CAN THE STRUCTURAL BARRIERS TO COMPETITIVE POWER MARKETS BE OVERCOME?

Anne-Malorie Géron, Head of Markets, EURELECTRIC

The need for action

With just over a year to go before the 1st July 2007 deadline for the full liberalisation of the European Union (EU) energy market, recent news headlines may give the impression of a process which has run into serious difficulties. The European Commission has found itself compelled to intervene to restore momentum and confidence to the process of opening up the markets, while well-publicised sensitivities over competing industry initiatives for national and cross-border energy mergers, meanwhile, have fuelled accusations of "economic nationalism".

What recent events highlight in fact is an urgent need for government, regulators and other stakeholders to respond to the development of the market. National barriers are being broken down by industrial economies of scale and increasingly interconnected markets. As a number of leading pan-European electricity companies emerges, government and regulators must reassert control of the process by ensuring a proper framework to support a changing marketplace. The power industry, as one of the key stakeholders, has a central role to play in this process, and this paper sets out ways to overcome the hurdles that stand in the way of a viable, competitive, and liberalised European market for energy.

Identifying the barriers

There are several barriers currently slowing down this process. Linking the European markets will bring liquidity and dilute market share in a consolidating industry. The linking up of progressively larger wholesale market regions, proceeding in parallel with the liberalisation and integration of these regional markets, is the foundation for EURELECTRIC's Road Map to a Pan-European Market for electricity, published in 2005.

Physical interconnection between market zones is of course key. The obstacles in the way of physical interconnection can include local community opposition to infrastructural investment, but also excessively complex licensing rules. These must be streamlined and made more consistent across Europe. However, connecting markets also requires cross-border cooperation between TSOs, regulatory authorities and power exchanges.

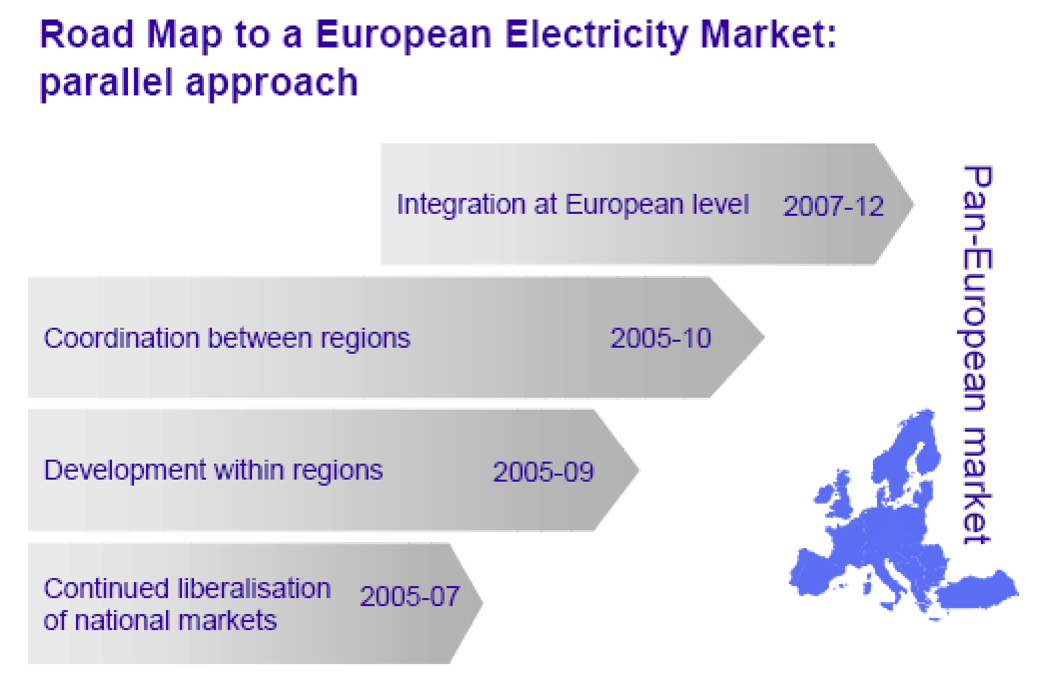
The legal barriers standing in the way of a competitive European energy market are many and complex, and highlight the role of regulators and government in ensuring progress. Among the key issues is the further development of liquidity in spot and forward markets and the need for workable and commonly accepted standards of market transparency as well as market-based mechanisms to optimise capacity allocation on congested interconnectors. Furthermore, the co-existence of regulated and non-regulated market price segments within the same marketplace, and its adverse effects on competition, is a particularly acute problem that needs to be resolved urgently. Likewise, long-term Power Purchase Agreements (PPAs) should be rescinded if they are deemed to be a cause of market foreclosure.

The breaking down of legal barriers to market liberalisation is not a naturally occurring and self-sustaining process. Its success depends on support at a political level and in this respect much progress remains to be made, as is suggested by pending Commission action against most Member States for delays in implementing European gas and electricity market directives at a national level.

The way ahead

The EU's Internal Energy Market (IEM) directives and cross-border Regulation on energy provide a template of the market that is being aimed for: a fully opened European market for electricity and gas, free from internal barriers. The vision set out by the IEM crucially depends on a wholesale market capable of supporting these objectives, but the directive does not by itself guarantee that such a market will be put in place. However, in EURELECTRIC's view the wholesale market for energy has the potential to deliver these objectives if it is channelled by the correct regulatory framework. Liquid, transparent and strongly interlinked wholesale markets will help to drive the integration of European markets, a process which will entail the development of strong links between wholesale and retail prices for electricity.

EURELECTRIC's Road Map proceeds through a series of strongly interlinked wholesale markets comprising progressively expanding price areas within the EU and other closely associated States such as Norway and Switzerland. Given the right conditions, this has the potential to lead to larger European price areas.



Along the way, it is essential that the constituent marketplaces fulfil at least the following criteria:

- Have liquid day-ahead and forward markets and open balancing and intra-day markets with trustworthy prices;
- Have a sufficient number of market participants in the day-ahead and forward markets, in particular more large consumers from the demand side;
- Provide transparent access to common sets of market information; and
- Have market-based mechanisms for congestion management.

EURELECTRIC sees the development of regional markets as a pragmatic intermediate step towards a single European electricity market, provided that the market macro-regions driving the process do not diverge along the way. The process will be a dynamic one and the boundaries of the regional markets should not be rigid but rather chosen on a functional basis and with the awareness that they will change over time. With this in mind, EURELECTRIC envisages the following seven regions emerging as reference market units in the early stages of the process:

- Nordic region
- Northwest Europe
- Iberia
- UK and Ireland
- Southeast Europe
- Central and Eastern Europe
- Baltic States

The timeline envisaged sees liberalisation within each of these macro-regions proceeding in parallel with increasing harmonisation between the regions. This will require an adequate process to further enhance cross-border trading through larger and ever more liquid and transparent wholesale markets, efficient capacity allocation mechanisms and incentives to develop regional grid planning processes. Investors in this capacity, as well as TSOs, regulators and governments, will be called upon to think and act in increasingly Europe-wide terms, with the needs of the entire regional market's development guiding decisions.

Factors helping and hindering progress

In the process of integrating and liberalising Europe's regional price areas, market forces will be a key driver, but political support is also essential. With regard to the latter, recent developments give rise to both hope and concern.

On the positive side, the European Commission has taken a leading role in driving market liberalisation to the top of the agenda. Without prejudging the outcome of the Commission's ongoing sectoral inquiry, the investigation is necessary to resolve and address conclusively any suspicion of market failure. The market needs to have the confidence of all key stakeholders if it is to develop.

Where much progress remains to be made is in achieving an overall clarity and unity of purpose to drive the process of European market integration forward. In part, this is a question of evolving both the structures and the mindset of key stakeholders from a national to a European way of operating. Some of the objective difficulties are clear. For example, unifying the European market for electricity requires a degree of harmonisation of charges for access to the network. Any national regulator called upon to raise domestic access charges in the interests of harmonisation would naturally be in a difficult position.

The issue is not merely one of national loyalties, however. Co-ordination is also needed among different policies, and different policy objectives. With the start-up of the EU ETS, for example, emissions abatement costs are now an integral part of the energy price in Europe. Different policy objectives such as security of supply and environmental protection (in particular the promotion of renewables) need to be reconciled, and their impact on the price of fuels and electricity needs to be clearly costed so that industry players can make the right investment and trading decisions.

This, in turn, requires an open exchange of views and co-ordination both between and within the regulatory, European and national government authorities which have the responsibility of steering the market's development. Most industry stakeholders share the same objectives in terms of the kind of market we all hope to have in place in ten years' time. Where we face a variety of options is in choosing the route that will successfully get us there. In this respect, regulatory and political decisions taken over the next 12 months will be crucial.