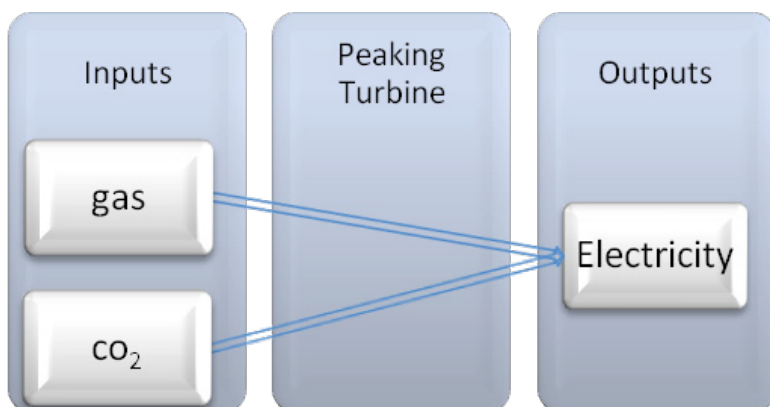


Who should do what to improve market efficiency and liquidity?

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Setting the scene

I have recently been involved with a peaking turbine project in Central Europe. In theory, this is an easy exercise:



The commercial value of a peaking turbine depends on the future value of the spark spread (electricity *minus* gas *minus* CO₂). While working on this model, I have discovered a striking contrast between the gas and electricity aspects of the peaking turbine project.

We managed to build a Central European electricity forward curve without any major problem. The same exercise for gas proved to be difficult. We could not get reliable forward gas prices in Central Europe. The next best solution would be to move gas from one of the Western European hubs to Central Europe. This exercise was also challenging. Predicting medium term transportation and cross-border costs was hard, if not impossible.

What are the main reasons for this difference between electricity and gas markets in the same geographical region? I would list two points here, not in any particular order:

(1) Compared to electricity trading, gas is a micro-cosmos: micro volumes trade at a micro hub. There are over 300 electricity trading licence holders in Poland alone⁸; the Central European Gas Hub (www.gashub.at) had 93 members, as of 8 September 2009⁹. POEE, one of the Polish organised electricity markets, is trading around 10.00 TWh/day¹⁰; the same number for CEGH is 0.00022 TWh/day¹¹.

(2) Gas is an over-politicised commodity. I was active on the privatisation side of the Central European gas markets in the early 1990s. Back then, the industry was all about an Eastern country and a particular company in that country. I have recently re-contacted my gas-industry friends to get some help with building that gas curve. I had good and bad news. The good news was that some of my old friends are still around; the bad news was that the gas sector seems to be as politicised today, as it was in the early 1990s. When asked about the forward curve for the peaking turbine, the discussion quickly went back to an Eastern country and a particular company in that country. Marcel Proust was correct: Time (with a capital T) can indeed stand still.

Creating a gas market

I would like to discuss who should do what and when to reduce this 'spread' between the Central European electricity and gas markets?

We have to address the two points listed above and things should improve.

I would argue that Point (2) is the cause of Point (1), but not everybody shares this approach. Some market participants want to expand the micro-cosmos, hoping that this 'big bang' will de-politicise the gas markets. Two recent examples should suffice here:

- a **Austria:** Three leading companies have agreed in November 2008 to establish a Central European gas exchange¹²;
- b **Hungary:** PowerForum, an internet-based electricity trading platform, launched a gas trading section in April 2009¹³.

⁷ The views expressed in this paper represent those of the author and not EDF Trading

⁸ Polish Regulator's web-site: http://bip.ure.gov.pl/portal.php?serwis=bip&dzial=import&id=4&szukaj%5B1%5D=OEE&szukaj%5B2%5D=&szukaj%5B3%5D=&szukaj%5B4%5D=&szukajod_5=&szukajdo_5=&szukajod_6=&szukajdo_6

⁹ https://www.gashub.at/downloads/CEGH_memberlist.pdf;

¹⁰ <http://www.cire.pl/poee/index.php>

¹¹ Dr Ingholf Hoven: Who should do what to improve the liquidity and efficiency of EU regional gas markets? In: APX Energy Trading Symposium, 22 April 2009, page 38, Chart B

¹² https://www.gashub.at/pr_downloads/20081105_IN_OMV_engl.pdf

¹³ <https://www.powerforum.hu/powerforum/Hir.psmi?articleId=4428>

This approach will fail because it is concentrating on the effect (point 1 above) without fixing the cause (point 2). The history of the Central European electricity exchanges proves this point. A number of Central European countries set up a number of local electricity exchanges during the last decade. Liquidity on the Central European electricity market increased sharply, but most of these exchanges failed.¹⁴ What is the moral? We need a large pool of active, creditworthy and experienced traders to de-politicise the Central European gas industry.

Attracting more traders

Traders like simplicity and predictability and dislike over-politicised commodities, like the Central European gas market.

There is no magic formula to de-politicise quickly the Central European gas markets. But we should not underestimate how much co-ordinated, step-by-step actions from politicians, regulators and traders could do to maximise market efficiency and liquidity in CEE gas markets. There are in my view, three key requirements

1 Politicians: attitude change

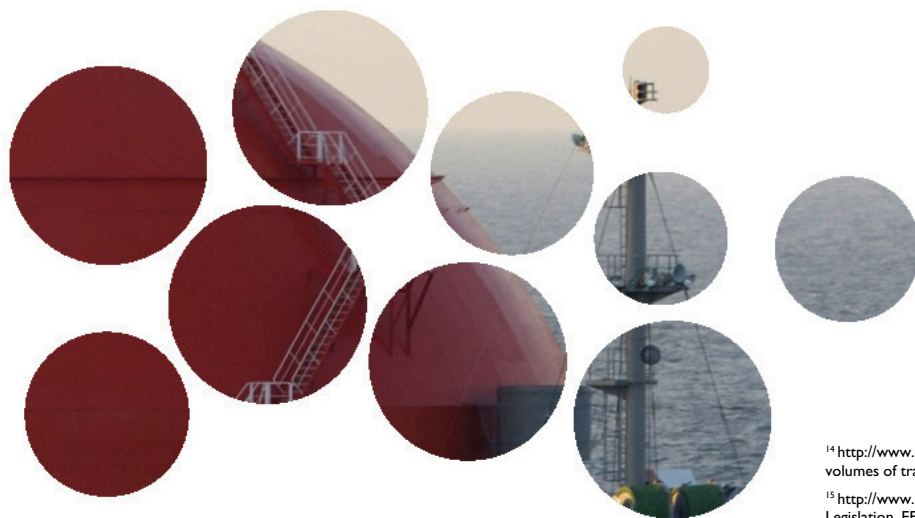
The number one priority is to convince politicians that gas trading is best left to active, creditworthy and experienced gas traders. As an example, I would note that the Central European electricity markets have been fully liberalised. Long-term electricity contracts, once deemed to be the corner-stones of security of supply, have been terminated and pre-allocated cross-border capacities cancelled. The Central European electricity market did not collapse after liberalisation. Quite the contrary, all market participants, including politicians and final customers, benefited from electricity liberalisation.

The same success story could be repeated in the Central European gas sector. The basic ingredients, such as regulation, separate transmission companies, are ready. Politicians are not: they do not seem to acknowledge that active, creditworthy and experienced gas traders are indeed a viable alternative to inter-governmental bodies and oil-indexed, long-term contracts. Security of supply and over-dependency on imported gas are not valid excuses to delay proper gas market liberalisation. As the EFET Gas Committee pointed out recently, “*Competitive markets help to maintain secure supplies because the gas flows respond to price differentials as far as physically and economically possible.*”¹⁵ As I said above, our number one priority is to get these messages to politicians in Central Europe.

2 Regulation: transparent and simple

Strong independent regulation is a necessary, but not sufficient pre-condition to improving market efficiency and liquidity in Central Europe. Regulators should repeat the following words, as their daily mantra: *transparency and simplicity.*

- a **Transparency:** This is a requirement of natural justice and, usually, requires no special discussion. Yet Slovakia introduced non-transparent storage constraint rules earlier this year¹⁶;
- b **Simplicity:** The slightest barrier to entry, like the need for a local office or uncertainty about VAT re-claims, will discourage traders from entering the market. For example, an EU entity could obtain a wholesale electricity trading licence without any local office requirement in Hungary but the same applicant would have to set up a local branch to obtain a gas trading licence.



¹⁴ <http://www.borzen.si/pripone/249/Report%202008.pdf>, page 12, figure 3 ‘Monthly volumes of trading and SLOeX index fluctuation during the years 2002 to 2008’

¹⁵ <http://www.efet.org/default.asp?Menu=283>, Improvements to EU Gas Security of Supply Legislation, EFET Response to the European Commission, dated 26 March 2009, page 1.

¹⁶ *Ibid*, point 2.2, page 5.

3 Traders: standard contract and credit

Finally, the traders. I wish to concentrate on two points only: standard contracts and credit. As a main rule, gas traders should use the standard EFET General Agreement. My experience of the electricity sector are that even tiny amendments to the general EFET agreement could delay execution. Home-made EFETs, i.e. EFET principles mixed with local contracts, should be avoided at all costs.

So far as credit is concerned, the recent turmoil in the financial sector was a painful, but useful reminder that credit control is important. One or two Central European energy trading firms failed earlier this year. They had one thing in common: all operated on the basis of name trading. Hopefully, the Central European gas traders learned their lesson namely that, trading lines are opened following appropriate credit checks, and not on a name basis. This is not an easy task in Central Europe. I have mentioned in my introduction that CEGH had 93 registered users as at September 2009. Of this total 71 are declared to be active; it would be interesting to see how many would satisfy the *'credit-checks and no name-trading'* principles.

Conclusion

To conclude, I wish to return to the original question: what about the forward gas curve for the peaking turbine? I believe that the above recommendations would help to minimise the striking contrast between the electricity (forward curve ready) and gas (no forward curve) sides of my model. Once I have the gas forward curve, I can calculate the forward value of the spark spread and decide whether to build the peaking turbine in Central Europe or not. I would like to think that this will happen soon.

