

## What needs to be done to ensure regional electricity prices reflect fundamental demand and supply conditions?

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### Introduction

For a market to develop, traders require confidence that prices reflect real market conditions. But, traders are also interested in efficient pricing because this encourages greater market liquidity and product innovation, which is a fast track towards market maturity. Efficient pricing removes factors that are external to fundamental demand and supply dynamics.

So if efficient pricing is important, is there any reason why the CEE region should create its own efficient pricing mechanisms, or should it accept a role as an ancillary market to more mature neighbouring markets?

We believe the CEE region should determine its own pricing and take control of the mechanisms to ensure that prices reflect the fundamentals of supply and demand.

This is important because of the geographical position of the market wedged between the energy exporters to the East and the large consumers to the West, as well as the different infrastructure characteristics. The influence of net external market flows just becomes part of the regional pricing stack rather than a price leader for local generation.

Creating regional specific pricing via a liquid market will bring benefits in terms of investment both in the energy sector and other areas, because energy exposures can be managed with more confidence.

### Issues

Should the CEE be considered as one market or a number of distinct markets?

A recent survey by Moffatt Associates for the EU Commission (July 2008) revealed significant variations in market liquidity and efficiency across the region (see chart below).

	Number of active traders	Volume of trading	Number of new entrants	Demand and supply transparency	Influence of dominant market incumbent(s)	Representative spot market price	Ability to trade forward
<b>Austria</b>	Weak	Weak	Weak	Weak	Moderate	Moderate	Weak
<b>Bulgaria</b>	Weak	Weak	Moderate - Weak	Weak	Strong	Weak	Weak
<b>Czech Republic</b>	Moderate	Weak	Moderate	Moderate	Moderate - Strong	Moderate	Moderate
<b>Hungary</b>	Moderate	Moderate	Weak	Weak	Moderate - Strong	Weak	Weak
<b>Poland</b>	Moderate	Weak	Weak	Weak	Strong	Moderate	Weak
<b>Romania</b>	Moderate	Strong	Moderate	Moderate - Weak	Moderate	Moderate - Strong	Weak
<b>Slovenia</b>	Weak	Weak	Moderate	Moderate	Strong	Weak	Weak

KEY: Weak rating – green, moderate – yellow and, strong – red

Development in isolation of neighbouring markets is to be expected when regulatory regimes are not focused on a regional outcome. Although, progress in some markets can spur on developments elsewhere, introducing a more regional focus at an early point could have additional benefits, namely:

- harmonised approaches could maximise the efficiency of infrastructure investment;
- shared experiences could resolve difficult issues without the need to re-invent the wheel;
- shared development plans can provide a lower level of domestic political risk and avoid the temptation to favour local incumbents;
- the development of regional pricing can provide a stronger basis for liquid markets that reflect local pricing outcomes rather than be a derivative of larger nearby markets.

The success of Nordpool is a good example of a collective approach to generate additional market liquidity. While the design in Nordpool may not be appropriate for the CEE region, it does show that a co-operative approach can lead to a rapid increase in market liquidity and market confidence.

### Local liberalisation

Measures at a domestic level are essential for success for the development of wholesale markets.

Such measures should include the development of more stable regulatory rules, a rapid opening up of supply competition, and transparent cross-border power flows without any undue restriction. Improvements in transparency around generation costs, fuel costs, plant outages and a consistent calculation and provision of cross-border capacity and congestion management approaches would also help.

The wholesale markets are a tool to allow stakeholders to better manage risk. The emergence and quality of those markets is a function of need and this comes out of market structure such as the level of supply competition and access to power and customers. Wishing for a liquid wholesale market in the absence of a sound market design is pointless.

### Positive steps

The development of the Capacity Auction Office (CAO) is a strong message that a regional solution to capacity can add to better market outcomes. While the system is new and innovative and the lessons are yet to be fully understood, it is clear that thinking “regionally” introduces a number of additional challenges; namely:

- to stress test the old way of doing things, and to discover if stakeholders have the capacity to learn.
- to reduce mental barriers that often stop the policy-makers thinking beyond national frontiers.

### Negative actions

Recently, we have seen attempts within the region to protect local markets through physical and fiscal measures that restrict power exports. Other than the dubious legality of such measures, the policies are short-sighted and ultimately damaging to local consumers.

The predictability and stability of cross-border capacity calculations have also proved illusive. Even recent market coupling activity between Czech Republic and Slovakia has raised concerns about whether the correct level of capacity was initially offered to the market. Whether or not such concerns are valid, the perception is important as this can add to market risk.

Regulators need to respond in a positive way to ensure that the maximum amount of capacity is made available. This requires a clear understanding and exposition of the security needs for the TSO, and also the development of appropriate tools and incentives for a TSO to manage capacity rather than just reduce availability.



### Investment benefits

Investment in energy assets, as in other assets, requires consideration of how to manage the risks, whether they relate to credit, financing, input costs or delivered energy. Having market prices closely related to the assets themselves makes this task significantly easier as this directly impacts on the fundamental valuation of an asset.

A tougher environment for risk management will make the use of correlated markets a more difficult sell. A visible liquid trading curve in the target market for investment will be viewed even more favourably in today's environment.

### Pricing within an EU context

The physical realities of the power market means that different price zones should naturally emerge. The introduction of more renewable and potentially intermittent generation strengthens this outcome.

It is not sufficient for Regulators to simply wish for single price zones or to shoe-horn different markets into a uniform solution. The key to efficiency in pricing is to allow differences to be exposed and managed (e.g. through the development of intra-day markets). Indeed, Regulators blindly driving single price zones without consideration of physical realities will add to uncertainty about investment spending and location.

It is entirely feasible that a large part of the CEE region could form a key pricing hub for European power. Only by developing the conditions conducive for efficient regional pricing will the role of the CEE as a pricing hub be truly tested.

### Conclusions and challenges

Our view is that the CEE region can represent a significant pricing zone in Europe. A lot of the work in progress will help make this a reality, but there is still a need for strong domestic action to ensure that the foundations of a regional market are not weakened by poor implementation. What we do not need is undue focus on the rules rather than the spirit of the liberalisation process, or attempts to protect domestic consumers through inappropriate restrictive practices.

The need for additional investment in energy infrastructure and services is undisputed. However, this investment pool is not bottomless and, in the wake of the financial crisis, investors will look not only at net margins, but will have a greater eye on the associated risks. By tackling issues at a regional level, there is a greater opportunity to lower investor risks and to better position the CEE when competing for these limited funds.

The evolution of the CEE power market faces similar challenges to other European markets. It would be difficult to conclude that the CEE region faces more difficult circumstances, particularly when the speed of liberalisation and regional integration are controllable, and it is these factors that will dictate the level of market development and investor interest. The opportunity to lead is available, and allowing the conditions for efficient market pricing to emerge will bring numerous other benefits.

