UNION OF THE ELECTRICITY INDUSTRY
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Union of the Electricity Industry – EURELECTRIC Comments on the Commission's Strategy paper "medium term vision for the internal electricity market"

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These comments have been drafted by the EURELECTRIC Working Group "Market Regulation " on May 2003:

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The **Union of the Electricity Industry - EURELECTRIC**, formed as a result of a merger in December 1999 of the twin Electricity Industry Associations, UNIPEDE and EURELECTRIC, is the sector association representing the common interests of the European Electricity Industry and its worldwide affiliates and associates. Its mission is to contribute to the development and competitiveness of the Electricity Industry and to promote the role of electricity in the advancement of society.

Union of the Electricity Industry – EURELECTRIC Comments on the Commission's Strategy paper "medium term vision for the internal electricity market"

Introduction

The liberalisation of energy markets has brought tremendous changes in the way these markets are operated and developed. Therefore it would appear all the most necessary, in view of the uncertainties laying ahead in the post-liberalisation era, to draw up a road map for the coming decades. It is essential to identify and anticipate today the necessary changes and adjustments to ensure a homogenous development of the markets which is able to ensure a secure supply of electricity on a pan-European dimension, serving both industry and commerce and meeting the needs of our modern society as a whole.

For all these reasons, EURELECTRIC strongly welcomes the European Commission's initiative to draw up a Strategy Paper with a medium-term vision and to launch a broad consultation with all stakeholders. With this Position Paper, EURELECTRIC intends to actively contribute to this important debate and prepare for a fruitful discussion at the Rome Forum of 8-9 July.

The first part of this paper is dedicated to general comments relating to the structure and the philosophy of the Strategy Paper. The second part goes through the paper chapter by chapter and sets out more detailed comments.

General comments

EURELECTRIC notes that the new March 2003 draft of the Commission's Strategy Paper is a much more structured and elaborated version, which introduces a number of significant improvements on the first outline, notably along the lines highlighted in our December letter. While this undoubtedly constitutes a positive start in the process of drafting a road map, we believe nevertheless that still more needs to be done if we want to develop a real, comprehensive picture with respect to the development of an internal energy market within the horizon of 2020-2030.

- **A wider strategic vision is necessary**

The objective of this Strategic Paper should aim to design a stable regulatory framework capable of providing sufficient harmonisation to create a level playing field, combining dense competition with a robust industry. This strategy should be underpinned with a more encompassing medium term vision including competition, security of supply, investment, public service obligation, sustainable development, environmental objectives and an approach towards the developing world. Taking all these points into account would result in a more comprehensive road map on the further necessary steps toward a successful internal electricity market. We welcome the basic reliance on competition, the aim of harmonising framework conditions and the focus on market oriented regulatory instruments. We look forward to the further development of a comprehensive road map, which will contribute to the necessary regulatory stability.

- **Status of the paper: how does it fit into the liberalisation package agenda and the Florence discussions?**

The Strategy Paper does not limit itself to merely making an assessment on the issues which need to be addressed in the future but also includes practical steps, including indicative tables. We appreciate this concrete approach but we wonder how this new agenda can be linked in and how it will interact with the liberalisation package agenda and the Florence discussions. It seems to us that this agenda has been developed without sufficient account being given to the time table of the liberalisation package (1st July 2004/ 1st July 2007). Seeking to develop one price area within the regional markets by 2006 before the package has been fully implemented, and a sufficient level of harmonisation between market structures has been reached, does not seem realistic. Therefore, we would recommend that the Strategy Paper should better integrate this central timetable and seek greater coherence. Furthermore, we note that on the basis of work capacity/ delivery as evidenced in the developments at the Florence Forum, the indicative tables are quite ambitious in terms of the work load imposed on both CEER and ETSO.

- **Changing approach: from a European integrated market to regional markets**

The Strategy Paper is based on the basic fundamental of a progressive integration within regional markets until 2006 and then between these markets by 2010 (underpinned with the approach of one price area and implicit auctioning at the borders). With this new approach, the Commission could be potentially introducing a change in paradigm. Prior to “European integration”, the focus would be on “regional integration” for a transitional period. While this seems to be an attempt to find a pragmatic approach, it would nevertheless be a change in the Commission’s strategy and in the way competition should be achieved in the European Union.

EURELECTRIC recognises the development of regional markets but would like to stress that there are several questions that must be solved to enable functioning regional markets. Therefore, it needs more in-depth consideration and discussion before a formal view is taken. Care should be taken that regional aspects do not develop autonomously and that the Commission does not lose focus on overall EU coherence.

- **Industry: an essential partner in the success of the completion of Internal Electricity Market**

Ensuring consistency in national energy policy and regulatory models within the EU internal electricity framework will be key to the success of the market. Nevertheless, creating the proper conditions for maintaining a sustainable Electricity Industry should be regarded as an equally important objective, which cannot be dissociated from the achievement of a successful internal electricity market. We believe that this point is not sufficiently addressed in the Paper, which places excessive weight on market concentration but seems to ignore crucial issues for the future of the Industry <u>and</u> the market, such as the importance of well-designed, stable and consistent regulatory frameworks and the need to create favourable investment climate and investment incentives. EURELECTRIC looks forward to being continually involved in the very important process initiated by the Strategy Paper.

Detailed comments

Introduction

Although the Strategy Paper is only intended to look at the developments in electricity, we believe that specific attention should nevertheless be given to **convergence in the liberalisation of the electricity and gas markets**. A successful energy market implies a homogenous and parallel development of competition in both the gas and electricity markets, which offers the same benefits and business opportunities to all market participants.

CHAPTER 3 – FULL IMPLEMENTATION OF REVISED ELECTRICITY DIRECTIVE AND REGULATION

For the parts of this chapter which look at the implementation of the liberalisation package and the Florence discussions, we will not restate the views that we have widely expressed, but would refer here to our previous Position Papers[1].

The most important item in this chapter is the new objective of ensuring integration within regional markets by creating a single price area and solving congestion through implicit auctioning by 2006, subsequently achieving integration between these regional markets, notably through co-ordinated implicit auctioning by 2010.

Further work needed on regional markets
We consider that the Commission should clarify this strategy, in particular indicating in greater detail how this single price area in each regional market is to be achieved and whether this approach requires the establishment of a power exchange in each regional market. With regard to the regional markets, as set out on page 3, we wonder what the driving criteria for shaping the map were. In our view, it would be logical that the regional markets follow the potential major physical congestion, not the national borders. This is all the more relevant to the so-called "core market" composed of Germany, Austria, Switzerland, France and Benelux, where the congestion between most of these countries seems to have been simply ignored.

Market splitting: attractive model but not feasible for the whole of Europe in the mid term
To facilitate the discussions on congestion management mechanisms, a preliminary short analysis from the Commission on the pro's and con's of the varied applied methods all over the European Union could have provided a helpful basis and introduction.

[1] Regarding the liberalisation package, see Position Papers of February 2001on the further liberalisation of the Electricity Markets and of April 2002 on the latest developments on the draft Electricity Directive. Concerning cross-border trade issues, we would refer to our Position Papers of September 2002 on the more permanent mechanism, of June 2001 on the harmonisation of G and L at EU level and of November 2000 on congestion management.

As we have stated in the past (Position Paper November of 2000), in an ideal world, **market splitting** appears to be a very attractive solution, but the prerequisites for establishing such congestion mechanisms are far from being met (the existence of power exchange or power-pool arrangements and sufficient harmonisation on exchange patterns - timetables, bid format, market clearing procedure). For this reason we can only reiterate our statement that "explicit auctions would be the preferred and more acceptable option for capacity allocation in the mid term horizon". For all these reasons, the objective of implicit auctioning by 2006, - ie even before the final opening date of the energy markets under the new Directive - seems to us particularly ambitious.

We would rather recommend that, as a first concrete and feasible step, increasing use be made of explicit auctioning and that market-based mechanisms be introduced at all borders, in accordance with the guidelines of the 6th Florence Forum.

Co-ordination of TSOs: better acting as one

Whereas the first outline envisaged the creation of one single TSO, this aim has been abandoned in the second draft of the Strategy Paper. We do not regard the question of merging TSOs as essential as long as there is proper **co-ordination among TSOs** (which is already existing to a certain extent within ETSO) so that, at regional level, they can be seen as acting as one. Thus, we believe that greater co-ordination among TSOs is an important goal and that the interface presented to the market should be gradually standardised and harmonised.

The need for liquid wholesale markets

The development of liquid wholesale markets is playing an important role in the further development of electricity markets. Liquidity is vital to the efficient operation of power and gas markets as it helps to ensure a good quality reference price, which in turn feeds into longer-term decisions on investment, and provides a means of managing risk. Therefore, care should be taken to ensure favourable and compatible regulatory regimes for energy trading, with the aim to facilitating trading all over the European Union.

CHAPTER 4 "IMPROVED INTERCONNECTION BETWEEN MEMBER STATES"

In this Chapter, the Commission reiterates the overall objective of an average increase to 10%, in the level of interconnection between Member States, which was first presented in its Communication of December 2001. In addition, the Commission is also looking at ways to stimulate investment, notably through an increased rate of return and the development of merchant interconnectors.

Infrastructure projects should be determined on economic grounds

Increasing the level of interconnection is of course an important issue for the development of electricity markets. However, we do not think that setting a notional standardised target across all EU borders is the most appropriate way to do so. In our view, interconnector investment should be determined primarily on economic grounds including security of supply.

Where one Member State has a significant cost advantage through a non-transportable natural resource such as hydro-power, or where the costs of transporting the primary fuel are greater than that of electricity transmission, as can be the case for coal, then a high electricity export from that Member State can be expected. However, where there are few differences in cost base, then there is little rationale for high volume trade.

Increasing interconnection: not the only solution

It is also incorrect to assume that building interconnectors is the only way to resolve congestion – the construction of new generating plants in areas of high demand and/or increasing of transmission capacity will often be a more cost-effective alternative. There are also various other mechanisms such as co-ordinated redispatch and countertrading, which can deal with this problem.

Favourable climate for investment

The incentives proposed by the Commission go in the right direction. It is important to create a favourable climate for investment in new interconnectors, incentivising TSO and encouraging an entrepreneurial approach. The basic problem should be addressed: the investor in an interconnector is typically not the one – and even not that country – which benefits from the establishment of the interconnector. The necessary monetary flows must be ensured in order to create incentives for the investment. It must also be noted, - particularly in the case of merchant lines -, that conflicts of interest may arise between the users of the interconnectors, and the owners of the installation, the former having an interest in greater capacity while the latter would logically seek to obtain revenues from the congestion. It must be ensured that any additional benefits obtained from the management of the interconnections lead to more investment or a reduction of the tariffs.

Underground cables: inappropriate for overcoming environmental/ planning obstacles

EURELECTRIC has highlighted in the past that the need to stimulate investment is not the sole problem in developing interconnections but that in a number of cases, infrastructure developments face lengthy authorisation procedures and public resistance. The Commission's proposal to remedy this through the use of underground cables is most unlikely to be a viable option, given the huge cost differentials involved, and would result in a significant increase in tariffs.

CHAPTER 5 FACILITATING COMPETITIVE CHOICE BY CUSTOMERS

In this chapter, the Commission addresses a number of considerations regarding the customer switching models and the role of the supplier of last resort.

Enabling competitive choice by customers and ensuring effective customer switching procedures are the goal of European energy market-opening. Potentially the numbers of people exercising this opportunity will be very large, since all Europeans have access to electricity. The industry will have to solve many technical questions if it is able to handle large numbers of customers switching their supplier.

Moreover, establishing procedures that make it easier for a customer to change supplier implies a cost and it does not seem unfair to expect this cost to be paid by those who benefit from switching.

In the large majority of cases the electrical energy consumed by household customers is not metered in real-time, but companies usually rely on estimated typical consumption patterns, or so-called load-profiles. The actual consumption is typically measured 1-4 times per year. Before expanding hourly metering to cover all customers, establishing load profiles is therefore important to reduce the cost of metering household customers and small industries. In the long term, the trade-off between real time metering (automatic meter reading) and the use of load profiles or hourly meters must be based on the cost of the technology and the need of consumption flexibility in the market.

Considerations on the supplier of last resort

With regard to the supplier of last resort, our consistent position[2] has been that even though the initial supplier of last resort may be a distribution company, it is preferable that the supplier of last resort be selected through a non-discriminatory procedure compatible with EU rules. This procedure should be completed as soon as possible after the original supplier has left the customer. With regard to the tariffs applicable to this supplier, prices should be reflective of the full cost of supply or otherwise allow for compensation for the extra costs. Regarding the appropriateness of introducing a price cap, please refer to our comments on the next chapter.

Customer switching: industry standards are preferable

The Strategy Paper calls on CEER to come up next year with a definition of best practice for customer switching procedures. We believe that our association should be closely consulted, and could co-operate with CEER on this. Work has already begun within EURELECTRIC with regard to the identification of best models of customer switching. We are currently studying the different European models for customer switching, with the intention of coming up with recommendations for best practice for the switching procedures. We are confident that we can actively contribute to this discussion, by pointing out practical solutions for customers and the industry.

[2] Position Paper « Union of the Electricity Industry – EURELECTRIC comments on the latest developments on the draft Electricity Directive" – April 2002

CHAPTER 6 MEASURES TO REDUCE THE PROBLEMS OF MARKET CONCENTRATION

In this chapter, the Commission looks at ways to reduce so-called concentration in the market, through a wide range of instruments such as divestment and capacity release programmes, and also restrictions in import capacity bids in case of dominant position and the introduction of price caps in the wholesale and balancing markets.

Answers to structural problems should be sought elsewhere
In so doing, we feel that the Commission is not proposing the right answers to the structural problems affecting the development of the electricity markets, notably congestion and lack of interconnection. Big players should not be considered responsible for this situation or for the fact that their size is already of a European dimension whereas the market dimension is still lagging behind. It should also be borne in mind that the electricity sector is basically a capital intensive industry and the critical mass is therefore rather large. This, in our view, should not be considered as a threat but as a guarantee for the efficient operation of the sector and for providing necessary security of supply.

Big players should not be discriminated against because of their size
Reading this chapter gives the impression of an overall and systematic suspicion towards the big players in the electricity market. EURELECTRIC supports the establishment of a market with well functioning de facto competition. Both bigger and smaller players will have a role to play in various parts of this market. No player – or no group of players – must restrict competition. Big players can exist in the market without abusing their position. Calling for divestment and related measures merely because of the size of market players would constitute unfair discrimination, which cannot find any justification under competition law. There is a consistent principle under competition law that dominant players in a market do not raise any concern as long as these players do not abuse their dominant position. Thus, it is clear that behaviour - not size - is the criterion under competition law. We would therefore highly recommend that the Commission review this chapter along these lines.

The need to develop a robust, competitive and sustainable industry
We also believe that the issue as how to ensure a robust, competitive and sustainable electricity industry has not been addressed in the Strategy Paper. The developments of the markets has shown that a bad regulatory framework can quickly erode the industry's potential and further attention should be given besides the mere customer protection to the quality of regulation notably with respect to simplicity, transparency and investor-friendly legislation. It is essential to ensure that regulation will develop in a homogenous and consistent way so that it will not further introduce market distortions at national level and thus reinforce the regionalisation of electricity markets. These risks can be partly avoided if high-level dialogue and co-operation between regulators are established. Co-ordination both between regulators and TSOs[3] will be crucial to enhance the coherence of the market, and this should be further emphasised in the Paper.

[3] see comments made on page , the proposal in this chapter for « a single system operator for the region concerned » is not relevant.

Price caps detrimental to the market
Price caps in the wholesale market are most likely to deter investment. Furthermore, this would mean greater uncertainty as to the value of the underlying elements for derivatives contracts, with consequent serious impact on the attractiveness of derivative products as a tool of risk management. All in all, liquidity both in the spot market and in the derivatives markets would be reduced, posing a serious threat to a liberalised market, in which transparency is key. For the same reasons, we would make the same comments about price caps on the retail market. The negative effects that can be exerted by such price caps on all the market players and consumers involved were graphically illustrated by the situation that occurred in the Californian electricity market.

The need to ensure well functioning balancing markets
As stated previously in these comments, we believe that liquidity in the wholesale markets will play an important role in the development of electricity markets. Therefore, sound and well functioning balancing markets are also an essential element and greater integration between them should be sought.

Pools
Regarding the last remark on pools, we would not support the contention that pool based systems necessarily amplify the effects of market concentration. However, we agree that a pool should never be mandatory in the sense that it rules out other alternatives as bilateral physical contracts, financial contracts, etc.

CHAPTER 7 CONSISTENT APPROACH TO GENERATION ADEQUACY

In this Chapter, the Commission sketches the scenario of a European electricity market still characterised by overcapacity but likely to see that capacity reduced over time, and looks at ways to enhance investment in generation - notably through capacity payments to generators, price floors and obligations on retail suppliers.

In its assessment, the Commission rightly acknowledges the crucial importance of adequate generation with a view to ensuring long term security of supply, but at the same time recognises the complexity of this task and the ambiguity of potential measures such as capacity payments.

We consider in the first place that prices should deliver important signals for investment in generation capacity and it is clear that a period of high prices will be needed to reward such investment. However, some form of mechanism, might be considered, capable of providing enhanced investment signals, especially concerning peak load generation. EURELECTRIC is currently undertaking work on how to ensure investment in both network and generation facilities and intends to deal with this chapter in further detail when the findings are available by the end of this year. Streamlining authorisation and planning processes should also be encouraged.

In relation to the sharing of generation capacity, the potential for exploiting the different timings of the demand peaks must not be overestimated. Peak-coincidence should be analysed in further detail before drawing any conclusions.

We also believe that further attention should be paid to how fuel diversity should be encouraged.

CHAPTER 8 CONSISTENT SUPPORT FRAMEWORK FOR RENEWABLES

The Commission looks under this heading at subsidies to electricity generation and their potential side-effects on competition. This also includes further consideration of emission trading and the Commission acknowledges the need to further consider the interaction of emission trading with the market for electricity.

Renewables and emission trading should be treated separately
The impact on competition of promotion measures for renewable energies and the introduction of emission trading schemes should not be neglected as these may create additional trade obstacles. Having said this, we would not place renewables and emission trading on the same level with respect to the reduction of greenhouse gas effect. While this is the primary goal for emission trading, this is not the case for renewables which furthermore is a rather low-efficient way to reach this objective. For this reason we would like to see a clear separation between the treatment of renewables and emission trading.

Market-based mechanism is best
We welcome the Commission's analysis of the market distortions resulting from feed-in tariff schemes and the superposition of various different support mechanisms. This clearly shows that the promotion of renewables can only be achieved through market-based support mechanisms (a view which we have consistently supported[4]). Transparency of costs is crucial. Market-based mechanisms also offer the best way of addressing this requirement.

Renewables & CHP: further consistency and harmonisation needed
It is vital to ensure compatibility not only between different national supports but also between different EU promotional systems and different promotional systems within a given country. We are quite sceptical that the Commission's goal of adopting a common framework for renewable support can be reached. As we have stated in the past, current national support schemes are most likely to consolidate over the years so that it will be even more difficult in the future to find a common EU-wide support model. This highlights the need to review as soon as possible the current national renewable supports, in order to favour market-based oriented mechanisms at European level. It is furthermore surprising that the principles advocated by the Commission with respect to the use of market-based mechanisms, are <u>not</u> reflected in its own proposal for CHP. Furthermore, with a view to maintaining EU coherence, the development of a multitude of trading systems should, as far as possible, be avoided.

Emission trading schemes must not create market distortions
As regards emission trading, we note with satisfaction that the Commission intends to look further at its interaction with the electricity market and we consider that this issue should deserve further developments in the Strategy Paper.

[4] See the following EURELECTRIC Position Papers: « promotion of renewables in the EU and possible harmonisation – October 1999 » and « EURELECTRIC remarks on the proposal for a renewable Directive – October 2000".

In this context, we would also refer to EURELECTRIC's GETS simulations (particularly GETS 1 and 2) which explicitly explored the inter-relationships and inter-actions between electricity and greenhouse gas markets. Specific attention needs to be focused on ensuring that the national allocation process does not create serious distortions. The issue as how to ensure that the allocation process does not unduly disadvantage those companies that have undertaken "early actions" will also have to be carefully addressed. Thus, EURELECTRIC would like to stress the contribution that the Electricity Industry will provide towards pursuing the EU Kyoto objectives through the planned emission trading regime. For these reasons, EURELECTRIC finds it inappropriate that electricity should be taxed for the reason of pursuing these very Kyoto objectives.

CHAPTER 9 REMOVING OTHER DISTORTIONS

In the preceding chapter, the Commission showed in its analysis that certain schemes, be they renewable support or an emission trading scheme, could have side-effects on competition. In Chapter 9, the focus is placed on market distortions resulting from differences in taxation (excise duties, VAT) or from state aid to primary fuels.

Introducing a certain level of harmonisation on taxation between the different Member States is essential to create a level playing field between the market players. We appreciate the Commission's intent to tackle this point under the Strategy Paper but wonder whether voluntary convergence of excise duties can be seen as a realistic alternative to the failure to reach agreement between the Member States.

The streamlining and clarification on the application of VAT rules to cross-border exchanges of electricity are most valuable and we look forward to their rapid implementation in the systems of the Member States.

The elimination of subsidies with respect to certain primary energy sources used for energy production must also be welcomed.

CHAPTER 10 RELATIONS WITH THIRD COUNTRIES

This Chapter looks at the progressive implementation of the liberalisation package by the candidate countries together with some alignment of third countries (South East Europe and Mediterranean Ring) with the energy "acquis communataire". The situation of Russia and the former Soviet republics with regard to the potential trade volume through the interconnections is also addressed.

EURELECTRIC considers that a clear legal framework should be introduced for harmonising market structures with neighbouring regions after the forthcoming EU enlargement. Bearing in mind the advantages and shortcomings of multilateral and bilateral approaches for external trade in electricity, certain steps should be undertaken to harmonise (but not standardise) the international trade law (deriving from WTO rules) and EU bilateral requirements comprising cost-based pricing, market rules, environmental standards and nuclear safety issues. How WTO rules apply to electricity trade with respect to competition, safety and reliability should be further investigated.

In addition, the date of 2007 for full participation of acceding countries in the internal market should be clarified.

The integration of Switzerland represents another important issue in the development of the electricity markets which seems to have been left aside. The Helvetic Confederation - which is an important transit country of the UCTE area but at the same time is not subject to the same level of commitments as EU or candidate countries (notably in terms of energy liberalisation and Kyoto commitments) - also needs to be addressed in such a strategic paper.