BUSINESS STRATEGY, TRADING AND RISK MANAGEMENT
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Introduction

Europe already has a healthy cross-border energy trading market. In 2002, overall cross border power trading approached 300TWh, or nearly €6bn. This meant some €300m of profit for those participating: above average profits for those that have the access and the capability.

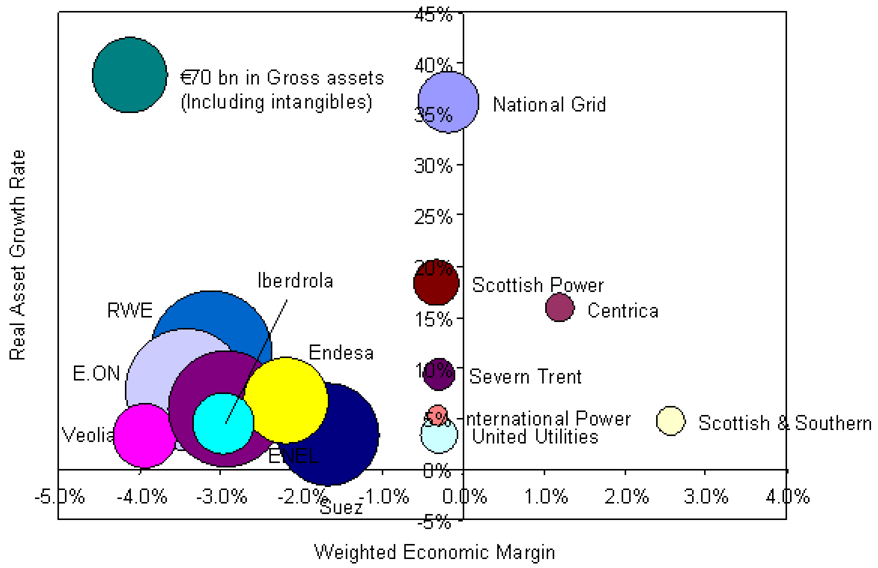
The European energy market continues to echo to the drum-beat of liberalisation.

In this paper I want to explore the present ‘condition’ of the industry and explore the implications for energy market trading over the next 3 years or so.

Present ‘Condition’

Throughout the past year it has been evident that the acquisition cycle has run out of steam. The E.on closure on Ruhrgas was the last big deal in Europe, just as the finality of the US energy credit crunch was recognised. Expansion has left companies at or near technical insolvency, or destroying significant shareholder value.

Shareholder Value Creation in European Utilities 1999 - 2003



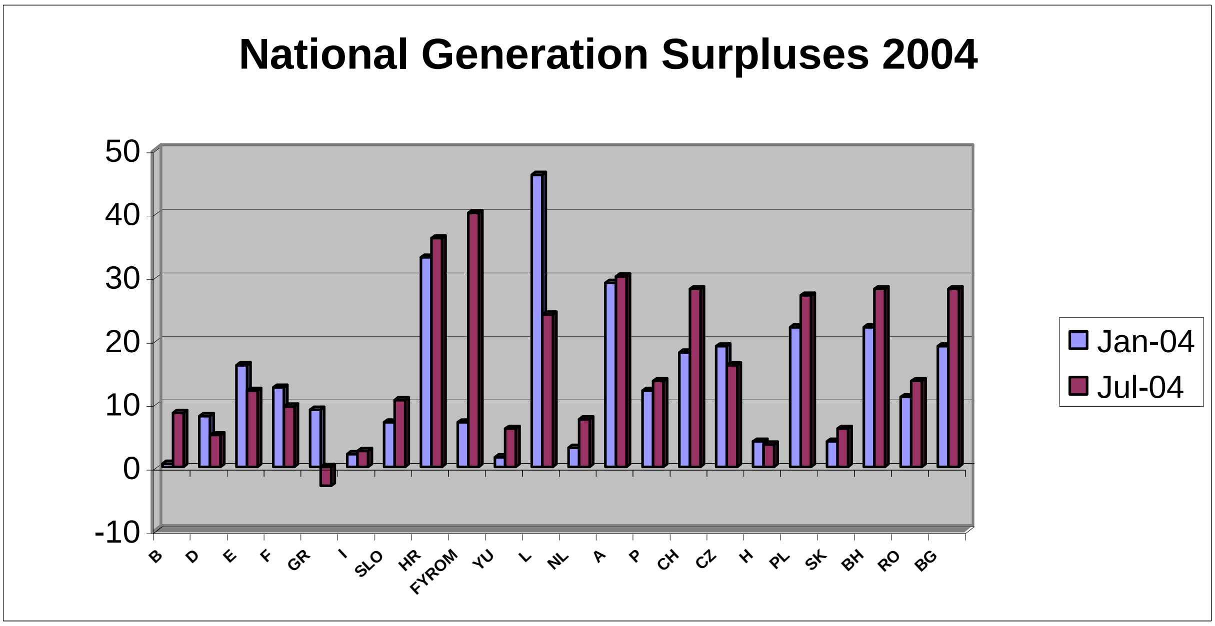
Source: Company Accounts/ Deloitte analysis / UBS

The phase of expansion is ’done’, even including the new accession states into the EC. The process of rationalisation has started.

The rationalising companies have returned to the ‘utility’ model. Large quasi-monopolies, with little need to be customer responsive, see cost control and regulatory management as the means to create value. Apart from the UK, the vertically integrated national monopolies have been displaced by vertical national monopolies with extra-national business interests. Their operating style is a multinational portfolio, rather than an integrated ‘global’ energy business.

It might almost be said that the power industry has gone full-circle; except of course that the energy trading ‘genie’ is still out-of-the-bottle. We may no longer have the players like Enron, Dynegy or Dreyfus aggressively seeking to shape the market, but the know-how, experience and income expectations of their alumni continuing to play-out today from their present employment within the refocused utilities and the commodity trading houses.

We see vertical monopolies now clearly beginning to challenge ‘trading’ as a focus within their business portfolios. Asset and wholesale market activities are being reined back in favour of focus on ‘energy management’ to optimise internally the integrated value-chain portfolio. EDF’s recent reorganisation and integration of London based EDF Trading within a new branch <<équilibre-commercialisation-production>> is an example of such a direction.



Source: Deloitte Consulting

The rational man would also say that Europe has limited necessity for cross-border power trading. The legacy of national ‘power islands’ means that virtually every country within the European power system has sufficient generation capacity to meet its own peak national demand. There are some countries where there is a structural need for cross-border transfers; where there may be enough capacity to meet peak demand but insufficient rainfall to meet annual consumption. Such positions however have been successfully managed bilaterally for many years

There are also price differentials arising from different fuel sources, which counterparties have bilaterally shared between buyer and seller for decades, on terms that satisfied different national interests and rivalries. Organisations while recognising the value in returning to the national integrated quasi-monopoly are also realising the extent of the value destruction they have inflicted upon themselves from within, through their participation in and fostering a liberal trading environment. Some would say that the ‘trading’ culture and reward structure has squandered the ‘family silver’ of value inherent in the legacy assets, resources and rights of utilities in exchange for the short term profits and bonuses of the trader.

EU view of congestion published in December 2001

Connection	Congestion or not	Allocation method	Price difference neighbouring markets (€/MWh)	Average price of interconnector capacity (€/MWh)
Within Nordpool	Y-sporadic	Linked to spot market	3.0	1.62
DK-DE	Y at DE border	Auction	3.0	1.62
BE-NL	Y at NL border	Auction	N/A	3.01
DE-NL	Y at NL border	Auction	5-25	10.75
FR-UK	Y into UK	Auction with floor price	0-10	5.75
SP-PT	Y-sporadic	Part auction part spot market	4.0	
FR-SP	Y-into SP	First come first served priority for LT contracts	6-15	
FR-BE	Y-into BE/NL	First come first served priority for LT contracts	9.0	
FR-IT	Y into IT	Pro-rata, priority for LT contracts	ca 30	
AT-IT	Y at IT border	First come first served	N/A	

€300m of profit from cross-border power trading compares poorly with the €100bn of shareholder value destruction that the largest power players in Europe are estimated[1] to have achieved since 1999.

The return to the national integrated quasi-monopoly model is a sharp curtailment of the optimism and expectation that abounded in the first phase of liberalisation. The presumption of 'net' value growth has not been realised. For the utilities model, liberalisation is value destroying. The greatest commercial advantage is where there are barriers to access and superior benefits from the capacity to trade.

The polarised positions of utility and the commodity trader are now, some would say finally, being recognised in the utility boardroom.

What may the future bring?

The new focus on financial performance is the start of a new cycle for the European power industry. Investors and credit rating agencies insist on seeing the numbers being delivered.

This means raising margins within an organisation's federated businesses. Cost reduction and 'regulatory management' have already been recognised by the sector as the lowest risk and most immediate sources of improved financial performance.

[1] UBS Deloitte Will value destruction continue forever? September 2003

In cross-border trading, the volume of power being shipped under long term contracts, added to the complexity of many cultures, languages and technology, means that there are still substantial barriers to entry for new players. The vertical national players can be expected to focus on realising the fullest enterprise value from current structural market constraints for as long as they remain Apparent profits from trading will be assessed more aggressively against the level of profit latent in the legacy assets, resources and capacity rights.

New IFRS rules effective in 2005 will also introduce additional challenges in reported earnings volatility from trading activities. Utilities focusing on delivering a new and consistent level of financial performance may be unlikely to achieve this if exposed to mark-to-market accounting on trading activities. This situation is inherent in the new near-preclusion on the use of hedge-accounting where there is any trading activity other than for 'own use'.

These factors subscribe to a view that cross-border trading of the national vertical players will be significantly curtailed.

This however is not necessarily a departure from the 'trading-centric' business model. Instead it can be seen as a return to the fundamentals of that model, which lie in the role of an optimiser managing across all 'positions' of the national vertical player within national boundaries. This is a return to true 'energy management': managing the trade offs in asset management, portfolio management and market management to optimise the lifetime value of assets and customers. This is an old concept with few examples of effective realisation.

In the immediate future the role of any utility-owned 'European' trading or energy management function appears likely to add most value through providing central fuel procurement where portfolio benefits of price and risk management can be achieved.

This market state is not of course enduring.

A further consequence of the focus on financial performance is likely to be the disposal of low margin businesses. We have already seen these forces at work in the oil and gas sector over the past 5 years: a whole new 'middle market' has emerged to take the place of those absorbed by the consolidation of the late '90s. Within the UK we already see the network operator seeking disposal of low margin gas distribution activities.

The European Commission is also active in moves to remove congestion and to integrate the operation and commercial structure of the European power system. Supported by the commodity trading organisations, this will progressively erode the superior value of the legacy assets, resources and rights of the traditional national incumbents.

Recent developments in the capital markets seem also likely to herald the role of financial institutions in the ownership of imminent investment to replace the growing proportion of European power plant that are approaching the end of their economic life.

Eventually a tipping-point will be reached when European cross-border trading is relevant and value enhancing for the legacy utilities. Only a clear strategic understanding of value will position organisations to time this next step correctly. This understanding of value needs to be as much a priority for management as margin improvement will be over the next 3 years.

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