According to Adam Cooper, Vice-President of Regulatory Affairs at Merrill Lynch, more competitive energy markets are starting to emerge and, in the current climate, policy-makers need to avoid hitting the panic button.

Avoid Hitting the Panic Button

SETTING THE SCENE

"It's not the bulls and bears you need to avoid – it's the bum steers" Chuck Hillis

The unprecedented upheaval in market economies and the immediate transmission to non-financial sectors has thrown up extraordinary challenges, real threats and some opportunities.

In the eye of such a storm, the industry must continue to ensure that regulatory policy is aimed at positive outcomes and to resist knee jerk solutions such as price capping, the creation of monopoly exchange services, controlling price formation via regulation and a retreat into "economic nationalism."

"A well functioning market also provides the right signals for balanced decisions on investment."

Of course, in wholesale electricity and gas markets, the most immediate concerns relate to trading liquidity and counter-party risk. A well functioning market also provides the right signals for balanced decisions on investment.

NEGATIVE INFLUENCES ON LIQUIDITY

The most immediate impact of the current environment is credit aversion. Credit markets rely on a fluid mix of analysis and trust and, with a breakdown in the quality of risk models, there is necessarily a heavier reliance on trust.

We have witnessed a number of reactions as market parties seek to manage risk while flying blind. Instead of focusing on the immediate impacts, industry needs to consider what measures can be undertaken to reduce the emotive responses to stress situations. Perhaps now is the time to push harder towards central clearing models.

The outcomes of a more fearful environment creates increased short term volatility which is driven by greater credit risks feeding into pricing and creating a more short term trading focus. An uncertain economic recovery timeframe, with consequential impacts on demand levels, could make curve trading a more difficult prospect. However, to date, trading does not appear to be adversely affected, and perhaps this reflects a more mature market where trading has become a tool for broader portfolio management rather than a purely speculative tool as is believed by some market observers.

Consolidation and retreat of some market players will directly impact liquidity. As we saw with the US based merchant trader decline, there can be a drop in market activity. However, so far the level of consolidation and loss has not been as significant as in the past. The true test will come in the first half of 2009 as businesses decide whether trading commodities represents the best use of capital. This will be the case for recent new entrants still looking to build commodities platforms.

The EU's 3rd Energy Package could, in part, reduce liquidity by increasing costs of reporting and there is a small risk of having other capital requirements or heavier regulatory scrutiny on firms not currently subject to such regimes.

The threat of asset deflation along with tougher debt markets will also impact upon investment decisions (along with uncertainty on the demand side). It would be surprising if asset based companies had not spent significant time looking at existing and future programmes to assess whether decisions based on previous macro-economic assumptions were still valid and economic. At the very least, the timing of major infrastructure projects could be impacted.

POSITIVE INFLUENCES ON LIQUIDITY

In this environment, it may be surprising to consider whether there are any positive forces at work to improve market liquidity. The timing of such positive forces are long dated, but if policy responses to the difficult times are considered properly and market participants play an active role, the medium term aim of more active regional and European markets is not a lost cause.

Despite the angst, disappointment and threat to some of the 3rd Energy Package, many elements will help to promote further market liberalisation. One of the main outcomes of the liberalisation programme is the role of the markets to solve risk issues and to better manage assets.

The implementation of the expected measures will be the key to how quickly the reforms will speed market development. As there is already some momentum for reform from earlier packages, domestic actions and competition outcomes, there is reason to believe that resistance will not be as blatant or successful with these measures.

> “The market downturn can also create some opportunities if capital costs of projects decline making them more viable than before.”

In addition, a fresh look at the investment needed to integrate markets and diversify supply in gas should gain further impetus from the push toward regional solutions and in response to recent supply disruptions in gas.

Industry driven initiatives, such as the introduction of better market clearing, will benefit trading. Better clearing provides a lower barrier to entry so there can be a reduction in counter-party negotiations and a more homogeneous approach to credit assessment.

The market downturn can also create some opportunities if capital costs of projects decline making them more viable than before. For example, lower input prices may help pipeline investments, and lower gas prices could help storage projects previously struggling to finance cushion gas.

Even demand destruction may have benefits if restrictive policies such as the ETS bite less allowing the expansion of otherwise constrained industries.

SOME CONCLUSIONS

It is easy to conclude that times are tough and that the outlook will remain uncertain and fearful for a long time. But this would unfairly discount the progress made over the last few years and the promise of further improvements through regulatory changes and a more active pan-European business plans being exhibited by many of the large trading companies.

While the first steps on the path may appear rocky, market players could reasonably ask themselves what they expect the trading environment to look like in 3 to 5 years time, and we suspect that not many would envisage anything but a more active regional market. We can only hope that policy makers and Governments draw the same conclusions and avoid hitting the panic button.