ENERGY MARKET LIBERALISATION – PROGRESS AND MARKET EXPECTATIONS
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Electricity and gas markets are continuing to develop rapidly now that the basic political and strategic aims for the industry have been agreed. The implementation of the gas and electricity Directives and the Regulation on cross border exchanges will continue this transformation.

Competition for large consumers is already a reality in the majority of Member States. The latest information reported in the Commission's benchmarking exercise show that, with only a few exceptions, around 15% of large users are changing supplier on an annual basis.

The extension of market opening to smaller users and households is now underway. This task is more complicated, requiring well developed technical procedures, safeguards in terms of public service and some form of education process so that customers can get used to the new arrangements. The transformation from monopoly regulated prices to a freely determined price for electricity and gas supply will take some time. Indeed there may always be an element of regulation present for electricity and gas supply.

All Member States are committed to the market opening process, as are the countries of the south east Europe regional electricity market initiative (SEEREM). However the degree of development varies as set out in the summary table below.

Level of development of competition	Electricity	Gas
not functioning	GR, EE, LV, LT,	all the new MS, FI, PT, GR
initial steps only	BE(f)[1], LU, PT, PL, CZ, SI, SK	DE, LU, SE, BE(f)
some progress	ES, BE(n), IR, IT, FR, HU, RO	AT, BE(n), FR, IT
well developed	DK, AT, DE, NL	NL, IR, DK, ES
complete	UK, SE, FI, NO,	UK

Measures required to complete the liberalisation process

In order to achieve a well functioning market the basic principles of unbundling of networks and regulated third party access need to be in place as set out in the electricity and gas Directives. It is only once these measures are developed that countries will advance in the table above. Member States also need to adopt a clear market design with a liquid structure that produces transparent and reliable price signals. Currently, many countries have too much concentration in the hands of one or two companies. This needs to be solved by making better use of interconnection, by infrastructure investment or by direct action on the part of Member States to reduce market power. The regulation on cross border electricity exchanges will be a key element in improving the impact of competition.

There are several tasks required at EU level to support the actions of Member States in this area; in order of priority,

[1] BE(f) – francophone Belgium (Brussels and Wallonia), BE(n) = Flanders

i. Adoption of guidelines following the entry into force of the Electricity Regulation leading to non discriminatory and market based congestion management and tariff harmonisation.

ii. Achieve agreement in Council relating to the Gas Regulation so that free capacity is made available to network users, tariff structures are harmonised and fair access to storage becomes a reality.

iii. Achieve agreement in Council relating to Electricity Security of Supply directive in order to develop a stable framework and provide correct incentives for investment.

Creating a liquid market

Currently most electricity passes from generators to suppliers in the form of bilateral contracts, often within the same group. This practice is likely to continue to cover a significant proportion of the market, even after liberalisation. For example it is likely that financers of generation capacity and gas infrastructure will require a significant proportion of the capacity of new plant to be covered by some form of purchase contracts.

However, suppliers which have purchased capacity on this basis will then be expected to trade between themselves in order to best match their portfolio of generation contracts or gas portfolio with their requirements of their final customers.

Thus, although the Commission does not wish to impose particular market structures on actors in the energy market, it is clear that a degree of liquidity in the exchange of electricity is to be encouraged. A liquid market, with a transparent set of reference prices will facilitate both competition and provide correct signals for new investment.

Electricity exchanges are gradually becoming more liquid. The standardised contracts and settlement mechanisms offered by them help reduce transaction costs and risks. However liquidity will be constrained if there is an insufficient number of players in any market and if congestion in the European network does not allow competitors from other Member States to fully participate. This explains the importance of the guidelines to be adopted under the electricity regulation and the need for similar measures for gas.

Increasingly there will also be a need to monitor the behaviour of the large companies in these markets. Repeated trading in spot markets is rather conducive to collusion between market players tacit or otherwise. Customers should retain the ability to negotiate bilaterally. In addition, requirements concerning market surveillance and transparency will become more stringent, particularly in relation to outages and maintenance.

Expectations for the market in the medium term

If all the relevant legislation is adopted and properly implemented, the electricity and gas markets will look very different in 3-5 years time. To the extent that more cross border capacity is made available, energy supply could become a more European market or at least based on regions made up of several countries. Many more customers will be supplied by foreign owned companies which will be looking to exploit the economies of scale of a large customer base. There is likely to be rapid consolidation of the smaller supply companies organised on a municipal basis. There will be some new entry, but the most important area of competition will probably be between existing incumbents.

With the implementation of the regulation, the gas market will evolve gradually into a more European market. Although long term capacity reservation will remain an important feature of the industry it is expected that there will increasingly be room for short term trading in gas allowing suppliers to adjust their portfolios to better serve their customers.

There may well be further vertical integration between gas and electricity companies which feeds through into the retail market with companies offering dual fuel deals to customers. Customers will increasingly be offered low cost payment options such as direct debits. Meter reading will also be increasingly carried out through remote options. Customers which have a good payment record may, for example, send in their meter reading by SMS with the amount then automatically paid from their account. A significant portion of efficiency gains will be achieved via customer service innovations.

Depending on their degree of flexibility, large customers will either opt for contracts linked to the spot market or increasingly long term agreements with suppliers with a fixed price. This will allow suppliers to sign longer term agreements with producers in order to bring forward new investments. Large customers will increasingly examine whether it is optimal to become auto-producers if prices rise further towards cost recovery levels.

The increase in electricity prices recorded during 2003 would appear to be, in part, a durable trend as the supply-demand position becomes tighter. Spot prices will continue to be volatile and progressively increase (on average) to full cost recovery level (around €35/MWh) towards 2010.

This will affect large users more than household prices since the latter were relatively unresponsive to the lower prices experienced in 2001-02. Some of this increase will be offset by reductions in network tariffs, as regulators become more assertive in their requirements and from the reductions in customer service costs referred to above. Of course, this is all, to a certain extent, dependent on the price of primary fuels.

Winners and losers

The successful companies will be those which can successfully match their generation and gas supply portfolio to customers, which can time their investments correctly to deliver the most optimal mix of resources and maintain a good balance between long term contracts (which reduce risk) and the flexibility to take advantage of favourable short term conditions through trading.

Successful companies will be able to minimise customer service costs and to offer more complete energy solutions, including energy efficiency. They should be able to communicate well with their customers and offer tariff options that are easy to understand.

This paper represents only the views of the author and are not the position of DG TREN nor the European Commission
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