

THE BENELUX MARKET – MARKET DRIVERS AND INHIBITORS

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Setting the scene

On Tuesday April 12 the Wall Street Journal reported significant progress had been made on reaching agreement on a Russia-EU gas price accord. As part of Russia's attempt to join the World Trade Organisation, this accord has proved a major hurdle because of the artificially low price for industrial gas in Russia. We are now close to agreement on the price for Russian natural gas.

In terms of EU timescales 'being close' is probably a couple of years away, but as a siren call to EU member states to get their energy market policy in line with that dictated by the various EU Directives on Energy and Gas, this cannot be ignored.

I must also declare an interest, in that APX Group, consisting of Amsterdam Power Exchange Spotmarket, APX UK and EnMO (with UKPX on its way), is the first combined energy exchange for gas and power in the UK and the Netherlands and as such we have considerable interest in the rapid liberalisation of the European energy markets.

The supply, delivery and pricing of energy affects every person in Europe and beyond. The EU's demand for energy has been growing at a rate between 1% and 2% since 1986 and energy demand in the new member States should surge in the medium term as their economies will be growing much faster than those of the current Member States. The EU currently imports some 50% of its energy requirements, a figure that will rise to 70% if nothing is done to reduce demand.

On December 10 2003, only four months ago, the European Commission proposed a new package of measures designed to encourage investment in energy infrastructure with a view to increasing security of supply and improving the functioning of the internal energy market. The Commission recognises that in spite of efforts deployed to reduce energy consumption and the development of new demand management technologies, considerable new investment in transmission and in generation capacity will indeed be necessary in the run up to enlargement. These new proposals, it claims, should also help prevent the reoccurrence of the blackouts that took place last summer, most notably in Italy.

So according to the EU Directives, by July of this year, all commercial consumers will be able to choose their gas and electricity suppliers and three years later all domestic households will have the same opportunity.

Without more interconnection between Member States, the functioning of the internal market will be constrained. This is particularly important where established producers and suppliers retain a strong position in their home market. This is entirely understandable from a historic perspective as generation capacity and distribution grids were of course designed to cover regional demand and the ownership of these utilities, whether local or national authorities, reflects this fact. However, without measures designed to ensure that additional interconnector capacity is built, national energy markets will not be integrated into the wider European markets and customer choice will be limited.

The Commission also states – ***“A re-examination and clarification of rules is needed to ensure that the required levels of investment in electricity generation, in long distance gas transport and in the internal EU transmission networks are made.”***

In the electricity sector, congestion, a lack of interconnection and difficulties in building new infrastructure hamper security of supply. For gas, there is deemed to be no general shortage of infrastructure, network access should be extended to bring about a real competitive market for natural gas. An action plan to this effect was agreed at the Madrid Forum in 2003 by the regulators, industry and the Commission, and again, according to the Commission the enormous progress made in this forum now warrants being consolidated into European Energy law.

The Benelux dilemma

Whilst the Netherlands has made considerable progress towards market liberalisation – both in theory and practice, and perhaps Belgium slightly less so, there is no doubt about the drive in both countries to see open markets in the shortest possible time. However, as with all good intentions the route to realisation is slightly more difficult.

The geographical location of The Netherlands and Belgium should support the Benelux region as the prime area for open markets. Zeebrugge natural gas hub, which has strong links with the UK's NBP, is among the most heavily traded in Europe with over 50 subscribed members and over 40 trading on a regular basis. Trading activity on the Dutch TTF-hub is growing. . In the Dutch power market, five players are active in generation. However, Holland also has cross border power links with Germany as Belgium has with France, so theoretically the conditions exist to support an open market, with multiple sources of power, multiple delivery routes and security of supply. Even the historic position of Holland as a major trading nation, reliant for several hundred years on its ability to effectively buy, sell and deliver goods throughout the world lends credence to its present day role as an energy trading hub.

As a consequence the region should be perfectly placed to satisfy the demand from its own industrial and domestic energy users and as a logical marketplace for buying and selling gas and electricity.

Unfortunately the issues undermining the market potential are those perennial villains - self-interest, misplaced national pride, conflicting regulations and ultimately the lack of a truly open and effective market structure, which would encourage the required investment.

Barriers to market integration

Improved international transmission and congestion management is also high on the agenda of issues needing to be resolved before true market conditions apply. An integrated Benelux market with a single price regardless of country of generation would be a great step forward. In times of interconnector congestion a market coupling technique such as that APX has developed over the past few years with universities in Belgium and the Netherlands could handle any significant price differential.

Whilst I am talking specifically about problems that beset the Benelux market, I perceive it to be better placed than most other European countries where electricity markets are plagued by the slow adherence to the interconnector targets set by the Barcelona Council in March 2002. Even the low target level of 10% has not been met.

Too many European countries have monopoly, or close to monopoly generating companies and until this fundamental problem is sorted out, there can be no solution. When you realise that the market share of the single largest generator company in Greece, Ireland and France is close to or exceeds 80% it gives you some idea of the scale of the problem.

An interesting footnote to an EU discussion document states: ***“In various parts of Europe it has become increasingly difficult to achieve major electricity transmission projects. Several projects in advanced stages have been cancelled and there are even important projects which are almost finished but in some short parts are missing. There are also examples of interconnectors between countries where one party has failed to finish the link whilst the other party has built the line to the border. Examples of these shortcomings include the links between Belgium-France, Italy-Switzerland, Italy-Greece and key projects to reinforce the Austrian network.”***

Monopolies only exist on a national scale. They will remain if we do not invest in more interconnection capacity and make more efficient use of existing interconnectors by improved access mechanisms like market coupling. The core problem is that you need sufficient scale to survive in the energy market, a scale too large for one country. European players have outgrown the regional or national market structure still imposed by the physical infrastructure.

Within the gas market, transport is also a major issue. The ownership of transportation rights at border crossings is one example. There is a lack of clear information from the unbundled gas industry about capacity – it is available or fully used? Differences in balancing rules between one transporter and another; for example Transco’s daily balancing model compared with the shorter balancing rules operated by continental TSO’s.

Nonetheless gas is in a slightly better situation than electricity across Europe and the functioning of a competitive market has been somewhat helped by awareness of the limits on reserves and the need for alternative sources of supply. Dwindling supplies in the UK and the Netherlands now means we look elsewhere for supplies, primarily to Russia, as previously mentioned, already the largest single energy partner to the EU along with Algeria and Norway. The EU proposes a new regulation on access conditions to the gas network that will cover a range of issues including:

- Third Party Access services to be offered by TSO’s;
- Capacity allocation and congestion management, including use it or lose it and secondary trading mechanisms;
- Transparency requirements;
- Tariff structure and derivation, including balancing charges;
- Requirements that national regulators ensure the agreed guidelines are implemented.

Role of energy exchanges

Europe has to overcome its distaste for liberalisation and accept all market participants will benefit from the availability of the right products, at prices that accurately reflect supply and demand. On-line trading encourages the standardisation of delivery rules, contract terms, counterparty pre-qualification policies, default procedures and other parameters that describe energy products. This standardisation facilitates the transaction management process and makes it easier to compare prices across a large number of transactions. The on-line market tends to focus on standardised products and to price unique product offerings as differentials to the standard. This standardisation will bring further efficiency and transparency to the marketplace and will tend to concentrate trading activity around European hubs of concentrated liquidity. Effective exchanges also mean accurate indices, which in turn create confidence for each trader to continue trading. Open indices means no more gaming or price manipulation leading to unaccountable price spikes. Over four years, APX publishes market prices and volumes as well as (aggregated) curves on a daily basis, and as a result has engendered confidence, a pre-requisite of an open market. Without transparent and fair prices, companies are hesitant to invest in this sector.

However, market signals for long-term infrastructure development are difficult to achieve. The development of commodity and/or capacity trading will provide medium term price transparency and facilitate risk management, thereby helping to create investment signals. The availability of short-term capacity (preferably via implicit auctions or secondary capacity trading) is essential to the sustainable development of the competitive market. Capacity that has been contracted on a long-term basis should be subject to a use-it-or-lose-it regime.

The potential for cleared solutions to provide risk mitigation in the face of the considerable complexities at fledgling hubs could promote delivery confidence, thus providing valuable dynamics and stimulus to kick-start and sustain trading activity.

The centrally cleared model also offers the spectre of cross netting (cross margining) across multiple commodity venues (i.e. multiple gas hubs in Germany), borders (i.e. multiple Europe gas hubs) and across multiple commodities (i.e. gas, power etc.). The advantage of open cross netting, for example netting off gas purchases at a German gas hub against sales at a UK power trading hub, is to minimise the margin collateral the trader needs to lodge to secure the traded positions held, thus freeing up more cash with which to carry out more trading. Thus, active liquid markets are encouraged.

Towards a pan-European exchange

This Utopia of seamless European cross netting is of course subject to the cohesion of a complex web of European legislation. Legal concerns centre on ensuring appropriate taxation handling and the adoption of generic taxation treatment, plus enshrining insolvency provisions and ensuring sovereign jurisdictions and laws are not infringed. The other overriding complexity is the emergence of regulatory environment in which a pan-European exchange could exist and flourish, i.e. an agreed pan-European regulatory platform and guidance from which all national, or indeed a central European regulator can assess market conformity.

The use of gas as a fuel for generating electricity and the subsequent convergence between the two markets is an issue worth touching on, as it will increase in importance over the coming years. Market pundits are forecasting up to 70 percent of increased gas demand will be due to gas fired power generation. As a result we see integration of the suppliers and naturally,

convergence in the energy markets. Traders using the spark spread need the technology and tools to trade both commodities on the same system with the same exchange, something we at APX are due to announce in the next few months. There are issues of possible manipulation of the system by combined utility companies, but such issues once more support the open market environment supported by effective exchanges with dependable indices.

A pan-European exchange opens the potential for a pan-European trading platform offering multiple commodities and venues, promoting trading liquidity with minimal collateral requirements for active traders. The creation of reliable, credible indices at a range of European hubs and indeed the creation of pan-European indices could in time, become a reality and thus open the potential for the facilitation of transparent physical and derivative trading across swathes of Europe.

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