

**Electrabel contribution to DG TREN consultation
concerning the European Commission 2005 Report
on the functioning of the electricity and gas directives**

(letter of Mr Helmut Schmitt von Sydow, Director, DG TREN, 23 May 2005)

1. Who is Electrabel?

Electrabel is the seventh European energy utility in size. It is active in the production of electricity, in the selling of energy products and services, in trading and in the operation of distribution networks on behalf of distribution system operators. Its market share represents 4.8% of the EU-25 electricity market and 9.4% of the Benelux-France-Germany regional electricity market where a substantial part of its assets is located.

Since 2000, Electrabel has been pursuing an active policy for becoming a true European player. It has acquired or is building assets in the Netherlands, France, Germany, Italy, Poland, Hungary, Spain and Portugal, and has actively participated to the creation of several power exchanges.

Electrabel has a diversified power generation system: 36.5% of its production is nuclear, 24.2% is coming from conventional sources, 18.1% from combined cycle units, 13.2% from renewables and 8% from cogeneration plants.

It has some 15 000 staff members in ten European countries. It is part of SUEZ, an international industrial and services group that is active in energy and the environment.

2. Electrabel's assessment on the questions identified in Mr Schmitt von Sydow's letter

Electrabel welcomes the initiative of the Commission to consult with stakeholders before issuing its progress report 2005. Electrabel is happy to contribute to it by expressing its views on the progress accomplished so far in the energy market.

2.1. Current and likely future developments of the gas and electricity markets

The first electricity and gas directives, the amending directives 2003/54/EC and 2003/55/EC as well as Regulation 1228/2003 on the cross border trade of electricity induced major changes in the regulatory and legal environment of the gas and electricity markets.

Essential in this liberalisation process is the fact that the previous highly regulated organisation evolved to an environment that combines regulated characteristics (transmission, distribution activities) and competitive facets (generation and supply). This process also led to the creation of sometimes quite unusual and complex markets. The balancing market in NETA (and later in BETTA) is an example of these unusual, sophisticated markets. The existence and adequate performance of these special markets is a prerequisite for the success of the liberalisation process.

Electricity related markets, whether energy itself (MWh) or associated services (transmission, capacity, reserve), whether spot (real time) or forward (day ahead or

more long term) may be difficult to put in place. As a result, there are successful restructuring experiences, others are just satisfactory, some are disastrous. This diversity of outcome reveals the importance of what is now referred in restructured electricity as market design.

The importance of market design

Experience shows that different designs are possible in electricity (e.g. the market design in BETTA is the opposite of the former pool in England and Wales and both differ from Nordpool); one cannot however dispense with selecting one. The problem is complicated in the EU by the fact that market designs in Member States must be compatible in order to allow for integration. Compatibility does not necessarily mean full harmonisation; but successful experiences (e.g. Australia, Nordpool and PJM) reveal that some common key design feature is a prerequisite for successful integration.

Electrabel considers that the restructuring process conducted at the EU level has not given sufficient attention to the market design, that this shortcoming hampers the development of competition and may have severe consequences. Electrabel also believes that the ex ante application of competition law will not correct the problem. Competition law does not create a market design. It can only correct coordinated or unilateral practices in working markets. Because electricity is not a normal market that can function per se, competition law can only be usefully applied after an appropriate market design has been put in place. Only special harmonisation laws can create market designs but the existing legislation did not do so. Indeed, the first electricity and gas directives and the regulation of cross border trade removed exceptions to standard market organisation such as exclusive rights and restrictions due to essential facilities. The amending directives went somewhat further by introducing regulators. None of this did really address the idiosyncrasies of electricity markets.

Electrabel acknowledges that the ETSO-EuroPEX market-coupling proposal that resulted from the Florence Regulatory Forum is the first serious attempt to introduce a market design. However, this sole step is insufficient for achieving an internal market. Many questions indeed remain on market coupling as well as on many other market design issues that have not been addressed so far: balancing market, capacity market, reserve markets....

Too much focus on national markets

The regulatory and legal framework has so far mainly resulted in the creation and development of national liberalised environments and the fragmentation of the incumbent operators through unbundling in some countries. Even Regulation 1228/2003 on cross border trade leaves implementation entirely in the hands of national authorities.

Electrabel recalls that one main justification for the completion of the internal market in 1992 was that it would permit firms to fully take advantage of economies of scale and of scope while being subject to competitive pressure. The focus on national markets sacrifices this objective. It may even result in damages if the transition to a "competitive" national market is conducted without proper market design such as adequate transmission or balancing system. Last but not least, the inception of national "competitive" markets that resulted from the electricity and gas laws without the necessary instruments for integrating these markets has transformed former regulated

monopolies into incumbents in dominant position, with the suspicion, but no proof, of abuse of this dominant position.

There is for the moment a lack of framework to support the development of regional liberalised environments and an ongoing failure for regulators and governments to push for electricity markets to expand beyond national boundaries. This is bad for both the industry and its clients.

The regional market approach

Regional market frameworks can pave the way towards an integrated electricity market provided the need for market design is taken on board from the beginning. The slow progress on the Iberian market shows the difficulties of achieving a regional market when the compatibility of the designs is not carefully thought through from the early stage. Regional markets can certainly contribute to a better functioning of the wholesale market: they introduce liquidity in the market, lower market concentration and create a level playing field for the different market players. Moving towards a single European energy market however remains a major challenge for all stakeholders.

If Electrabel backs the development of regional markets, it stresses that the ultimate goal is (and should remain) the establishment of a single (or Pan) European market. Regional energy markets should only be considered as an intermediary stage that can act as driving force to reach this goal.

The functioning of the wholesale market

One of the most important cornerstones of a successful energy market is the presence of a well functioning wholesale market. This creates a level playing field for all market players: it allows access to generation capacity for new suppliers and provides instruments to optimise portfolios.

Electrabel observes that the development of well functioning wholesale markets in Europe suffers from a number of constraints. Existing wholesale markets initiatives on national levels generally show a lack of necessary products (long term products, day ahead products, intraday and balancing products, etc.) or a lack of transparency and liquidity due to the limited size of a national market. Extensions of the national wholesale markets to larger regional markets in order to increase the necessary transparency and liquidity are confronted with different constraints:

- The variety of different national regulatory and operational jurisdictions leads to a sub optimisation of the current commercial transmission capacities on the borders. It is not clear yet how this will be overcome;
- The physical laws of energy flows make that in an interconnected network congestions are not necessary due to local constraints but can be generated by constraints in other areas of the network. This creates a TSO problem that is not addressed yet.

Electrabel notes that the European energy market as well as energy prices are subject to decisions from a variety of public authorities, from national regulators and governments to EU institutions. Due to the numbers of actors intervening in the market, energy companies are confronted with a more complicated regulatory environment where the market, the regulation and the geographical scope of companies have

changed. This creates undue, non-market driven uncertainties that unnecessarily increase costs.

2.2. Whether improvements to any aspect of the market opening framework should be explored either at national or Community level

As argued above, Electrabel believes that the market design prerequisites of the regional and internal market are not met. It also notes that, as a result, some domestic regulation raises true barriers to entry. These unnecessarily increase the risk for a company to penetrate a new market. These also create unjustified suspicion of market foreclosure by the incumbent (most generators no longer have their say in the organisation of balancing or transmission). Real and supposed barriers to entry do not favour competition.

Electrabel believes that the only way to get rid of these barriers is to first move to regional markets and then to integrate markets. As indicated above, this cannot be done without compatible national market designs. Electrabel notes that all successful restructuring experiences are based on a carefully thought through market design. It also notes that all successful market integration experiences have been realised under more centralised approaches than what it sees at the EU level. Electrabel therefore concludes that the questions of market design should be taken up at the EU level. In this respect, comforting statements that integration does not require a full harmonisation are useless, if not dangerous. The real question is indeed to find the adequate level of harmonisation of market design that will allow an integrated market where companies fully exploit economies of scale and scope and are subject to competitive pressure.

Electrabel believes that this integration is best achieved with a supranational regulator and/or a supranational TSO at the transmission level. This is what both economic arguments and field experience suggest. Electrabel recognizes that governments strongly resist this solution that is thus unlikely to prevail. In the absence of a supranational regulator and /or TSO, the development of regional markets can only be realised through a tight collaboration between the different national regulators and TSOs in order to achieve a coordinated and harmonised regional market. The little and slow progress in Florence does not bode well for this perspective. Electrabel therefore believes that the scope of the Florence Forum should be expanded and its pace accelerated.

Whereas work on congestion and cross border tariffs has been going on in Florence, much remains to be done in other respects. Specifically,

- Physical reinforcement and optimisation of transmission interconnection capacity is required on an international coordinated way. In this regard, the real congestion drivers of the interconnected network should be determined and tackled adequately (e.g. large unpredictable windmill generation in North Germany, under dimensioned North-South connection in Germany, French/British interconnector variations, etc.).
- Long-term wholesale products require the availability of explicit market-based allocations of interconnection capacity (yearly, quarterly, monthly). Market-based allocations have the advantage to give the right incentive where new investments (be it generation or transmission) are needed following the (commercial) appreciation of the market actors.

- The efficient trading of day-ahead, intraday and balancing products on a regional basis requires the availability of implicit allocations of interconnection capacity via market coupling. Putting in place well functioning and between Member States compatible day ahead, intraday and balancing markets is one of the most urgent steps to realise: they stimulate the liquidity of the market by increasing the number of market players and by also allowing other sources (from abroad) to reduce with short notice the imbalances.
- Counter trading and/or international re-dispatching organised by TSOs should allow ensuring that allocated capacity is firm.

Market monitoring frameworks should be put in place to guarantee the well functioning of the wholesale markets. Ex ante information on transport, generation and load constraints should be available to all market players, giving transparency to the market and creating a level playing field. Ex post monitoring should be available to survey any abuse that might have occurred and, if so, to take the appropriate measures against the involved market players. Regulatory interventions should only be applied when all other market-based mechanisms are exhausted.

In this still changing and developing energy market, a favourable climate for investments is needed to ensure the good functioning of the markets. This implies regulatory coherence and stability and the elimination of a number of public, political and/or administrative constraints. Electrabel considers that Public Authorities should be clear, consistent and transparent in establishing the rules and measures. They should also ensure a better understanding of their decisions and of their impact on energy supply (for example costs, reliability, etc.). Electrabel favours a systematic use of impact assessment for new regulation. A better coordination of the market-opening framework amongst Member States should also be a target.

Electrabel is also concerned by the wrong signals given by the CO₂ market and their possible impact on prices. This market is obviously not mature at this stage and could jeopardize the long-term development of investment. CO₂ is a global issue and should be addressed at a global level.

2.3. Whether any reinforcement to measures to protect the interests of customers need to be considered

Security of supply is of utmost importance for the customers and for the realisation of the internal energy market. Security of supply based on reserve capacity policy remains a permanent concern in liberalised markets.

It is well admitted that reserve capacity may not be adequately supplied unless it is properly remunerated. It is also acknowledged that markets may be too volatile to achieve this task. This requires a coordination of regulation that is totally absent from current practice today. It ties in with the development of capacity markets found in other systems.

The problem of adequate reserve capacity in an interconnected system with limited transmission capacities is technically quite difficult. It is still made more complex by the fact that the elements of the system are operating under a variety of different regulatory and operational jurisdictions. Today, many national markets justify their local reserve capacity on the basis of high voltage transmission import capacity. This is a very crude approach that somehow moves the responsibility of security of supply to other jurisdictions. Needless to say, there is no guarantee that at scarcity moments in one

jurisdiction there is sufficient spare generation capacity available in the other jurisdictions. These questions are not particularly well addressed in the existing laws.

Electrabel takes the view that a general security of supply policy should be set up at a European level and in a transitional stage, at regional level. Therefore, it is pleased that the Council will soon adopt the Directive on security of electricity supply. In this regard, Electrabel stresses its concern about the recent decision from the Court of Justice of the European Communities regarding the abolition of priority rights of certain historical contracts on interconnection capacities. Whereas those contracts have a direct impact on the supply capacity in the Member States, an insufficiently considered extrapolation of the decision to all the existent historical contracts will endanger security of supply in all Member States of the European Union.

Security of supply also implies demand side management. Electrabel considers that Public Authorities should increase incentives for energy efficiency programmes.

Finally, specific reinforcement measures could be undertaken for the different customer segments:

- Large and small industrial consumers should be able to use market mechanisms to hedge the possible risks of their energy contracts.
- Concerning residential consumers, the liberalisation of the energy markets reinforced the "public service obligations" inherited from the captive market. Coherency and harmonisation of the social rules should be a must and should aim at increasing their efficiency by targeting the weakest customers and by focusing on energy saving measures.