



## **European Commission 2005 Review of Electricity and Gas Directives –**

### **AEP<sup>1</sup> Comments**

#### **1. Main Points**

- The Association supports the continuing development of competitive energy markets in Europe and sees implementation of the existing liberalisation package as the first priority;
- Given the substantial investment needed for power generation and networks, any proposals from the Commission must contribute to providing a stable and predictable regulatory framework;
- The EU electricity and gas markets will become increasingly interlinked and it is therefore important that greater progress is made towards gas liberalisation;
- Priority should be given to removing the obstacles to cross-border trade and here greater coordination between regulators and between TSOs will be needed;
- Incentives need to be developed to ensure that TSOs reinforce their networks and maximise available capacity;
- The focus should be on practical improvements to cross-border trade rather than on theoretical considerations, such as whether market coupling is superior to explicit auctioning;
- Interconnectors should be developed on an economic basis and the option of merchant interconnection should be kept open;
- Transparency arrangements should reflect best practice in the UK and NordPool markets;
- Additional measures to protect customers are not necessary at this stage and could be counter-productive in undermining the competitive market.

#### **2. Current and Future Developments of Electricity and Gas Markets**

##### **General**

The 2003 energy liberalisation package, supplemented by the Gas Regulation, provides a sound basis for ensuring competitive electricity and gas markets in the European Union. The legislation covers all the major

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<sup>1</sup> The Association of Electricity Producers (AEP) represents the interests of the electricity generation sector in the UK, with a membership of more than 100 companies. Between them, the members embrace virtually all of the fuels and technologies used for commercial electricity production, from coal, oil, gas and nuclear power to wind, wave and hydro and production from a wide range of waste products.

issues: the creation of competitive markets in generation and retail; unbundling of networks from competitive activities; non-discriminatory access to networks based on published tariffs; and the creation of independent regulators.

However, progress to competitive markets in Europe has so far been disappointing, particularly in the main continental market and particularly in gas. New entrants have found it difficult to challenge existing players in the generation market and, while competition has developed in the large customer market, the picture for smaller customers is rather less satisfactory in most Member States. The key requirement is therefore that Member States should fully implement the Electricity and Gas Directives and the two Regulations. Moreover, it is not enough for governments simply to create a theoretical level playing field on the basis of paper requirements – they must ensure that their national markets provide for genuine competition and that there is a level playing field between incumbents and new entrants. It is important that the European Commission thoroughly monitors implementation and takes firm action against any breaches of the legislation.

The Association still has an open mind on whether further legislation is needed to liberalise the electricity and gas sectors – the results of the DG Competition investigation and the DG Tren review should provide the necessary data for taking these decisions. If further action is taken, it is important that full account is taken of the need for a stable and predictable regulatory framework. Very large amounts of investment in the power generation sector will be required over the next 25 years and such investment will only be forthcoming if there is certainty about the regulatory framework both at national and EU level. Any new Commission proposals must be based on a rigorous assessment of costs and benefits and clearly referenced to the findings of the DG Tren review.

Increased efforts must be made to ensure consistency between the liberalisation of the market and other policy measures, both at national and EU level. In the last few years we have seen new EU Directives on electricity security, renewables, cogeneration, energy efficiency and a host of environmental issues. Initial Commission drafts of these proposals have not always been compatible with the development of competition and indeed have often promoted a centrally-planned approach. Where interventions in the market are justified on public policy grounds, their impact on competition should be minimised and they should be undertaken transparently.

Even if national markets were fully liberalised, additional action would be needed to ensure compatibility of arrangements so that energy can be traded freely across borders. A framework for cross-border issues already exists in the shape of the EU Electricity Regulation, which introduces decision-making mechanisms relating to interconnection issues. It would seem sensible to make full use of these mechanisms, as well as promoting more localised cooperation between regulators.

## Interconnection

The Association recognises the importance of interconnection to the European market and welcomes any initiatives which will make transmission reinforcement easier. For instance, planning processes could be simplified and it is important that regulators work closely together to facilitate interconnection. However, the AEP does not support arbitrary targets for interconnection, as transmission investment should be driven by economic need. New interconnection should therefore be justified primarily through cost-benefit analysis undertaken by TSOs or other developers.

Greater interconnection is only one of several approaches which can be used to promote competition and increase trade. Better management of the generating reserve, the closure of old generating plant, and the construction of new generating plant close to load centres can all have the same effect on interconnector congestion as the construction of new lines. Regulatory frameworks should provide incentives to respond to congestion with the most economic investments, whether in generation or transmission. Arbitrary intervention in transmission investment can distort the generation market and should be avoided.

The Association can accept that AC interconnection may need to be financed on a regulated basis. Nevertheless, this has the potential disadvantage that large investments may be undertaken by neighbouring TSOs simply because they are allowed to recover the costs from customers in monopoly charges. In the case of DC interconnectors, which can involve substantial investments and high levels of risk, it is important that the option of building merchant lines is maintained as an alternative to the regulated route. This is particularly relevant for island systems such as the UK. Where projects are market-driven, regulatory intervention should be minimal if long-term investment is to be encouraged.

## Regional Markets/Cooperation among Regulators

Regulators need to work together more closely and to focus on tackling barriers to trade. The Association sees benefits in promoting the regional market approach because of the difficulty of agreeing EU-wide solutions. However, unless regional markets develop in the same direction, integration at EU level could even be delayed. Dissimilar regulatory decisions can distort trade between regions, and so an effort must be made to achieve regulatory convergence across the EU, not only within but also between regions. This depends first and foremost on ensuring that the liberalisation Directives and Regulations are fully in place in all Member States.

There have been delays in introducing market mechanisms for congestion management at borders because of dissimilar approaches between regulators. Improvements have occurred recently at certain borders, but at others the use of non-market-based methods, e.g. pro-rata rationing, reserve prices etc, has continued and the general rate of progress in this area has been slow.

## Gas Liberalisation

Competition in the gas market has tended to lag behind electricity, as confirmed by previous Commission benchmarking studies. At national level, customer switching rates have been significantly lower and the lack of gas-to-gas competition is reflected in the continuing link to the price of oil. Moreover, the framework for competitive cross-border trade is much less developed than in electricity. This is unfortunate, since large quantities of gas have to be traded across borders and access to gas supplies is important for competition in electricity generation. The power and gas markets are likely to converge further as liberalisation develops, and so action to increase competition in the gas sector should be a priority.

It remains difficult to obtain gas supplies in many continental gas markets. Most capacity on existing pipelines is reserved for long-term contracts and transparency requirements have been significantly lower than on electricity networks. Gas release programmes have been successfully implemented in a number of markets and the Association believes that this route needs to be pursued in those Member States where the market structure is insufficiently competitive. Cross-border issues also need to be tackled and here the Gas Regulation should have a major impact if properly implemented.

Storage is a particularly important source of flexibility for power generators, since electricity cannot be stored and has to be produced in line with demand. It is crucial that storage is made available to third parties throughout the EU on a transparent and cost-reflective basis and therefore the Commission and Regulators must carefully monitor implementation of the Good Practice Guidelines.

### **3. Possible Improvements to Market Opening Framework**

#### Priority to Cross-Border Issues

Once Member States have properly implemented the existing Directives, the main priority for the Commission should be to remove barriers to cross-border trade. The Comitology process introduced in the Cross-Border Regulation should be used to tackle some of these issues. Notwithstanding the benefits of the Florence Forum as a focus for debate, progress on resolving cross-border issues has so far been slow; for instance, the inter-TSO compensation scheme has been discussed for over five years and a final proposal has still to be made. The Association believes that priority should be given to establishing the Comitology process effectively and to encouraging more rapid resolution of cross-border issues.

## Network Access and inter-TSO Cooperation

Non-discriminatory and transparent access to networks is the cornerstone of the single European market, and these issues therefore need to be tackled as a priority.

Progress is being made towards the introduction of market-based mechanisms for congestion management. The Association supports the use of both explicit and implicit auctions, whichever is more appropriate at a given interconnector, and does not believe that one method should automatically be given precedence.

The Association recognises that some progress has been made in inter-TSO coordination, e.g. in managing complex congestion, but believes that more still needs to be done. For instance, there has been a problem of different approaches to ATC estimation, with the result that the lowest value has generally been offered to the market. TSOs need to work together more closely to ensure more accurate estimates of transfer capacity in meshed networks. TSOs, with support from regulators, also need to harmonise congestion management methods where these have a significant impact on trade on other interconnectors.

Cross-border trade could be further promoted by expressly incentivising TSOs to maximise available capacity and avoid congestion. The TSO should have scope to earn additional revenue by making more capacity available, but should also bear the costs of curtailment, by having to buy back allocated capacity if it is not maintained. The Association would also like to see TSOs offer firm capacity on interconnectors on a long-term basis and facilitate secondary trading to ensure efficient allocation.

Congestion management and security standards are inter-dependent, and so reliability rules should also be reviewed at European level. The Association believes that it would be helpful to have an agreement on definitions, but that full harmonisation of technical rules is unnecessary. For instance, there will inevitably be differences between the security standards on the Irish and UCTE networks.

## Transmission Charging

The Association believes that significant trade distortions are likely to occur unless there is greater harmonisation of transmission charging methodologies. As an example, average generator charges in the UK and Ireland equate to 6-8% of the wholesale price and are out of line with those elsewhere in Europe. This reflects a different generation/demand split rather than transmission cost differences and cannot be justified on the basis of providing locational signals, since charges can be varied above and below the average within the Member State.

It is disappointing that the draft charging Guidelines tabled so far have simply acknowledged the status quo rather than attempting to tackle the problem.

The Association favours a planned move over a period of time to harmonising the percentage generation/demand split rather than the absolute level of charges. We also believe that steps need to be taken to harmonise connection charging methodologies.

### Transparency

The Association would like to see transparency requirements throughout the EU brought up to the standards prevailing in the UK and Nordic markets. The principle should be that, within the limits of commercial confidentiality, all market participants have equal access to information regarding network availability, utilisation, costs and charges. In relation to interconnectors, TSOs should ensure that there is transparency about allocation and dispatch methods, including the status of existing contracts, and should publish information on ATC/NTC and real-time flows across each border. Within national markets, real-time offer and demand curves should be made available. In gas, delivery infrastructure booked and available capacities need to be published.

### Wholesale Markets

Integration of wholesale markets is a complex issue and will have to be tackled over a period. Liquid day-ahead and forward markets need to be established first at national and then at regional level, together with open intra-day and balancing markets. Regulatory frameworks and trading rules will have to be harmonised to some extent, but this does not require a single model throughout Europe. For instance, we do not see the need to mandate over-the-counter or exchange trading within Member States. The Association endorses the conclusions of the EURELECTRIC Roadmap<sup>2</sup>, which outlines how the process of integration could be undertaken.

One major obstacle to trade is the fact that balancing and wholesale market timetables are not harmonised across Europe. It will be essential to harmonise such timetables to facilitate greater cross-border trade. It is desirable in each regional market to have a central clearing function, through which all regional deliveries and offtakes are recorded and notified (including exports/imports to neighbouring regions).

### Gas Market

The Gas Regulation will be implemented in the course of 2006 and should make a significant contribution to improving the cross-border framework. In AEP's view, the Regulation deals with most of the current problem areas in gas trading and it is essential that the provisions are fully implemented. The same goes for the Good Practice Guidelines on Storage which were recently agreed.

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<sup>2</sup> Integrating Electricity Markets through Wholesale Markets: EURELECTRIC Road Map to a Pan-European Market; June 2005

Some further action may be needed to ensure the harmonisation of transmission charging methodologies; despite the welcome move towards entry/exit charging, the different approaches used by TSOs still pose problems for gas shippers. Similarly, different balancing regimes can be a significant obstacle to shipping gas across borders, and specific Guidelines to promote harmonisation would be desirable here. The Association nevertheless accepts that the Regulation must be given some time to work before further action is taken.

Interoperability of networks is likely to become an increasingly important issue as gas trade develops in Europe, so it is crucial that different quality standards are not used as an artificial barrier to trade and that cost-effective solutions are found to promote interoperability. The Association believes that a Guideline on gas quality would be helpful for promoting more rapid progress in this area.

### Regulation

Article 23 of the Electricity Directive requires Member States to give extensive responsibilities to regulators, in relation both to network access and the promotion of competition. Given the importance of a level playing field, the Commission should carefully verify that each Member State has fully implemented the provisions of Art. 23. If so, the Association believes that these powers should be adequate.

There has been some discussion about the existence of a “regulatory gap”, particularly in relation to cross-border infrastructure, and it has been suggested that the competence of regulators should be extended to close this gap. This could, however, result in overlap with the European Commission’s role, leading to duplicate regulation. The Association takes the view that the problem lies not in the extent of competences, but in the national remits of regulators, whose primary function is generally to protect national customers, with only weak obligations to promote a European market. In the short term, regulators should tackle this by developing closer cooperation with their counterparts in adjoining markets, particularly on issues such as interconnector licensing. Regulators should also ensure that they give adequate prominence to the European dimension of their remit. Over time, the balance between objectives may need to be adjusted to take account of the wider EU market.

## **4. Reinforcement of Customer Protection**

The Electricity and Gas Directives contain the essential elements for protecting consumer interests:

- the promotion of fully competitive markets in power generation, gas supply and energy retail;
- the creation of independent regulators to regulate monopoly segments and safeguard the consumer;

- scope for Member States to impose public service obligations provided that these are transparent and non-discriminatory.

In liberalised markets such as the UK, competition has been effective in improving cost efficiency and driving down prices to consumers. From 1990 to 2003, for instance, electricity prices for domestic consumers fell 31% in real terms in the UK, despite increased taxation. The Association accepts that specific measures are needed to protect consumers during the transition to full competition. However, once markets are fully liberalised, measures such as price controls can work against the consumer interest by dampening competition and discouraging new entry. Care also has to be taken in imposing public service obligations, since such obligations are generally easier for incumbents than new entrants to bear.

The Association therefore recognises the importance of consumer protection, but believes that the EU institutions should give competition a chance to work. Customer protection arrangements, e.g. service standards, vary among Member States in line with national political priorities and we do not see the need to harmonise these at this stage. National regulators can in our view be relied upon to ensure that high standards of service are maintained throughout the electricity and gas sectors.

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*Association of Electricity Producers  
17 Waterloo Place  
SW1Y 4AR  
London  
UK  
Tel.: +44 (0) 20 7930 9390  
Fax: +44 (0) 20 7930 9391  
[www.aepuk.com](http://www.aepuk.com)*