

European Commission
Directorate-General for Competition
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1049 Brussels
Belgium

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Subject: Energy Sector Inquiry: Response to Draft Preliminary Report

Dear Mr, Mrs,

February 2006 you published the "Energy Sector Inquiry Draft Preliminary Report". Thank you for offering market parties the opportunity to respond to this report. Below you will find APX' response. I'll start with some general remarks. Thereafter I will go more deeply into the gas and electricity part specifically.

General

First I would like to express that I support the chosen approach. Although it might not be adequate on all aspects, in general the sector specific regulation provides a clear framework for the development of a well functioning internal European energy market. Now this regulation should have been implemented in national law, it's time to analyse whether the market functions properly and if not to see whether this is caused by inappropriate or a lack of regulation or by competition issues. In any case we have to be careful to link a rise in prices to malfunctioning of the market. Also in well functioning markets prices might rise. On page 10, under 2, such a link between high prices and malfunctioning seems to be suggested.

Second I would like to express my worries about the discrepancy between the size of the markets and the position of the market players. Liberalisation is going on for about ten years. The level of liberalisation currently varies per member state. However in all member states market players have been seeking how to cope with liberalisation and how to survive in a liberalised world. Often this led to mergers, take-overs, etc. So where market players have strengthened their position, have grown, the markets didn't. Markets are still fragmented. Both on the electricity and the gas market, the market players became large animals in small cages, which by itself frustrates competition. Although the lack of market integration is one of your conclusions, it should get a greater emphasis.

Before I will go over to the electricity and gas specific remarks I would like to note that also the fact that the level of liberalisation differs per member distorts market functioning. The weakest link determines the pace of the creation of a real internal energy market. For example, if Germany keeps it's borders closed it's different for Denmark to access the Netherlands. So it's a real need that the European directives will be implemented soon and properly in all member states.

Gas

In general I support your conclusions. However two important ones need to be more emphasized. The two biggest problems for the development of one European internal gas market are the lack of gas trading platforms and the limited availability of free tradable gas.

Lack of gas trading platforms

In the gas market an entry-exit system is common practice to access the network. Such a system hinders the development of wholesale gas trading, unless a hub has been developed. Only on such a hub parties can transfer gas from one party to another. Therefore a hub is a prerequisite for the development of a liquid wholesale market. On its turn having a hub is a prerequisite for the establishment of organised market places, for example physical exchanges. In order to develop one internal gas market all member states should have a hub in place. This requires support from the European Commission.

In respect to the above I also would like to mention the following. Under 59 you write: "Liquid hubs will underpin the functioning of the market in many ways. They would provide a price formation mechanism that reflected supply and demand They would enable supplies to optimise their portfolio's in a cost-effective manner. They would enable traders to take advantage of short-term price differentials." It isn't correct to assume that all these provisions will occur only when a hub has emerged. It's only true when there's an organised market, an (spot) exchange active on that hub, and when there's sufficient gas available that can be traded on such a hub. Besides support required for the development of hubs the European Commission should also stimulate TSO's to support the development of market places, in particular spot exchanges and should make sure that the entry-exit system is developed in a way that it never hinders wholesale trading.

Among others (spot) exchanges offer clearing and settlement services. These are important services in order to support gas trading. APX operates gas exchanges in the United Kingdom, Belgium and the Netherlands. So your statement that "No European gas hub has an operator ensuring the clearing function of the market ... (under 61)" isn't correct.

The development of hubs and organised market places (spot exchanges) are prerequisites for the development of a well functioning internal European gas market, as proven in the United Kingdom. APX developed gas exchanges in the United Kingdom, Belgium and the Netherlands. The exchange in the United Kingdom is very successful. The exchange in the Netherlands has a great potential, but some governmental support is needed to benefit from this potential. The Belgium exchange isn't very beneficial at the moment. I'm very happy to share my analysis on the successes of the UK exchange and the problems we face in the Netherlands and Belgium with you.

Availability of free tradable gas

Hubs and (spot) exchanges will only contribute to the development of liquid wholesale gas markets when market parties are willing (incumbents) and able to trade gas. For example in the Netherlands the incumbent doesn't participate on the APX. The incumbent also isn't very willing to deliver contracted gas on the hub (TTF). It delivers gas at the gas delivery station. Once gas is delivered at the gas delivery station it can't be delivered back to the grid, because the TSO doesn't allow (re-)entry on these gas delivery stations. So gas delivered at a gas delivery station can't be traded. As a result parties that buy gas from the incumbent are unable to trade shortages and surpluses on the market.

The incumbent should be “stimulated” to participate actively on the market and to deliver gas at the TTF as a buyer asks him to do so.

The above includes recommendations to stimulate the development of liquid national wholesale markets. Starting from the present state, with little or no real competition in the vast majority of the EU countries, I truly believe that we have to go through three stages to reach the required level of competition in the end. In the first stage, liberalisation of national markets is needed to ignite some form of competition. The next stage involves working at a pan-national level to link the national markets. In stage three, Northwest Europe is an open market for gas.

Liquid national wholesale markets improve possibilities to swap gas. Some gas swapping is taking place at the moment, but will increase if every market has an organised market place in place to facilitate swaps. Sufficient possibilities to swap gas reduce the problem of insufficient availability of cross border capacity and enables market parties to trade across the border.

To conclude for gas, APX asks you to pay more attention to the development of gas hubs, organised market places and the availability of free tradable gas.

Electricity

After reading the part about electricity of the Energy Sector Inquiry I have some remarks about this part. I will set them out below. I will focus on market coupling and transparency. I will first make remarks about those two subjects and then will deal with the other subjects mentioned in the Inquiry. It would be of great importance if the European Union, in general, and DGs Competition and TREN, in particular, could underwrite our vision about market coupling, as well as transparency.

Before I will go to the two major issues mentioned above, I will first make a remark about security of supply (section 320). A well-functioning market will attract more market parties and the security of supply is automatically guaranteed.

Market coupling

The lack of competition in the fragmented market is caused (at least in the electricity market) by the contractual (!) scarcity of cross border transport capacity. There is a solution to improve the situation quite fast, referring to the omissions analysis on the relative inefficiency of explicit auctions: market coupling. Market parties do not bid for transmissions capacity first, not knowing the energy prices. They bid on one integrated market for energy and transmission all at the same time. Most important in that market coupling will lead to a single market for those hours with one single market price and one single pool of all European utilities. Besides market coupling:

- removes risks;
- maximizes the use of transmission capacity (because import and export flows will be netted).

APX is of the opinion that the lack of market integration is primarily caused by contractual scarcity of cross border capacity instead of physical scarcity. Therefore APX truly believes that market coupling (especially for the short term) is a much better solution for market integration than the build of new cables.

Market coupling can be realised on a relatively short period (compared to the build of a new cable). TSO's and exchanges have to agree on market coupling and have to develop the IT systems needed.

In the Netherlands, Belgium, France project the biggest problem is caused by differences in regulation in the different countries. Three different set of regulation, three different regulators, without any central coordination, slows down the implementation process. In order to realise these kind of projects, which are of major importance for the development of internal European electricity market, it would be very helpful if the European Commission would even more stimulate the harmonisation of rules and procedures, but also could coordinate these kind of processes. The European interest should prevail above national interests in these kind of projects, therefore European coordination is needed.

Transparency

Transparency is needed for two purposes. First, for a more efficient market and second, financial and other players (next to the physical players) can enter the energy market.

APX agrees that there's an urgent need to require all market participants to publish more information.

A distinction needs to be made between transparency for market parties and transparency for the regulator:

1. Transparency for market parties. It is relevant for market parties to estimate the trading opportunities as good as they can, such as: space at the market and availability of the products, availability of internal capacity, balancing on the system and price-making;
2. Transparency for the regulator. The regulator should have information on market behaviour and developments in the market. They should also be able to exchange information with other national regulators.

Improved access to relevant information - or greater market transparency - may improve market conditions in a number of ways, including:

- the reduction of risk and uncertainty (by providing market participants with better information);
- the removal of information asymmetries (by allowing participants access to the same information);
- the improvement of market liquidity (by encouraging more parties to actively participate in the market).

All in all, the result of better transparency will be more cost-effective operation across the industry, it enables parties to make better use of the market and that will lead to a more honest price towards the consumers.

As a general principle, as much information as possible, should be made available to market participants in a non-discriminatory and transparent way. However, in competitive markets, it is also clearly important to protect the commercial interests of market participants.

Market concentration

Achieving progress towards a truly internal European energy market is important. Non-discriminatory and transparent allocation of available interconnection capacity is of fundamental importance for the realisation of the internal European electricity market. As the Member States, pursuant to the Electricity Directive, remove the constraints of monopoly markets, the electricity markets will cease to be national and become regional and in some respects European-wide markets.

System load provides information about overall supply and demand conditions. Such information is necessary in order to evaluate the evolution of the market and to forecast future developments. These data were available in the past in the Netherlands, but is not available to the market anymore.

It would appear that, at the moment, nobody has access to information on system load. Data on system load should be considered non-confidential by nature as it describes the entire market and hence provides little or no opportunity for identifying the behaviour of individual participants.

Data on system load should be published on a real-time basis, for example on the website of the system operator, in a manner that allows for easy downloading. In addition to the publication of actual load *ex post* one should also consider the publication of *ex ante* load forecasts, for example based on the daily forecast made by the system operator for operation planning purposes.

Due to historical decisions, transport limitations can not be solved on a short notice. Transport limitations leads to a more fragmented market. Market parties in this fragmented markets are too small to have a fully efficient European market. Explicit auctioning is one of the causes, because it confirms and enhances fragmentation, even when there are no transport limitations. In the explicit auction the national markets in Europe remain separate fragments, even when there is no constraint e.g. at risk.

Creating a level playing field on the European energy market is essential for the different energy companies in Europe. At the moment this does not exist.

A level playing field in Europe will lead to a fast harmonization of rules with regard to market transparency, market information and the equal position of information that is crucial to the market. This is possible when the assumption is that the energy market is a financially regulated market on which selective insider trading (for example: fall down energy plant) never can and may be used.

Lack of market integration

The European market can gradually get stronger by using different methods, like integrated flow-based auctioning (implicit) by introducing financial transmission rights and by strengthening the border connections as well as building new interconnectors. As stated in section 486, APX agrees on investing in the expansion of interconnector capacity is one way to lower congestion on the borders between Member States. APX would add that the existing interconnectors could be better used in this regard.

It is of the highest importance that the abovementioned is tackled at the basis and the regulatory pressure in a period of time gets better. That will lead to a better perspective for the energy sector. However, it requires the need for better coordination of the supervision.

In conclusion APX can say that the seriousness of market fragmentation is a greater challenge to be dealt with than technically is foreseen. By having implicit auctions fragmentation will be cancelled if there are no transport limitations.

As a whole, an integrated European market is possible on a part-time basis and when a international liquid market is available.

Price formation

Regulated supply tariffs, like any other public tariffs for electricity supply, may jeopardize the development of the market. Public supply tariffs will have an adverse effect on the development of the market, as said in your conclusion on this subject.

In section 555 you state that Member States could be tempted to set the supply tariffs below the corresponding wholesale benchmark to ensure lower price levels for customers. APX fully agrees on the fact that an adverse effect of such tariffs is that new suppliers with no access to own generation are squeezed out from the market. A malfunctioning market is not the best start for a internal European energy market and should be avoided at all costs.

As a conclusion APX would like to express that it is very important to expose clear abuses, but it is even more important to work on structural aspects to become a single European market. In a larger integrated market more competition would exist between companies with sufficient size at the same time supporting security of supply.

This Energy Sector Inquiry could be a big step forward in starting a single European market. Therefore, should you have any questions in regard to our response, don't hesitate to contact me.

Yours sincerely,

APX B.V.

Bert den Ouden
CEO