

## EFET response to Francois Lamoureux, Director General, DG TREN, on questions about progress in EU electricity liberalization and the state of the markets

*8 July 2005*

*- electricity -*

### EFET, the European Federation of Energy Traders

#### Description

EFET is an industry association for wholesale energy market participants, who may also be engaged in other parts of the energy value chain such as production, supply, consumption or finance.

#### Purpose

EFET promotes and facilitates European energy trading in open, transparent, and liquid wholesale markets unhindered by national borders or other undue obstacles.<sup>1</sup>

#### Vision

EFET foresees energy markets throughout Europe, in which traders efficiently intermediate in the value chain on the basis of clear wholesale price signals, thereby

---

<sup>1</sup> EXPLANATION OF TERMS USED IN EFET STATEMENT OF PURPOSE:

Promoting and facilitating includes the elaboration of recommendations to energy policymakers and regulators and the development of contract and data exchange standards.

European indicates a determination to remove cross-border as well as national barriers to the wholesale trading of energy across the entire geographical area of Europe.

Energy means gas and electricity, but may also entail related commodities (such as oil and coal), financial derivatives, and any tradable certificates and allowances.

Trading refers to own account dealing and risk management services, utilising physical or financial contracts for large volumes.

An open market allows access to transmission grids and customers for any qualified company, without bias as to nationality or degree of integration in energy services.

In a transparent market information about infrastructure availability should be published for all market participants on a non-discriminatory basis.

In a liquid market it is possible to trade substantial volumes without moving the market price significantly.

A wholesale market brings together sellers and buyers for re-sale, whether they aim at managing financial risks, trading for profit or balancing a physical portfolio.

Markets which are unhindered by national borders or other undue obstacles can constitute eventually a true European single market, where trading in energy commodities and related instruments is unimpeded by technical and legal barriers, economic or national distortions, poor management practices, industry discrimination or political lack of objectivity

optimising supply and demand and enhancing security of supply, to the overall long term benefit of the economy and of society.

## **The realities of the market**

### ***The benefits accruing from flourishing wholesale power markets***

In a liberalised and competitive power and gas markets, contractual “products” are traded bilaterally, over-the-counter or on exchanges. The result is that the prices for buying and selling the contracts are readily observable to all market participants. This allows them to make informed decisions on when and how to source their requirements. Vertically integrated players, independent generators, independent retailers and “pure” traders both compete and co-operate to buy and sell in the market. As the number of such players and the frequency of their transactions increase, forward markets become increasingly liquid, such that they can buy or sell significant volumes without a material impact on market prices. In turn, the spread between buy and sell prices (i.e. the “premium” paid by market participants for managing their wholesale market risks) narrows. This results in improved short and long-term efficiencies in the linking of supply with demand:

- *Efficient operation and maintenance*  
Generation is sourced at best conditions e.g. at long or short term least cost level. With a readily observable price for each time period, generators can choose either to generate themselves or to buy contracted deliveries from the market (effectively from other, cheaper generators). Large consumers with tariffs linked to wholesale prices may choose not to consume at particular times of the day or year to avoid relatively high prices. The overall result is an economically efficient pattern of generation and consumption.
- *Efficient risk management*  
Forward markets allow market participants to buy and sell electricity over many different periods and to fine-tune their portfolios as their expected requirements change. Traders facilitate this process by adding liquidity and reducing the costs of buying and selling power.

### ***Current state of wholesale and retail power markets around Europe***

The more mature liberalised European energy markets are to be found in Scandinavia for electricity and in Britain for electricity and gas. Strong regulation and partial ownership unbundling have helped developed competition in the Netherlands. Germany made progress in the electricity sector around the turn of the millennium, after the first energy law reform of 1998 led to an outbreak of competition between indigenous utilities. An OTC wholesale market became well established by mid 1999; Germany is key for the whole of Europe in terms of volume, price setting and patterns of cross border transmission access; despite setbacks from 2001 to 2003 Germany internally still enjoys today by far the greatest wholesale liquidity in the

UCTE area of Europe. Meanwhile other European countries, some of which are among the original EU15, have remained relatively hesitant to open or restructure even their electricity markets. Islands of difficulty remain in western and southern Europe. Competition in generation and supply in Belgium, France, Greece, Ireland, Italy, and Portugal is still limited in practice. In Switzerland debates about liberalisation have continued over several years without discernible progress, although the voluntary formation of a separate joint venture to run the high voltage grid is an encouraging sign. Today it remains challenging for new entrants to break into these countries.

In the past three years tangible progress towards further electricity market competition has been rather modest, pending and even after the implementation of revised EU liberalization legislation, due by July 2004. Perhaps certain well-established players are relatively content with the gradual implementation of market opening measures, and with a cautious approach to concerted intervention on the part of some existing regulatory authorities. On the other hand, every “national champion” is a potential new entrant or a disadvantaged competitor in a foreign territory. And the key German market still waits to see the impact of the impending installation of a national regulator, charged with the oversight of fair access and adequate unbundling.

## **Policy and regulatory priorities**

### **Effective unbundling**

EFET holds central to market opening success the necessity of clear and true separation of businesses conducting high voltage and high-pressure network transmission operation from any affiliated or related energy businesses. The truth of this separation must be evident when viewed in terms of legal structure, financial governance, management reporting and physical location of staff and offices. A commercial function, such as production, trading or supply, which remains within the same group corporate structure, may of course need to use the transmission network of its corporately affiliated TSO. If it does so, it must never be treated any differently from a third party user, nor be allowed preferential access to information held by the TSO. Compliance procedures must be robust, independently audited and sufficiently transparent to give third party users confidence that separation has been effective.

In considering *how* to separate the TSO from the other businesses, it is essential to bear in mind the TSO’s fundamental *raison d’être*: The unbundled transmission operation business must be principally responsible for the safe and efficient operation, maintenance and development of its network, so as to meet all reasonable demands of current and future network users. Although another purpose of the TSO’s existence may be internally to provide a stream of dividend income to its parent energy company, this purpose should *never be allowed to interfere with*

*the discharge of its principal responsibility in a non-discriminatory, objective and transparent manner.*

We suggest that if a TSO is to be legally and functionally unbundled, without ownership control changing at the same time, there are two key questions that should be asked upon the consideration of each and every functional or organisational change:

- Could the change hinder possible discrimination against third parties?
- Could the change enhance the development of a competitive market?

If the answer in any case is “probably not” then best practice would be to seek a different way of fulfilling the function or arranging the administrative tasks, so as more positively to promote non-discrimination, objectivity and transparency in the delivery of transmission services.

[Annex 1: Position paper on electricity sector unbundling of May 2004](#)

### ***The crucial cross-border markets dimension***

Interactions between national or regional markets naturally occur at all the key stages of production, transmission and supply in both gas and electricity across Europe. In electricity the dynamics across most of the continent involve cross border transmission access and tariffs, arrangements for nomination day ahead or intra-day, the compatibility of wholesale market designs and balancing mechanisms, and the degree of constructive, market-facilitating inter-TSO communication, collaboration and co-ordination. Differences in market operation and structure between countries or regions in any of these respects have the potential to produce inefficient patterns of both trade and trading. In this context *wholesale power market distortions, which remain to be dealt with, include:*

- Availability of transmission access rights and the need to enhance both the (financial) predictability of network access across the EU for market players, and incentives for TSOs to provide such access; in essence a new market in transmission capacity rights needs to be facilitated
- A continuing continental ‘regulatory gap’: The current framework of sector regulation of unbundled monopoly transmission operators and/ or suppliers is designed to apply primarily within national boundaries. *In spite of the coming into force of Regulation 1228/2003*, not enough is yet being done in a consistent and coherent manner *jointly* by national regulators to ameliorate market interaction across borders

[For examples of the pernicious effects of this lack of joint enforcement and action see the recent paper of our EFET TF France, dealing with allocation mechanisms in effect at the French borders with Germany, Italy and Switzerland: Annex 2](#)

- The further development and integration of intra-day and balancing markets
- Insufficient transparency of information about transmission capacity availability, actual flows, generation intentions and actual generation output
- The setting in place of consistently structured and cost reflective transmission access charges across each region in a manner which properly integrates market based congestion management methods and inter-TSO compensation arrangements

### Reforming the management of electricity transmission congestion

The new EU cross border Electricity Regulation 1228/2003 places great emphasis on the availability and use of interconnection transmission capacity between Member States. However, despite this directly applicable Regulation having come into force in July 2004, there has been a notable lack of progress at many borders. We still await compliance with clear obligations to release the maximum amount of capacity to the market and to implement non-discriminatory, market-based approaches to congestion management and the allocation of cross-border capacity. Instead of well-developed plans to introduce market-based systems from July last year, we find widespread inertia even now on the part of some TSOs and national regulators.

EFET has put forward a better-developed practical framework for approaching cross-border transmission capacity allocation and congestion management in a major paper published in November last year. (We were most disappointed not to have the chance to present this paper directly in the Mini-Fora organised from December to January.)

The paper focused on the following key questions:

- How should cross-border capacity be allocated and what methods qualify as “market based” allocations?
- How should congestion be managed and what methods qualify as market-based?
- How can the physical amount of cross-border capacity be maximised and how can the maximum allocation and usage of that capacity be ensured?
- How should revenues stemming from the sale of capacity rights be used by the TSO?

See Executive Summary of this paper in Annex 3. (Full version on the EFET website: [www.efet.org](http://www.efet.org))

We argued that the *availability to network users of fixed-price contractual rights to cross-border transmission capacity would be of great benefit for further development of the internal EU electricity market.* To compete effectively across borders, market participants need the ability to fix the delivered price of electricity in advance. This requires a market means to fix the price of transmission for cross-border deliveries, in addition to an ability to manage electricity commodity price risk within national markets. Market participants should be able to buy transmission contracts, which allow them to fix the price for transmission in advance. Such contractual rights can either be for physical capacity, entitling the holder to schedule power “deliveries” at

borders, or financial (e.g. contracts for differences), and would provide a hedge against variable short-term costs associated with transmission between markets.

We have now (June 2005) opened a serious debate with CEER about these ideas, and are pleased to report that we have been invited to start a dialogue about basis risk hedging methods and products with ETSO in a meeting on 8 July. *But greater impetus is also needed from the Commission and other stakeholders.* The “priority projects” for market coupling relating to Belpex and the Kontek cable so far fail to deal with the needs of wholesale market parties for contracts granting longer-term transmission capacity rights.

We also argued that defining the amount of transmission capacity to be allocated in advance is not a technical decision, but a commercial one. The enforcement in real time of security standards means that actual flows will face the same constraints, irrespective of the amount of capacity previously allocated. Far from endangering security of supply, allocating more capacity in advance equates simply to an increased commercial requirement for system operators to rebalance flows to the actual capacity available. *By restricting capacity allocations in advance, system operators retain for free a valuable commercial option on whether to release further capacity over time. The result is overly conservative views on the availability of capacity, lower levels of capacity allocations and ultimately sub-optimal usage of the actual cross-border capacity.* System operators must be required to allocate the maximum amount of capacity expected to be available in advance to market participants; and yet *many national regulators show little sign of understanding their obligation under Article 1228/ 2003 in this respect, let alone enforcing it.*

[Annex 4: EFET slides July 2005 about a new market in transmission capacity rights, presented to ETSO](#)

[Annex 5: EFET commentary July 2005 on the Belpex scheme of Elia, APX and Powernext; see especially sections focusing on calculating available capacity and on the parallel existence of physical, explicitly auctioned transmission rights with the market coupling arrangements day-ahead](#)

### ***Intra-day and balancing markets***

Aside from the problems associated with securing cross-border capacity and the lack of transparency (see sections of this response above and below respectively and relevant previous EFET position papers), one of the key obstacles to realising our vision of a well-functioning internal electricity market is the lack of harmonisation and integration between different national markets. Across the EU, market participants face radically different market structures and rules, radically different timetables for the “trading day”, different and onerous balancing arrangements, a plethora of different IT platforms for trading and scheduling and numerous other artificial requirements. These collectively raise barriers to the entry of new market participants and significantly reduce market efficiency by restricting the opportunity for market forces to determine an economic pattern of generation and load. By restricting many market participants’ ability to move power across the system freely

to balance supply and demand, such variations also undermine the security of the would-be single electricity market.

The different arrangements for bidding in national wholesale markets, allocation of transmission capacity, management of cross-border flows and balancing of energy inputs and outputs may be broken down as follows:

- Day-ahead capacity auctions, power exchanges and OTC nomination gates close at different times; the variation effectively imposes a trading “cascade”, whereby market participants have to close out any residual positions in markets which close later. While this can be seen as concentrating liquidity in the later closing markets, it also gives local generators with flexible plant within the last market an inherent commercial advantage in the wider market.
- The cascade of markets creates the need for a trading team to ensure coverage across the entire day and on non-working days, which raises a significant barrier to the entry of smaller trading participants.
- Different market “timetables” can limit market participation across borders. eg, although some markets allow provide facilities for intra-day trading up to 1 hour ahead of delivery, others have limited intraday sessions or confine the intraday activity to local balancing actions. This limits the ability of the market to optimise flows within the day between national markets.
- Interconnector flows – and hence cross-border participants - are often unable to participate in national within-day and balancing markets which again limits the market’s ability to optimise flows between national markets.

Faced with these difficulties, EFET believes that the key to integrating EU markets successfully is not to prescribe a uniform solution, but to maximise the opportunities for the “market to work” by moving to dynamic, flexible, continuous and inclusive trading arrangements. They would tend to maximise the ability of market participants to optimise their positions and hence maximise the scope for the market to balance supply and demand approaching delivery, without waiting upon perfect uniformity of design”. The primary operational reform must involve broadening and streamlining all national or regional nomination procedures, to facilitate a continuum between “day-ahead” trading and trading within day (“intra-day”) and to move the very last gate closure for each quarter or half hour as close as possible to the real time of delivery.

[Annex 5: Analysis paper, prepared this year by the EFET Project Group Electricity Market Harmonization.](#)

[Annex 6: Slides, presented by EFET to ETSO in April 2005 about balancing and intra-day markets.](#)

#### Transparency of infrastructure availability information for the wholesale markets

EFET in July 2003 published a position paper on “*Transparency and Availability of Information in Continental European Wholesale Electricity Markets*” (July 2003).

[See Annex 7.](#)

The paper called on European energy regulators to secure the release of more information about transmission, demand and generation in European electricity markets. We concluded that this is necessary, to help overcome the lack of transparency currently hindering the development of efficient wholesale markets in the UCTE area. Further information release will improve wholesale market competition, remove entry barriers and underpin the acceleration of European liberalisation.

To compete effectively in the wholesale market, all wholesale market participants – traders, generators and retailers - need to be able to predict the likely evolution of supply and demand fundamentals and the ability to move electricity around the transmission system. Participants base these predictions on analysis of expected levels of future demand, transmission capacity and generation capacity, but also by detailed analysis of actual events in the past and the observed impact on prices. The release of demand, transmission and generation data – both before and after the date of delivery - is therefore crucial to market participants' ability to analyse likely market developments and to participate in forward electricity markets.

Some European markets – notably the UK and Nordic markets – are already very transparent with hundreds of thousands of data items being released every day. Many other markets remain opaque, which requires market participants to risk their capital on events that they do not fully understand, which increases risk premiums and reduces market liquidity. This is inefficient and ultimately imposes significant costs on electricity consumers.

Specifically, EFET suggests that the Commission and European energy regulators work to secure the release of post-delivery data on each generating plant's production, actual demand by market hub and the physical flows across transmission links between markets. This information should be supplemented by forecast demand data, forecasts of physical transmission capacity and forecasts of available transmission capacity, taking account of any prior commitments under long-term contracts. In each country or market region all stakeholders must consult about the best way to release information on forecast production plant availability, without compromising generators' commercial confidentiality. We recognise that aggregation of forecast generation data – by market hub and by fuel type, after proper consultation – is likely to be appropriate in each relevant geographic market.

Since our 2003 paper was published little progress has been made in improving transparency of all these types of information in the core markets of continental Europe. One notable overall exception is the Netherlands, where the Regulator has taken action to require the TSO to yield to the market more transmission data and at least aggregate generation availability data; additionally in France and Belgium network availability data is now more readily accessible.

## **National market concentration: The impact on wholesale competition**

Market consolidation, as well as existing market concentration, is a difficult issue in the European electricity sector. Excessive concentrations in production, import, export or retail supply can sometimes impair liquidity. Non-storability and a low elasticity of demand require a more informed approach to competitive analysis by regulators and competition authorities than in some other sectors of the economy. Within the framework of competition policy and law, the reality of geographically dispersed and still economically separate national or regional product markets has to be taken into account. This inevitably has so far resulted in both existing monopolies or oligopolies and new concentrations being viewed in varying ways by individual EU Member States. Some Member States would never tolerate the kind of market concentration, which remains unchallenged in other countries. It would seem that this discrepancy must eventually be resolved, in parallel with pan European harmonisation of energy sector regulation and accelerated market opening. It remains to be seen whether the means is the natural (or commercial) evolution of geographical markets, through the advent of more cross border competition, as has already occurred in Scandinavia.

We have noted that the Commission has exhibited a more consistent approach to market dominance. However, it may lack jurisdiction and, even when willing and permitted to intervene, is short of resources. EFET members on the whole welcome the reinforcement of the unit of DG COMP charged with looking at energy and the recently announced sector review for electricity and gas.

In those countries where greater concentration is not in prospect because a monopoly or close oligopoly already exists, regulators must closely monitor the proper implementation of unbundling of the transmission affiliate of the dominant supplier. Regulators should also remain vigilant as to the existence of covert discrimination against foreign companies. The protection of consumers is clearly one yardstick for regulatory intervention, but this criterion must not preclude due regard being paid also to efficient wholesale market operation and the creation or preservation of adequate competition at the wholesale level.

Where regulators encounter difficulties in requiring or stimulating new market entry, for example through the dismemberment of existing concentrations or through capacity or commodity release programmes, one related matter for them to consider will be the degree of market transparency (see above).

## **Avoiding other artificial wholesale power market distortions**

The environmental dimensions: Renewable power and emissions trading

*Renewable supports*

Much of the current national renewable productions support legislation in EU Member States has become caught up in arguments about protection of a domestic industry, security of energy supply or diversity of fuel types. Objective environmental protection goals then become lost in the fog of lobby claims and counter-claims. Meanwhile the EU RES Directive in force for the time being represents a watered-down compromise, after the EU Council failed to agree to support the Commission on setting obligatory production targets or, more seriously, on mandating market-based support mechanisms.

EFET is convinced that the most economically efficient way to reach sustainable levels of renewable energy supply and production across Europe is through the introduction of market mechanisms. Provided these are properly applied, according to policy preferences per technology or source, they will not only support investors' interests, but also encourage technological innovation. That in turn will lead to lower market prices and improved choices for consumers.

EFET therefore advocates the European-wide tradability of certificates related to renewable energy production and supply. Currently there are several obstacles, which work against the creation of such a market, however.

*Inconsistency in environmental objectives impairs also emissions markets*

Wind and biomass are consistently considered as renewable and emission free energy sources in the European Union. Whereas nuclear energy is definitely free of carbon emissions, it is not deemed renewable. There are also some problematic cases, e.g. large hydro, which some governments do not consider as a renewable energy source and is not in the scope of the RES Directive. However, it is also accepted that large hydro is not doing harm to the world climate.

Most renewable electricity production is a rather expensive GHG abatement method, i.e. just with the extra money obtainable from emissions trading a renewable energy project would not normally be profitable. Financing of renewable energy projects requires additional money, either from a certificate market or from a feed-in scheme, investment or operational subsidies or other comparable schemes.

In order to increase the number of participants in a future European market for emission credits, national systems should be harmonised EU-wide and across potential accession nations too. Otherwise the cost-effectiveness of emissions trading can only affect smaller subsets of countries but not Europe as a whole. The Emissions Trading Directive does not rule out the use of further political instruments to achieve national reduction allocations, nor to fulfil sector targets. The cost-efficiency of emissions trading will be strongly enhanced, if governments forswear other climate change-related measures, such as supplementary energy taxes or efficiency incentives, with a direct equivalent effect on the parties likely to sell or buy emission credits.

The use and availability of banking periods for emissions allowances and the bankability of allowances or JI and CDM mechanisms for a future period are still subject to determination in the EU and internationally. This is still a source of uncertainty.

[Annex 8: Final version of latest EFET TF Emissions Trading paper on requirements for the next commitment period 2008-12.](#)

The future challenge of harmonizing market mechanisms for emissions allowances and renewable generation supports

There is of course even more uncertainty in the future functioning of renewable certificate systems. The existing systems are not yet stable and are subject to rules being changed according to national political circumstances.

Greater economic efficiency will be achieved only through rigorous attention by policy makers to the facilitation of market liquidity and transparency in relevant tradable instruments. The *economically efficient* transfer of a GHG emission related permit or exemption leads to a cost-effective reduction of greenhouse gases, because a contributory technical abatement measure may then be taken by the company that can achieve the greatest mitigation effect at least additional cost. The same applies in principle to transfer of mutually compatible renewable certificates in relation to the lowest cost means of renewable power production.

However, transfers are unlikely to be achieved in an economically efficient manner, unless a “wholesale” marketplace in the appropriate instruments is accessible to those who may wish to commit to additional abatement measures or renewable power production, as well as those who may wish to avoid them. And even accessibility is not alone sufficient; all potential participants must have confidence in the reliability of the price signals given in that marketplace.

### ***Fuel source mix disclosure and electricity attributes “labelling”***

There is continuing pressure from some national policymakers to furnish detailed fuel mix information to electricity consumers. This in turn is placing demands on wholesalers.

The EU Electricity Directive 2003/54/EC (the second internal market directive) introduces an obligation for retail suppliers to specify the fuel mix, and some related aspects of the environmental impact of certain types of generation, involved in the production of electricity sold to consumers. The obligation can be fulfilled either through the identification on customer bills of the contribution of each energy source to the overall fuel mix of the supplier over the preceding year; by referring to existing publicly available sources (such as web pages) containing information on environmental impact (emissions of CO<sub>2</sub>, output of radioactive waste) resulting from the electricity produced by the overall fuel mix of the supplier over the preceding

year; or, in the case of supplies obtained through a power exchange or imported from a generator outside the EU, by using aggregated figures provided by those respective organisations. (Prior to the adoption of the Directive EFET advocated to EU policymakers and officials the same treatment for OTC traded power volumes as for exchange traded transactions, but our argumentation was ultimately not heeded.)

EFET obviously respects the overall objectives of the Electricity Directive, much of the content of which does follow our policy suggestions dating back to 2000. Traders are certainly aware of the desirability of consumers being given more information in the interests of increasing public awareness about the potential of renewable energy and the threat of climate change. Wholesale market participants should have no objection, equally to suppliers using legitimate source information as a marketing tool or as a way of increasing the ecological awareness of consumers. However, EFET is concerned that a misguided implementation in some EU Member States of source information provisions of the Directive could have severe negative effects on wholesale power markets.

EFET believes that it is fundamental to the future success of the European liberalisation process, that any channelling of fuel mix information does not hinder the liquidity of the wholesale market. This in turn requires some degree of simplification of information processing.

Any type of simplified approach to help retailers meet their new obligations will necessarily entail perceived inaccuracy. However, EFET observes that different Member States are implementing the provision in widely varying ways. National rules and/or legislation, some enacted some in draft, have been drawn up based on non-harmonized methodologies, assumptions and approximations. EFET believes that a common European approach would be in due course appropriate. We therefore contemplate developing a methodological proposal, which will entail determining a “national or regional trading mix” for each relevant geographical power supply market. The mix will be based on the average fuel composition for generation in the relevant geography and, if possible, also take into account observed cross-border flows.

*EFET emphasises that availability of trading mix data would not prevent suppliers from differentiating specific sources. This could be done by verifying their supply data, by reference to power sourced from their own generation or via contracts linked to specific production facilities. Another possibility could be by “improving” their energy mix, through the use of a certification system to back-up their purchases of renewable energy.*

A deemed trading mix would be expected to become approximately consistent with the physical reality of the power grid, where indeed cross border flows (imports as well as exports) are the fundamental reason why the fuel mix from one country influences the fuel mix in its neighbouring counties. Together with the imports from a

country A to a country B, the “generation mix” from country A is replacing generation in country B, and by doing this, it is influencing the generation fuel mix in country B. The fuel mix associated with the imports and exports, put together with national generation mix, seem to us to offer a simplified but very reasonable approach for estimating the “trading mix” in a country, albeit still an approximation.

We are in active discussion with UCTE, ETSO and Eurelectric about these ideas. We have agreed to participate in an Advisory Committee to the E-Track Project, subject to due consideration of our offered input.

Is there a need for regulation of power trading activity *per se*?

EFET does not perceive any need for explicit regulation of physical commodity trading in the EU. EFET members agree that the application of bank-style regulation (and the concomitant capital adequacy and own funds requirements) to commodity markets as such is inappropriate. The inappropriateness of regulating physical energy transactions is well recognized among European governments. The interests of electricity and gas consumers in relation to the supply and performance of the wholesale electricity and gas markets are safeguarded by other means. These typically within the EU involve a mix of consumer protection rules, anti-trust measures, and intervention by sectoral regulatory authorities, having a specific remit with regard to the physical supply of electricity and gas and access to networks.

Some European politicians and commentators have nonetheless raised allegations of excessive, speculative position-taking in wholesale power markets, pointing to law suits in California. There have furthermore been suggestions that the use of derivative contracts could destabilize wider financial markets. Trading in financial derivatives, on behalf of clients but also, subject to certain exemptions, on own account, is already regulated in some Member States. While overall harmonization of the regulation of investment services is desirable, EFET has cautioned against the mandatory inclusion of all energy derivatives in a “heavy touch” regulated regime.

To the extent that energy markets may be touched by financial regulation, due account must be taken of the specific nature and purposes of energy trading. The withdrawal from European markets of most American owned energy traders has actually occurred in a relatively orderly fashion. The closing of positions, including the resolution of outstanding derivative transactions, was handled in a contained way. In our submission to DG Market in 2003 EFET argued:

“We see no need for regulatory intervention to achieve the Commission’s stated objectives of market efficiency and investor protection in the context of energy markets. With respect to the promotion of market efficiency, information held by a market participant about its supply-demand imbalances is proprietary information that is regarded as confidential and commercially sensitive. The market as a whole is informed about aggregate movements and physical flows in aggregate requirements through the prices and information provided by exchanges, brokers and price reporting agencies. It is in this manner that price efficiency and effective competition are achieved. With respect to investor protection, it must be recalled that commodity derivatives markets are predominantly wholesale markets. Certainly transactions in energy commodity derivatives do not normally involve retail participants. Investor protection measures designed to protect innocent customers are thus neither necessary nor appropriate in this market. The EU’s Lamfalussy Good Regulation Criteria would suggest that the Capital Adequacy Directive requirements should not be applied to energy trading until that directive is reviewed, so that any sector-specific capital requirements eventually deemed necessary are proportionate.”



Put simply, injudicious regulation of energy commodity derivatives could further jeopardise liquidity in Continental wholesale markets, while not actually addressing the mischief of aversion to credit risk. Energy traders' concerns are well recognised for the time being, but need still to be born in mind when DG Market comes to its 2008 or 2009 review of derogations in MiFID for limited categories of commodity derivative transacting parties.