

Comments on the Preliminary Findings of the Energy Sector Inquiry released by the European Commission on 16 February 2006¹

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Pownernext SA thanks the European Commission and the Competition DG to have the opportunity to comment on the preliminary findings of the inquiry regarding the European gas and electricity wholesale markets. Given the nature of our activities, we will respond on the electricity part only.

Pownernext welcomes the initiative of the Commission. The wholesale market in electricity is indeed not developing as well as it could be expected. The reasons for such a slow development have been clearly highlighted by the Commission in its report.

We will comment on the “issues under review” before considering specific points mentioned in the report.

1. Comments on some of the “issues under review”

On page 7 of its report, the Commission lists a number of issues on which comments are solicited.

1.1. The price setting practices on electricity wholesale markets including power exchanges

→ The right balance between exchanges and OTC and the interaction between price setting practices and transparency

If carried out, the assessment of the price setting practices must be made both on power exchanges and on the over the counter market. The wording used by the Commission suggests that this is the case but the fact that only power exchanges are mentioned also suggests that issues are mainly arising on power exchanges. This is not the case.

Besides, the Commission rightly insists on transparency at production and transmission levels, i.e. at the level of market fundamentals. We would like to point out that transparency issues also arise at the level of market mechanisms when trading is carried out bilaterally over the counter.

In this respect, we would like to highlight that the price is set on both trading environments and only power exchanges offer a consistent transparent framework.

¹ European Commission, Competition DG, Preliminary Report, Sector Inquiry under Art 17 Regulation 1/2003 on the gas and electricity markets, 16 February 2006.

Power exchanges guarantee that:

- the market rules are public;
- the market rules are non discriminatory and apply in the same manner to all participants;
- the list of participants is public;
- offers to buy and sell are known to all members;
- matching is based on a neutral mechanism taking into account the price, the quantity and the timing of the offer;
- prices and quantities are public;
- indices, market prices and closing prices published by the exchanges are based on actual transactions;
- regulators see what is traded on the market and have the means to carry out inquiries.

These features guarantee a level of transparency and quality of price formation which cannot be compared to the over the counter market.

On the over the counter market :

- the market rules are not public. Even if standard contracts are used, it is not possible to know if counterparties have modified such contracts;
- there is no equality of treatment between the participants,
- the list of participants is not public;
- offers to buy and sell are not known to all participants but are bilateral ;
- matching is based on the willingness of participants to trade bilaterally with other participants. This can be influenced by other elements than just price, quantity and timing.
- prices and quantities are not public; when made public, they are not verifiable;
- indices are based on assessments made by editing companies and news providers. Such assessments are based on reports by a limitative number of traders. Such reports are not verifiable;
- regulators do not see what is traded on the market and do not have the means to carry out inquiries. Only competition authorities can carry out inquiries on an ex post basis.

Despite these differences, indices published on the over the counter market are placed at the same level as those published by the exchanges and are used in the commercial documents, newspapers and official documents. Such over the counter indices are also used as basis for indexation.

The Commission indicates that its review may lead to regulatory action. We would like to highlight that exchanges are operated by private companies. Providing such a transparent and secure environment has a cost that must *in fine* be charged on members. Exchanges are also perceived as more bureaucratic than the over the counter market precisely because the rules are set in advance and must be complied with. Increasing the tasks of exchange operators or increasing the regulatory burden placed on such operators for the sake of improving the price setting mechanism may lead to an increase of administrative burden on members and an increase of cost. The risk is that members eventually choose to trade out of the exchange to avoid such burden and cost.

It is interesting to note that regarding commodities or securities which are sensitive in nature such as equities and grains or when concentration of participants is relatively elevated, exchanges rather than OTC have imposed themselves throughout the world as the main centres of price formation. This results from the need of concentrating liquidity as much as possible and the provision of a regulatory safety net. The case is not similar for currencies or bonds for instance which are mass-markets by excellence.

As a conclusion, in our view, efforts should be made in priority to create the conditions for increasing the liquidity on power exchanges and gather there the largest spectrum of participants in order to generate a truly representative price, easily auditable. Over the counter markets must coexist with Exchanges as some degree of flexibility is needed for market participants. But we should take care not to place durably the bulk of the market activity in the OTC, precisely where it is less controllable, a situation which prevails today at the time of this inquiry. We would welcome such improvements as they would contribute to the confidence on the overall electricity market.

→ *The participation of the demand side*

The price formation results from the matching of the offer and demand. As a consequence, the wider the number of participants on both sides is, the stronger the price. It is critical that companies representing the demand side are able and willing to access the market and contribute to the debate on prices. Actions promoting such participation are welcome.

The demand side can participate to the price formation by several means:

- by becoming members of exchanges or trading bilaterally;
- by using intermediaries;
- by exercising the market flexibility mechanisms such as arbitrage.

The suggestion is that the price setting *mechanism* can be improved but a better diversification of market participants may lead to greater and more visible results.

→ *The distinction between price and cost*

On several instances the Commission did make reference to the cost of production. It is obvious but worth reminding that prices are not necessarily similar to costs as the latter do not interact with the level of offer and demand.

1.2. A possible more generalised use of electricity release programmes (VPP) as well as other measures reducing the effects of concentration and further measures to reduce upstream supply concentration

The situation in France is that market prices are higher than the regulated tariff since the end of 2003 for most eligible consumers and that the production is made by a dominant operator. In this respect, it is desirable for the sake of markets' efficiency that conditions for a fast growing wholesale market are set up in France: announced program of a progressive removal of tariffs, continuation and at least doubling of VPP auctions, limitations of special treatments such as the "consortium" recently set up with some industrial companies, to a percentile of the wholesale market which does not jeopardize its liquidity and preferably in a European context rather than a national one.

1.3. Other suggested issues under review : harmonising exemptions to financial markets regulation

The regulatory framework mentioned in the report in pages 99 s. does not mention the regulation applicable to financial markets, despite its potential impacts on the energy wholesale market. When buying or selling energy, market participants can in some circumstances be deemed to buy or sell financial instruments and should therefore have the appropriate licence or benefit from an exemption. In this respect, the Market in Financial Instruments Directive of 21 April 2004 contains a number of exemptions. But such exemptions are only valid for the purposes of the directive, which is to grant a passport to companies acting cross-border. National regulation on the licence and the definition of exemption survive the MIF directive.

As a consequence, the choice that market participants face is:

- either to register locally in order to benefit from the passport granted by the MIF directive, with the burden of asking a licence which is not adapted to the current energy market participants,
- or not to register in its home country on the basis of an exemption which may not exist in other countries, thus blocking access to the wholesale markets in such countries.

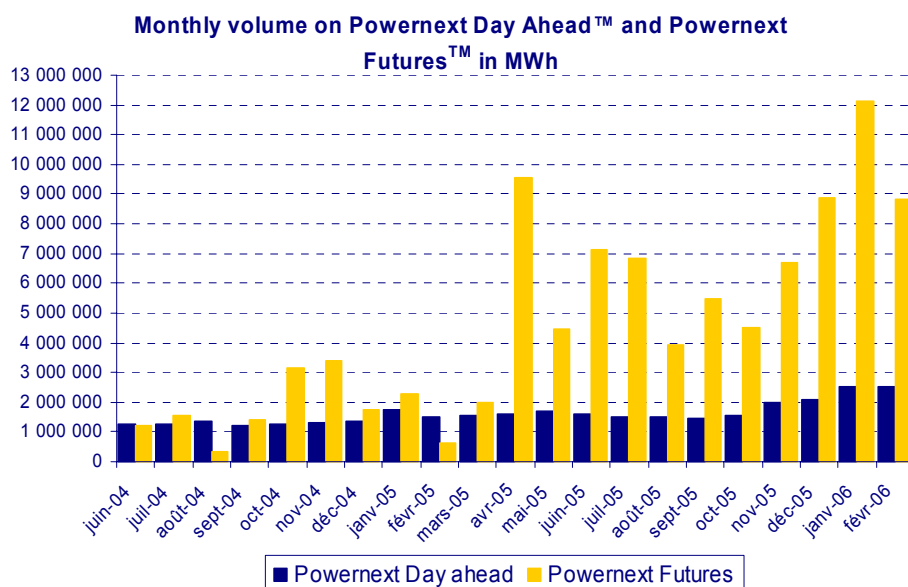
This dilemma stemming from an absence of harmonisation of the conditions for an exemption is an obstacle to the participation to the wholesale markets. In other words, one of the many reasons for the non development of the wholesale markets is also the regulatory burden.

We would suggest that this issue be reviewed by the Commission in light of the development of the energy wholesale market. This is one of the few easy tools that the Commission can use to eliminate an obstacle of the development of the energy markets.

2. Specific comments

2.1. Traded volumes on spot markets

On pages 111 and 112, the inquiry shows spot and forward volumes traded on European power exchanges as a percentage of total consumption. As far as Pownernext is concerned, we suggest that it would be more relevant to compare the spot volume with the total eligible consumption as the French market is not yet 100% open. For 2005, the corrected figure would amount to 6% of the eligible consumption for Pownernext Day-Ahead and 18% for Pownernext Futures. This is still a conservative approach since, according to the French “Conseil de la Concurrence” in its Avis 05-A-23, the “free market” should not yet exceed 150 TWh, most eligible consumers having chosen not to exercise their eligibility and continue benefiting of the shield of a much cheaper tariff than the market price.



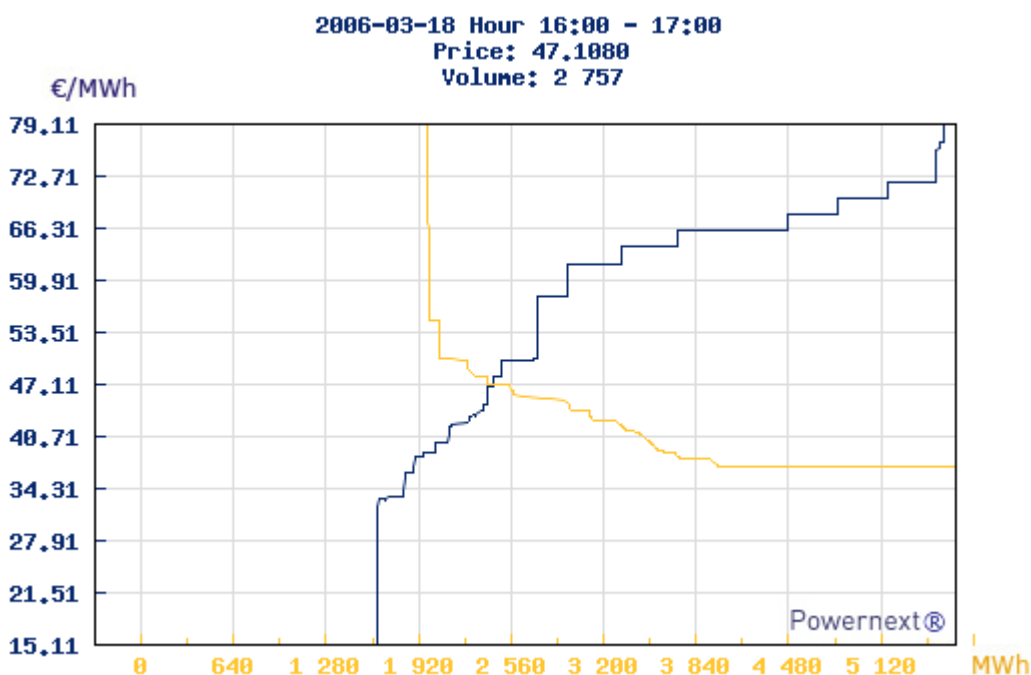
Moreover, the first two months of 2006 show a significant rise in Pownernext volumes which represented roughly 9% of the eligible consumption for Pownernext Day-Ahead and 37% for Pownernext Futures.

	Pownernext Day-Ahead		Pownernext Futures	
	In MWh	In % of eligible consumption	In MWh	In % of eligible consumption
January-06	2 533 710	9%	12 138 664	43%
February-06	2 520 218	9%	8 806 902	31%

2.2. Price formation on spot markets

The analysis of short-term price formation developed in the report is based on a very physical and static picture of the electricity market. The merit curve, which is often referred to in the report, is a theoretical representation of the electricity generation mix. Building the merit curve corresponding to the generation mix of all European producers active on a power exchange would imply being able to represent the “behaviour” of thousands of production units in Europe, which seems to be a difficult task both from a theoretical and a practical point of view. Besides, the merit curve does not take into account all costs pertaining to electricity production and especially it does not consider the costs of starting and stopping production units. The availability of power plants is also impossible to assess in real time. Moreover, not only is it complex to build a realistic merit curve but it might not be an accurate and helpful representation of the offer curve on an auction market. Indeed, there are many reasons for a producer not to sell electricity on the market at its marginal cost. For instance, a thermal electricity producer may wish to bid at a cost lower than its marginal cost on off-peak hours because it would be more costly to stop a plant for only a few hours than to sell on the market. Another illustration would be the case of a hydro electricity producer which, in the case of heavy rains, may find it profitable to sell its surplus on the market at any price, even if very low.

Moreover, as far as the demand of electricity is concerned, the inquiry considers that it is systematically price-inelastic and that this characteristic makes prices easier to manipulate. Demand may be price inelastic from the end-user point of view but it is definitely responsive to price variations on the wholesale market. See for instance on the chart below the slope of the purchase curve between 53,51 € and 34,31€ on Powernext Day-Ahead.



Buyers take into account the fact that they can purchase from several markets, or they try to make the most out of arbitrage opportunities or to optimize a structured portfolio. For all these reasons, buyers may bid price-elastic purchase curves on an auction market. Demand is in fact far less static and predictable than the inquiry seems to consider.

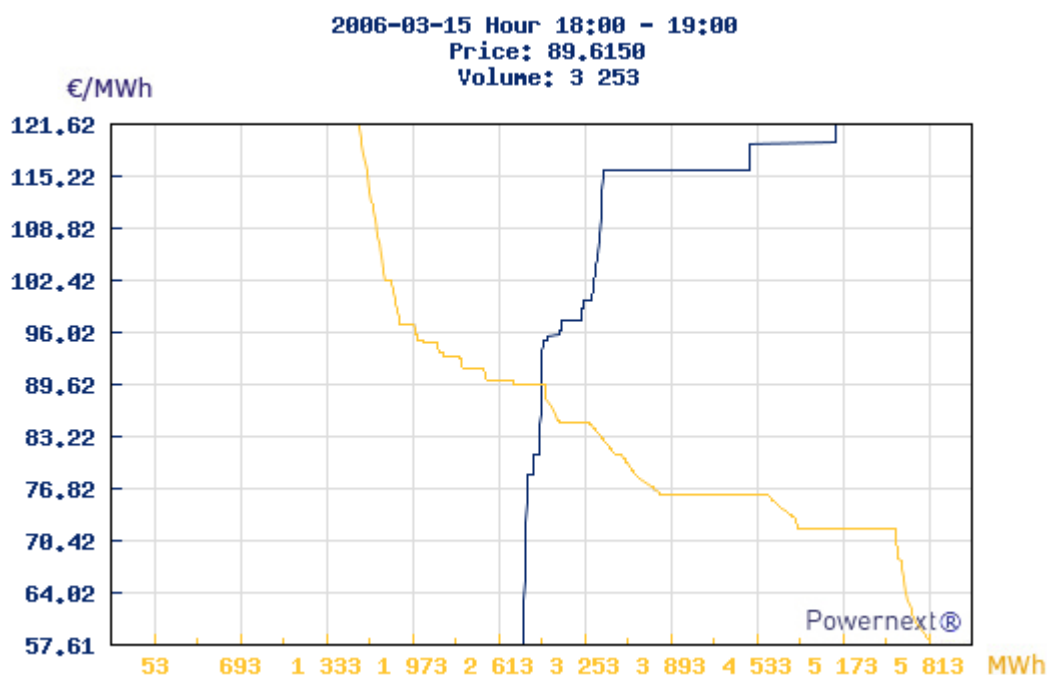
In this respect, it is questionable to consider that « (the) price (is) equal to the highest offer made in power exchange » as mentioned on p117 of the report.

2.3. Price setting frequency

The inquiry tries to evaluate the capacity of suppliers to influence the price on power exchanges via their selling bids.

In a practical way, suppliers trade on day-ahead markets to optimize their portfolio which implies that they must be active both on the selling and the buying side on the exchange. That is the reason why price setting frequencies and market shares around the clearing prices should definitively also be examined on the demand curve.

In any case, it must be clearly stated that sellers do not systematically set the price on power exchanges. For instance, if the demand curve is more price-elastic than the offer curve (see chart below) then most sellers seek to sell as much electricity as possible regardless of the price and are then considered price-takers whereas buyers are *de facto* price-setters.



2.4. Market resiliency

Even if we consider that prices can be artificially inflated by suppliers withdrawing offers from the power exchange, such behaviour should have no impact on the price if the market is deep and “resilient” enough because, in that case, another seller would be able to replace the “defaulting” seller.

Pownernext’s resiliency index is defined as the average of market clearing price variations caused by the addition or the withdrawal of offer and demand bids on each of the hours of the period. This index can then be used to evaluate the impact of the withdrawal of a significant seller on Pownernext Day-Ahead™ market price, all other things being equal.

We have simulated the impact of the withdrawal of 500 MW on the 24 hours of each day in January 2006 (this represents roughly 15% of the traded volume on Pownernext Day-Ahead in January). This “shock” has resulted into an average variation of 3,84 €/MWh, which represents 6% of the average price (67,87 €/MWh in January). This variation is very small if we compare it to the distribution of daily prices around the average monthly price which represented 20% on average.

This result shows the depth of Pownernext Day-Ahead’s order book and the market consensus surrounding the price established on Pownernext Day-Ahead™.

2.5. Interconnector allocation mechanisms

The report underlines the inefficiencies of current allocation mechanisms at the borders. Even market based mechanisms such as explicit auctioning is no panacea and only implicit auctions lead to an economically rational use of interconnection capacities. Pwernnext would like to draw the Commission's attention on the fact that Belpex, Pwernnext and APX along with RTE, Elia and Tennet are in the process of linking the day-ahead markets of Belgium, France and Netherlands using a form of capacity implicit auction called market coupling. This project which is the first step of a much larger design, soon extended to NordPool via the Norned cable, is ready and is waiting now for the final clearance of the three regulators involved. In this respect, it would be important that general interest prevails over domestic regulatory considerations.

A cost benefit analysis has been undertaken showing how a move from explicit to implicit auctioning would help remove inefficiencies in two ways:

- **Improved utilisation of interconnector capacity by market players** – explicit auctions create risks and uncertainties for market participants who have to acquire transmission capacity before knowing whether energy trading will actually be profitable in the direction for which they acquired capacity
- **More capacity available for trading due to netting** – rights for the use of capacity constitute an option for capacity usage. As the TSO does not know whether capacity will actually be used, he cannot net off capacities sold in opposite directions at a border and resell free capacity until after the rights are exercised or expire. With netting, TSOs could systematically make more capacity available to the market.

Both inefficiencies lead to higher than necessary costs of electricity production as less power is traded from low to high price countries than would be possible with an implicit auction regime.

Market coupling may also help to reduce the opportunities of exercise of market power thanks to a mutualisation of the exchanges order book and to the improvement of resiliency.

Finally, this project is also a significant step towards the harmonization of the rules governing the wholesale electricity markets and the improvement of information transparency on interconnection capacities.

2.6. External factors explaining price increases

The report shows some of the external factors that may explain the increase of electricity prices over the last few years such as the increase of fuel prices (natural gas and coal) and the introduction of the CO2 market. These factors are indeed necessary to explain at least parts of the rises in electricity prices, but the increasing tightness of the balance between electricity supply and demand on the European scale also probably requires to be further assessed as another explanation.

As a matter of fact, the report does give an illustration of this tighter supply/demand balance showing the increase of load factors (i.e. of the ratio between effective production and installed capacity) in Germany in a context of raising demand. Such findings could also probably be reached in other European countries where the lack of capacity becomes more and more obvious especially to cover peak demand. In this context, increasing prices can be considered as a necessary stimulus for future investment in generation capacity and the role of price as a signal should then also be examined. Market mechanisms should be able to express their full potential without bias. Transition mechanisms to help certain categories of consumers should be dealt with at the European political level. But an integrated electricity market will not be achieved if national exceptions are the rule and leave the market without any substance.