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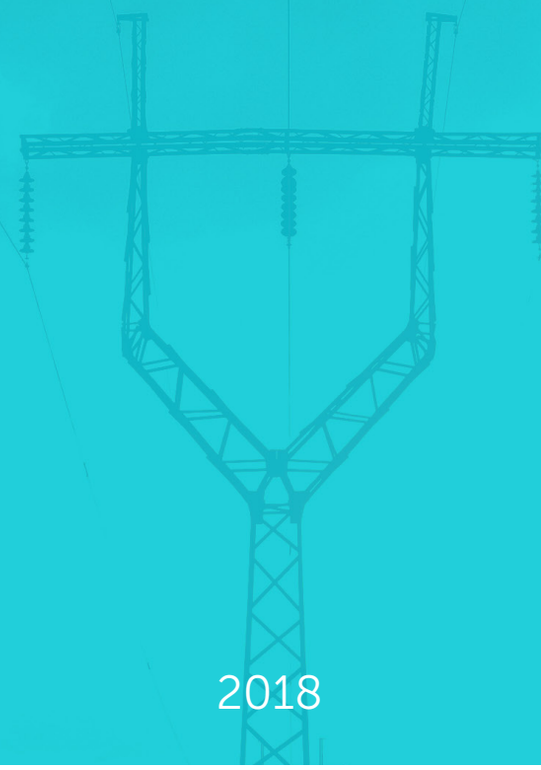
Electricity Market Liberalisation

Slow and Costly, but Beneficial for SEE



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Electricity Market Liberalisation
Slow and Costly, but Beneficial for SEE

By Tsvetan Ivanov, Business Analyst at SeeNews

Cover photo by lemurdesign

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1. Overview of the electricity market liberalisation in EU

The European Union defines the ultimate goal of electricity market liberalisation as achieving a secure, competitive and sustainable energy supply to all EU citizens and the economy.

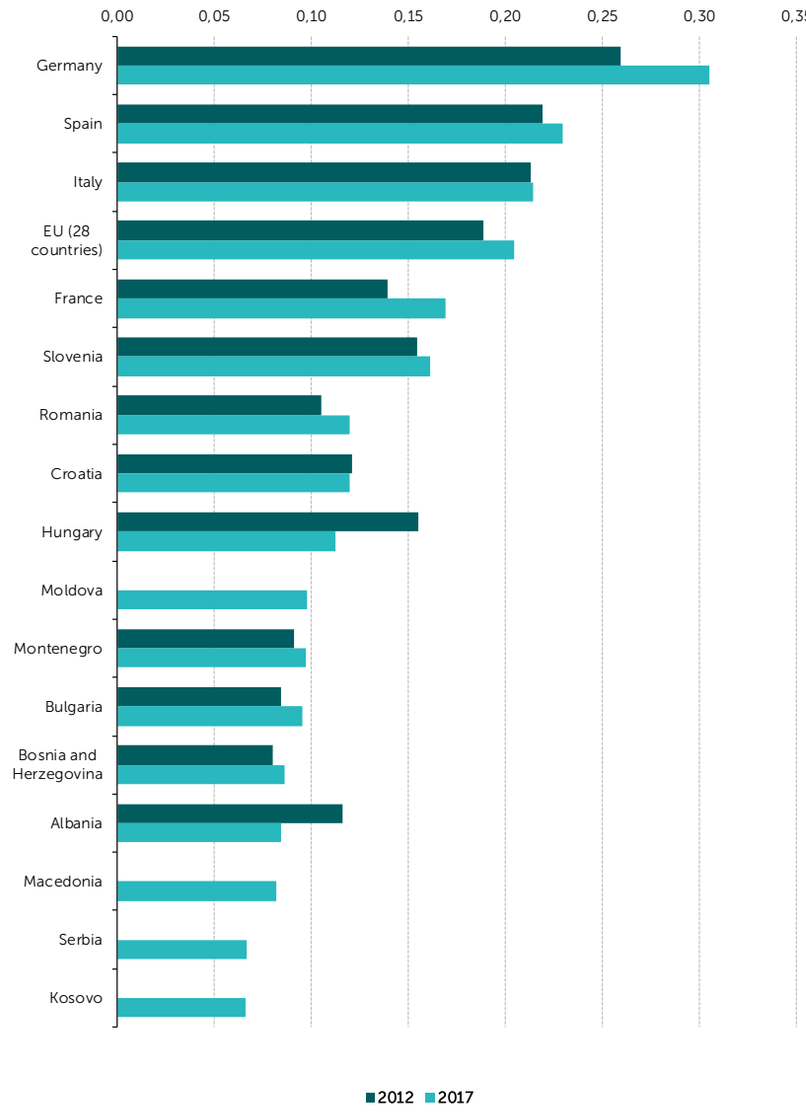
The measures for reaching this goal are simultaneously stimulating investments in electricity infrastructure, cross-border connectivity, and greater use renewable energy sources, while also enforcing competition on the integrated internal European power market. However, the quest for full liberalisation and integration is far from over yet. National electricity markets are still pretty fragmented in structure and regulatory framework. A number of actions have been taken to implement the directives but the results have not been achieved within the set deadlines and individual countries have reached a different stage of liberalisation. A correlation between the level of economic development and the delays in implementation of the directives is clearly identifiable. EU members with more stable and well developed economies have fewer difficulties to cope with and achieve the targets much faster than SEE, southern and central European countries. The directives and regulations of the Third Package of the EU from 2009 had to find a place in the national laws of all EU member states until 2011 at latest, which led to emergence of new players on the power retail markets throughout Europe. According to the Council of European Energy Regulators their number jumped to 3,719 in 2016 from 2,871 five years earlier. Newcomers to the free market recorded the sharpest increase – Bulgaria led the ranking for fastest growth of suppliers' numbers – to 45 in 2016 from only five in 2011. These developments testify for the improving degree of competition across Europe and greater choice of suppliers for households. However, the choice of active suppliers is strongly related to the size of the respective market.

Power market liberalisation follows similar patterns in most European countries, regardless of the period when it happens, the structure of the sector and the economic development of the countries. Prior to the liberalisation, electricity in all European countries was supplied to end customers by vertically integrated production and distribution monopolies, most often owned by the state or regional governments. In most cases industrial customers were the first to benefit from market deregulation and could access the free market, while households received the right to choose their suppliers on average five years later. Due to multiple supply and demand-side factors and regulatory barriers, complete liberalisation in most countries is achieved between two and five years after the set deadline. Among the major issues hampering liberalisation is the need for fast regulatory changes by national authorities, which meet resistance from other stakeholders. Default suppliers lobby against introduction of competitors, while new market players often do not have the capacity to invest in the infrastructure needed by them to operate efficiently.

Price regulations are viewed as a major factor that harms competition on the European market. In spite of abolishment of regulated prices being set as a goal in the Third Package of directives by the EU in 2009, seven years later, 11 of the 28 member countries still had some form of

Electricity prices for medium size households in EUR/KWh

Source:Eurostat



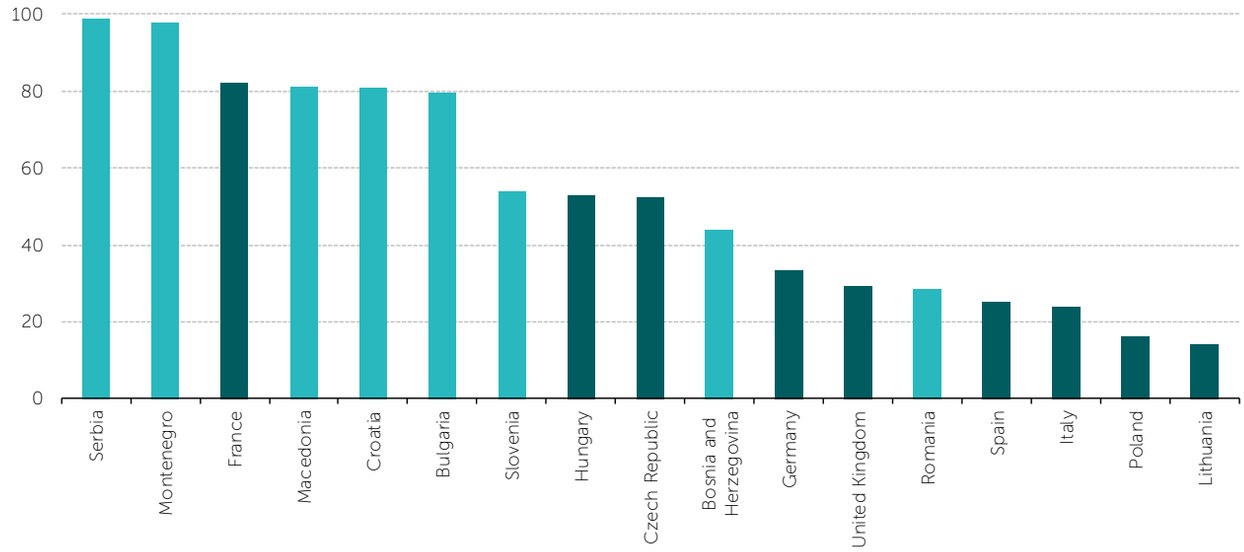
electricity price regulation mechanisms either for all consumers, or only for vulnerable ones. In the same time, five states, less than required by the EU, abolished state intervention in electricity price formation. Price intervention is especially common in Southern Europe, Southeast Europe, Poland and Denmark. Out of the four SEE countries part of the EU, price regulations for household customers exist only in Bulgaria, while in Romania, Slovenia and Croatia prices are formed on the market.

The number of end customers served by other than the incumbent supplier is an important measurement of liberalisation and degree of competition. In the UK, more than two out of three households have chosen a different supplier, while in Germany, despite the presence of a huge number of suppliers on the free market, 71% of the households stay with their incumbent supplier due to strong attachment of customers to their suppliers. Germany, along with Italy, France and Lithuania, are the countries with lowest share of nationwide suppliers to households – only one in 25 companies supplies electricity to end consumers throughout the country. In the same time, in more than half of the EU members all suppliers operate on national level.

Market concentration remains high on European level, with the three largest suppliers holding an average of 80.6% of each country's market in 2016, down from 84.3% in 2011. The electricity sector is considered a natural monopoly and the market is prone to concentration due to economies of scale and consumer habits above all. In more than half of the EU members the relative share of the leading three suppliers to end-consumers fell during the five-year period. In two countries, Cyprus and Malta, the market was still a monopoly.

Power market concentration* by country (%)

Source: Eurostat



Inherited market structure and the right allocation of investments are the keys to success

Germany and the UK are considered the best examples of how the liberalisation process should be carried out in a sustainable manner. The liberalisation of the German electricity market was introduced 20 years ago, when the market structure included several regional suppliers, partly private, partly state-owned. There was regional market allocation scheme, which prevented proper competition. In the first two years of liberalisation electricity prices declined due to the effect of competition between a growing number of suppliers. Starting in 2000, retail prices began to climb gradually. This development was attributed to the process of consolidation of suppliers, on one hand, and on the other hand to the increase of taxes, network costs and subsidies, especially for renewable energy. Thus, although the wholesale price of energy fell in Germany, taxes and other additions to the bills of end consumers, which form around half of the total price, continuously push retail prices upwards. Despite the freedom to choose a power supplier, most consumers adhere to the incumbent suppliers, as they are afraid to change it because of lack of trust to smaller and less reputable companies. Price is the main driver for choice of supplier for German consumers and socially vulnerable consumers adhere to former monopolies.

In order to attract customers, some German companies advertise lower bills by removing network costs when they install solar power capacities on the premises of the customer.

Unlike Germany, the UK had a quite differentiated market structure prior to the market deregulation, which led to a wider supplier base immediately after it and a seamless transition to competitive market with one of the lowest degrees of market concentration in Europe.

In contrast, Spain failed to achieve sustainable competitive market for electricity and faced price spikes and social unrest due to miscalculated investments and subsidies to new renewable energy capacities.

*** The EUROSTAT statistic measures market concentration based on the market share of the largest generator in the electricity market.**

2. Current state of electricity markets in SEE

Free market development in SEE follows the EU example at a slower rate

In terms of achieving the goals of interconnected free European power market, the SEE countries can be classified into several groups. Slovenia and Romania practically have deregulated power markets integrated into the European market. Bulgaria, Croatia and Serbia have liberalised their markets for industrial customers, but full and effective liberalisation for households is still to happen. All of them launched national power exchanges in the last two years and are working on coupling them with each other or with other neighbouring countries. Albania, Macedonia, Montenegro, Kosovo and Bosnia and Herzegovina still struggle with the harmonization of their legislation with European regulations and are yet to begin establishing power exchanges and liberalising their markets.

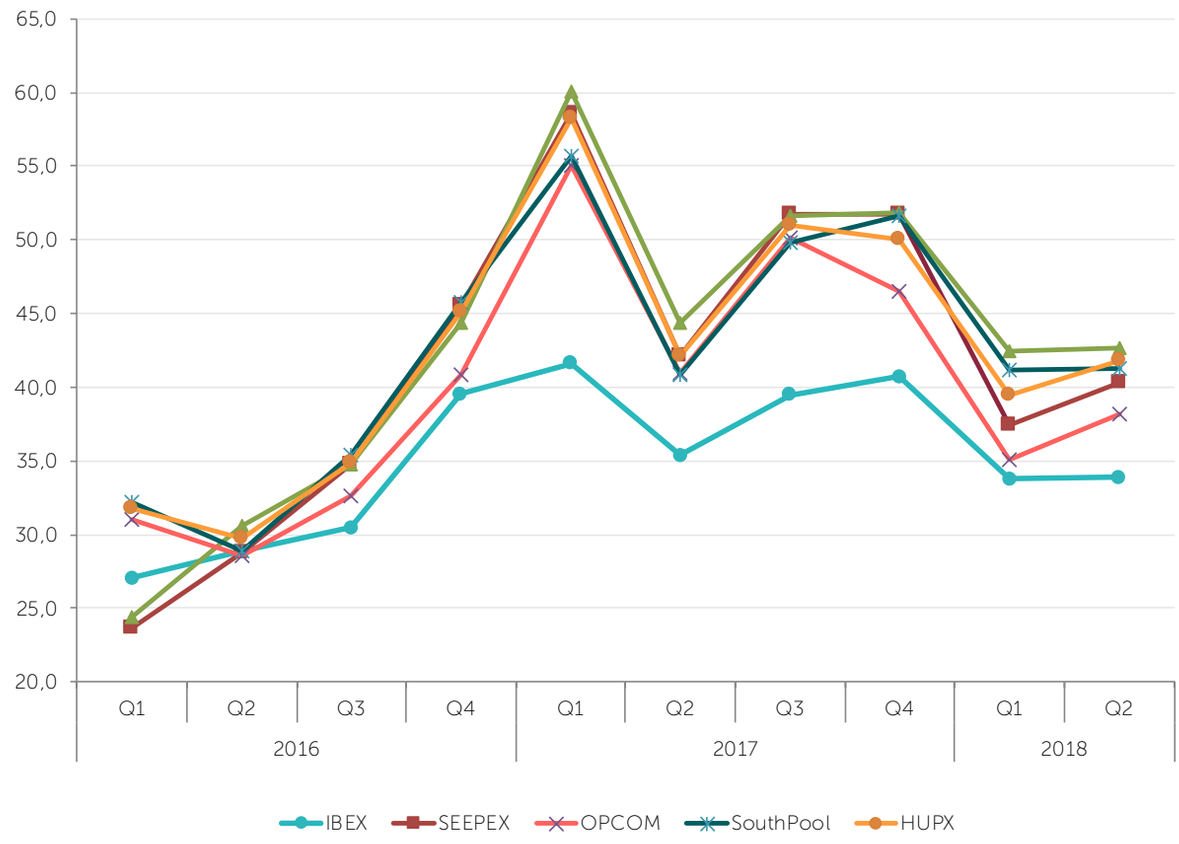
The Baltic States can be viewed as a region similar to SEE in terms of starting position, political and economic background and geographical location as far as the liberalisation of power market is concerned. The process there is progressing faster and has reached a more advanced stage than in SEE. The three Baltic States' electricity grid still operates in a synchronous way with the Russian and Belarusian systems, but it will be integrated into the continental European network, including their synchronous operation, by 2025. It is now among the best interconnected regions of Europe, with an interconnection level of 23%. Further electricity infrastructure projects are in the pipeline.

SEE countries differ from the rest of the continent in the structure of end consumer prices. While in Denmark and Germany taxes, renewables support schemes and network costs form more than half of the bill for final customers, these components are much lower in the SEE region and vary between 12% in Montenegro and 23% in Serbia, compared to an EU average of 37%.

Price differences are also visible within the region. In 2017, Montenegro had the highest retail price of electricity for households among the non-EU member countries on the Balkans, followed by Albania, Macedonia and Bosnia and Herzegovina. Serbian consumers enjoyed the cheapest electricity, while prices in Kosovo climbed the most compared to 2016.

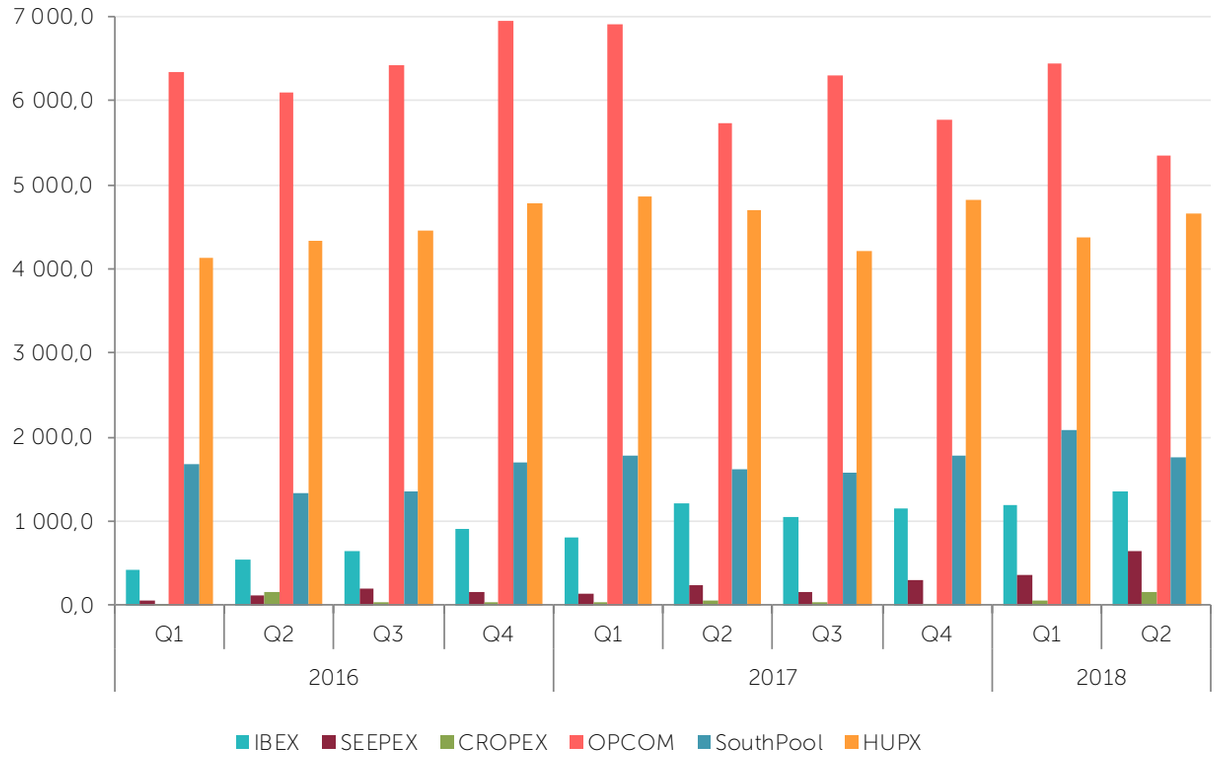
Average price on day-ahead market (EUR/MWh)

Sources: IBEX, SEEPEX, CROPEX,OPCOM, SouthPool, HUPX



Traded volumes of electricity on day-ahead market (GWh)

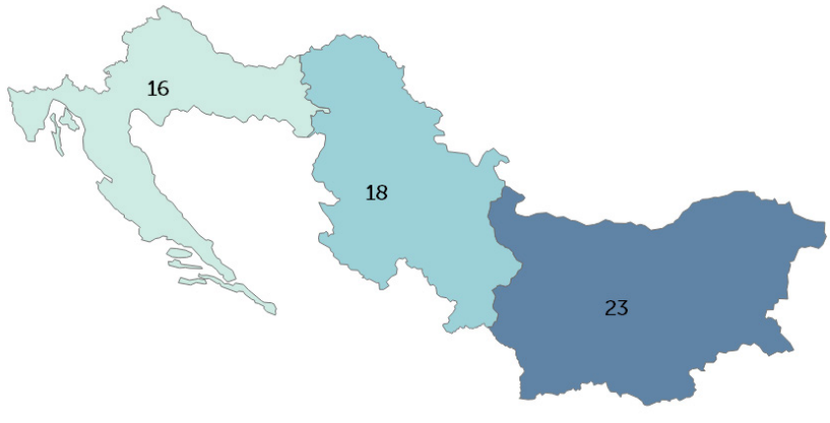
Sources: IBEX, SEEPEX, CROPEX,OPCOM, SouthPool, HUPX



3. Country analyses

Number of electricity suppliers on the power exchanges in Bulgaria, Serbia and Croatia in 2018

Sources: IBEX, SEEPEX, CROPEX



3.1 Bulgaria is still far from open competitive electricity market

Bulgaria's electricity market is open for wholesalers and liberalised for companies, but the country is one of the last EU members to liberalise the market for households. The process is still at an initial stage and full liberalisation is planned for 2022 following the model proposed by the World Bank.

In 2016, more than 98% of the households in Bulgaria were supplied with electricity at regulated prices – one of the highest values in

Europe, along with the monopoly-supplied Cyprus and Malta. Bulgaria is also the only SEE member of the EU with regulated electricity prices for non-household end consumers.

One of the main reasons for the slow liberalisation is the monopoly position of the incumbent supplier, which is the only regulated market supplier and is obliged to buy the energy of almost all large producers under long-term power purchase contracts.

Another reason is the financing of large electricity infrastructure projects in the past, which caused financial difficulties. The Bulgarian energy system has more capacities than domestic consumption needs and future interconnection with neighbouring countries is extremely important for effective exports.

Since the beginning of 2018, all producers with installed capacities of more than 4.0 MW are obliged to sell all generated electricity on the energy exchange. Still there are many producers with preferential power purchase contracts which do not trade on the free market.

According to the Association of Traders with Electricity in Bulgaria (ATEB), a negative trend is observed since 2017 – customers who have decided to go to the free market change back to the regulated market, especially in the case of small businesses due to the price difference between climbing market prices and the fixed prices offered by the incumbent supplier. In order to attract customers to the free market, suppliers have to offer additional services, which may include variety of payment terms, different tariff plans, support for energy efficiency measures, monitoring of consumption, consultations, information campaigns, clear and easily accessible information regarding the pricing model.

The Independent Bulgarian Energy Exchange (IBEX) began as a subsidiary of the local stock exchange and is the main prerequisite for the existence of a functioning free market. It officially launched day-ahead trade (DAM) in January 2016, which posted a 68.9% increase in traded volumes a year later, and intraday market in April 2018, where 10.4 mln MWh were traded for the first four months, according to IBEX. As of September 2018, there are 69 registered participants on DAM, 54 on centralized market for bilateral contracts (CMBC) and 40 for intraday trade. Average day-ahead market prices in Bulgaria's IBEX power exchange increased to EUR 39.32/MWh in 2017 from EUR 31.46/MWh in 2016. The share of traded electricity at IBEX from the total consumption in the country rises each year since the exchange's creation and stands at 12.7% in 2018, up from 11.2% in 2017 and 7.1% in 2016.

IBEX is a full member of Multi-Regional Coupling (MRC), the largest coupling of market zones within EU, and an associated member of Price Coupling of Regions (PCR). As of end-2017 only five consumers were active on IBEX, where they purchased power from 23 local and 25 foreign traders. The number of international suppliers represented on IBEX has grown eight times within the two years of existence of the exchange (January 2016 – April 2018) compared to a 50% increase in the number of Bulgarian traders, which is a sign of the underdeveloped local free electricity market.

In the next stages of deregulation of prices, Bulgaria will most probably suffer a considerable price hike on the retail market. Due to the artificially low regulated prices, the country's energy strategy contains a forecast for a 50% increase in consumer prices in 2020 compared to 2013.

3.2 Social concerns bring price deregulation in Serbia to a halt

The electricity system of Serbia is characterised by complete liberalisation for industrial customers and lagging deregulation of the market for households. Prices for end users are subsidised by the state and kept at levels often insufficient to cover costs for generation and transmission. The number of suppliers is very low – out of 106 licensed suppliers, only 12 deliver to end customers.

Although 44% of the consumed electricity is traded on the free market, Serbia's government considers the country not ready for liberalisation of retail power trade due to the large share of vulnerable customers, estimated at 400,000, and the high social risks that price deregulation would bring. Therefore, as of end-2017 there were no conditions for removal of subsidized prices, which will continue to slow down the process and turn potential investors in the electricity system away.

3.3 Croatia outpaces its SEE counterparts on the road to liberalised power market

Croatia is among the first SEE countries to put its legislation in line with the European directives and ensure a fully liberalised electricity market for both industrial and household customers. In Croatia, liberalisation is underway since 2004, when the market was open for customers with consumption above 20 GWh. Four further stages of liberalisation were implemented by 2009, when all industrial and household customers gained access to the deregulated electricity market.

Croatian Energy Exchange (CROPEX) started day-ahead trade in February 2016. In July 2018, it coupled with Slovenia's market, which intensified electricity trade nearly tenfold within a couple of months. As of September 2018, the exchange has 16 registered members.

3.4 Romania leads the way to market deregulation in SEE

Romania was the first SEE country to completely liberalise its electricity market for all types of end users. The government abolished price regulations for household consumers in the beginning of 2018. The process was launched in 2013 and followed a roadmap by the local energy regulator, implementing all stages within the determined deadline. A distinguished feature of the Romanian electricity retail market immediately after the deregulation is the significant price difference between electricity suppliers of end customers. The cheapest supplier's price for small households is more than two times lower than that of the most expensive, and 20% below the price of the default supplier. This variety is caused by the large number of options that retail suppliers have – they can buy energy from a multitude of local hydropower, coal, nuclear, gas, wind or solar power producers, or import it from abroad.

The country has one of the oldest power exchanges in the region, OPCOM, operating since 2005 and integrated in the 4MMC regional group, together with Hungary, the Czech Republic and Slovakia.

3.5 Slovenia is closest to the end goal, while Albania, Kosovo, Bosnia and Herzegovina and Montenegro are still at the start

Slovenia's electricity market is fully liberalised and the country has one of the oldest power exchanges in SEE. Slovenia is a step ahead of the others because of the integration of its network with the networks of Italy and Austria.

In Albania there were 80 licensed suppliers serving 5,000 industrial customers on the free market in 2016, which accounted for 15% of the total electricity consumed. In 2018, all industrial consumers have to enter the competitive market. This measure would raise the share of free market in the total consumption to 40%. According to the local Ministry of Energy, the Albanian electricity network is completely ready for liberalisation. However, since its launch, power market liberalisation has always failed to meet deadlines and complete liberalisation for business consumers is expected to happen later than 2018. The country aims to achieve full liberalisation of its power market by 2025. Liberalisation is part of the national energy strategy for the period 2018-2030, which says EUR 2.7 bln will be invested in the country's energy system. Renewable energy is a major pillar in the strategy and is planned to form 42% of the total electricity consumption by 2030. Albania's power system will be coupled with Greece, Italy and Kosovo.

Bosnia and Herzegovina faces a significant delay in the implementation of the EU regulations which jeopardizes investors' interest and the creation of a day-ahead free market. The country plans cooperation with Croatia's CROPEX for the establishment of an integrated power exchange.

4. Interconnection projects and investments in SEE

A growing number of regional interconnection projects are underway in SEE

The complete integration of the European power market is seen as the only way to achieve the long-term goals of the European Union in the electricity and related sectors. The decarbonisation objectives for 2030 imply greater use of renewable energy and electric vehicles. However, these goals cannot be reached if markets remain fragmented.

The EU regulations aiming to create an integrated competitive electricity market imply that in order to survive small regional power exchanges have to consolidate. National markets are inefficient due to limited size and fragmentation, which prevent sufficient liquidity.

In July 2018, a cross-border intraday initiative (XBID Project) was set up as a joint initiative by the power exchanges (PEXs): EPEX SPOT, GME, Nord Pool and OMIE together with the transmission system operators (TSOs) from 12 countries, to create a joint integrated intraday cross-border market. The first wave included 14 countries: Austria, Belgium, Denmark, Estonia, Finland, France, Germany, Latvia, Lithuania, Norway, The Netherlands, Portugal, Spain and Sweden. Plans included extending the mechanism for cross border intraday trading to all Europe and, potentially, interconnected countries.

In March 2018, SEEPEX signed a memorandum of understanding with HUPX (Hungarian Power Exchange) and EPEX Spot (European Power Exchange) for the creation of a single power exchange for Central and Southeast Europe, and defined market coupling with the electricity markets of Hungary, Romania, Slovakia and the Czech Republic as a strategic priority. At a later stage, the power exchange will aim to couple the future Serbia-Montenegro integrated market with Italy. EPEX Spot and Nord Pool are considered as an example of successful creation of functioning regional power exchanges out of fragmented national markets as a step towards the creation of the integrated European market.

The first two years of existence of SEEPEX are considered a success, leading to increased trading volumes and stability of supply in unfavourable weather conditions. SEEPEX is created in February 2016 with Serbia's power network operator EMS AD and the European Power Exchange EPEX Spot as stakeholders.

Bulgaria's IBEX was created in the beginning of 2016 and as of 2018 has no agreements with neighbouring stock exchanges. Talks with Romania are at a standstill, but an agreement is expected in the end of 2019, when the 4MMC group will integrate into the Multi Regional Coupling (MRC) project, which is operated by EPEX Spot and includes the power exchanges in 19 countries. As of 2018, more than 85% of the electricity consumption in Europe was traded in the MRC market.

Further market coupling partnerships are planned with Greece, Serbia, when the country meets the MRC technical requirements, and with Macedonia, when it launches its day-ahead market in 2019.

Power exchanges are an important pillar in the integrated internal European electricity market. They are the platform on which competitive prices are formed and contribute to achieving the goals of the liberalised market, such as increasing competition, guaranteed supplies, direct access to the market for end users and equal conditions for all market participants.

The Western Balkan 6 initiative kicked off in 2015 as the major project for improvement of energy connectivity in SEE. Its measures include power interconnections Serbia-Montenegro and Albania-Macedonia, as well as establishment of regional energy market. Each of the six participating countries has to integrate its day-ahead market with at least one WB 6 or EU member. Out of the planned regional power exchanges under the initiative, Serbia's SEEPEX is already in operation since 2016, while day-ahead markets are planned in Albania and Montenegro. Balancing mechanisms are available in Serbia, Montenegro and Bosnia and Herzegovina.

In the 10-year network development plan of the European Network of Transmission System Operators (ENTSO-E) interconnection targets for 2030 in the SEE region include:

- Slovenia – Hungary corridor, which will enable efficient interconnection between the Italian and Croatian systems on one side and Hungary, Slovakia and the Czech Republic on the other hand;
- Mid Continental East corridor – runs along the borders between Hungary and Romania, Serbia and Romania, Bulgaria and Serbia, Bulgaria and Macedonia and Greece with Macedonia and Albania. The corridor will cross the whole eastern half of the SEE region and will ensure connection between Ukraine and the Adriatic coast in north-south direction;
- Hungary – Romania interconnection;
- Romania – Serbia interconnection – upgrade to double line;
- Bulgaria – Serbia interconnection – construction of a new double line.

The construction of these interconnections would allow the region to export to Italy and Western Europe the electricity generated in the thermal power plants in Romania and Bulgaria, as well as electricity from renewable energy capacities installed in Bulgaria, Romania and Greece. Furthermore, the implementation of all projects would ensure sufficient capacity of the region's transmission network to take on the intensifying electricity consumption resulting from the integration of the internal European power market.

5. SWOT analysis of the electricity sector in process of liberalisation in SEE

Strengths

• Diversity of energy sources - all SEE countries have the potential to rely on solar, wind and hydro sources in addition and as an alternative to nuclear and coal-fired power plants. This decreases the vulnerability of the electricity sector, making it less dependent on fossil fuels.

• SEE countries are among the top performers within the EU in terms of implementation of the 2020 renewable energy goals. Bulgaria, Romania and Croatia have already met their respective targets. In all EU members in the region renewable energy sources account for more than 20% of gross final energy consumption.

• The network capacity in the region is currently adequate for the proper electricity flow between most countries with very few exceptions. However, investments will be needed in smart grids and improvement of transmission efficiency.

• Growing investment in renewable electricity

Weaknesses

• Low level of investment in new facilities and network capacity – lack of favourable legislation and delays with the deregulation process in SEE discourage potential investors in this extremely capital intensive sector.

• Lack of competition is caused by the strong concentration in the electricity supply sector.

• Incumbent suppliers often lack motivation and financial leverage to invest in innovations.

• The share of vulnerable customers and the amount of state aid in the electricity sector is much higher than the EU-average.

• The costs associated with electric grids increase and represent a growing portion of the amount end consumers pay for electricity.

Opportunities

• The integrated European power market means pooling and efficient usage of all assets and will guarantee access of SEE producers to customers across the continent, while local consumers will be free to choose electricity from any European supplier.

• The EU decarbonisation objectives and subsequent transformation to a low carbon economy present many new possibilities for development of renewable energy sources.

• Sector coupling, or use of electricity in other energy-driven sectors, such as transport and industry, can develop in SEE given the increased affordability of renewable energy facilities – solar panels and wind turbines have lowered more than fivefold their price and stimulate clean energy generation.

• As retail prices are expected to rise continually, many customers will turn to energy-efficient technologies, which will stimulate innovation in SEE.

• The upcoming full liberalisation of retail markets will push new suppliers in competitive environment to provide customers with better solutions in order to attract them.

Threats

• The future internal European market will function through a fully synchronized transmission network, which requires significant investments, above all in interconnection capacity in SEE. This is unlikely to be affordable for most governments and companies in the region.

• When all borders are opened for free trade of electricity, prices will tend to reach equilibrium, which will affect negatively consumers in countries with previously lower prices, such as all SEE countries.

• Excessive dependence on a single country influencing the single European market can arise, as is the case with wholesale electricity prices dragged down throughout Europe by the reduction of prices in Germany, caused by the subsidizing of renewable energy producers by end customers.

• Traditional incumbent power suppliers in the region may fail to survive in a completely competitive environment. Many of them already have financial difficulties as a result of over-investment in production and transmission capacities, which become redundant with the fast penetration of renewable energy, and turn into a burden for taxpayers through state aid.

• Given the importance of the sector for a country's economy, electricity supply can often be subject to political interference, either by domestic governments, or by third parties.

• As a commodity, electricity prices are volatile in the long run in global aspect, which imposes uncertainty among SEE end customers.

6. Power market liberalisation in SEE – slower than the rest of Europe, but equally beneficial if done right

Today, the fully competitive and deregulated internal European power market seems hardly possible in the medium term, due to the stages of implementation of the EU rules vary greatly from country to country. Europe's power markets remain fragmented and the legislative power in the field of electricity that national authorities still retain largely determines this lack of uniformity among countries. As a result, in the short term policymakers will tend to focus on integration at regional level.

Barriers in the electricity sector vary a lot between countries, but remain generally high. Regulatory barriers are the most common and hardest to overcome, especially in lower-income countries. When regulated prices are set by the regulator at a level below costs for the production and distribution of energy, no economic incentive exists to switching suppliers upon liberalisation, as prices often jump. Regulatory barriers will be the major obstacle to creating a free market in all SEE countries.

On the other hand, economic barriers also prevent customers from choosing a new supplier, even if regulatory barriers are removed or did not previously exist. In more than half of the EU member states these barriers include insufficient monetary gain, satisfaction and loyalty to the incumbent supplier and lack of trust in the new market conditions and unestablished suppliers. The level of fixed regulated price compared to the market one always affects the dynamic of the future market price in the moment of complete liberalisation, but the extent is hard to forecast.

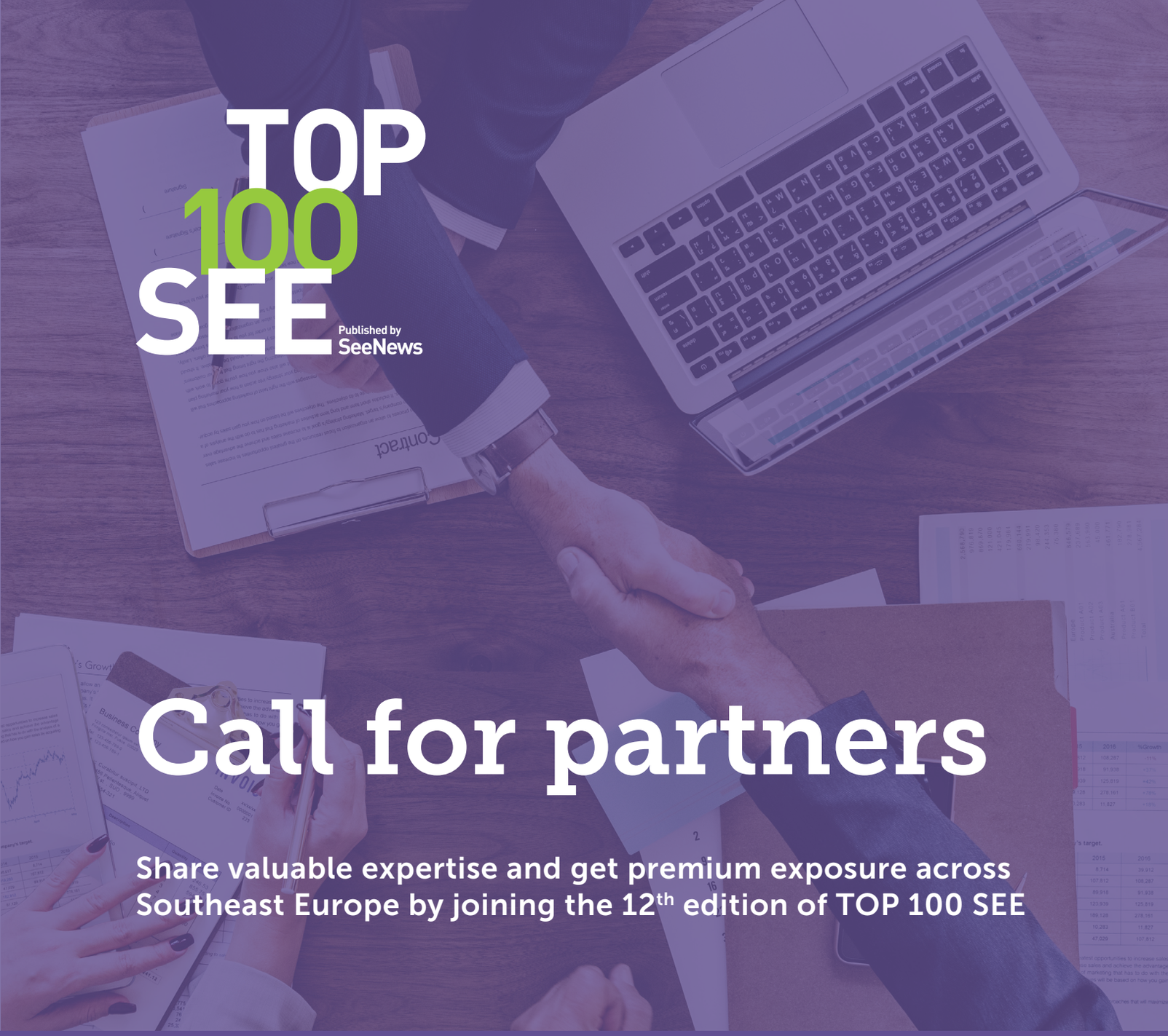
When talking about liberalisation of the electricity market in SEE, the question is not whether it should happen. It is obligatory under EU legislation. The question is rather when it will happen and at what cost.

Based on the experience of EU countries with fully liberalised markets, the proposed market model has benefits for customers, suppliers and power generators. If it is applied correctly and mistakes previously made in some countries are avoided, it is very likely that the power market liberalisation will succeed in SEE as well, and the integrated European market will be achieved.

The power market liberalisation process in SEE will take more time than in the rest of Europe, until the final goal of competitive and interconnected market is achieved. In all countries, even in the EU members, European regulations are implemented partially and with significant delays. Since the market does not follow market principles before deregulation, when it is enforced usually problems occur. The level of economic development and the political background are the major factors that slow down the process. In countries with lower GDP per capita social issues are the biggest concern since a vast majority of the end customers cannot afford to pay the market price, which is usually substantially higher than the regulated price. Therefore, at least in the short run, some form of state intervention in price formation is inevitable in SEE countries, in order to ensure social stability.

When it comes to an integrated continental marketplace, liberalisation is expected to be successful and bring positive effects to the national electricity systems and to end consumers. Plans for establishment and coupling of power exchanges are present in all SEE countries. In some of them, like Romania integration with neighbouring markets is already a fact. Infrastructure projects that will enable connectivity and sufficient capacity of national power networks across Europe are currently underway and are expected to be completed within five to seven years.

As far as retail prices are concerned, liberalisation will most likely lead to a considerably higher overall price level in the region than it currently is in a state-regulated environment. This is the major difference between SEE and EU countries where market deregulation is already successfully implemented. In the UK, Germany and other countries in western and northern Europe prices before liberalisation were close to the market prices and deregulation immediately resulted in a decrease of the price levels due to intense competition. In SEE however, there is little enthusiasm, because the beneficial effectts and price reduction caused by free competition will be fully offset in the short run by upward movements towards equilibrium market price once the subsidized tariffs are removed. Thus, the positive effects of power market liberalisation will be delayed in time for end users in SEE and will also come at a high social cost.



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