Higher fossil fuel and carbon prices have driven up power prices. But according to Dr Hans Grüenfeld, president of IFIEC, the adverse impact on user costs is aggravated by the lack of competition in EU energy markets.

Impact of Market Structure on Energy Prices

The highest (marginal) cost sets the benchmark for power prices. To this has to be added the effects of the EU Emission Trading Scheme (EU ETS). Carbon credits, given to generators free of charge, are added to every unit produced even when there is no fossil input. Similarly on gas, prices are set at the marginal LNG level, and are not related to average costs.

"It has been argued that the rise in energy costs is a global phenomenon."

When energy can account for 30% or more of total production costs, uncontrolled price increases create competitive distortions. When the energy "market" delivers extraordinary price increases in the short term and then these prices fluctuate around the new highs on a daily basis, even the most efficient energy users can struggle.

It has been argued that the rise in energy costs is a global phenomenon. There is some truth in this, as long as all competitors work to the same financial principles and energy costs are similar.

"Investment is essential throughout the EU electricity and gas supply chains and security concerns point to the benefits of technology diversity."

The reality is that the profitability of IFIEC's members, is under greater pressure than other global competitors. As EU energy companies are not competing with those outside EU, costs can be passed through in a way not available to industry competing globally. The result is that European energy markets have undermined the competitiveness of Europe's energy dependent industry.

MARKET IMPERFECTIONS

The issue is whether current market design and market concentration is resulting in customers paying not only for the increase in fuel cost, but for something else.

The findings of the energy sector competition inquiry launched in 2005 by the European Commission (EC) identified serious shortcomings in the electricity and gas markets: "too much market concentration in most national markets, a lack of liquidity, preventing successful new entry, too little integration between Member States' markets and an absence of transparently available market information, leading to distrust in the pricing mechanisms..."

These findings clearly suggest the need for structural and design changes of energy markets that by their nature are oligopolistic. Today's uniform price setting mechanism covering a multiple generation technologies may not be a balanced choice.

Investment is essential throughout the EU electricity and gas supply chains and security concerns point to the benefits of technology diversity. This must include the development of LNG terminals, gas storage capacities, nuclear facilities and cross border reinforcement in both gas and electricity networks. Renewables will also be important and although IFIEC questions the feasibility of EU ambitions, these technologies must be explored fully. This is major structural change, not system maintenance and IFIEC accepts that costs will increase.

IFIEC has always pressed for competitive energy markets, but competition cannot be imposed on downstream markets without competition in generation. There are insufficient checks and balances across the EU to cope with the structural problem of market power. Markets suffer from insufficient guarantees to avoid the abuse of market power by incumbents.

CONSUMERS HAVE A RIGHT TO:

- choose suppliers and delivery options;
- know that incumbents cannot restrict new entrants that might offer consumers different options;
- see how the capacity is being utilised to remove concerns over market price distortion;
- appreciate how prices are set.

NEED FOR GREATER TRANSPARENCY

Key to this are transparent pricing mechanisms with competition established between assets. New investment consortia should be encouraged to introduce new asset management and pricing mechanisms. New regulator arrangements need to ensure that there are no entry barriers to such consortia being able to offer all technologies.

> "Co-ordination of TSOs would be a way forward to guarantee system security and to decide the grid improvements needed."

Some Canadian provinces have removed marginal pricing mechanisms by arrangements that make existing assets openly competitive, whilst developing competition in new power generation. This kind of scheme is benefiting both consumers and producers and should be encouraged in EU.

The EC's proposals to liberalise energy markets should be implemented along with the necessary regulatory arrangements. Co-ordination of TSOs would be a way forward to guarantee system security and to decide the grid improvements needed.

VALUE OF LONG TERM CONTRACTS

The benefits put forward by utilities for buying gas under long term contracts apply equally to major energy using industrial customers because:

- they provide investment assurance for both suppliers and consumers based on criteria acceptable to competition authorities;
- major industrial consumers provide 24 hour demand for +360 days in the year; providing suppliers with levels of efficiency and system stability not available otherwise;
- they can agree to shut down all or part of their activities during supply shortages;
- they can invest or co-invest either in production assets or through schemes to reduce grid loads.

EFFICIENT PRICE FORMATION

The relationship between the exchange price and prices charged to customers needs clarification and agreement. The final price must:

- include cost transparency over both existing activities and new projects in Europe. How these costs are amortised are central to questions of entry barriers and long term price structures;
- be based on actual input costs, providing new investors the prospect of covering the cost of new investments;
- ensure that the EU ETS on cost reflects the actual carbon content and does not generate any windfall profit;
- ensure that renewable support systems both reflect regional suitability and encourage technology development.

Finally, IFIEC recognises and accepts that energy markets are not the same as other commodity markets. Even so, all customers have a right to be confident that the price they are charged is fair. This means (a) effective transparency in costing structures and (b) assurance of open competition in delivery to final customers.