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IFIEC Europe

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European Commission draft Strategy Paper concerning

MEDIUM TERM VISION FOR THE INTERNAL ELECTRICITY MARKET

Position Paper

Electricity is a key variable cost for European manufacturing industry, with direct impact on the competitiveness of its diversified activities in a global market. Achieving effective competition in generation and supply, as well as adequate grid capacity and access in the scope of the Single Market objectives are essential conditions for the survival of industrial energy users. Industry requires freedom of choice in competitive electricity supply.

Based on its overview of the current electricity market situation, IFIEC Europe, which represents the interests of over 70% of the industrial energy users in Europe, offers hereafter its initial contribution to the important EU debate on medium-term strategy for electricity, including recommendations to ensure competitive electricity prices, a prerequisite to maintain the competitiveness of industrial consumers in Europe.

• Overview of the current market situation and suggestions for improvement

National electricity markets within the EU have been gradually opening-up as solutions for non-discriminatory and transparent network access provided for under the Electricity Directive are implemented: appropriate regulatory mechanisms at both national and European levels are being put into place and independent TSO management in unbundled infrastructure entities is slowly emerging. However, the Single Market for electricity has yet to be achieved.

For the industrial energy consumers in IFIEC Europe, the main challenge today is to ensure that the full market opening under the revised Directive is effective, with non-discriminatory access to a diversified and competitive supply of electricity that meets the current and future requirements of customers throughout Europe. Strong vigilance is required at this crucial point to keep the internal energy market process on track. In particular, efficient mechanisms must be put into place to closely monitor developments in the market place. Competition authorities should be mandated to take a more pro-active stance in promoting competition in this field.

In this respect, IFIEC Europe would like to call urgent attention to three key issues which, if left unchecked, risk undermining the competitiveness of industrial energy consumers, with permanent and grave consequences for their future development in Europe :

- **lack of effective competition in the electricity market,**
- **insufficient available transmission capacity and abusive grid access charges,**
- **excessive surcharges and taxes on electricity.**

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The cumulative effect of these issues is an alarming increase in delivered electricity prices. In order to reverse this trend, appropriate measures must be taken as soon as possible.

1. LACK OF EFFECTIVE COMPETITION IN THE ELECTRICITY MARKET

In some countries, effective competition has not emerged because strong, dominant players continue to retain control of the national market.

Examples vary, from countries where no competition has been introduced at generation level (ELECTRABEL in Belgium and PPC in Greece) to countries where one dominant player continues to control the national market (EDF in France).

In some other parts of Europe, where competition was beginning to emerge, the number of generators and traders/suppliers has dramatically declined over the last three years due to consolidation within the electricity sector.

Examples are the mergers between RWE/VEW, BAYERNWERK/PREUSSEN-ELEKTRA, EDF/EnBW, VATTENFALL/HEW/VIAG, ELECTRABEL/EPON, NUON/ENW et al., MEGA Limburg/PNEM and EGD/Ijselmij, as well as the proposed take-over of Reliant by NUON..

In addition, increased horizontal integration of the electricity and gas industries hinders the competitors of the incumbent utilities as risks for new investments in gas-fired power plants grow.

Prime examples are the mergers between E.ON/RUHRGAS and RWE/Thyssengas/WFG.

Consolidation has been intensified recently, in spite of numerous protests from consumers, institutional and other parties; this trend is likely to continue, reducing the scope of competition for Europe at large.

In parallel, independent traders have abandoned the European wholesale market, reducing liquidity and leaving trading activities in the hands of a few integrated incumbents, resulting in further erosion of competition.

A pre-condition to effective competition in the electricity market is the availability of ample generation capacity. In situations where oligopolistic structures exist, the incumbent players tend to retain generation capacity, or even moth-ball plants, to tighten the supply-side of the market.

As alternative supply offers vanish due to lack of competition, wholesale electricity prices for base-load consumption have been rapidly increasing since 2000 (for example, from 40 to 50% in Germany, France and Belgium). The reasons given for these dramatic price hikes seem to be arbitrary.

For example, higher fuel prices linked to the threat of war in Iraq were offered as an explanation for higher electricity prices in 2003; since the war, the decrease in fuel prices has not been reflected in electricity prices.

The speed at which concentrations are occurring at both national and transnational levels is unfortunately proving to be faster than the development of competition via the growth of cross-border trade.

IFIEC Europe recommendations for improvement :

In order to reduce anti-competitive effects of concentrations and promote competition in the relevant (national or regional) markets,

- **increase the number and type of suppliers in the different national or regional markets by limiting market share per player, for a duration compatible with achieving real competition, via asset sales, split-ups (e.g. England and Wales) or virtual generation capacity ;**
- **reduce the cost of developing new power plants : cost of administrative compliance, cost of connection, cost of back-up power, development of effective competition in the gas market ;**
- **scheduled shut-down and moth-balling of significant generation capacity should be published, thus allowing regulatory scrutiny to avoid abusive behavior ;**

- data concerning the de-commissioning and commissioning of power plants should be published, allowing regulatory control to ensure the adequacy of supply/demand evolution ;
- improve the terms and conditions for interconnections within the enlarged EU ;
- enforce existing competition law to promote competition, ensure against abuse of dominant positions of suppliers and establish pro-competition merger and acquisition policies.

2. INSUFFICIENT AVAILABLE TRANSMISSION CAPACITY, ABUSIVE GRID ACCESS CHARGES

2.1. Non-discriminatory network access

2.1.1. Strict Unbundling of TSO and DSO activities

In liberalized markets, electricity transmission and distribution remain de-facto monopoly activities which need to be treated accordingly. Availability of grid services at lowest cost and adequate quality is of central importance to the smooth-functioning of the whole electricity market.

Regulation and/or control of transmission networks needs to pay particular regard to ensuring that all market participants are entitled to access the network on non-discriminatory terms.

Costs must be properly controlled and accounted for, and monopoly profits from transmission and distribution service providers must not exceed the low level of risk these businesses face.

IFIEC Europe recommendations for improvement :

- In order to ensure confidentiality of highly-sensitive commercial information regarding market transactions, grid operators should be subject to a strict code of conduct in the exercise of their technical and economic functions.
- The most effective and best long-term guarantee to avoid conflicts of interest and possible discrimination is *ownership unbundling*, whereby the infrastructure accounting and management operations are under the responsibility of independent, legal entities, and whereby transmission and distribution are clearly separated from other generation and supply/trading activities open to competition. This is the clearest approach to ring-fence such monopoly services and to make their services available to all market participants.
- To improve transparency of monopolistic services, grid operators need to make information concerning grid costs, revenues, reliability statistics and other relevant data available not only to the regulatory authority but also to their customers.

2.1.2. Access tariffs

The management of grid investment and operations is not generally conducted in the most efficient manner possible. In particular, current management and investment do not lead to the lowest possible costs that are compatible with customer requirements regarding reliability.

Instead, the risk remains of cross-subsidies between transmission and distribution revenues, on the one hand, and generation and supply costs, on the other hand.

Transmission pricing is not always globally cost-reflective, based on rate-of-return and efficiency criteria. In particular, return on investment does not reflect the low level of risk associated with this activity.

Ancillary services are made available by the transmission system operator (TSO) in order to balance the system. Balancing power must be purchased by the TSO in a transparent way without giving an unjustified advantage to incumbent power suppliers. Abusive behavior by the suppliers of balancing power that can result in excessive costs for the grid users must be avoided.

IFIEC Europe recommendations for improvement :

In order to improve the efficient management of the grid and ensure non-discriminatory access to grid services,

- **integrate adequate efficiency and reliability criteria into the price regulation mechanisms concerning access to the grid ;**
- **ensure that the national regulator has full and independent authority to fulfill his duty, and in particular to avoid excessive grid charges and cross-subsidies ;**
- **ancillary services must be made available through non-discriminatory and transparent mechanisms under regulatory scrutiny.**

2.2. Cross-border congestion management & allocation of capacity ; pricing & locational signals

IFIEC Europe considers that the long-term goal should be to establish mandatory coordinated management of the different national or regional grids as if they were one European grid. In the future, cross-border issues of a political nature should disappear, even though technical constraints might persist in certain parts of Europe.

Today, coordination between national or regional TSO's is based solely on voluntary procedures without binding obligations. Progress in addressing cross-border issues under the current transitional phase has been very slow.

Insufficient TSO coordination currently leads to inadequate data exchange, lack of physical flow modeling and excessive loop flows and phantom flows, thus reducing the net transfer capacity (NTC).

The primary features of any cross-border allocation and congestion management scheme must be simplicity, transparency, maximum use of transmission capacity and low cost.

All revenues received by TSO's in connection with congestion management and capacity allocation measures must be subject to regulatory scrutiny. The funds must be exclusively used to reduce congestions.

As long as imperfect market conditions prevail, IFIEC Europe opposes the generalization of auction mechanisms to allocate available transmission capacity. Instead, it favours recourse to a so-called **"dynamic toolbox"** whereby a mix of TSO management techniques is permanently adapted to different and changing local control area condition, on a case-by-case basis. This will involve co-ordination between two or more TSO's, as well as multiple-border solutions. When/if the congested situation improves, appropriate measures are adopted accordingly.

As explained in the IFIEC Europe working document dated 14.10.02 entitled "A Dynamic Toolbox" approach to cross border capacity allocation and congestion management", the IFIEC Europe "Dynamic Toolbox" contains three basic types of measures: soft measures to deal with grid organisation, calculations and information; allocation measures based mainly on current practices (pro rata, market-splitting, coordinated re-dispatching, coordinated cost plus, etc.); and timely structural measures to enhance the grid interconnexions where necessary.

Reservation of interconnector capacity linked to historical contracts are contributing to the lack of available transmission capacity at the borders.

In order to stimulate increased cross-border exchanges, cross-border prices should be non-transaction based (a "t" factor should be rejected).

IFIEC Europe supports the concept of a two-term price: a generation price component (G) should be based on electricity being supplied into, and a load price component (L) should be based on electricity being taken out of the system.

Locational signals should give appropriate incentives to grid users to improve the efficiency of the operation and investment in grid infrastructure. Locational signals may vary either on the generation and/or the load component of grid charges in order to stimulate growing grid use in areas of sufficient grid capacity. Accordingly, all locational signals leading to higher grid prices in so-called congested areas need to be fully offset by lower prices in non-congested areas. Additional income for grid operators needs to be avoided.

IFIEC Europe recommendations for improvement :

In order to enhance supply competition through cross-border exchanges,

- **data covering historical contracts need to be published,**
- **adjust national legislation so that national and regional TSO's are obliged to cooperate in a binding manner within an appropriate management structure(s),**
- **set a European timetable to maximize net transfer capacity (NTC) through TSO cooperation, de-bottlenecking of interconnectors and standardization of NTC calculation methods,**
- **mechanisms to allocate cross-border capacity should primarily aim to facilitate competition in supply, rather than create a market for transmission capacity; auctioning methods should be avoided as soon as possible,**
- **apply a basket of methods best adapted to changing local conditions, as defined in the so-called IFIEC Europe "dynamic toolbox" approach (*pro rata, market-splitting, coordinated re-dispatching, coordinated cost plus, etc.*) to reduce short term congestions,**
- **promote coordinated system management initiatives between Member States at regional level,**
- **resolve longer-term structural congestions by reinforcing and developing interconnections,**
- **all network users should contribute to the network costs through the "G" & "L" components, and the G term should therefore be significant.**

3. EXCESSIVE SURCHARGES AND TAXES ON ELECTRICITY

Increasing surcharges and taxes are borne by electricity consumers to finance not only public policies relating directly to electricity, but also policies concerning other sectors. Unless urgent action is taken, the existing financial burden is likely to increase significantly in the next years as a result of new electricity and CO2 taxes, trading permits, special regimes to support renewable energies, public service charges, etc.

Charges relating to the financing of renewable energies are only one component among others in the total package of charges and taxes currently weighing on electricity prices.

In the UK, for example, electricity suppliers are required to have a percentage of their sales from renewable generation or pay a penalty of approximately 45€/MWh. The renewable obligation increases as a percentage of total supply from 3% in 2002 to 10.4% in 2011 and remains at this level until 2027, adding 1.9€ to 5.5€/MWh. This cost has been passed through to consumers.

The total direct surcharges and taxes borne by most industrial consumers of electricity in 2003 is estimated to be from 4 to 12 €/MWh, depending on the particular situation in each Member State.

Above and beyond these charges, the introduction of CO2 emissions trading schemes from 2005 may have a substantial impact on electricity prices (from 10 to 15€/MWh on average), if national schemes impose absolute caps

on individual companies. By contrast, if national schemes impose relative targets linked to company performance, it is estimated that the impact would only be marginal.

The overall effect of assigning these additional costs to the consumer's electricity bill, is to cancel all expected benefits from market integration and contribute to the current decline of choice and flexibility in the marketplace.

IFIEC Europe recommendations for improvement :

In order to mitigate the impact of surcharges and taxes on the competitiveness of the electricity price:

- **the cost-efficiency of public policies should be increased,**
- **energy, environmental and other public policy initiatives should not be financed through surcharges and taxes on electricity,**
- **surcharges related to public service obligations should be limited in scope and capped.**

Conclusions

European industrial energy consumers are currently operating under a competitive handicap, as compared to industries located in other regions of the world, such as China, the Middle East, Australia and South Africa, where energy prices are lower by 30-50%. The situation is particularly critical for the survival of energy-intensive industries in Europe.

- **The backward trend towards de facto oligopolistic market structures and behavior needs to be reversed.**
- **Efficient measures to actively promote competition and stronger integration of EU-wide markets need to be urgently put into place.**