

The Future Role of Power Exchanges: A regulator's view

The design and operation of power exchanges varies substantially across the EU. According to Johannes Kindler, Vice President of Bundesnetzagentur (the German Regulator) proper regulatory oversight is essential to ensure well-functioning exchanges and greater market liquidity.

A variety of exchanges

Since the stepwise opening of the European electricity markets, electricity trading has developed rapidly in a number of European countries. In most, bilateral trading in the OTC market has been supplemented by the set-up of organised markets. The design of these power exchanges or exchange-like organisations differs substantially in the member states. Whereas there are some more or less mandatory local or regional pool models, trading on the power exchange is optional at least in the most developed member states.

As a result, there is currently a large, in some regions still growing, number of exchanges in the European electricity market with a wide range of institutional designs and traded products and sometimes overlapping market areas. With increasing liquidity at the power exchanges these markets attract not only generators and suppliers from the energy industry, but a wide community of players with different objectives, such as commodity traders, financial institutions or investment funds.

Reliable price formation

Independently of the institutional design, power exchanges can play an essential role in the market once liquidity has increased to a sufficient level. Electricity prices determined at the power exchanges will then function as reliable price indicators. This implies that prices determined by the power exchanges are of vital importance not only for participants on the exchange, but also for any kind of bilateral contract, including supply contracts for industrial and even household customers. In the future, the importance of the prices

on the power exchanges will even grow as national electricity markets become more and more integrated by the introduction of market coupling for optimisation of cross-border price arbitrage. Market coupling means that at the exchanges in adjacent countries available day-ahead cross-border capacity is taken into account in determining the energy price. With market coupling it can be expected that prices will be financially as close as technically possible on a common level.

A similar market design has already been implemented in the Scandinavian market where all the available cross-border capacity is exclusively handled via market splitting by the power exchange Nord Pool Spot. Market splitting is done at MIBEL for the Spanish and Portuguese market and trilateral market coupling is in place between the Netherlands, France and Belgium. Furthermore, the introduction of implicit auctions is planned for the German-Danish border by the end of September 2008 and for the Central Western Europe region in 2009.

The integrity of the wholesale markets and especially of the power exchanges is therefore crucial. Against the background of the increasing importance of well-functioning power exchanges and greater market integration at the same time, proper oversight of power exchanges is crucial for trust in the well-functioning of the whole market.

Varying regulatory regimes

Trading on the power exchanges – and also the energy exchanges themselves – are mostly subject to supervision already. But the supervisory schemes differ significantly in ►

the different member states and do not always cope with the challenges resulting from the integration of electricity markets. There are fully licensed exchanges versus Multilateral Trading Facilities. There are mandatory (EU sector inquiry calls them “incentivised”) versus free competition markets. There are pure spot versus integrated spot and derivatives markets, some of which covering also adjacent products like CO₂, gas, and others. It is the view of the European Regulators’ Group for Electricity and Gas (ERGEG) that a consistent supervisory scheme for the power exchanges and energy trading overall – based on co-operation among the competent national authorities – should be in place to deal with the challenges resulting from the increasing integration of electricity markets and the accompanying consolidation of power exchanges.

Need more transparency

A consistent supervisory scheme is important but is only one of the main pillars for fostering the integrity of power exchanges and wholesale markets. A major pre-condition for providing reliable price signals for the market is that the market has sufficient information. The information the market needs can be divided into two categories. On the one hand, information about traded volumes, prices and price formation rules is important. Whereas this kind of information is widely available for trading on the power exchanges, information on bilateral trading in the OTC market is not available to every market participant. On the other hand, information about the factors driving electricity prices, including for instance real-time information about infrastructure availability and generation availability, is vital. ERGEG is convinced that a Europe-wide, consistent framework

for transparency will contribute to fostering market integrity. This will also combat the possibility of the manipulation of electricity markets, highly sensitive to such behaviour due to the increasing scarcity of generation capacity Europe-wide.

It must be also underlined that other energy and energy related markets, such as the gas and carbon emissions trading markets, have an impact on the electricity market to be considered. Organised gas markets are still not very liquid, due mostly to high market segmentation. Only last year, short and long term gas trading was introduced on the European Energy Exchange in Leipzig. Enlarging market areas in which gas trading can take place without restriction will encourage liquidity in these markets.

Carbon emissions trading plays a vital role in the energy markets as well. It was implemented in 2005 and liquidity has grown. A proper market design for the European emissions trading scheme is of the utmost importance, not only for emissions trading. It is also important for the integrity of the energy markets as there is strong linkage between the emissions markets and the energy markets.

The importance of a Europe-wide consistent regulatory framework for energy trading was underlined in December last year by a mandate from the European Commission to ERGEG and CESR, the Committee of European Securities Regulators, an ambitious objective. The European Commission seeks joint advice from the two associations on the oversight and transparency rules in the energy markets. This again stresses the need for a consistent supervisory framework for physical as well as financial energy trading, taking into account the specific features of the energy market. ■

