

German Price Wars Cut Into Profits

By Fereidoon P. Sioshansi*

As *The Economist* so accurately observed in its 28 August issue, “Germans are often wary of change. When they embrace it or have it forced on them, however, they do not go in for half-measures.” Now that the German power industry has finally accepted that competition in the electric power supply is real and is here to stay, the industry has gone on a rampage unparalleled by anything seen elsewhere. The signs of this are noticeable on a massive scale on several fronts:

- **Consolidation.** The highly fragmented German electric power sector is thinking and breathing mergers and consolidation. Surprisingly, it is not just the small guys who are thinking of getting bigger merely to survive, but the very big who are trying to become gigantic on a global scale.
- **Price cuts.** What initially started as a bonanza for large industrial customers has now been extended to even the smallest of customers on a national scale.
- **Open war.** There are no sacred cows, no service area boundaries and no limits to what goes. It is open warfare, hand to hand, house to house, nationwide.

First, on the consolidation front. The long-rumored talks between Veba AG of Dusseldorf (a giant conglomerate that owns PreussenElektra, the number 2 German generator) and Munich-based Viag AG (another giant conglomerate, which owns Bayernwerk, the number 3 generator) were rapidly progressing in September. If all goes according to plan, the new company will be bigger than the archrival RWE Energie AG, based in Essen, in terms of generation (see Table). Moreover, the combined company will become the third largest power generator in Europe, after state-owned Electricity de France and ENEL of Italy—which, ironically, is being cut into pieces to be auctioned off in stages to private investors.

Who Is The Biggest Of Them All?

Top German generation companies ranked by sales, in TWhs

Company	Sales
RWE Energie	138
PreussenElektra	106
Bayernwerk	73
EnBW	51
Veag	47
VEW Energie	35
HEW	17
Neckarwerke	14
Bewag	13

Source: VDEW

Second, on the price cuts. It started with the large industrial customers. The German market was officially opened to competition in April 1998—well ahead of the

* Fereidoon P. Sioshansi is a Partner with Convecton Consulting Inc. in Menlo Park, CA. He edits and publishes the *EEnergy Informer*, a monthly newsletter. This is an edited version of an article which appeared in the October 1999 issue and is available on the web at <http://members.aol.com/eeinformer>.

European Union Directive, which opened 25% of the market this February. Since then, large customers have been swamped by a deluge of price cuts and extra sweet offers from competing generators on every corner.

Price cuts of 10-20% are the norm; 30-35% savings are not unusual. The competition has been particularly keen among the top generators—who are fighting a door-to-door battle for market dominance.

What started with the industrial customers, however, has now spread to smaller consumers. RWE Energie started the latest round of price cuts in August. RWE—which currently supplies some 2.3 million, or roughly 6% of Germany’s 38 million households—decided that it wanted to double its residential market share. It launched a campaign called PrivatStrom—the term translates roughly to “domestic power”—offering something unprecedented in Germany. For the first time, a generator offered all German customers the same low prices regardless of where they reside or who they currently buy power from. Given the maddeningly complicated and controversial third-party access (TPA) and transmission pricing rules in Germany, RWE’s offer was particularly bold and novel.

In essence, RWE said that it would charge all new customers the same low prices it now charges its current customers in its traditional service area. Moreover, RWE would figure out how to get the power to the consumer, would look after switching the customer including—presumably the costs of switching metering, billing and all the rest! To make its offer irresistible, RWE said that if any customer could find a better deal, it would further cut its costs to match or beat the lower price. How can you go wrong on an offer like this?

This, of course, is not an ordinary offer, nor is it coming from a fly-by-night operator. RWE was immediately deluged by phone calls from customers who wanted to switch. RWE, whose domestic tariffs are estimated to be roughly 20% below the national average (see Table), figured that it could double its market share by acquiring another 2.2 million customers from other regional and municipal utilities. This, however, assumes a static market where rivals sit and watch their customers walk away.

As one might suspect, however, RWE’s rivals were not going to lay low and let this happen. And literally overnight, every major and many minor German utility launched their own counterattack, matching—and in some cases, beating—RWE at its own game. EnBW AG, based in Dusseldorf, the fourth largest generator, and an aggressive player in the German market, offered an even more amazing offer. Through a new supply subsidiary called Yello Strom, based in Cologne, the parent company offered an even lower price, countrywide! Other companies, notably VEW Energie, HEW and MVV Energie, have also come up with major price cuts, but none as spectacular (or suicidal?) as EnBW’s.

Because of fixed and variable charges and a number of other complicating factors, it is hard to compare the bottom-line prices to consumers. But the price cuts now being offered in some cases are 60% below the current average national prices. Consumers couldn’t be happier.

The bottom line? What’s good for customers won’t necessarily be good for the generators. Admittedly, the German power industry had been protected for too long and prices might have been padded in the past—but not by 20-30% or more. So it is not surprising that the recent price wars will

have a negative—and noticeable—impact on company profits. Take the case of Veba. The Dusseldorf-based company recently reported a 15% *increase* in its *consolidated* sales relative to last year (the company does a lot more than just energy), but a 5% *fall* in operating profit in *electricity* sales.

What Does It Cost To Keep The Lights On In Germany?

National average electricity costs in the German residential sector for a household using 3,500kWh per year is estimated to be 32.5 Pf/kWh [roughly 17¢/kWh].

The average cost breakdown is as follows:

Component	% of Total Cost
Generation	40%
Transmission ¹	25%
Distribution ²	9%
VAT & Concessions	26%

Source: VDEW

¹ Both high- and mid-level voltage transmission charges are included.

² This includes maintenance and operations of low-level voltage grid.

And In The UK?

Average residential customer in the UK pays an estimated \$375 per year for electricity, broken down as follows:

Component	% of Total Cost
Generation	49%
Transmission	5%
Distribution	32%
Supply Costs including profit margin	13%
Fossil Fuel Levy	1%

Source: OFGEM

Veba said that it expects the profit figures to bounce back by the end of the year, but that may be wishful thinking. Even though Veba's electricity prices are among the lowest in Germany, and despite recent price cuts, the company has admitted that its current prices "may not be sustainable in the longer term." Further price cuts will result in even lower profits.

Its arch enemy, RWE, has also experienced the pressures of lower prices in the energy sector. One can always squeeze the costs a little here and a little there, but ultimately price wars will take their toll on profits. Perhaps that's the price to pay for bigger market share. ■

Future IAEE Events

June 7-10, 2000	23rd IAEE International Conference Sydney Australia <i>Sydney Hilton</i>
September 24-27, 2000	21st Annual USAEE/IAEE North American Conference Philadelphia, PA, USA <i>Wyndham Franklin Plaza Hotel</i>
April 25-28, 2001	22nd IAEE International Conference Houston, TX, USA

Publications

Gas to Europe: The Strategies of Four Major Suppliers, edited by Robert Mabro & Ian Wybrew-Bond (1999). Price L 39.50. Contact: Oxford Institute for Energy Studies, 57 Woodstock Road, Oxford OX2 6FA, United Kingdom. Phone: 44-1865-311377. Fax: 44-1865-310527. Email: energy@sable.ox.ac.uk URL: <http://associnst.ox.ac.uk/energy>

Energy Demand in Asian Developing Economies, by M. Hashem Pesaran. (1998). Price: L 39.50. Contact: Oxford Institute for Energy Studies, 57 Woodstock Road, Oxford OX2 6FA, United Kingdom. Phone: 44-1865-311377. Fax: 44-1865-310527. Email: energy@sable.ox.ac.uk URL: <http://associnst.ox.ac.uk/energy>

The Economic Appraisal of Natural Gas Projects, by Willem J.H. Van Groenendaal. (1998). Price: L 39.50. Contact: Oxford Institute for Energy Studies, 57 Woodstock Road, Oxford OX2 6FA, United Kingdom. Phone: 44-1865-311377. Fax: 44-1865-310527. Email: energy@sable.ox.ac.uk URL: <http://associnst.ox.ac.uk/energy>

Oil in Asia: Markets, Trading, Refining and Deregulation, by Paul Horsnell. Price: L 39.50. Contact: Oxford Institute for Energy Studies, 57 Woodstock Road, Oxford OX2 6FA, United Kingdom. Phone: 44-1865-311377. Fax: 44-1865-310527. Email: energy@sable.ox.ac.uk URL: <http://associnst.ox.ac.uk/energy>

Electronic Energy Trading, a new report about electronic commerce and energy trading by Peter Fusaro and Jeremy Wilcox. Price \$995. Contact: Global Change Associates, 211 West 56th Street, #23M, New York, NY 10019. Phone: 212-333-4979; Fax: 212-399-3471; E-mail: peterfusaro@global-change.com URL: www.global-change.com

Competition and Regulation in the European Electricity Industry, by Lars Bergman, Gert Brunekreeft, et.al. Price: \$45.00. Contact: CEPR, 90-98 Goswell Road, London EC1V 7RR, UK. Email: orders@cepr.org. Fax: 44-171-878-2999. Phone: 44-171-878-2900.

Guide to the Economic Regulation of the Electricity Industry. (April 1999). Price: £125 Contact: OXERA Publications. Phone: 44-1865-251142. Fax: 44-1865-201080. Email: infoservices@oxera.co.uk

Strategic Hedging: Balancing Risk and Reward in the Oil Industry. Price: £5,000. Contact: Marketing Department, Centre for Global Energy Studies, 17 Knightsbridge, London, SW1X 7LY, United Kingdom. Phone: 207-309-3610/12. Fax: 307-235-4338. Email: marketing@cges.co.uk

Calendar

8-9 November 1999, Profit with Nuclear Power. Chicago, IL. Contact: Registration Dept., The Center for Business Intelligence, LLC, 500 W. Cummings Park, Suite 5100, Woburn, MA 01801. Phone: 781-939-2438. Fax: 781-939-2490. E-mail: cbireg@cbintet.com

8-9 November 1999, North American Gas Strategies Conference. Westin Hotel, Calgary, Alberta, Canada. Contact: Ziff Energy Group. Phone: 403-234-4285. E-mail: gasconf@ziffenergy.com URL: www.ziffenergy.com/nagsconference

9-10 November 1999, Border Energy Forum VI. San Antonio, Texas. Contact: Texas General Land Office, 1700 North Congress Ave., Austin, TX 78701-1495. URL: www.glo.state.tx.us/border

11-12 November 1999, 4th Annual Latin Upstream '99. Miami, Florida, USA. Contact: Fax: 281-597-9589. Email: global.pacific@pixie.co.za URL: www.glopac.com

17-18 November 1999, Asia LNG & Power '99. Shangri-La Hotel, Singapore. Contact: Ms. Gamar, Event Manager, 80 Marine Parade Road #13-02, Parkway Parade, Singapore 449269. Email:

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Calendar (continued from page 31)

gamar@cmtsp.com.sg Phone: 65-346-9132. Fax: 65-345-5928.

17-19 November 1999, FERC 101 & 102, Washington, DC, USA. Contact: The Energy Daily, 627 National Press Bldg., Washington, DC 20045. Phone: 202-638-4260. Fax: 202-662-9744. E-mail: kingcomm@kingpublishing.com

2-3 December 1999, Buying & Selling Oil & Gas Assets. Houston, TX, USA. Contact: Conference Connection, Inc, Raffles City, PO Box 1736, Singapore 911758. Phone: 65-226-5280. Fax: 65-226-4117. Email: info@cconnection.org

6-9 December 1999, The Energy Trader's Institute. Chicago, IL, USA. Contact: Infocast, 22134 Sherman Way, Canoga Park, CA 91303. Phone: 818-888-4444. Fax: 818-888-4440. Email: mail@informationforecast.com URL: www.informationforecast.com

8-9 December 1999, The Geopolitics of Energy into the 21st Century. Monarch Hotel, Washington, DC. Contact: www.ftenergyusa.com or the Center for Strategic and International Studies - P-202-775-3209.

8-10 December 1999, Houston, TX. Mark Price Volatility: How to Model, Assess and Manager Price Volatility in Today's Power Markets. Contact: Infocast, 22134 Sherman Way, Canoga Park, CA 91303. Phone: 818-888-4444. Fax: 818-888-4440. Email: mail@informationforecast.com URL: www.informationforecast.com

9-10 December 1999, Private Energy in Turkey '99. Washington, DC, USA. Contact: Registration Dept., Center for Business Intelligence, LLC, 500 West Cummings Park, Suite 5100, Woburn, MA 01801. Phone: 781-939-2438. Fax: 781-939-2490. Email: cbireg@cbinet.com. URL: www.cbinet.com

10-21 January 2000, Utility Regulation and Strategy. Gainesville, Florida. Contact: Public Utility Research Center, Warrington College of Business Administration, University of

Florida, PO Box 117142 (Matherly 205), Gainesville, FL 32611-7142. Phone: 352-392-6148. Fax: 352-392-7796. E-mail: purcecon@dale.cba.ufl.edu. URL: www.cba.ufl.edu/eco/purc

12-14 January 2000, FERC 101 & 102, San Diego, CA, USA. Contact: The Energy Daily, 627 National Press Bldg., Washington, DC 20045. Phone: 202-638-4260. Fax: 202-662-9744. E-mail: kingcomm@kingpublishing.com

7-11 February 2000, CERAWeek 2000 - CERA's 19th Annual Executive Conference. Westin Galleria, Houston, Texas. For more information call Steven McCarthy at 617-441-1308 or visit www.cera.com/ceraweek

10-11 February 2000, Buying & Selling Oil & Gas Assets. Calgary, Alberta, CN. Contact: Conference Connection, Inc, Raffles City, PO Box 1736, Singapore 911758. Phone: 65-226-5280. Fax: 65-226-4117. Email: info@cconnection.org

5-7 March 2000, Middle East Petroleum & Gas Conference. InterContinental Hotel, Abu Dhabi, U.A.E. Contact: Vimla Mulchand, Managing Director, The Conference Connection, PO Box 1736 Raffles City Post Office, Singapore 911758. Phone: 65-226-5280. Fax: 65-226-4117. E-mail: cconnect@pacific.net.sg

4-6 March 2000, Electric Power 2000. Cincinnati, Ohio, USA. Contact: Electric Power 2000, 1220 Blalock Road, Ste. 310, Houston, TX 77055. Phone: 713-463-9595. Fax: 713-463-9997. E-mail: warrens@tradefairgroup.com URL: www.electricpowerexpo.com

8-10 March 2000, Renewable Energy for the New Millennium Conference. Sydney, Australia. Contact: Kelvin Kent, Phone: 61-2-9241-2955. Fax: 61-2-9241-5354. E-mail: meetings@tnm.com.au URL: www.esaa.com.au

12-14 April 2000, 5th Annual Energy Trading Summit, Orlando, Florida. Contact: Global Change Associates, 211 West 56th Street, #23M, New York, NY 10019. Phone 212-333-4979; Fax: 212-399-3471; E-mail: peterfusaro@global-change.com URL: www.global-change.com

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Contributing Editors: *Paul McArdle* (North America), Economist, US Department of Energy, Office of Policy, Planning and Analysis, PE-50, Washington, DC 20585, USA. Tel: 202-586-4445; Fax 202-586-4447. *Tony Scanlan* (Eastern Europe), 37 Woodville Gardens, London W5 2LL, UK. Tel 44-81 997 3707; Fax 44-81 566 7674. *Marshall Thomas* (Industry) 3 Ortley Avenue, Lavallette, NJ 08735, USA Tel 908-793-1122; Fax: 908-793-3103.

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