

## IMPROVING THE ELECTRICITY MARKETS IN CONTINENTAL EUROPE

### *Position Paper*

#### *with a view to the European Commission 2005 Report on the functioning of the Electricity and Gas Directives*

Over the past two years, electricity prices have risen significantly above pre-liberalization levels, and they are still increasing. As a consequence, the international competitive position of the European metals industry has deteriorated sharply, chiefly due to the fact that our prices are set worldwide and our industry cannot pass on higher regional costs to its customers. Plant closures and disinvestments have already been announced, attributable primarily to this unaffordable cost of electricity. This deterioration is difficult to accept, especially as the EU has a relatively favourable primary energy mix and sound generation cost structure, chiefly composed of hydropower, nuclear power and coal. We believe that this distortion is due to the non-functioning of the market and welcome the enquiry launched by DG COMP. We are convinced that all the information that will be made available will allow DG TREN to develop a comprehensive report and set the direction for the future in order to achieve the desired – Fair, Transparent and Competitive markets, as stated in the Directive.

### **1. Current and likely future developments of the electricity markets**

Both the electricity consumers and producers had hoped for a successful liberalization of the electricity market in order to ensure sufficient supply at competitive prices. However, concerns about the security of supply remain, and prices, which already are prohibitive, continue to rise. As production is oligopolistic and the energy supply chain is highly vertically integrated, prices are being set in a distorted manner and the demand side is under-represented in the market. It is clear that further work is required to ensure the effective functioning of the liberalized market. Because of the uncertainty created in the electricity market, the EU has become a high-risk area for new industrial investments. As a major consumer of electricity, the non-ferrous metals industry has an immediate and pressing interest in improvements that would address these market conditions. Our assessment of the current situation and suggestions for solutions follow.

#### ❖ *The producers have taken advantage of the uncertain situation*

The role of the Regulatory Authorities is not clear in most Member States. The electricity producers have adopted a new commercial practice, using electronic trade platforms in Continental Europe. Market power and vertical integration allow these platforms to indicate prices that are not related to fundamentals, and also allow relatively risk-free behaviour by traders in influencing prices. Because of these factors, the platforms are the source of many problems that will not be solved by the effective implementation of the existing Electricity Directive, as the latter does not define how commercial practices should be organized.

#### ❖ *The producers dominate the market, and do not compete in any real way*

The Continental European power market is the most significant market in the EU. It is dominated by a concentrated generation sector. The leading producers, *de facto*, do not compete although the illusion of competition has been created through wholesale trading on the platforms.

The producers' ability to influence prices, and the effect of capturing demand through vertical integration in the utility supply chain, discourage new entrants.

❖ *Large industrial consumers have no real choice of supplier*

The number of utility suppliers that are independent from the incumbent generators has decreased in all the Member States. It is possible to switch to another supplier in theory, but in practice, large industrial consumers have discovered that this may yield, at best, a slightly lower trading margin on balancing costs. For large volumes, independent suppliers are unable to manage the trading risk and to compete with suppliers that are integrated with generators.

❖ *Grid ownership is misused*

In Germany, the producers not only dominate the markets but also own the grid. Auctioning of interconnection capacity results in a (border) levy, for instance between Germany and the Netherlands, which constitutes an extra revenue for the producer/grid owner. Access to interconnection capacity between France and Italy also clearly provides a few players with an unjustifiable advantage. Another distortion arises from the fact that producers can withdraw power capacity, declare it as reserve capacity, and transfer its cost to the grid cost.

In the UK, the rules of the electricity market are set by vertically integrated energy companies : these rules are so complex that they require specialist expert knowledge. The impact of the rules is known in detail only to the main players, because their internal transactions are not revealed. The manufacturing demand side is barely represented.

❖ *The use of trading platforms distorts market practices*

The current power exchange model functions very differently from established commodity markets and from a Pool system (Spain, Scandinavia, Australia, etc.), and is unique in the world. It has created a purely illusory financial trade environment for power supply in Continental Europe. Within an electricity producer's organization, the sales unit does not set price offers, but merely passes prices on to customers. These prices are constructed by their trading units on the electronic platforms. Remarkably, there are very few physical transactions on the power exchanges. Nevertheless, they are used to set the price for *all* transactions. Typically, prices are established on trade platforms for annual supply contracts. The Regulatory Authorities<sup>1</sup> do not monitor this central marketplace constructed for annual contracts. Customers have no choice but to accept the fixed price established on the trade platforms on the date they contract their power supply.

❖ *No independent traders are left*

The lack of market information for other parties has eliminated most of the independent traders/financial intermediaries, and the few that remain have no impact on price development. The dominant traders are subsidiaries of the producers and are integrated into their commercial organizations. In normal commodity markets this situation does not exist. On the contrary, in large established commodity markets, the majority of traded volumes are effected by financial players and not by physical players. Financial instruments exist to manage risk. In this context, electricity is not a normal commodity, as it cannot easily be stored and transported. Consequently, the detailed knowledge held by vertically integrated energy companies is a significant advantage to their traders compared to financial players, and will discourage the latter except to the extent they believe they can share and amplify the price trends set by the vertically integrated producers.

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<sup>1</sup> Regulatory authorities monitor the central marketplace to trade balancing power (day-ahead auctions and imbalances mechanisms).

❖ *No risk management is possible for consumers*

By setting the price on their trade platforms, producers constantly shift prices, irrespective of the anticipated balance of supply and demand. This price risk is passed on to the end-user who has to gamble on exactly when to 'take' the price, as the situation for him is completely unclear.

❖ *There are more signs of market non-functioning*

Before 2002, discussions with suppliers took place on an equal basis and negotiations were intense. Due to regulatory uncertainty, there have been few successful negotiations during the past two years. With long-term contracts expiring, industrial consumers have no bargaining power and are squeezed when sellers know that they have to buy. Industrial consumers, confronted with steep price moves, do not dare to wait to make their purchase, as they have no understanding of these price moves. **The producers do not negotiate prices.** There are no spontaneous offers, and quotations have to be requested. All offers are based on the same price reference; only the trading margin and the payment conditions can be negotiated. The producers merely impose this price and pass it on to the consumers. In practice, **no new long-term contracts are being signed between producers and consumers.** Moreover, there is a **high premium to be paid if higher volumes are requested, contrary to commercial practice in all other commodities.** In many countries, very few producers – sometimes even only one – are available to supply large volumes. In general, for the non-ferrous metals industry and other power-intensive industries, the power price is fixed for one or two years, based on the published price references (Platts, Argus) observed on the day of the quotation.

❖ *Interference by non-genuine consumers causes further market distortion*

*The municipal distributors in Germany* are price takers on the platforms, and thus help to set prices at high levels for Germany, which, in turn, sets the reference price for Continental Europe. In addition, the German municipalities are increasingly linked to the producers and the German *grid operators* can help their holding companies to take capacity out of the market by increasing their demand for balancing power. In the whole of Continental Europe, as mentioned above, **the producers are acting as purchasers**, via their trading arms, to influence prices.

❖ *The ETS price effect and other incremental burdens*

On top of the problem of non-functioning markets, comes a range of additional burdens : energy tax, renewable energy sources, CO<sub>2</sub> emissions trading, etc. Under the EU CO<sub>2</sub> Emissions Trading Scheme, power producers factor the price of CO<sub>2</sub> allowances into the wholesale price of power, creating huge windfall profits. This effect can be further reinforced by the electricity generators actively influencing the allowances price in the CO<sub>2</sub> market. The price of CO<sub>2</sub> has more than tripled since the beginning of the year to nearly 30 euros per tonne of CO<sub>2</sub>, and is the major cause of the current power price increases. As an example, the German wholesale power price has risen by more than one-third since the beginning of this year.

## **2. Improvements of the market operating framework to be explored at either national or Community level**

❖ *Medium term : how can this pressing problem be solved ?*

- The DG Competition Energy Inquiry should be able to clearly describe the situation in the electricity market and correct any distortions identified. This will allow DG TREN to set the basis for a normally functioning electricity market.
- The implementation of the current Directives alone will not be sufficient to solve the current market problems : the 3<sup>rd</sup> package is needed without delay and should include recommendations for better market functioning.
- At Member State level, strong independent regulators, especially in Germany, will have to use their authority to guarantee national market functioning.
- The current power exchange model should be replaced by a true market design that allows cost fundamentals to be properly reflected and gives equal weight to all market participants. In the this context,
  - DG TREN should actively build on its expertise in the Energy Inquiry and seek with DG Competition the replacement of the current commercial organisation,
  - DG TREN should be involved (in some way) in the design of the new commercial market organisation, and make sure it is built with all stakeholders.
- A dual power market needs to be established. There should be a market enabling large industrial users to buy stable, long-term, competitively-priced power. The non-ferrous metals industry and other power-intensive industries must be able to negotiate again long-term wholesale supply contracts. In order to provide a level platform for the negotiation of such contracts, the regulators must require full transparency of supply potential and not allow vertical integration by power companies.
- In addition to price monitoring, trade practices should be closely monitored.
- There is also a strong need to ensure that sufficient infrastructure and interconnection are constructed, especially in view of the current problems of the 'Supply Directive' on interconnection.
- The producers' domination must be resolved by unbundling ownership of the entire power value chain and unbundling traders from producers.
- Lastly, it is vital for existing capacity to be freed, more investment to be made, and the market opened to new entrants.

❖ *Short term : given the urgency of this issue, temporary solutions need to be defined in the short term*

Although some of the difficulties are now acknowledged, achieving consensus for the implementation of real "win-win" solutions for both consumers and producers will necessarily take a long time considering the complexity of the issues at stake. The non-ferrous metals industry cannot wait for any new market regulations to take effect. Many long-term contracts are coming to an end and, if no action is taken, they are being or will be replaced by the current short-term contract at peak prices, without the possibility to manage long-term risk. This has never been the intention of any authority. Short-term solutions are needed immediately to avoid the imminent delocalisation of the European non-ferrous metals and other power-intensive industries. The European Commission should enable temporary measures to be implemented. The Member States should act as facilitators in the dialogue between producers and consumers. The regulatory authorities should define appropriate market rules.

The non-ferrous metals industry would very much welcome an opportunity to continue the dialogue and work on the identification and implementation of these measures.

**3. The need to consider the reinforcement of measures to protect the interests of customers**

As stated above, solutions to the injury currently suffered by customers should be addressed at national level as soon as possible. DG TREN should actively and publicly support this and point out that these solutions are allowed by the Electricity Directive.

In order to ensure customer protection the current market structure must be replaced. As stated under section 2, frameworks should be set up, that will endow strong regulatory authorities with the responsibility and powers to enforce proper market functioning, as mandated by the Electricity Directive.

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