

CAN GOVERNMENTS AND REGULATORS HELP TO CREATE COMPETITIVE MARKETS?

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Setting the scene

Whilst great strides have been made in certain EU member states, the holy grail of full and effective market liberalisation remains elusive across much of Europe. And this despite the ambitious and lasting commitments of governments and regulators. In 1999 the EU heralded the movement towards liberalising the energy sector. In electricity the following pronouncement was made:

“The single market for electricity will, progressively, produce a competitive and vibrant electricity market across the European Union. It will contribute to the three European energy policy objectives of increased competitiveness through better service for energy consumers, improved environmental protection, and greater security of energy supplies, while ensuring the continued achievement of basic public service requirements.”

Seven years and an extensive set of regulations and directives later, the preliminary report of the EU inquiry strikes a markedly more sobering note:

“Most wholesale [electricity] markets remain national in scope with high levels of concentration in generation, which gives scope for exercising market power.”

Even recent legislation in the EU designed to inspire retail gas competition by enabling consumers to change suppliers has been met with un-inspiringly low switching rates, a stark reminder that legal action alone cannot achieve results on the ground. Indeed catalysing the emergence of free markets may in some instances be a less important and potentially conflicting role for governments when compared to securing national energy supplies. In an increasingly tense geopolitical environment where energy security is fast gaining an importance on par with national defence, governmental involvement in both security of supply and market liberalisation will need to be well defined and consistent with long-term national policies.

Government and regulatory involvement is a necessary condition for the establishment of conditions that are conducive to allowing competition to develop

Broadly speaking, government and regulatory backing of the liberalisation process is a necessary condition for the initial establishment of conditions that are conducive to allowing competition to develop. Experience, EU inquiries, and new entrant failures have clearly taught us that far more is required to establish a functioning competitive marketplace. Well-worded manifestos, transposed directives and even strong regulatory action do not competitive markets make. Even as market entry takes root, governments cannot be expected to independently establish the lasting market structures and institutional arrangements required to sustain competitive conditions for the long-term. For that, much more corporate stakeholder involvement must be sought, built upon an enduring dialogue spanning public and private sectors.

Government commitment to market liberalisation is but one of many factors that are critical to the success of competitive markets

While the existence of competitive markets in wholesale energy in Europe is gaining ground (German power, Dutch power and gas, and French power being notable for their increasing liquidity), government commitment to market liberalisation is but one of many key factors critical to its success. In fact the delivery of the horse to water is a very small step on the way to success. It is the actual willing participation of corporates on the market that provide the context for lasting competition.

Despite government and regulatory will to the development of competition, factors of equal or greater importance include: i) size and diversity of the market, ii) development of trading hubs, iii) harmonisation of rules and procedures, and iv) transfer and dissemination of information. Market size, as well as market growth, enables contenders to vie for market share, and market diversity ensures that players are adaptive enough to exploit rapidly changing market environments. Trading hubs (and traders) are critical to establishing spot and forward markets, without which price transparency and capacity access are not feasible. Information transfer, as well as robust information management systems, is paramount to linking physical and financial aspects of gas (and power) markets. Such systems will require private sector innovation and investment and must be seamlessly integrated with the ongoing establishment of rules and regulations around trade.

The role of ‘agitators’ has typically been pivotal in reaching the ‘tipping point’ towards competitive conditions

Where wholesale markets appear to be struggling, many commentators quote the persistent dominance of national incumbents. In many EU countries (e.g. Austria, Belgium, France, and Sweden) and four years after implementation of the first Gas Directive, a single energy entity controls more than 90% of the gas volumes. An aggressive stance amongst contenders and other regional incumbents will therefore be vital to stimulate competitive tensions. Key players in this effort are expected to be:

- Strong players from other markets seeking expansion or the replacement of losses in their domestic market;
- Oil and gas producers seeking to move downstream;
- Intensive energy users;
- Merchant operators; and/or
- Pure wholesalers or traders.

In addition, other ‘agitators’ may come, for example, in the form of US and UK entities seeking further expansion into the developed markets. Such players have traditionally played a vital role in fortifying liquid spot markets, as has been witnessed in the US and UK. The roles of such independent players will be critical if the market is to signal that entry is possible and profitable, even in the midst of much larger vertically integrated players who are becoming permanent and, in some cases, more benign features of the energy landscape.

International strategic obstacles may hinder domestic government efforts to launch liberalisation at home

On a broader level, each national market now faces exterior strategic obstacles to market liberalisation - against which domestic governmental initiatives have little or no effect - and these are likely to remain formidable barriers for the foreseeable future. Evidence suggests that countries with more competitive markets are more susceptible to takeover by foreign companies – themselves tending to originate from less competitive markets. This is not without ramifications for the domestic economy of any state considering commitment to liberalisation. The UK, for example, is presently in a situation where many of its energy assets are being purchased by dominant players on the Continent, and in the meantime there is the sense that its prices may be nonetheless propped higher by high prices prevailing across the channel. It is therefore unable to tap the full benefit (in the form of lower prices) of liberalisation while having to endure the increased weakening of its companies with respect to Continental rivals. Thus, any state that commits to liberalisation runs the risk of losing its competitive position with respect to neighbouring states who have not committed. Such a situation constitutes a prisoner's dilemma, in the sense that there is limited incentive for individual states to commit as long as all other states have not.

Fair access to transmission capacity will be critically dependent on asset ownership through national and private financial consortia

Potential contenders must also see fair and open access to capacity infrastructure. Strategically, access to capacity is critically linked to asset ownership. This has long-lasting implications for emerging competition, especially as much new gas transmission infrastructure - trans-channel, trans-European pipelines, LNG, and storage – comes online prior to 2010. Notably, the North European Gas Pipeline will span 1,200 km linking Russia to the German coast, and is then planned to extend onshore to Holland and the UK. With an estimated cost close to US\$6 billion, investment in this project will demand corporate sponsors with deep pockets and a networked syndicate of bank supporters. Rules for equity (and debt) participation in this project are therefore key to establishing the initial ownership profile, and this will likely impact the way capacity is used for much of the project life. While the EU supports the pipeline by funding feasibility studies, no formal partnership is yet established. The strategic implications of eventual equity ownership of this vital asset are likely to send strong signals to potential entrants across Continental gas markets.

Energy security may kindle a fundamental reassessment of the role of free markets and complicate government efforts at liberalisation

But in relation to the question at hand, there remains an elephant in the room – the question posed presumes that governments are still committed to competitive markets.

Fast becoming a top priority for policy makers, manufacturers, and their energy suppliers, security of supply is likely to become even more important as demand centres in the West become more dependent on hydrocarbon fuels sourced in the East. In this context, industry resistance to free markets is not surprising; as power companies integrate vertically they are better positioned to manage supply risks, and can consequently more reliably deliver power to their consumers. Robust long-term contracts are easily integrated across company portfolios and are consistent with upstream long-term contracts which are *de rigueur* industry-wide. On a national level, governments know it is easier to deal with a national champion than a plethora of foreign suppliers (or their respective governments) when national security of supply is at stake. Volatile energy markets may ultimately reconcile supply and demand within an interval of 15 minutes and at high cost, but that makes many a politician ill at ease. As energy security fast becomes a priority on a level comparable to national defence, it becomes more difficult to entrust this critical national interest to the

sometimes capricious care of free marketeers. Indeed the subtle wisdom of consolidation may even be appearing through the spate of mergers recently approved by local governments and/or the EC; of six cases of proposed energy-related mergers or acquisitions in this decade only one (the ENI and EDP bid for Gas de Portugal) has been blocked.

And perhaps we have come full circle. Going forward it may be incumbents of old who will fight the good fight for establishing and preserving their commercial freedom within competitive markets.