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

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Setting the scene

It has almost been ten years since the EU issued Directives on unbundling and supply competition. But progress has been slow and uneven – why?

In my view it is because we energy traders have failed to fully utilise levers available to us to create a truly liberalised pan-European energy market. You might ask: Why us?

It is our problem because, at the end of the day, it is up to us - the community of wholesale traders - to break down barriers and create more pressure to speed up the process of liberalisation. We are still too long on excuses and too short on actions.

Conventional wisdom on how to make liberalisation work includes the following proposals:

- A scrutinising regulatory regime and framework will remove old incumbent oligopolies.

- Full information transparency at all levels and at all times will automatically lead to an efficient market.

- Physical cross-border connections without congestion are necessary for markets to grow together.

- More generation capacity must be built, primarily by new entrants.

"Why a lie told often enough does not become the truth" (Lenin 1870 – 1924)

- **Regulation must not be confused with liberalisation**

  For example, there is strong regulation in Spain and other European countries but these are still markets with no competition. Instead, there is arbitrary, politically-motivated market intervention compared, for example, with the so-far unregulated German market, which acts as the liquidity pool for Europe's wholesale power activities. The existence of the German power wholesale market was even acknowledged in the EU Commission Competition Inquiry. This does not mean to say that everything is perfect in Germany, but it proves that regulation per se does not guarantee competitive markets. Quite often the opposite is true, with regulators having repeatedly destroyed markets by political intervention.

- **Transparency is an important ingredient, but not the main dish**

  When asked about the benchmark for transparency, many will cite Nordpool which is, along with the UK, a prime example of a power wholesale market which has experienced declining liquidity in recent years. On the other hand, Germany and France, both markets that are publicly denounced as opaque – have seen the steepest increase in traded volumes.

  Also, in Germany, all active market participants are able to access essential information. Since private information providers (e.g. Genscape or powermonitor.org) started offering their service in late 2004, even real-time power plant information has become publicly available. Nowadays, planned generation data is “served on a silver platter”, as it is available in the public domain at no cost via the EEX website. Nevertheless, transparency obviously does not create a market - but it can certainly help to increase liquidity and at the very least it answers those critics who complain about missing data.

- **Cross-border flows: convergence of markets**

  Cross-border congestion inhibits the smooth-functioning of wholesale markets. But a closer look at how congestion is managed reveals that not all market participants are in favour of full liberalisation. Although some cross-border capacity is offered to the interested market participants via auctions, other capacities are allocated through biased, non-competitive procedures and/or legacy contracts. This reveals the variety of (partly conflicting) interests of the participants and demonstrates to me that trading companies are the only ones with a vital interest in an unbiased form of access.

- **New entrants will only build new plants if it makes economic sense**

  Up to 2012, more than half of the new build capacity in Germany will be undertaken by new entrants. The market price signals and maturity of the German power wholesale market have encouraged these investors to invest in new power station projects. But these investments will only happen if the investors see a good chance to earn an appropriate return on their investment. If power prices were to fall, the investment from new entrants and incumbents will be cancelled or postponed.

  If the hourly power market price does not reflect the cost of production in the marginal plant the only way to guarantee long-term security of supply would be to return power generation to the public sector. We all know that this will lead to a high degree of inefficiency with huge economic waste. Thus the only way to attract new entrants to build an asset base is to allow liquid, deep and long-dated traded wholesale markets to provide economic price signals and hedging of risk.

Security of supply is also an issue of diversity

On the eve of World War I, First Lord of the Admiralty Winston Churchill made an historic decision: to shift the fuel source of the British navy's ships from coal to oil. He intended to make the fleet faster than its German counterpart. But the switch also meant that the Royal Navy would no longer rely on coal from nearby Wales but on insecure oil supplies from what was then Persia. Energy security thus became a question of national strategy. Churchill's response was that "Safety and certainty in oil," he said, "lie in variety and variety alone."

Since Churchill's decision, energy security has repeatedly emerged as an issue of great importance, and it is so once again in the light of today's "pricing" issues. The flow of LNG to meet gas demand will be determined by liquid and deep wholesale gas price benchmarks like "Henry Hub" or "NBP". Where these wholesale price benchmarks do not exist gas producers are hesitant to supply "merchant LNG" because prices are not transparent and therefore there is a risk for buyers if they do not have access to the retail market. In a global market competing for gas, the best way to achieve security of supply is to let markets work.

Some conclusions

We have to realise that the early euphoria of energy market liberalisation has vanished in light of rising energy prices caused by global competition for scarce energy resources and the price rises for production capacity (power generation, gas storage, transmission lines, gas pipelines, etc.) required to trigger the next round of asset investment. So what has been the impact on the views of different stakeholder groups?

- **Politicians**

  We see a world of deteriorating global stability, increasing self-confidence of commodity (specifically energy) producing nations and as a consequence rising commodity prices. Against this background, many politicians consider their twin objectives of security of supply at low prices to be at risk. They fall into the same trap that young traders fall into: They think they are bigger than the market. Nobody is bigger than the market. Those politicians who demand more competition but intervene when prices rise – as we have seen recently in Italy and Spain – destroy markets and disable competition.

- **Industrial customers:**

  Energy market liberalisation brought choice of supplier and initially falling prices as a result of the squeezing out of the inefficiency of the "government agency" energy markets prior to market opening; but it also brought price risk and the responsibility of managing this risk. We have seen many companies – especially from energy intensive industries – complaining about the effects of liberalised markets, from which they profit via higher product prices and margins.

  In addition, many industrial customers have not spent much time analysing the economic dynamics of the energy markets and have for this reason grossly misjudged the market and the resulting price increases. Some industrial customer associations are calling for government intervention into energy markets but this negates the principles of open markets and exposes their own industries to government intervention when other stakeholders complain about price increases in their markets.

- **Household and small business customers**

  In most markets we see very low switching of retail customers despite the fact that there is choice, ability to switch and significant price competition. The reason for not switching is convenience but nevertheless we continue to see consumer groups calling for government intervention.

It is clear that the majority of stakeholders in our markets are biased in favour of intervention and against the reign of free, open and competitive wholesale markets. The only stakeholders left to defend markets and demonstrate that the principle of competitive markets can work in energy is us – the energy traders.

If we do not succeed in developing a truly open European energy market our commercial *raison d'étre* ceases to exist. As Sir Winston Churchill put it: "Men occasionally stumble over the truth, but most of them pick themselves up and hurry off as if nothing ever happened".

Let's not hurry off, let's fight for the common objective of free, open and competitive energy wholesale markets. We have demonstrated as an industry that we can achieve a lot if we unite behind this objective and organise ourselves rather than being victimised by interventionists.