ARE MARKET MECHANISMS WORKING TO CREATE COMPETITIVE PRICES FOR POWER AND GAS?

Paul Dawson, Director, Commodities Regulation, Barclays Capital

---

Setting the scene

2006 is a pivotal year for European energy markets as the impact of high energy prices and security concerns have heralded an unprecedented level of regulatory activity in the sector. Gas and oil price increases, coupled with the introduction of the EU Emissions Trading Scheme (ETS) and the consequent rise in EU electricity prices have led to significant customer concern about the extent of competition within the sector.

DG Competition is in the middle of a comprehensive review of the barriers to greater competition and their conclusions toward the end of the year, when coupled with individual competition law cases, could lead to profound changes in the structure and regulation of the sector.

In parallel, DG Transport and Energy (DG Tren) is studying the progress of liberalisation in each member state and rising EU Government concerns about energy security – particularly in respect of the future sourcing of EU gas – have led to their Green Paper on greater cooperation in EU energy policy. DG Environment are also set to review the National Allocation Plans for Phase 2 of the ETS in parallel to concluding their review of what the ETS might look like post-2012.

Finally, in conjunction with DG Enterprise, the three Directorates are engaged in the Commission's high-level group looking to reconcile the Commission's three primary energy policy objectives of security, sustainability and competitiveness.

With the energy sector receiving such a high degree of scrutiny, now is a very good time to be asking - are market mechanisms working to create competitive prices for power and gas? The short answer is - apparently not.

Recent reports from DG Tren and DG Competition paint a comprehensive picture of a widespread failure to implement the provisions of the second package of Directives both in letter and spirit and identify huge barriers to the further development of competition in the gas and electricity sectors.

Gas sector competition

Potential entrants to the EU gas sector face major barriers at every point of the supply chain in accessing sources of gas, transportation capacity, storage flexibility and customers. The result is the absence of any material competition and market liquidity outside of the UK. Specific problems include:

- Very high levels of concentration in the control of imports and domestic production via long-term contracts incorporating high levels of offtake flexibility with the result that liquid wholesale gas markets are yet to develop;

- Gas networks are largely owned by the incumbents and the failure to unbundle these facilities effectively from the supply functions, coupled with widespread allegations of discrimination, has meant that new entrants lack effective access to the networks;

- Although there is little or no alternative to storage flexibility in most markets, regulatory guidelines on storage unbundling have been largely ignored and available storage capacity remains scarce or non-existent;

- Transit capacity is fully booked for the foreseeable future (even then incumbents have preferential renewal rights) and normal third-party access rules and effective congestion management fail to apply to transit. The net result is that cross-border trading does not exert any significant competitive pressure; and

- There is a complete lack of transparency over the usage and availability of transport and storage capacity and other market fundamentals (production, imports, load) and the "three or more" rule in the Gas Regulation could prevent any information being provided at all on key transit pipelines.

Competition in the power sector

Competition in EU power markets compares favourably with the gas market. Many countries have organised wholesale markets and exchanges, transmission unbundling is more advanced and the last year has seen the removal of many non-market based methods for allocating cross-border capacity and the dismantling of many grandfathered long-term cross-border contracts. However, problems remain:

- Generator concentration remains high in many countries and the Commission has identified that operators in Spain, Italy and Denmark may have the scope to influence prices. They also plan to investigate further the situation in France, the Netherlands and Germany (where they plan to look more closely at the influence of plant withdrawals on prices);

- The combined effect of concentration and vertical integration continues to have an impact on market liquidity in many countries particularly in those markets exhibiting high degrees of concentration (e.g., France, Belgium) and where long-term PPAs are prevalent (e.g., Portugal, Poland, Hungary and, to some extent, the Czech Republic);

- There is a fundamental lack of transparency on generation, demand and transmission capacities and usage which makes it difficult to explain the evolution of prices in most markets and remains a fundamental barrier to competition;

- System operators have little incentive to minimise congestion and to maximise the amount of firm capacity made available to the market to ensure effective cross-border competition; and

- The lack of harmonisation between markets and timing discrepancies between day-ahead capacity nominations and the submission of bids to the power exchanges has led to sub-optimal use of transmission capacity.

Action to improve competition

The Commission has already initiated enforcement action against member states for the failure to implement the provisions of the Gas and Electricity Directives and although DG Competition's final conclusions will only emerge towards the end of the year, it is already pursuing individual cases for competition law infringements.

The primary focus of these cases seems likely to be the anti-competitive effects of the long-term contracts and the operation of the transit, transport and storage facilities in the gas sector. There are also likely to be some parallel cases in the electricity sector. The outcome of these cases should hopefully lead to a significant improvement in the scope for competition and allow new entrants to establish a toehold by freeing up access to gas, transport and flexibility services and facilitating the development of more liquid, transparent wholesale markets. It is also clear that any future mergers in the sector will, and should, face detailed and informed scrutiny to prevent further undue consolidation.

Aside from structural changes, there is a fundamental requirement to improve market transparency to ensure that market participants – and crucially customers – can understand, explain and respond to market price movements and to increase the scope for competition and new entry. Regulators also need to ensure that system operators contribute actively to the development of competition by providing efficient and commercial transmission services that allow power and gas to move seamlessly across European networks.

In this area, it seems likely that several welcome regulatory changes may also come out of the Commission's enquiry, including:

- There will be a major effort to provide greater information transparency on several fronts by the national regulators group (via ERGEG) and by the Commission directly through new legislation or through competition law actions;

- Ownership unbundling of transmission and distribution networks will become mandatory unless substantial progress is made not just in implementing the letter of the Directive's requirements but also in the spirit of genuine arm's length provision of transport services; and

- There is a growing sense that national implementation of the Directive's provisions will not be sufficient to achieve the required levels of coordination between national regulators and system operators and that EU-wide structures including an EU grid code and European energy regulator may be required.

A long-term, international framework for emissions is essential

Beyond the immediate competition agenda, the long-term question is **will** market mechanisms work to deliver the required investments to ensure reliable and secure supplies within the context of an overall carbon constraint? A stable, credible long-term regulatory and policy framework is required to provide greater certainty for the significant investments necessary to meet these goals. However, the fundamental building blocks for this policy framework are largely already in place:

- If allowed to work unhindered, competitive European energy markets can and will deliver the investment required in fuel sources, infrastructure and generation to deliver affordable, reliable supplies. Regulators should therefore focus on removing the barriers to competition and in providing longer-term policy certainty (e.g., on planning, nuclear waste management and decommissioning, the treatment of carbon capture and storage etc); and

- Emissions trading ensures that companies factor the cost of carbon into their commercial decisions and provides economic – and technology blind - incentives to bring in the required investments in low- and zero-carbon sources of electricity.

Although improvements to the competitive landscape are already in progress, there is an urgent need to provide clarity now on the key parameters of emissions trading beyond 2012 (in terms of the reduction commitments, methods for allocation, etc). However, to underwrite the credibility of these long-term emissions commitments, the EU must first address the fervent criticism from industry associated with the pass-through of carbon costs into electricity prices. The fact that carbon now has a price in the EU – and electricity prices factor in that price - is an inevitable consequence of the EU's climate change policy rather than the introduction of emissions trading per se. However, the long-term sustainability of the scheme will continue to be called into question if the EU continues to "go it alone" in taking the hard steps necessary to tackle climate change.

Consequently, the problem is not that emissions trading has led to price increases within the EU, but that industry outside the EU does not face a corresponding constraint on, and hence a price for, their emissions. An international commitment to tackle climate change beyond 2012 via long-term, enforceable caps on emissions and international emissions trading will therefore be crucial to underwriting the long-term credibility of the EU's climate change policy.

In summary, while markets mechanisms are currently struggling to deliver competitive prices, a hugely ambitious programme of regulatory action to improve competition is currently underway. This should lead to a fundamental improvement in competition both in the short-to-medium term, and, alongside a long-term credible commitment to emissions trading, will play an essential role in achieving the longer-term imperatives of affordable, sustainable and reliable energy supplies in the EU.