ECONOMIC CONSULTING ASSOCIATES

**Market Brief**

# Expansion of the exchanges: a cautious welcome

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*Seven years on, the repercussions of the financial crisis may be set to play a major role in upheaving an unlikely sector – the European power markets. As with their financial cousins, forward contracts for electricity have traditionally been dominated by uncleared, and some may argue inaccessible, over-the-counter ("OTC") products. Everywhere bar the Nordic region exchanges have played, at best, a supporting role to the main event. However, with a few blasts of regulatory intervention, the dam which has been holding such platforms back may be getting breached.*

## Focus on forwards by EU regulators

The Internal Energy Market ("IEM") is an attempt to bring the EU's Single Market to electricity and gas. The initial stages have involved tortuous attempts at liberalisation in national markets, while the most ambitious "3rd Package" is currently bending into place harmonised rules to initiate true cross-border competition. A central pillar of these efforts is the notion of Price Coupling based on liquid cross-border Day-Ahead and Intra-Day physical trading, with the intention of maximising the efficiency of interconnector use and providing accurate price signals for further investments.

Efforts to encourage increased liquidity in these markets are a key objective for regulatory bodies across the continent. Active wholesale trading is seen as an indicator of market competitiveness both via price transparency and through enabling independent generators and suppliers to enter the industry. However, due to inelastic short-term supply and demand curves, real-time prices in power markets are inherently volatile. Vertical integration provides the means for hedging against such price risk but reduces market activity at the wholesale level. Therefore if this form of structure is to be discouraged, access to forward markets for hedging becomes a necessity.

## Derivative market controls hit the power sector

So there is a clear desire from within the European power sector to increase the availability of forward market products. And thanks to the repercussions of the financial crisis, this desire is receiving external support. At the 2009 G20 summit in Pittsburgh, agreement was made to reduce systemic risk and increase the transparency of financial derivative markets via implementing stringent reporting and capital requirements. These efforts are being led by the US through the Dodd-Frank Act and the EU via its European Market Infrastructure Reform ("EMIR") programme and the Markets in Financial Instruments Directive ("MFID").

The laws require all standardised derivatives to be cleared on a central clearing platform, while placing high capital requirements on non-standard contract forms. The resultant removal of some of the advantages of OTC trading, together with the higher margin requirements of swaps, in turn creates an incentive to substitute them with exchange-based futures.

## Commercial forces add to new market landscape

Furthermore, the new requirements have encouraged the closure of a number of power trading arms of large banks and utilities, with staff moving to smaller specialist trading houses and hedge funds. Lacking the track record and capital of their former employers, as well as difficulties in negotiating master agreements for non-standardised products, these entities find the mutualised counter-party risk offered by exchanges a more natural fit. Exchanges themselves have been keen to exploit this new landscape with fresh product offerings and expansion into new territories.

The impact of these reforms and trends has already been noted in the European Energy Exchange ("EEX") which has reported substantial growth over the last 2 years, noting record highs in power derivatives for the German, French and Italian markets for January 2015. As a picture of how the future could look, the Nord Pool area, which represents a role model for the IEM, saw over 1.6 TWh of volume (4.7 times the physical market size) in 2014 traded as exchange-based futures or cleared OTCs on the EMIR-approved Nasdaq OMX market. Liquidity is such that even highly capital-intensive renewable developments are able to receive project financing absent of a long-term Power Purchase Agreement.

## Suppressed impact on retail competition

The question remains as to what benefits end consumers will ultimately receive from these trends. The theory is that by allowing easier access to forward markets, barriers are lowered for new suppliers and retail competition is ramped up.

However, this may not be a full solution to the problems faced by new entrants. In order to compete effectively against incumbents in retail supply – a business usually relying on payment in arrears – upfront cash must be found for the party to take positions in the forward markets. Banks and large businesses with customer service skills do not generally have electricity trading skills and so it is far from certain that cash rich competitors will easily appear to challenge incumbents just because they can now trade more easily in forward markets

*The immediate benefits to be derived from the expansion of exchanges may therefore be less pronounced than is hoped. Caution should be expressed when welcoming their growth and attention paid to other barriers to entry – notably financing. However, in the mid to long-term the new structures do present a real opportunity. Active and accessible forward markets will encourage cross-border trading, leading to the development of greater interconnection capacity and, supported by enhanced use of demand-side measures, can assist in the continent-wide smoothing of load profiles. This provides the potential for the more efficient use of all our energy infrastructure.*

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