

Electricity Trading beyond “Buy and Sell”

Wholesale electricity trading is essential for utilities in Southeast Europe (SEE) to prepare for a successful transition into a liberalized energy market

Position of electricity trading in utilities

Electricity trading has become a common and important value chain component in most large energy utilities in liberalized markets. Trading acts as an essential link between a utility's own electricity production, the wholesale market, and sales to final customers. The companies' trading departments are accountable for electricity portfolio optimization and for value chain optimization, achieved by performing transactions with various financial instruments in wholesale power markets.

In most non-EU countries in SEE that are currently preparing for electricity market liberalization; electricity trading and wholesale markets are still in an early development stage. However, utilities in opening markets need to prepare in time for the emerging wholesale market in order to capitalize the future potential of electricity trading.

Path from “buying & selling” to “real” energy trading

Electricity trading can be performed on several development stages, differing primarily by the purpose, the volume, the type of trading activities and the acceptable risk exposure. We distinguish several business models for electricity trading:

- The Buying & Selling model simply balances a utility's physical need by selling surpluses and buying in to cover production deficits
- The Brokerage model is used for trading on behalf of external customers who pay a service fee to the electricity trader
- The Portfolio and Risk Manager model aims at optimizing the structure of the utility's production, trading, and sales portfolios in order to maximize the profit across the entire value chain
- The Proprietary Trading model achieves profits by pure wholesale

trading without connection to the utility's own production facilities or retail.

For most utilities in European markets, “Portfolio and Risk Manager” is the given trading model, as it is key for the steering of the value chain in an integrated utility. Companies that are more experienced and that have developed their risk management capabilities, often extend their trading activities to “Proprietary Trading” which provides opportunities for additional profit, but also increases risk.

Trading as the “steering tool” of an integrated utility

The implementation of energy trading typically changes the steering model of the value chain in an integrated utility. In particular, the relationship between trading and generation needs to be modified, with trading being responsible for the definition of the power production and procurement portfolio. This implies that power plants are managed as an “option” that provide physical backing for the company's trading activities, therefore reducing risk significantly.

Risk Management in electricity trading

The implementation of effective risk management is an essential precondition for any type of electricity trading. Trading activities on power exchanges or as “over the counter” business, expose a utility to several risks, e.g.:

- Market risks involving price risk, volume risk and basis risk
- Counterparty risk lying in not fulfilling the financial or delivery conditions by the counterpart of the contract
- Additional business risks like regulatory risk, environmental risk and operational risk that come with each business activity, so they need to be mitigated for trading as well.

Risk management for trading needs clearly defined allocations of responsibilities for each risk. Effective risk reporting must show the actual risk exposure of the company at any time, and there must be an appropriate IT solution that is integrated with the trading system. The risk management responsibility must be separated from trading operations in order to avoid any potential conflict of interest.

Conclusions – What needs to be done?

Utilities in Southeast European markets need to implement trading capabilities in advance in order to be prepared for market liberalization. According to Arthur D. Little's experience the following main steps are inevitable:

- Define the company's strategy for trading and select the appropriate business model
- Design the organization of the trading department according to best practice
- Develop the company's risk policy and implement risk management processes
- Select and implement an IT solution that meets the specific requirements of the utility

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