

**Union of the Electricity Industry - EURELECTRIC Position Paper on the
more permanent mechanism**

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Contribution to the 9th Florence Forum

These comments have been drafted by the EURELECTRIC Sub-Group "Cross-Border Transactions" on August 2002:

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Introduction

The establishment of a proper cross-border tarification (CBT) mechanism is key to ensuring the integration of electricity markets and supporting the acceleration of the liberalisation process. Following the call made at the Florence Forum for a non-discriminatory, non transaction-based, cost-reflective, simple and transparent mechanism, ETSO introduced on 1st March 2002 a temporary CBT system based on a mixed contribution (export fee plus “socialisation” via national tariffs).

The European Commission, the CEER and the main electricity stakeholders, notably EURELECTRIC, were concerned that the temporary mechanism did not meet all the founding principles as agreed at the Florence Forum, in particular with regard to the export fee element. Therefore, they requested that the provisional system should apply no longer than end of 2002 and should then be replaced by a more cost-reflective tarification mechanism. In the last Florence Forum, it was agreed that this more permanent mechanism should include “no extra tariffs for import, export or transit providing that appropriate and efficient locational signals are in place”.

In drafting this Paper, Union of the Electricity Industry - EURELECTRIC is seeking to contribute actively to the ninth Florence Forum by specifying further its views on the desirable principles and content governing a more permanent mechanism, bearing in mind that it is an on-going process and that further improvement will be needed in the course of the integration of electricity markets. These views are coherent with EURELECTRIC’s former Position Papers of December 2000 (Tariffs for cross-border exchange), of June 2001 (Harmonisation of G & L charges at the EU level) and of December 2001 (Regulation on conditions for access to the network for cross-border exchanges in electricity).

1. Characteristics of the new mechanism

Taking into account the above considerations, EURELECTRIC believes that a more permanent mechanism must have the following characteristics¹:

- be based on real physical flows (ie non-transaction based), which must be measured as accurately as possible;
- be based on compensations among TSOs only, which must be based on real costs and be as low as reasonably achievable;
- eliminate any specific export and import fee;
- advance towards the inclusion of locational signals so as to guarantee efficient operation of the existing system and to give appropriate signals for the siting of new generation and load;
- take into account the experience acquired so far with the temporary mechanism;
- be simple, cost-reflective, easy to implement and accepted by the various stakeholders;
- be based on a harmonised approach for cost recovery by TSOs.

In the following paragraphs, a more detailed description of the EURELECTRIC proposal for the more permanent mechanism is set out.

2. Description of the more permanent mechanism

There are no differences between the final goal of the temporary and the more permanent mechanism. The common purpose is to contribute to an internal electricity market without artificial barriers while providing proper compensation of ‘transited’ TSOs². The two fundamental aspects to be defined are, then:

- the size of the compensation
- the contributors to the compensation

Besides, there are two other aspects of interest that EURELECTRIC believes must be included or considered in the definition of the more permanent mechanism:

- harmonisation of charges for transmission
- locational signals

Each one of the above-mentioned points is explained in the following paragraphs.

¹ One member is of the opinion that the 2002 mechanism in refined form provides a solid base for the more permanent mechanism. For this reason, this member fails to agree with Chapter 1 of this paper.

² EURELECTRIC agrees with the definition proposed by the Danish Presidency (30 July): “transit flow of electricity means a physical flow of electricity on a transmission network of a Member State that is attributed exclusively to the activity of generators and consumers outside of that Member State”.

2.1 Fair compensation among TSOs

The existing mechanism for compensation among TSOs is based on the concept of the Horizontal Network³. The different countries involved in the ETSO agreement have defined their corresponding network and calculated the costs related to investment and operation (including losses).

Once this calculation has been made, each TSO has calculated the costs corresponding to both internal consumption and cross-border use depending on the so-called “transit key” (proportion of transits related to the sum of internal consumption and transits). Although this method is intended to be very simple and objective, the practical application has been made without sufficient transparency. The principal problems that EURELECTRIC has identified in the application of this method, are reflected in our position paper of December 2000 and are as follows:

- lack of homogeneity in the definition of the Horizontal Network
- lack of harmonised criteria for establishing the costs associated with the Horizontal Network (investment and losses)

As stated in our former position paper, EURELECTRIC considers that not all assets included in the horizontal network are subject to compensation, but only those used more specifically for transit flows. In our view, this is not correctly reflected in the temporary CBT mechanism. **Therefore, EURELECTRIC welcomes the initiative developed by CEER and ETSO to improve the calculation of the compensation in a more analytical and direct way (i.e., through the ‘Transit Flow’ or the ‘Average Participation’ methods). EURELECTRIC intends to carry out in the coming months a detailed analysis of the different proposed methodologies in order to evaluate the costs covered by the inter-TSO compensation. The final harmonised methodology should in any case be approved by the national regulatory authority.**

With regard to the amount of the compensation, we stressed in our former position paper that the initial values resulting from the strict application of Horizontal Network methodology were too high and that a figure of €200 million could be accepted only for the temporary mechanism. **The more permanent mechanism should by no means give any amount higher than this figure.**

2.2 Contribution to the Compensation

EURELECTRIC takes the view that the contribution to the compensation must come solely from the payments among TSOs.

This principle will be applied just to the areas included in the TSO agreement. Current injection fees from peripheral area will have to be eliminated or reviewed so that the ‘Agreement Area’ could be enlarged.

³ ETSO defined the Horizontal Network (HN) as the “part of the transmission system, which is used to transmit electricity between countries and within the country. It contains the transmission system elements that are influenced significantly by cross-border exchanges [...]. For most countries, the HN consists at least of the 400 kV interconnections, lines and transmission sub-stations”. ETSO requested each TSO to publish the method used to define the national HN (paper “Cross-border tariffs for the IEM”, 19.03.2002).

As there will be no contribution from the exporting generators, the compensation will be provided by the TSOs of the countries that contribute to transits, i.e. TSOs of exporting and/ or importing countries according to their real net flow.

Further analysis is needed to determine how to share the costs between TSOs in importing and exporting countries.

EURELECTRIC takes the view that the analytical method mentioned in the above paragraph should also be used to determine in a more precise way those TSOs contributing to transit. In particular, the role of direct cross-border flows between neighbouring countries, which we believe, are not to be included in the calculation basis for compensation, should be clarified.

2.3 Harmonisation of Transmission Charges

EURELECTRIC firmly believes that in order to avoid distortions of competition among the various players in the Internal Electricity Market (IEM), transmission charges to generators and loads must be harmonised. Among the several possibilities to effectively harmonise charges to generators and loads, EURELECTRIC has demonstrated that $G=0$, (ie no infrastructure transmission charges imposed on generators) is the option that best leads to a level playing field for generators and, as a consequence, to a more efficient operation of the IEM.

With the intended abolition of the export fee, EURELECTRIC considers that harmonisation of transmission charges is more necessary and urgent than ever to better compare production costs among generators situated in different areas.

2.4 Locational Signals

Locational signals are necessary to take into account the geographical distribution of the generation and load for the efficient operation of the existing system and to give signals to the different agents that operate on a market regarding the proper location of new facilities (generation and load) and/or expansion of the transmission system.

Locational signals in the short term are related to losses and congestion. The energy-related charges for generators and loads may be adjusted to reflect their relative position and the impact of the production (or consumption) in the overall transmission losses.

Locational signals in the long term can be obtained by distributing in a non uniform way the corresponding national transmission charges to either generation and/or load.

EURELECTRIC is in favour of the concept of locational signals, in particular at regional (to be understood as “multinational”) level. However, the application of this concept at national level is not always so necessary, if the existing or expected geographical distribution of generation and load in a particular country is uniform or there is a public service obligation requiring uniformity of prices.

A possible way of implementing long-term locational signals in the more permanent mechanism that has been proposed by the regulators is to use the result of the compensation mechanism as a substitute for long-term locational signals.

In this way, charges on an exporting country that contributes to the fund will be levied on generators, while the corresponding charges in an importing country that also has to pay will be levied on loads.

This practice will help, in a way, alleviate congestion and, at the same, will favour the location of new generation and load in the 'right' place. **EURELECTRIC could accept this proposal at this stage of the discussion but wonders if this will be enough to provide appropriate locational signals.**

3. Conclusions. Next Steps

Although the temporary mechanism was not based on very sound regulatory principles, its application and the experiences drawn so far must be considered as positive, since it has allowed the testing of all information and procedures for the more permanent mechanism.

It must be remembered that the information used for this temporary system (declared exports and real transits) is the same as that which will be needed for the new period which starts next year. If a criticism can be made of the temporary system, it is that the differences in the practical implementation in the various countries (and in the current charges to generators) is preventing or distorting efficient trade. The need for harmonisation is becoming more and more evident.

At the same time, some improvement will have to be made in the proper allocation of capacity in congested border areas. Export fees charged in the countries of origin may have prevented a part of the cross-border trade that was going to cause congestion. In the absence of this fee, proper allocation of capacity, using market-based methods, will be more vital.

Furthermore, EURELECTRIC reiterates that decisions on cross-border transmission pricing reached at the Florence Forum should be given a binding regulatory status with their inclusion into the draft Regulation.

As a summary, we can conclude that the more permanent mechanism to be introduced on 1st January 2003 without any specific export fee is feasible. The details of the new system need to be finalised sufficiently in advance before it comes into effect in order that all parties can make the necessary preparations.

The main characteristics of this system should be as follows:

- **The amount of compensation will have to be derived from more homogeneous and analytical procedure without surpassing by any means the current € 200 million**
- **TSOs in both exporting and/ or importing countries should contribute to the fund needed to compensate the costs caused by transit. Further analysis is needed to determine how to share the costs between TSOs in importing and exporting countries.**
- **EURELECTRIC could accept, at this stage of the discussion, the CEER proposal to use the compensation mechanism as a substitute for long term locational signals but wonders if this will be enough to provide appropriate locational signals.**

- **Efforts must be made in the harmonisation and reduction of national transmission charges to generators to allow them to compete on more equal terms across the various borders.**