Rethinking European power

European energy firms are seeking to reposition their products and strategies in advance of European Union market deregulation. FAME Energy reports

The general economic slowdown in Europe in 2002 has not hampered merger and acquisition activity among Europe's principal energy companies. In fact, the pace of change has quickened, as companies seek to develop their energy supply businesses in time for the planned full European Union market deregulation in 2007. Here we look at the state of play among the dominant power companies and argue that we are witnessing a sea change in those firms' core strategies to protect their respective market positions.

Principal challenges

With milestones of 2004 – for mid-market liberalisation – and 2007, the ability to choose one's supplier will be extended to all EU households, and the consumer is expected to benefit by paying prices for electricity that are closer to the marginal costs of production. European directive 96/92/EEC came into force on February 19, 1999 establishing common rules for the production, transmission and distribution of electricity throughout the EU. It is fair to say now that most big electricity consumers in the EU now have the right to choose a power supplier other than their local monopoly. Certain markets, however, have only enacted the upper tier deregulation required from the directive.

In France, for example, one of the last EU countries to enact the legislation, an article in Platts' publication *European Power Daily* on February 17 reported that 17 % of the eligible market – that is, firms consuming more than 7 gigawatt hours a year – have switched from Electricité de France (EdF). Indeed, a study – Platts Report 05/03/2003 – by UK energy firm Centrica in late 2002 said: "80% of French consumers would switch suppliers if offered a 10% discount". Once we see the small-to-medium-sized-enterprise sector open up in France in 2004, the pace of change will be all the quicker, adds the report.

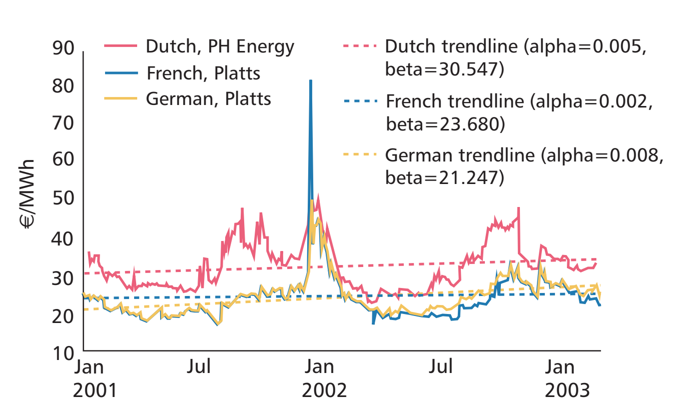
New competition challenges are further compounded by the fact that power companies are facing a credit squeeze. Credit rating agency Fitch reported in February that almost one in three of their utility ratings have a negative outlook. The downgrading of utilities will, therefore, hinder most European utilities' expansion plans involving cross-border acquisitions and force many to concentrate on internal market innovation.

And exacerbating the difficulties of increased competition and credit downgrading, asset-owning electricity firms appear to be turning their backs on the financial markets. Online publication Powernews.org recently reported that liquidity has more than halved on Nordic power exchange Nord Pool this year, compared with the same period last year. Whether we will see a similar downturn in the German and UK markets remains to be seen.

New initiatives

With these three significant challenges facing utilities – greater consumer choice, a credit squeeze and firms shunning the financial markets – the major players are increasingly turning their resources to satisfying their consumers. The European mid-tier market is scheduled to be fully deregulated in 2004, and the bigger players in France and Holland are aware that this is when they could lose significant market share.

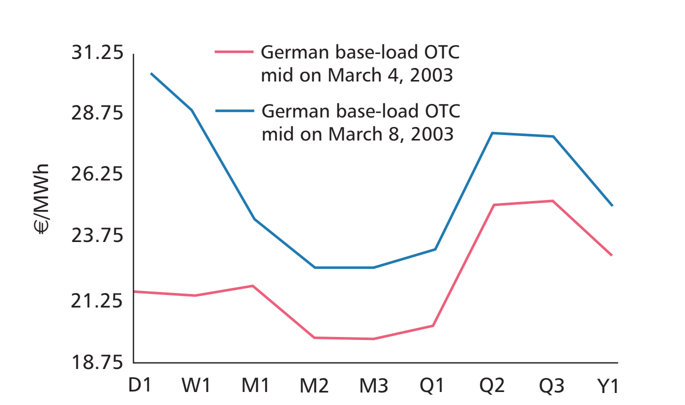
Figure 1: **Month-ahead base-load prices in Europe**



Source: PH Energy; Platts

The figure shows the base-load electricity prices in France, Germany and the Netherlands. There is a clear upward trend in all three markets. The French market has seen the smallest rise, which in part may attributable to the high dependence on nuclear generation meaning it is not subject to the rise in cost of coal- or gas-fired generation.

Figure 2: **Study of German base-load OTC curves**



Source: PH Energy

Forward curves covering two different years of the German over-the-counter base-load market are shown here. Even on the outlying region of the curve, we see a premium of 10% over power prices paid in 2002 – a significant shift in the market's long-run fundamentals. Is this is due to higher feedstock prices or a shift in strategy ?

Correlation matrix of energy prices

	Brent crude Platts dated ($)	HSFO 3.5% CIF ARA Platts ($/tonne)	ARA CIF API_2 coal ($/tonne)	NBP nat gas 24 hours PH Energy (UK pence/therm)	UK day-ahead base power PH Energy(£/MWh)	German day-ahead base power PH Energy (€/MWh)	French day-ahead base power PH energy (€/MWh)
Brent Platts dated crude ($)	1.000	0.848	0.470	0.681	0.425	0.797	0.797
HSFO CIF ARA	0.848	1.000	0.257	0.493	0.371	0.803	0.853
ARA CIF API_2 coal	0.470	0.257	1.000	0.856	0.824	0.266	0.492
NBP [nat gas] 24 hours	0.681	0.493	0.856	1.000	0.813	0.566	0.714
UK day-ahead base power	0.425	0.371	0.824	0.813	1.000	0.242	0.464
German day-ahead base power	0.797	0.803	0.266	0.566	0.242	1.000	0.918
French day-ahead base power	0.797	0.853	0.492	0.714	0.464	0.918	1.000

ARA=Amsterdam-Rotterdam-Antwerp area; HSFO=high-sulphur fuel oil; CIF=Cost insurance and freight; NBP=national balancing point

Source: Platts, PH Energy

EdF, for example, is planning to tackle competition by improving its customer services and marketing activities aimed at industrial consumers. The company's moves will include tailoring pricing packages to best fit its clients' energy needs. The EdF initiative is in preparation for July 2004, when nearly two-thirds of the market will open to competition. The French giant will continue its plans for expansion and is likely to offer diversified services via a single brand name.

As with RWE and its acquisition of Thames Water and E.on and its planned acquisition of Ruhrgas, big power firms believe they can improve customer loyalty by offering bundled services.

A change in initiative and a refocusing on internal markets will also affect technology service providers. Mid-tier initiatives will require electricity companies to plan new tariff structures and invest in sophisticated modelling and shaping tools.

For the most part, such moves will widen the marketing strategies of the big power firms – marketing strategies that for the past two years have concentrated much of their time and budgets on developing suitable risk management tools.

Rising prices

It is a given that current volatility plus a long-run upward trend in base-load electricity prices are a consequence of general market uncertainty. Figure 1 shows that in France, Germany and Holland, prices for base-load power have risen steadily from a base line dated from January 1, 2001, although admittedly a low base line.

A recent survey of European power executives conducted and published in February by Moffatt Associates says the market believes that power prices will continue to rise or, at best, remain level with those today. The question, therefore, is how much of this projected rise is attributable to higher feedstock prices for natural gas, oil and coal? The correlation matrix above suggests that the most significant relationship between primary energy and electricity prices is to be found in the UK electricity and the UK natural gas market. This is ironic, considering that this is the one European power market where prices have fallen overall since 2001.

Even more significant is the degree of correlation between French and German base-load prices month-on-month for the same period. It can be argued that EdF, with its significant captive-market advantage and considerable nuclear power assets is taking care to maximise revenues until mid-market liberalisation next year.

We must therefore look beyond mere higher feedstock prices to determine the factors affecting higher base-load prices. By examining the one-year-forward German market over-the-counter assessments shown in figure 3, we find a significant premium – more than 10% – in the one-year-forward price for power, as reported on March 8, 2003, over the same forward periods a year previously.

The significance of this premium cannot be underestimated, as it implies either a higher cost of production for the primary energy firms – due to feedstocks, high interest rates on bonds due to downgrading and so on – or that the cost of securing a forward market position is higher due to increased market uncertainty.

Changing strategies

While there is clearly increased market uncertainty at present, long-run fundamentals tend to wash out the 'white noise' caused by market shocks. If a premium remains so high for one-year delivery, when prices are likely to be falling in mid-central Europe due to deregulation next year, can this be interpreted as game-playing by the bigger companies?

As we saw earlier with the example of EdF, companies are changing their strategy towards meeting customer demands, because this is an area where, according to a survey published on February 6 by research firm Datamonitor, gross profits can be increased by as much as 20%. If customers are offered discounts from readily inflated prices and at the same time customer service is greatly improved, there is a greater likelihood that customers' propensity to switch will remain low.

And there is plenty of evidence that big incumbent power firms are developing long-term market strategies that will maintain a core – and stable – base-load demand for the electricity they produce. Last year, various acquisitions were made by the larger German and French players of firms with a wide retail base. Conversely, Nuon, a retail company with its primary operation in the Netherlands, acquired all Reliant Energy's power plant assets in that country.

It is fair to conclude that there is a tangible shift of emphasis by Europe's bigger power firms. Target companies with large retail operations have readily developed customer-retention strategies. Furthermore, retail companies provide the perfect customers and counterparties for power-producing firms. Power companies will, as a result, be able to protect core revenue and lessen the long-run price volatility by selling through a vertically integrated supply chain that links power production to a stable retail base spanning all the tiers. EPRM

Ivan O'Toole is based at Fame Information Services in London.
e-mail: iotoole@fame.com