

**Union of the Electricity Industry – EURELECTRIC Position Paper
Contribution to the 11th Electricity Regulatory Forum**

April 2004

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These comments have been drafted by the EURELECTRIC Sub-Group "Cross-Border Transactions" in April 2004:

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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, UNIPED 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.

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Introduction

The creation of a single Internal Electricity Market not hampered with national borders requires that existing electricity markets be further harmonised and physically integrated. In this perspective, and in relation to the entry into force of the Cross-Border Electricity Regulation in July 2004, Union of the Electricity Industry-EURELECTRIC sees the need for a number of concrete steps to be rapidly taken on the key issues of congestion management and harmonisation of network charges, and urges that the key principles for inter-TSO compensations and locational signals remain clear, transparent and consistent.

The focus placed in this paper on congestion management should not be interpreted to imply that EURELECTRIC is giving less importance to other issues also addressed in Section III.

SECTION I – GENERAL REMARKS ON THE REGULATORY CONTEXT FOR CROSS-BORDER TRANSACTIONS

In application of Article 13 of the Cross-Border Electricity Regulation, a Comitology Committee¹ will be set up as of July 2004. Acting essentially as an Advisory Committee, it will assist the Commission in:

- adopting/amending guidelines on the inter-TSO compensation mechanism and on the harmonisation of the underlying principles for G&L charges, including the reflection of the inter-TSO compensation mechanism in national network charges and the provision of locational signals;
 - amending the guidelines on the management and allocation of interconnector capacity;
 - deciding on the amounts payable as inter-TSO compensation;
 - taking a final decision when Regulators/Member States do not comply with a request from the Commission to amend or withdraw an exemption decision taken in application of Article 7 of the Regulation (exemption from the principle of regulated third party access or from the rule on how to use revenues resulting from the allocation of interconnection).
- On this issue, the Committee will act as a Regulatory Committee.

Besides this Committee, the Commission also announced last November the setting up of an Advisory Group of Regulators² that will assist in ensuring consistent application of the liberalisation package (Regulation plus Electricity and Gas Directives).

The creation of this ERGEG Group responds to the requirement of the Regulation for further cooperation between national Regulators and to the call formulated by the European Parliament during negotiations on the package.

¹ Committee composed of representatives of the Member States, in application of Decision 1999/468/EC of 28 June 1999 laying down the procedures for the exercise of implementing powers conferred on the Commission (OJCE L184/23 of 17 July 1999).

² Decision 2003/796/EC of 11 November 2003 establishing the European Regulators Group for Electricity and Gas (OJCE L 296/34 of 14 November 2003).

In EURELECTRIC's opinion, this proliferation of advisory bodies on regulatory issues needs to be carefully managed to ensure maximum coherence and avoid any unnecessary regulatory burden. Moreover, it is essential that the ERGEG group, as specified in Article 4 of the Decision establishing its existence, effectively consults at an early stage with all market participants, including EURELECTRIC and other network users.

EURELECTRIC also considers that transparency of information is fundamental for the adequate development of the market. The role of TSOs in providing Regulators and market participants with this information is in this respect vital, but should not extend to monitor the behaviour of market participants, which clearly falls within the competence of Regulators (Article 23 §1 of Directive 2003/54/EC).

SECTION II - CONGESTION MANAGEMENT

1. Description of the current EU situation

In September 2001, the 6th Electricity Regulatory Forum approved Guidelines for congestion management that called, in order to ease congestion, for the adoption of non-discriminatory and market-based capacity allocation mechanisms on all EU interconnectors³. The present situation however shows that this objective has not yet been achieved as non market-based methods are still in use on half of the interconnectors of the EU 15 (12 out of 24), as clearly shown in the Commission 2nd Benchmarking Report⁴.

At present, market-based allocation mechanisms are in place on the following interconnectors:

| | |
|--------------------------|---|
| ▪ Germany- Belgium | Explicit auctioning |
| ▪ Belgium-Netherlands | Explicit auctioning |
| ▪ France-United Kingdom | Explicit auctioning |
| ▪ Denmark-Germany | Explicit auctioning |
| ▪ United Kingdom-Ireland | Explicit auctioning |
| ▪ Italy-Greece | Explicit auctioning (only from IT to GR) ⁵ |
| ▪ Nordel area | Market splitting and counter trade |

Market based allocation mechanisms are also in use on the following interconnectors of the countries to join the EU on 1 May 2004:

| | |
|----------------------------------|--|
| ▪ Slovakia-Czech Republic | Explicit auctioning |
| ▪ Slovakia-Hungary | Explicit auctioning |
| ▪ Slovakia-Poland | Explicit auctioning (only on SL side) ⁶ |
| ▪ Slovakia-Ukraine | Explicit auctioning (only from SL to Ukraine) |
| ▪ Czech Republic-Poland | Explicit auctioning (only on CZ side) ⁶ |
| ▪ Czech Republic-Austria-Germany | Explicit auctioning |

³ For the definition to be given to market-based mechanisms, see Section II, point 2.1.

⁴ European Commission "Second Benchmarking Report on the Implementation of the Internal Electricity and Gas Market", updated version, April 2003.

⁵ For the other listed interconnectors, the allocation mechanism is the same in both directions.

⁶ There is no joint capacity allocation mechanism in place on those interconnectors. Capacity must thus be obtained on the Polish side through non-market based methods and final assignment corresponds to the minimum of capacity obtained on both sides.

The management of congestion on particular interconnections⁷ corresponds to the twofold activity of:

- *determining the Available Transfer Capacity (ATC) and*
- *allocating this capacity to the different potential users.*

2. Determination of the Available Transfer Capacity (ATC)

ATC, including transmission reliability margins, needs to be calculated on the basis of sound technical standards approved by Regulators and published (Article 5§2 of Regulation 1228/2003). EURELECTRIC believes that information on the specific methods used to calculate ATC on the different borders should moreover be made public and available to all stakeholders.

Homogeneous methods and improved information exchange between TSOs should be applied to better predict and manage loop flows so that the use of interconnections is optimised. Netting of flows in opposite directions should also contribute to maximising the commercial use of interconnections.

3. Brief definition of capacity allocation methods on interconnections

The available capacity of an interconnection that may be offered to the market corresponds to the capacity that remains available once security reserves and existing long-term contracts have been deducted from the line's total capacity. There are several methods for allocating available capacity:

1. First come, first served: capacity is allocated sequentially, according to the requests received, until all available capacity is booked. Capacity assigned to individual traders is sometimes capped to better distribute available capacity. No revenues are derived by TSOs from this method.
2. Pro-rata: market participants can freely make requests for capacity during a certain period. Allocation is then made on a pro-rata basis. No revenues are derived from this method by TSOs.
3. Explicit auctioning: capacity is allocated according to the bids received in an auction. In general, available capacity is assigned in sequential auctions (yearly, monthly, daily). Revenues result from this allocation method only on interconnections expected to be congested.
4. Implicit auctioning/Market-splitting: these two methods are very similar. In implicit auctioning, an auction based on energy bids is called on one side of the interconnector. In market-splitting, market operators on both sides of the interconnector use the net capacity to transfer energy from cheaper hubs to more expensive ones. Revenues result from this method on congested interconnectors.

⁷ Both calculation and allocation of capacity are made on a overall base for all interconnectors between two adjacent countries or TSOs. On some occasions, due to loop flows in third countries, this procedure involves the borders of more than two countries.

The basic market-splitting method can also be adapted to include the possibility for short-term bilateral cross-border trade, as proposed by EUROPEX in its “Decentralised Market Coupling” proposal⁸. Bids for bilateral trade are then accepted when they are above the price difference between the involved markets.

5. Counter-trading (or redispatching): all transactions are initially ‘allowed’ by the involved TSO(s). If congestions result from this transaction, TSO(s) will have to rebalance generation at both ends of the congested line to relieve the congested path. This method implies extra costs for the TSO(s) involved.

4. Compatibility of these methods with the provisions for capacity allocation in the Cross-Border Electricity Regulation

In accordance with the Cross-Border Electricity Regulation (Article 6 and the Annex on congestion management), capacity allocation methods must be:

- Market based. Market based methods are the only ones to provide the appropriate signals to both market participants (for efficient use of the grid) and TSOs (for adequate development of the grid).
- Non discriminatory
- Transparent.

The 9th Electricity Regulatory Forum “positively took note of a presentation of CEER of five basic principles for the allocation of interconnector capacities, as a basis for a possible future revision of the guidelines on congestion management, adopted by the Forum in November 2000”⁹. These principles are as follows:

- Economic efficiency. For EURELECTRIC, this general principle encapsulates the principles of market-based allocation, transparency and promotion of effective competition.
- Promotion of effective competition. This implies that there is no discrimination between market participants. In particular, bilateral trade and trade via a power exchange must be treated equally.
- Transparency. Transparency means not only that the method for allocation must be publicly available but also that market participants are in a position to confirm that capacity has been allocated according to the established rules. Simplicity and stability contribute to transparency.
- Maximisation of the capacity available. This has more to do with the calculation of the available capacity than the allocation procedure. Regarding the use of the available capacity, the “use it or lose it” rule will have to be applied to all methods physically assigning capacity.
- Generation of revenues only in case of congestion. For EURELECTRIC, this is more a consequence of the economic efficiency principle than a principle in itself.

⁸ EuroPEX paper presented at the 10th Electricity Regulatory Forum: “Using Implicit Auctions to Manage Cross-Border Congestion: “Decentralised Market Coupling”, July 2003.

⁹ Conclusions of the 9th Forum, point 4.3. Reference is made to the CEER paper “Principles on the management and allocation of available transfer capacity of interconnections”, September 2002.

The table shown below provides evaluation of the various interconnection allocation methods currently in use in the light of these various principles contained in the Regulation and the CEER presentation.

| | Non discrimination | ECONOMIC EFFICIENCY | | | Maximisation of the ATC and its use | Generation of revenues |
|---|---------------------------|----------------------------|--|---|---|----------------------------------|
| | | Market based | Transparency¹⁰ | Promotion of effective competition | | |
| First come, First served | NO | NO | NO, unless the complete priority list and updated ATC were made public. | NO | YES. Netting and the 'use it or lose it' principle need to be in place. | NO |
| Pro-rata | YES | NO | NO, unless requests of all applicants would be made public. | NO. Encourages gaming or distorted behaviour such as asking for more capacity than needed. | YES. See above. | NO |
| Explicit auctioning | YES | YES | YES | YES. Risks of market power abuse are eliminated with legal unbundling & the 'use it or lose it' principle. | YES. See above. | YES |
| Implicit auctioning / Market splitting | YES | YES | YES | YES, provided that enough liquidity and a sufficient number of players are operating on both ends of the interconnectors. | YES. See above. | YES |
| Counter-trading | YES | NO | YES, provided enough information on the transactions carried out by TSOs is disclosed. | YES | YES. See above. | NO. Imposes extra costs on TSOs. |

¹⁰ A method is transparent when there is a possibility for applicants to check that capacity has been correctly allocated. This is notably the case with explicit auctions, where applicants who have bid above the final clearing price automatically know that they are obtaining all the capacity they have applied for.

5. Evaluation of allocation methods

First come, first served

This method is both discriminatory and not economically efficient and should thus be altogether abandoned. It could only be transparent if the complete priority list would in practice be made public.

Pro-rata

Pro-rata is not discriminatory but is not economically efficient. This method encourages gaming and could only be transparent if requests presented by all applicants were made public.

Counter-trade

Counter-trade is not a market-based allocation method, as all transactions are accommodated regardless of their economic impact. In this method, TSOs do not fix any limit to the costs they incur in carrying out the counter-trading operation.

EURELECTRIC therefore believes that this method can be used¹¹ but only in cases where congestion is neither severe nor recurrent, as a sort of “emergency method”. It is moreover essential that Regulators monitor the correct use of this method by market agents.

Market splitting

Market splitting is in theory the ideal solution to manage congestion efficiently but it requires a network configuration with clear boundaries between price zones and the existence, on both sides of the interconnections, of a power exchange or power-pool arrangement. Furthermore, it is necessary that these exchanges or arrangements be adequately coordinated in terms of their design (timetables, bid format, market clearing procedure etc.) and that their borders, which determine the respective price zones, are precisely defined. It is moreover necessary that these exchanges or arrangements provide sufficient liquidity and that there are enough market players in each price zone.

These prerequisites are however far from being met all over the EU at present and EURELECTRIC thus believes that in the short to medium term explicit auctioning is the preferred and most acceptable solution for capacity allocation¹².

Explicit auctions

To ensure that the explicit auction mechanism works properly, appropriate organisation of auctions in time horizons, secondary capacity markets, coordination in time and format in the different interconnections and open access to information is needed. Coordinated explicit auctions should be promoted and EURELECTRIC notes with interest the ETSO pilot project for allocating capacity on related interconnections in a coordinated way.

Explicit auctions do not increase prices nor favour dominant players. Explicit auctions give an indication of the benefits that market participants can earn in using the interconnection. When the auction is properly designed, market participants bid for the expected price difference¹³ between the two relevant markets and revenues – corresponding to the average price bid times the available capacity - are equivalent to those resulting from market splitting.

¹¹ Counter-trade is accepted in the Guidelines to the Cross-Border Regulation (see “Principles governing methods for congestion management”), provided that the costs incurred by TSOs are set at an efficient level.

¹² EURELECTRIC already expressed this opinion in its position paper on Congestion Management, November 2000.

¹³ After allowing for losses and transaction charges.

Allocating congested capacity to particular users may not increase prices to them but it is inefficient and discriminatory.

As for the risk of market power abuse, this can easily be prevented with the “use it or lose it” rule, whereby agents who have obtained capacity must release it back to the market if they do not actually use it. There is thus no risk of capacity being withheld by any agent. It is moreover essential that information is made available to all market participants so that they are able to take rational decisions and benefit from the same opportunities, without any discrimination.

6. Other considerations

Payment for network access

EURELECTRIC argues, in line with CEER and the 9th Regulatory Forum (see 5th principle above) that network users should not pay to access non-congested interconnections. Payment should only occur in the event of a bottleneck.

Use of congestion revenues

Explicit auctions and market splitting produce revenues. Extra revenues coming from congestion management should not be retained by TSOs, as provided for under Article 6 (6a) & (6c) of the Regulation, but should be used to guarantee the firmness of the allocated capacity access or considered as an income by the Regulator when approving the tariff methodology or assessing whether tariffs should be modified.

EURELECTRIC takes the view that the Regulator should develop, based on these revenues, incentives for TSOs to increase the net transfer capacity (NTC) with operational and other short term measures, making good forecasts of available capacity and guaranteeing the firmness of allocated capacity.

Network development

EURELECTRIC firmly believes that the development of networks is crucial to ensure an adequate functioning of electricity markets but considers that it is not appropriate to set a notional standardised target across all EU borders. Investments on interconnections should be primarily determined on economic grounds, including security of supply¹⁴. A clear and stable regulatory framework is essential in order to provide appropriate economic incentives for expanding the network.

Role of Regulators

EURELECTRIC recommends that Regulators, besides approving the allocation methods in use, should also work towards greater harmonisation and monitor their correct application and efficiency.

¹⁴ See EURELECTRIC Comments on the Commission’s Strategy paper “medium term vision for the internal electricity market”, June 2003.

SECTION III – HARMONISATION OF NETWORK CHARGES AND INTER-TSO COMPENSATION MECHANISM

1. Harmonisation of network charges and locational signals

Rapid progress towards harmonising G charges in the EU is needed to ensure the existence of a genuine level playing field between power generators and reduce existing distortions of competition. EURELECTRIC believes that the best solution in this respect is a harmonisation at $G=0$, where generators do not pay for the cost of the transmission infrastructure but may contribute to payment for losses and congestion through appropriate energy-related locational charges¹⁵.

In July 2003, the 10th Electricity Regulatory Forum stressed again the need to advance in the harmonisation of basic G-charges and called, as a first step, for harmonisation within a range between zero and an undetermined value. This approach does not exclude at a later stage a harmonisation at $G=0$ but does not give any signals for real and speedy harmonisation. EURELECTRIC would therefore push for a clearer commitment in favour of $G=0$ to be taken by the Regulatory Forum at its 11th meeting.

Harmonisation at a basic $G=0$ does not exclude the existence of an additional long-term locational signals component in the tariffs, where necessary. At present however, EURELECTRIC supports the conclusions of the 10th Forum that the introduction of an EU-wide locational G would be inappropriate. The lack of harmonisation across the different regulatory models in the EU prevents the introduction of any effective locational signals. This is also the conclusion of a study on locational signals in the context of the EU multi-TSO environment which was carried out on behalf of EURELECTRIC by the Italian grid expert CESI.

2. Inter-TSO compensation mechanism

Almost two years after the introduction of the first mechanism in March 2002, the 2004 inter-TSO compensation mechanism is now almost fully socialised. EURELECTRIC welcomes this important development, which at last brings the mechanism in line with the key requirements already formulated by the Electricity Regulatory Forum back in March 2000 (5th meeting).

Further adaptation of the mechanism will still be needed for 2005, notably to adapt to the requirement of the Cross-Border Regulation (article 3(6)) to calculate costs resulting from the hosting of cross-border flows on the basis of a standardised approach to “long-run average incremental costs”.

EURELECTRIC also welcomes the extension of the mechanism’s geographical coverage, which now includes Nordel and five of the new Member States to the EU¹⁶, as this contributes to the creation of an Internal Electricity Market.

¹⁵ See EURELECTRIC Position paper on the harmonisation of the G and L charges at EU level, June 2001.

¹⁶ Islands (UK, Ireland, Malta, Cyprus) and the three Baltic States, not interconnected to the UCTE system, do not participate in the mechanism.

However, EURELECTRIC would like to reiterate its call for further transparency in the mechanism. For network users and market participants to give full trust to the mechanism, it appears imperative that more information be made public on the scope of compensation (including how investments and losses are treated), the method used to evaluate costs incurred by TSOs, the fund's overall amount and the expected amount per TSO.

Conclusions

In order to make significant progress on cross-border issues, EURELECTRIC recommends that proper action be taken in relation to the following:

Harmonisation of network charges for generators:

Rapid progress towards harmonisation of G charges is needed and EURELECTRIC is **resolutely calling for a clearer commitment of the Regulatory Forum in favour of G=0**.

Congestion management and use of interconnections:

To optimise the use of interconnections, TSOs should use homogeneous methods all over the EU to determine the available transfer capacity (ATC) and should net flows in opposite directions. As for congestion management, EURELECTRIC maintains its position of 2000¹⁷ and **strongly recommends the rapid implementation of non-discriminatory market-based allocation methods all over the EU**.

This position paper identifies market splitting and explicit auctions as the only two non-discriminatory, economically efficient, allocation methods. Market splitting, though in theory the ideal solution, cannot be implemented for the time being on all EU interconnections as its prerequisites are far from being met. **Explicit auctioning with appropriate organisation in time horizons, secondary capacity markets and application of the “use it or lose it” principle does not increase prices nor favour dominant players and is thus the preferred method in the short to medium term.**

Consistent market development:

EURELECTRIC is convinced that **coordination and cooperation between Regulators and between TSOs** is increasingly needed. Moreover, to avoid inconsistency, it is essential that the proliferation of regulatory bodies be managed carefully and that these bodies act in **full consultation with the electricity industry**.

Inter-TSO compensation:

EURELECTRIC welcomes the abolition of the “export fee” in the 2004 mechanism but reiterates its call for **further transparency on the mechanism**.

Network development

EURELECTRIC believes that **the development of networks is crucial** but the setting of a notional standardised target across all EU borders is not appropriate. **Investments on interconnections should be determined on economic grounds**, including security of supply.

¹⁷ EURELECTRIC position paper on Congestion management, November 2000.