According to Paul Dawson, Director of Regulation at RWE Trading, a continued commitment to the principles of open and competitive markets and a resistance to excessive intervention should keep market liberalisation on track.

Crunch Time for EU Energy Markets?

SETTING THE SCENE

"A universe that came from nothing in the big bang will disappear into nothing at the big crunch. Its glorious few zillion years of existence not even a memory."

(Professor Paul Davies, Director Cosmology Initiative, Arizona State University)

The financial crisis has pervaded every walk of life and no self-respecting news bulletin or dinner party is complete without considering the impact of the crisis on the weekly supermarket shop and the merits of quantitative easing. In the wholesale power and gas markets, the "Big Crunch" question is whether we have reached the end of the road for competitive markets or whether the push for further liberalisation remains paramount.

In reality, power and gas markets have proved pretty resilient in the face of the crisis, and while not immune from its impact, there is relatively little cause for concern. The departure and consolidation of some market participants has had an impact on liquidity and efforts on netting, credit-risk management and clearing have had to be redoubled to reduce credit exposures.

Nevertheless, market liquidity has held up very well and even as the economic outlook worsens, there is no reason to expect any significant turn for the worse coming down the pipe (or wire!). The main utilities will continue their participation in the market and, despite the challenging circumstances, many banks will continue in the front-line of the commodity markets (which inter alia allow them to diversify their activities away from the more traditional financial markets).

MARKETS STILL EVOLVING

Although it is pretty much business as usual in the traded power and gas markets, that is not to say that these markets are perfect, far from it. European power and gas markets remain in their relative infancy. Electricity market liquidity remains strangled by retail price regulation in France, Spain and Italy and the gas market is still struggling to develop outside North-West Europe.

There is an urgent need to improve information transparency across the board and effective choice at the retail level remains a novelty outside a few isolated regions. However, the regulatory response to these challenges was largely in place before the crisis. Competition and state aid cases are targeting industry structure and foreclosure and the 3rd Energy Package promises a significantly more robust and enforceable regulatory framework. Even in the area of financial regulation – which has understandably received the most scrutiny recently – work is already in progress on tailoring the financial services regime to the power and gas sectors. Indeed, it is hard to think of anything in the regulatory framework that we should be working on that was not in train before the crisis hit.

THREATS TO COMPETITION AND LIQUIDITY

Even with the relative constancy of the market and regulatory response, the crisis nevertheless presents significant threats to competition and liquidity. While many of the regulatory building blocks remain the same, the climate is radically different as trust in markets erodes and energy security and environmental challenges become more acute and politicised. The danger is no longer of insufficient regulation to underwrite competition, but of excessive intervention as inconvenient facts and delicate trade-offs get waved aside in the rush to take "strong" action. Now, more than ever, we therefore need to maintain our focus on the two main pillars of the regulatory agenda:

> "Greater transparency is more important than ever to maintain confidence and liquidity in the wake of the financial crisis."

- **Competition.** The crisis has created the political space to second-guess markets and regulators are exhibiting an increasing desire to dictate where, when and how people trade, e.g. safety valves in emissions markets and a bias toward exchange-based solutions rather than OTC markets (e.g. mandating congestion management via exchanges rather than by system operators). The development of competition between market places and in the provision of clearing and credit-risk management services – including the choice to take counterparty credit risk rather than clear – is a crucial component of an effective market. (Indeed, an increased focus during the crisis on clearers' credit standing – which has on occasion been worse than that of counterparties – has amply demonstrated that a real and effective choice in this area is essential). It would be deeply ironic if the regulatory response to the crisis created de facto monopolies in the name of promoting competition and liquidity.

- **Transparency.** Greater transparency is more important than ever to maintain confidence and liquidity in the wake of the financial crisis. However, the danger is that growing distrust about markets and traders' conduct shifts the debate away from information on market fundamentals towards trade data. Trade transparency is no bad thing: transparency of exchanges and over-the-counter markets is important in demonstrating that markets work well and are not subject to abuse. Indeed, contrary to popular perception, most wholesale markets are already very transparent in terms of events, prices and volumes traded. However, we need to remember that it is impossible to reach any meaningful conclusion on the merit of any individual trade in the absence of information on the prevailing production, transport and demand conditions at the time the trade took place. Despite legal difficulties and widespread opposition, increased fundamental data release should therefore remain the number one regulatory priority. In approaching trade reporting, we also need to resist the (lazy) conclusion that only traders with something to hide would urge caution in this area. Trade reporting has costs, consequences and limitations which – if not handled appropriately – can damage liquidity and competition by raising undue barriers to the entry of new traders into the market.

A continued commitment to the principles of liberalised markets, and resistance to the urge to second-guess and intervene, should keep the liberalisation of the EU power and gas markets firmly on track in the wake of the financial crisis. Far from a "Big Crunch," the coming years should deliver an ever-expanding universe of free-market competition and liquidity. As the outgoing US President put it:

"You can't put democracy and freedom back into a box"
(George W Bush)