, y$$ (28)

where $\text{PURCH}_{sy}^{S-R}$ is the decision variable for the storage operator’s purchases from the regasifier.

2.5. Storage Operators

The storage operators are modeled similarly to the equivalent players in [26] and [29] with the exception that they are now supplied by regasifiers, too. The storage operators buy gas from the transmitters ($\text{PURCH}_{sy}^{S-T}$) or regasifiers ($\text{PURCH}_{sy}^{S-R}$) and inject it into storage in the low demand season. They withdraw gas and sell it to the marketers ($\text{SALES}_{sy}^{S-M}$) in the two other, high demand seasons. This seasonal pattern of storage operation is a standard assumption in the modeling literature (e.g., [71]). The modeling of storage operators as actual natural gas traders, that are not only trading capacities but the gas itself, corresponds to the business model of many independent storage operators in Europe and especially in the UK. In our model, storage is used for the inter-seasonal arbitrage of demand, which implies that all gas that is injected in the low-demand season is withdrawn in the high-demand seasons.

In each season, the storage operator maximizes its profit which is the sum of revenue from sales ($\pi_{n(s)dy}^W \left( \text{SALES}_{sy}^{S-M} \right)$) subtracted from the total costs. Total costs include the
costs of purchasing the gas \(((\pi_{n(s)}^{T})_{1y} + u_{n}^{S-T})PURCH_{ST}^{S-T} + (\pi_{n(s)}^{R})_{1y} + u_{n}^{S-R})PURCH_{SR}^{S-R}\),

the costs of operating the storage facility \(c_{s}(PURCH_{ST}^{S-T} + PURCH_{SR}^{S-R})\),

assumed to be a convex function, and the costs of transporting the gas to the storage from the transmitters and from the regasifiers \((u_{n}^{S-T})(PURCH_{ST}^{S-T}) + (u_{n}^{S-R})(PURCH_{SR}^{S-R})\).

The storage operator’s optimization problem is then to select values for the decision variables \(PURCH_{ST}^{S-T}\), \(PURCH_{ST}^{S-R}\) and \(SALES_{sdy}^{S-M}\) subject to a number of technical constraints, such as upper bounds on the daily injection rate \((INJ_{s})\), daily withdrawal rate \((EXT_{s})\) and on the working gas volume \((WRKG_{s})\), which can be considered as the storage capacity\(^7\). The following sets and indices are used in the storage operator’s optimization program:

- \(S\) the set of storage operators
- \(S(n)\) the set of storage operators located at node \(n\)
- \(n(s)\) the node where the storage operator \(s\) is located

As the storage operators are assumed to behave competitively vis-à-vis their upstream and downstream markets, they are price-takers for the purchase prices \((\pi_{n(s)}^{R})_{dy}\) and \((\pi_{n}^{T})_{ndy}\) and the selling prices to the marketers \((\pi_{n(s)}^{W})_{dy}\). The interaction with the upstream and downstream markets is modeled in the market-clearing conditions with the regasifier, the transmitter and the marketers \((28), (16), \) and \((41)\), respectively.

The optimization problem for storage operator \(s\) therefore is to maximize its net profit by adjusting sales and purchases while taking into account injection, extraction, material balance, and volume constraints as well as nonnegativity conditions for the decision variables and is given as follows.

\[
\max \sum_{d=2,3} \sum_{y \in Y} \text{days}_{d} \left( \pi_{n(s)}^{W} \right)_{dy} \ SALES_{sdy}^{S-M}
\]

\[
- \sum_{y \in Y} \text{days}_{1} \left[ (\pi_{n(s)}^{T})_{1y} + u_{n}^{S-T} )PURCH_{ST}^{S-T} + (\pi_{n(s)}^{R})_{1y} + u_{n}^{S-R} )PURCH_{SR}^{S-R} + c_{s} (PURCH_{ST}^{S-T} + PURCH_{SR}^{S-R} ) \right]
\]

\(^7\)Working gas, as opposed to base gas, is the amount of gas that can be injected and withdrawn. A certain minimum amount of base gas is necessary to maintain a pressure level in the storage for normal operations. To inject the gas into the reservoir, a certain amount is needed to fuel the compressors effectively resulting in a loss \((loss_{s})\) of the original amount.

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2.6. Pipeline Operator

The pipeline operator’s problem is similar to the one described in [26] and [29]. We consider a pipeline operator for each pipeline \((n, m), (n, m) \in A\) (with \(A\) the set of pipeline arcs). The pipeline operator is modeled as a regulated player in the natural gas market that, based on complete Third Party Access, allocates pipeline capacity to market players demanding transport capacity. This corresponds to the political willingness in Europe to restrict the, a priori, high monopolistic revenues of pipeline owners by regulating their prices or revenues. We assume the first case of price regulation, where the price paid for pipeline use \((\pi_{A_{nmdy}}^{Reg})\) is regulated and fixed. The total revenue of a pipeline operator is determined by the sum of its fixed price and the congestion price \((\pi_{A_{nmdy}}^{Cong})\) income:

\[
\text{SALES}_{A_{nmdy}} = \text{PL}_{A_{nm}} \times \sum_{d \in D} \text{days}_{d} \pi_{A_{nmdy}}^{Cong} \times \text{SALES}_{A_{nmdy}}^{A}
\]

We concentrate on the variable part of the revenue that the pipeline operator can influence in its optimization problem: the congestion revenue. This revenue, for each season, is based on multiplying the congestion rate \(\pi_{A_{nmdy}}^{Cong}\) by the number of days in that season and then by the rate of gas sold (the pipeline operator’s decision variable) for each arc \((n, m)\) \((\text{SALES}_{A_{nmdy}}^{A})\).

The pipeline capacity of each pipeline arc \((n, m)\) has a limit on its daily flows \((\text{PL}_{A_{nm}}^{A})\). Capacity constraints of pipelines are an important characteristic of the natural gas market. A limited import capacity to a country can considerably influence the market situation in this country, as a possible oligopolistic player (transmitter) can exert more or less market power depending on the number of competitors that can enter this market. The pipeline operator’s optimization problem therefore is:

\[
\begin{align*}
\text{max} & \quad \sum_{y \in Y} \sum_{d \in D} \text{days}_{d} \pi_{A_{nmdy}}^{Cong} \times \text{SALES}_{A_{nmdy}}^{A} \\
\text{s.t.} & \quad \text{SALES}_{A_{nmdy}}^{A} \leq \text{PL}_{A_{nm}}^{A} \quad \forall d, y \\
& \quad \text{SALES}_{A_{nmdy}}^{A} \geq 0 \quad \forall d, y
\end{align*}
\]
Note that the congestion fee, $\tau^A_{nmdy}$, is exogenous to the pipeline operator’s optimization problem. His decision variables are the daily pipeline flows, $SALES^A_{nmdy}$. The market-clearing conditions for pipeline capacity ensures for each pipeline $a$ the equality of flows operated by the pipeline operator ($SALES^A_{nmdy}$), and flows transported by the transmitters ($\sum_{t \in T(n,m)} FLOW^T_{tnmdy}$), with $T(n,m)$ the set of transmitters present in both the starting node and the end node of the arc.

$$0 = SALES^A_{nmdy} - \sum_{t \in T(n,m)} FLOW^T_{tnmdy}, \quad \tau^A_{nmdy} \text{ (free)} \quad \forall (n,m), d, y \quad (40)$$

### 2.7. Marketers

Marketers are the interface with the final demand for natural gas. As such, and as perfectly competitive players the marketers simply pass on the final demand to the upstream sector. Their inverse demand function $\Pi^W_{ndy}(\cdot)$ is incorporated in the transmitters’ optimization problem (??). The total purchases of the marketer will by definition equal the total sales of the other players (transmitters, regasifiers, and storage operators) to the marketer. The following conditions enforce the market clearing wholesale price, $\pi^W_{ndy}$, to match the inverse demand function at the equilibrium point.

$$0 = \pi^W_{ndy} - \left( INT^M_{ndy} - SLP^M_{ndy} \left[ \frac{\sum_{t \in T(n)} SALES^T_{nmdy}}{+ \sum_{r \in R(n)} SALES^R_{nmdy}} \left[ + (1 - \delta^d) \sum_{s \in S(n)} SALES^S_{nmdy} \right] + \sum_{t \in T(n)} SALES^T_{nmdy} \right] \right), \quad \pi^W_{ndy} \text{ (free)}, \forall n, d, y \quad (41)$$

Collecting the Karush-Kuhn-Tucker (KKT) optimality conditions of the players’ optimization problems presented above and combining them with the mentioned market-clearing conditions constitutes an instance of a mixed complementarity problem (MCP) or variational inequality problem (VI) referred to as complementarity problem [23]. We ensure that the optimization problems are convex and that their Karush-Kuhn-Tucker optimality conditions are both necessary (due to polyhedrality of the feasible regions) and sufficient (due to the convexity of the objective functions and the polyhedral feasible regions) for global optimality of the solution [2].

The MCP model is programmed in GAMS using the PATH MCP solver [10]. The PATH solver iteratively solves a sequence of linear approximations to the model and avoids convergence to local non-optimal solutions. Model runs were performed on a computer with 3.2 Ghz clock speed, 2GB RAM and typically took about one minute to solve.
3. Numerical Results

This section presents results of using the complementarity system described above in four cases relative to the base case assumption of market power for the producers (transmitters). These other cases are: 1. if the transmitters were taken to be perfectly competitive; 2. the disruption of Russian exports via Ukraine; 3. a cutoff of the relatively inexpensive Algerian gas; and 4. capacity expansions in LNG and pipeline infrastructure corresponding to projections for the year 2011. (The first cases are simulated for the base year 2004.) The intention of running these scenarios was to show the breadth of the model capability as well as to indicate potential impacts on the global gas markets. These cases are abbreviated as follows: SBC (strategic base case), PCM (perfectly competitive market), UKR (Ukrainian gas curtailment), ALG (Algerian gas production cutoff), 2011 (capacity expansions for 2011).

Note that in this section, all volumes and capacities are in billions of cubic meters per year (bcm/y), costs and prices are in Euros per thousand cubic meters (€/kcm) with all market players and the input data assumptions shown in detail in the Appendices. The model was first calibrated for the base case by allowing parameters such as production capacities, demand curve intercepts and slopes, and market power constants to vary so as to have outputs match historically reported values for the base year 2004. The market power constants for Algeria, the Netherlands, Norway and Russia determined to be $\delta_C = 0.75$ and for the Caspian Sea region, Denmark and the United Kingdom the values were $\delta_C = 0.25$. For price elasticities we followed [13]: -0.25 for the residential/commercial sector, -0.4 for industrial demand and -0.75 for power generation. Based on [45] and [6] reference demand levels for 2004 were determined and the model was calibrated resulting in consumption levels within 1% for each country, except Japan at 1.3%. For separate seasons as well as separate sectors the calibrated outcomes were within 2% for each country, and within 1% for most. The average wholesale price in Europe after calibration was 148 €/kcm, which compares favorably to reported selling prices of circa 127 €/kcm (Statoil, [69]), 139 €/kcm (GasTerra, [35]), and the USD figure 126 $/kcm [6].

3.1. Strategic Base Case versus Perfect Competitive Market

All players, except the transmitters, are assumed to be price-takers in all cases. To simulate a perfectly competitive market for the case PCM the market power constants for all transmitters $\delta_C^i$ are all set equal to 0. In the following paragraphs the results for the two cases SBC and PCM are compared to analyze how market power affects the market participants, consumed volumes, market prices and producer profits.

As can be expected, production and consumption are lower in the strategic base case as compared to a market with perfectly competitive producers. In the strategic scenario, the transmitters increase prices by withholding quantities. In particular, in the strategic base case, the total consumption of all included countries is 674 bcm (the calibration value for 2004) as compared to 731 bcm under a perfect competition assumption (see Figure 4). This means that about 8.4% more consumption occurs when the producers (via their transmitters) are perfectly competitive; a similar result for production occurs (779 bcm...
for PCM and 721 bcm for SBC, see Figure 5). Additionally, in perfect competition, most production and export capacities are binding.

Consistent with economic theory, higher prices ensue when the producers are allowed to exert market power via their transmitters. In particular, Europe sees 27% higher volume-weighted wholesale prices (148 €/kcm vs. 116 €/kcm) as a result of market power; average worldwide prices are 21% higher. The higher price increase in Europe is due to the limitation of market power to the transmitters of gas via pipelines in Europe. However, the global LNG market spreads the higher price level to other markets as well. As Figure 6 shows, the countries with relative price differences under SBC higher than the European average are the Netherlands, Hungary, Poland, Turkey, Romania and the United Kingdom with differences of 62%, 52%, 38%, 38%, 29%, and 28%, respectively. Countries with low import capacities (Netherlands, UK) or little diversification possibilities of pipeline or LNG imports (Eastern Europe) are impacted most.

Countries with relatively small price differences between SBC and PCM are Germany (13%), Spain (10%), France (7%), and Italy (9%). These countries largely depend on imports. They have access to LNG or have good access to many pipeline suppliers and thus have a diversified supply portfolio. They face higher than average prices in PCM, but suffer less from exertion of market power. Especially Spain, France and Italy benefit from their relatively large share of LNG imports and LNG import capacities, since we assume the LNG players to behave competitively in all cases.

Besides lower consumption and production levels in the strategic base case, the mix between LNG and pipeline gas is also different. In particular, under market power assumptions, Europe consumes overall less gas (521 vs. 575 bcm) but counts on a larger share of it being supplied by LNG (7.2% vs. 4.4%). Additionally, in the SBC, Europe counts on storage for 14.2% of total consumption but only 7.6% under perfect competition. This is a direct effect of the higher prices in a Cournot model which provide an incentive for higher cost suppliers (LNG, storage) to enter the market.

3.2. Disruption Ukrainian Pipelines versus Strategic Base Case

In the winter of 2005-2006, Gazprom decided to cut off its pipeline gas to Ukraine based on contractual disputes. According to the New York Times, a case was made as to the political nature of this curtailment [54]. Later in 2006, supply shortages of Russian gas affected Georgia ([63], [62], [64]). Gazprom in particular, and Russia in general holds a strategic advantage given its huge supply of natural gas. According to Stern [67], the proved gas reserves for Gazprom as of the end of 2004 were 16,357 bcm. The Russian reserves account for roughly one third of the global natural gas reserves, and its supply share in European gas consumption is about 30%. Moreover, in the next ten to fifteen years, the global influence of Russian gas may be even more felt via LNG to Asia and North America and pipeline gas to Asia [67]. Thus, to represent the case of Russia exerting market power in the production market, we have designed a case corresponding to a disruption of pipeline gas to Europe via Ukraine.

\[8\] All price and cost comparisons are volume-weighted averages over seasons and countries, unless stated otherwise.
Figure 4. Consumption (bcm) in European countries in all five cases

Figure 5. Natural Gas Supply by Geographic Area (bcm)
To simulate the impact on the European gas market of disrupted Ukrainian pipeline transit the capacities of all Ukrainian outgoing pipelines (a total capacity of 171 bcm per year) are set to zero.\textsuperscript{9} The following paragraphs compare the results for the cases UKR (Ukrainian gas curtailment) and SBC (strategic base case).\textsuperscript{10}

Disruption of Ukrainian supplies leads to a model-wide gas consumption of 604 bcm, 11% lower than the SBC consumption level. European consumption decreases by over 12% to 456 bcm, the LNG supply increases to 42 bcm. The average worldwide wholesale price level increases by 16% to 178 €/kcm, and the European price level by 19% to 177 €/kcm. Storage supplies 59 bcm, 13% of total European consumption, however 15 bcm lower than in the SBC. Storage cannot play a bigger role mainly due to lack of supply in the low demand period and resulting higher price levels, especially in Eastern and Central European countries. Figure 7 shows that Hungary suffers from the largest increase in wholesale prices, from 157 to 375 €/kcm, due to 80% of its total import capacity being shut off with the Ukrainian curtailment.

Tables 1 and 2 show the worldwide LNG shipments respectively for the SBC and UKR

\textsuperscript{9}Setting the transit capacity for the whole year equal to zero is an approximation of the January 2006 events, since the actual disruption lasted for a few days only. One must also keep in mind that the results of the complementarity model are long-term equilibrium values and do not take into account short term adjustments.

\textsuperscript{10}The model was run with aggregate demand curves per country and the sector demands were calculated \textit{ex-post} based on their actual demand curves. In some countries with low consumption the equilibrium prices in the UKR case are higher than the demand intercepts of the power generation sector, leading to some negative values (\textit{ex post}). As aggregate country demand cannot be negative, and the negative volumes are small in magnitude (<0.5 bcm per case and 2.1 bcm aggregate) these outcomes were ignored.
cases. In both cases most LNG liquefiers are producing at full capacity, except for Norway which is the most expensive hence the marginal LNG supply option. Algerian supplies decrease by 1.1 bcm (30.8 to 29.7) and Norwegian LNG supplies decrease by 0.5 bcm (1.0 to 0.5) in the UKR case, presumably because there is less competition for Russian gas in the European market for their pipeline exports.

On the demand side, two countries import significantly more, and three countries import significantly less LNG. Italy and France have to replace the lost pipeline inflows of Russian gas and increase LNG imports by 4.5 bcm and 1.9 bcm. Japan, Turkey and South Korea import 3.8, 2.2 and 1.3 bcm less. Spain, which is a major LNG importer, sees LNG imports decrease only moderately.

The influence on international natural gas trade can be described as a "ripple-effect". In the SBC, European countries are only supplied by nearby regions: Norway and Mediterranean countries, especially Algeria and Egypt. But when Russian pipeline supplies are disrupted, the European demand for LNG rises and the Arabian LNG exporting countries shift some of their shipments to Europe, away from Asia. The U.S. receives less gas from Algeria and demands more from Trinidad & Tobago, which stops supplying to South Korea. South Korea and Japan compete for the South East Asian LNG supplies, and as a result both see prices increase by 13 €/kcm with lower supplies. The global LNG market provides an alternative gas source for affected European countries, and as a result global LNG prices rise. The average LNG selling price excluding transport increases by more than 13%, from 131 to 148 EUR/kcm.
Table 1
Wordwide LNG Shipments- Strategic Base Case

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Table 2
Wordwide LNG Shipments- Ukrainian Gas Interruption Case

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Under this scenario, while most countries face severe negative ramifications of the shut-off of gas through Ukraine, Turkey’s total imports are hardly affected. Turkey faces a large decrease in LNG supplies because there is a strong demand for LNG in the rest of Europe (Figure 8). But it benefits from the availability of more pipeline gas from Russia through the "Blue Stream" pipeline in the Black Sea which compensates the LNG imports.

3.3. Disruption of Algerian Supplies versus Strategic Base Case

Algerian natural gas production is important for the European and global natural gas markets for a number of reasons. First, natural gas production costs in Algeria are relatively low, due to geographical and geological conditions. Second, Algerian natural gas can be exported to Europe via offshore pipeline through the Mediterranean Sea. Currently, there are two pipelines in use, one to Italy and one to Spain, with a total capacity of 34 bcm. Two more pipelines between Algeria and Europe will be on stream before 2011. Third, Algeria is an important exporter of LNG, being the first country to start LNG supplies in the 1960s, and currently having a combined liquefaction capacity of 30.8 bcm. Its geographic location allows Algeria to arbitrage between supplying Europe and North America with LNG. In the strategic base case results, 24% of the Algerian LNG goes to North America, the rest to Europe.

To simulate a curtailment of Algerian natural gas supplies, the production capacity of Algeria was set equal to zero. This disruption leads to a drop in model-wide consumption of 5.2%, from 674 bcm (SBC) to 639 bcm. The model-wide production level falls by 5.3% to 683 bcm. European consumption also decreases, by 4.5%, to 498 bcm, and LNG supplies to Europe fall by 14 bcm to 23 bcm. The shortage in natural gas and especially LNG supplies leads to a price level increase of 11% to 170 €/kcm globally, and an increase of 10% to 163 €/kcm in Europe. Storage supplies 69 bcm of European consumption, about
5 bcm less than in SBC.

Italy and Spain are the main importers of Algerian natural gas. The Mediterranean offshore pipelines land there and both countries are LNG importers. In the SBC, the Algerian supplies to Italy account for 27% of total Italian consumption; for Spain, Algeria contributes to even larger 88% of its total supplies. Figures 9 and 10 show the supply diversification of Italy and Spain in SBC and ALG. A main difference is that Italy receives its Algerian supplies by pipeline, whereas Spain receives about \( \frac{3}{4} \) of its Algerian supplies as LNG. When Algerian supplies are disrupted, both countries face a drop in consumption of roughly 10% of their consumption in SBC. Although Spain relies more on Algerian gas than Italy, in this crisis situation it is more flexible to find alternative gas suppliers by turning to the world-wide LNG market.

![Figure 9. Gas supply to Italy in SBC and ALG](image)

A closer look at the European market in Tables 3 and 4 shows that the falling Italian imports from Algeria are compensated by an increase of the pipeline imports from the Netherlands, Russia, and to a lesser extent from Norway. The Dutch exports to Italy reduce the German imports from the Netherlands, but Germany can compensate by raising its imports from Russia. Overall, Russia (+25.5 bcm/y) and the United Kingdom (+1.1 bcm/y; incorporated in category "other") are the only pipeline exporters that benefit from the disruption of Algerian supplies by exporting more gas at higher prices to Europe. All other (pipeline and LNG) suppliers operate close to or at their (production or transport) capacity limits and Russia is the only producer with significant spare capacity. Spain hardly compensates the lacking pipeline imports because of lacking pipeline connections...
with the rest of Europe. Spain is connected to the European mainland only via a small pipeline to its neighbor France, with an annual capacity of 3 bcm. However, Spain can compensate with LNG supplies from Egypt and the Middle East. Thus, the presence of pipeline capacity plays an important role in determining the alternative supply schemes of Spain, Italy and overall in Europe.

In the global LNG market, Algerian LNG supplies go to Europe (76%) and to North America (24%) in the base case scenario. In the Algeria disruption case, falling LNG supplies to North America are mostly compensated by higher LNG exports from Trinidad and Tobago and from Norway. While Norway is the marginal LNG supplier in the SBC, it increases its total LNG exports in the ALG case (which are now shipped to North America) and benefits from the scariness of LNG in the global markets. There is a shift in Egyptian LNG supplies (from other European importers to Spain) and in Middle East exports (from Asia partly to Europe) but the binding liquefaction constraints do not allow for entirely compensating for the falling Algerian supplies in the global market. Italy does not import any LNG when Algerian supplies are disrupted, as all LNG imports are drawn by Spain. In essence, in both the pipeline and LNG markets, physical transport capacity is fundamental for determining the flows in the natural gas market.
Table 3
Pipeline Flows in SBC and ALG

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<tr>
<th>Pipeline Exports</th>
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Table 4
LNG Flows in SBC and ALG

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3.4. Increased Transport Capacity in the Near Future (2011) versus Strategic Base Case

The current development towards an increasing importance of LNG in the world natural gas markets will continue at a rapid pace through 2011. The International Energy Agency predicts the share of LNG to double from 2006 to 2010, to approximately 11% of world natural gas consumption [47]. An increased capacity expansion case is used to analyze how a bigger supply and import potential of LNG influences the European natural gas market. For the expansion scenario to be realistic, pipeline and LNG projects that are known or expected to come on line by 2011 are used.\footnote{Data on pipeline and LNG projects are from different sources, such as the IEA [47], and gas sector journals [65].} Predictions for a longer time horizon than the next five years are difficult because decisions on infrastructure and production expansions after 2011 are yet to be made.

In particular, a number of regasification projects to come on line are assumed, in Europe (Germany, the Netherlands, the UK, see Figure 1), as well as in North America (the U.S., Canada and Mexico) and the rest of the world. Upstream, a considerable amount of additional liquefaction capacity is expected to become operational by 2011. The highest increases of total capacity will come from the Middle East (increase by a factor of three, to an annual capacity of 120 bcm), from West Africa (also by a factor of three, to 48 bcm) and from Australia and Southeast Asia (increase by 50% to 140 bcm together). The coverage of our model, which includes all LNG exporters and importers, allows analyzing questions such as the arbitrage of suppliers in the Atlantic basin between Europe and North America, and the arbitrage of the Middle East LNG exporters between the Atlantic and the Pacific basin.

There are less pipeline construction projects until 2011 than LNG projects. However, some significant pipeline projects are assumed to be built, such as: 1. the first line of the Nordstream pipeline from Russia to Germany through the Baltic Sea; 2. two pipelines in the Mediterranean Sea, from Algeria to Italy, and from Algeria to Spain.

To simulate the natural gas market in 2011, production capacities and reference consumption values in the demand function [15] were adjusted in addition to liquefaction, regasification and pipeline capacities. Given the considerable pipeline and LNG congestion in the base case scenario, one can expect an increase in natural gas trade, production, and consumption from the capacity expansion and higher demand. Indeed, Figure 5 shows a rise of model-wide production of natural gas by 40% under the capacity expansion case compared to the SBC scenario, to a total of 1009 bcm per year. European consumption alone grows by 22% to 639 bcm. The share of LNG imports in Europe increases from 6% to 14.5% (92 bcm). With a projected demand increase in the period 2004-2011 of 123 bcm [15], and a model outcome of 117 bcm, the anticipated capacity expansions seem to somewhat accurately represent the increase in European gas demand for the period up to 2011.

A closer look at the details of LNG trade behind the values in Table 5\footnote{The LNG liquefaction capacity of Equatorial Guinea that is expected to come on-line in the next five years is for the case 2011 assigned to the LNG node Nigeria, which should be viewed more generally as "West Africa".} shows that the
Table 5
LNG trade flows in 2011 [bcm]

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U.S. will draw most of the LNG in the Atlantic basin. North America as a whole receives 136.2 bcm of LNG imports compared to 91.3 bcm in Europe. In particular, the U.S. will be the exclusive importer of Algerian, Libyan, West African (Nigerian) and Trinidad and Tobago LNG. The Middle East LNG exports, however, are characterized by a large mix of receiving countries in North America (23% of the Middle East exports), Europe (59%) and Asia (16%). This indicates that while there is a clear result in favor of the U.S. of the arbitrage in the Atlantic basin, there is no apparent tendency of the arbitrage of the Middle East exporters between the Atlantic and Pacific basins. European LNG imports only come from Norway, Egypt, and the Middle East. The main reasons for the dominant importing position of the U.S. can be found in the demand function assumptions (high demand growth in the U.S.) and in the (production and transport) cost structure.

Overall, in a competitive market for LNG, (production and) transport costs, and hence geography, would play an important role in determining the LNG trade relations. The Pacific and the Atlantic basins would mainly be supplied by exporters located in the same basin, with the Middle East providing swing supplies between the two basins. These results differ significantly from regional models of the European market which do not take into account demand for LNG in other world regions. In [38], for example, the authors find a larger diversity of European imports from all possible LNG sources and no cutoff of some sources.

For the pipeline market in Europe, the additional pipeline capacity leads to an increase of pipeline imports, providing some justification for the investments. Russia is able to increase its exports to Europe in 2011 to 142 bcm (compared to 117 bcm in 2011), and in particular to Germany, the destination of the Nordstream pipeline (from 17.6 bcm in the SBC scenario to 25.2 bcm in 2011). However, it must be noted that the current (2004) export capacity of pipelines from Russia to Europe already is of the order of 150 bcm, and that in 2011 Russia would still not be exporting at its full capacity. The Nordstream pipeline project must rather be understood as a strategic option in the transit game with Ukraine and Belarus. Algeria’s pipeline exports in the SBC scenario, however, are bound by the available pipeline capacity. The reason for this is the relatively cheap production costs of Algerian natural gas. Logically, the Algerian exports in 2011 will rise drastically after the construction of two new pipelines through the Mediterranean Sea, from 31.5 bcm in the base year to 49.2 bcm in 2011.

Storage delivers 11.5% of the total natural gas consumption in Europe, and operates
at its capacity limit.\textsuperscript{13} Price levels in terms of €2004/kcm rise to 153 and 157 for Europe and the global LNG market, respectively; this is 2.1% and 1.6% higher than the 2004 levels. These numbers must be considered with caution as they are dependent on the different assumptions for 2011, especially with respect to demand elasticities and demand functions calibrations.

### 3.5. Decomposition of costs and profits in the supply chain

Between the gas well and the end user, several middlemen add value to the gas. One would expect that the more competitive the market and the more supply and transport capacity there is available, the lower the total profits would be as a percentage of the total added value (i.e., total consumer spending for this study).

Figure 11 supports this intuition. The lower parts are the producers’ costs and profits (total of producers and transmitters); the upper parts the aggregate costs and profits of liquefiers, regasifiers and storage operators. Market power adds €11 billion to total producer profits (€33 billion in PCM vs. €44 billion in SBC). Alternatively, because of market power consumers pay €11 billion extra (€103 vs. €92 billion), for almost 8% less gas with the difference going to the producers (and transmitters).

As stated earlier, the disruption of the Ukraine transit has a higher impact on the total consumed volume than the disruption of the Algerian supplies. It is interesting to see that total consumer spending for both disruption cases is significantly higher than in the SBC, and between the two of them almost equal: €107.5 bln in UKR vs. €108.3 bln in

\textsuperscript{13}Note that the storage capacity was not changed in the model from 2004 to 2011.
ALG, for consumed volumes 604 vs. 640 bcm respectively. Especially in the UKR case, the producers benefit highly from the lack of alternative gas suppliers, and their profits add up to 50% of the total consumer spending. In 2011, producer profits go up a modest 3.2% relative to the SBC 2004. Liquefiers and regasifiers then benefit from playing a more significant role and see their added profits sextuple, while supplied volumes only about double.

4. Conclusions

In this paper, we have described a detailed and extensive model of the European natural gas market which includes 52 countries that produce, consume, or ship gas to Europe. The full supply chain is modeled, including producers and their marketing arms which we call "transmitters", pipeline and storage operators, marketers, liquefiers, regasifiers, LNG tankers and final consumption. The producers via their transmitters are modeled as strategic players with the possibility of market power; all other players are posited as price-takers. We chose this specification for two reasons. First, we are concentrating on international trade of natural gas where the market power possibility of the transmitters is the dominant characteristic. Second, modeling more than one type of player as strategic would give a more complex problem (in the complementarity framework, this would be an MPEC) that is hard to solve for a large-scale problem as ours.

The economic behavior of the players is characterized by solving appropriate optimization problems except for the LNG tankers and marketers which are implicitly modeled via cost and demand curves, respectively. Collecting the Karush-Kuhn-Tucker (KKT) optimality conditions for the players’ optimization problems, and combining them with market-clearing conditions results in a complementarity system. The model is calibrated to market outcomes for the base year 2004. A series of cases is run to reveal insights about the European and worldwide natural gas market. The cases cover: a strategic base case in which the producers (transmitters) can exert market power, a case in which the transmitters are modeled as perfectly competitive, a disruption of Russian gas supplies through Ukraine, disruption of Algerian gas supplies, and a capacity expansion case for the year 2011, with the last three assuming strategic behavior on the part of the transmitters.

When looking at the case of perfect competition, the strategic base case, and the lessons learned from calibration, the low production and consumption levels when assuming full Cournot market power may indicate that the main players in Europe are either not fully Cournot players, or possibly that policy and old long term contracts in place prevents them to exert their full market power. However even with lower than full Cournot market power levels, average prices in Europe are as much as 27% higher than in a perfectly competitive market.

A disruption in Russian supplies to Europe through the Ukraine may cause a substitution effect with worldwide higher LNG consumption and prices. The curtailment of Algerian supplies shows that high import shares from a single supplier are by itself not a cause for concern, flexibility is key in managing dependency. A mature global LNG spot market could possibly provide such flexibility, at least for countries with significant LNG regasification capacity. For countries relying on the pipeline market, sufficient pipeline
import capacity and a diverse supply portfolio is key for securing their imports. The capacity expansion case illustrates that LNG will be competitive with gas supplied by long-distance underwater pipelines. With the currently ongoing large investments in new LNG facilities in an increasing number of countries, a global LNG market is arising. The model provides insights in the future perspectives of LNG trade where Europe and North America will be in competition for LNG in the Atlantic basin, and model results indicate that North America could attract more LNG. Europe will continue to rely on its regional pipeline gas supplies to satisfy the majority of its demand (85% in the capacity expansion case), with LNG providing an element of supply security through diversification. The great detail of the model in terms of players and geographical coverage provides in-depth insight into the supply situation of each country.

Future work will be in three directions: extending this work to a more detailed representation of other regions beside Europe; allowing for stochasticity in the players problem to better reflect uncertainty in actual markets; and modeling of forward markets and capacity investments.

5. Acknowledgements

We would like to thank Prof. Yves Smeers of Université catholique de Louvain, Belgium for suggestions on an earlier version of this work as well as the reviewers for their insightful comments.

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Appendix A: Country groups and abbreviations

The data set that we have used for running the model comprises of 52 countries. The following tables show the countries logically grouped according to their world regions, as well as the abbreviations used to refer to them in tables and figures.
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Table 11
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