

A COMPETITIVE ELECTRICITY MARKET OF EUROPEAN DIMENSION: A GOAL WITHIN REACH

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A PROCESS, NOT AN EVENT

“Electricity market liberalisation is not an event. It is a long process that requires strong and sustained political commitment, extensive and detailed preparation, and continuous development to allow for necessary improvements while sustaining ongoing investment.”

- International Energy Agency (IEA) publication: “Lessons from Liberalised Markets” – 2005

A “process” view of electricity-market liberalisation makes it clear that the ongoing dynamics are crucial and that a snapshot approach to the situation at any given moment will not do. The current process is one of transition from national markets to international regional markets and, hence, to a market of genuine European dimension.

This process means that electricity-market liberalisation is based on steady progress on a range of multiple factors, not on reaching “ideal” conditions under a few selected criteria. Key characteristics of electricity, such as the physical and economic limitations on transport and the huge investments needed – both quite unheard of for any other industrial commodity – cannot be brushed away. They must on the contrary be basic considerations when assessing electricity markets and the structures of the electricity industry.

Simplification will simply not do. A simplified vision of European electricity markets based on a “copperplate” of transmission lines allowing for free flows of electricity all over Europe will not suffice. And that other, opposing, simplification - a vision of an “atomised” electricity industry operating within national or sub-national borders - will not do either.

Building competitive and international electricity markets thus requires progress on a range of multiple factors including:

■ Ensuring a competitive environment

- Effective implementation by Member States of the existing European legislative framework
- Independent operation of transmission and distribution systems
- Independent national regulators
- Openness to new entrants
- Internationalisation of electricity companies
- Market pressure from international customers
- Choice between suppliers
- Easy supplier-switching

■ Developing liquid and transparent wholesale markets

- Expansion of wholesale markets via regional markets as a stepping stone to a European market
- Wholesale market liquidity including participation from the demand side
- Abolition of cross-border fees
- Implementation of coordinated, market-based congestion management for interconnections
- Network reinforcement from a regional/European perspective
- Availability and transparency of key market and network data

■ Cooperation of main stakeholders

- Seamless cooperation between power exchanges
- Seamless cooperation between transmission system operators
- Seamless cooperation between national regulators on cross-border and Europe-wide issues

Electricity-market liberalisation is driven by overall progress on such multiple factors. Electricity markets function when these factors work in combination to a sufficient degree, not by achieving “ideal conditions” – whatever that might mean – for some or all of them.

With regard to many of these factors, Europe is already a world leader, very significant progress has already clearly been achieved, and the electricity industry has proved itself to be a partner in this process, not an opponent. For many years the European electricity industry has consistently advocated speeding up the liberalisation process and the abolition of the many barriers to a real European level playing-field.

Some examples where the industry has taken a leading role through cooperative efforts are:

- ETSO’s agreement on the abolition of cross-border fees and on an inter-TSO compensation mechanism ¹
- UCTE’s Operation Handbook putting together an up-to-date collection of the operation principles and rules for the transmission system operators in continental Europe ²
- The establishment of power exchanges
- Cooperation among TSOs and power exchanges on market-based congestion management and development of implicit auctioning ³
- EURELECTRIC’s Roadmap to a Pan-European Market ⁴
- EURELECTRIC’s recommendations on unbundling ⁵
- EURELECTRIC’s proposal on market transparency ⁶
- EURELECTRIC’s proposal for a supplier-switching model ⁷
- EFET’s work to organise the trading business ⁸

These cooperative efforts must be seen against a background of:

- Impressive cost-reduction and productivity improvements achieved by electricity companies ⁹
- Internationalisation of electricity companies, which is transforming many of them from national to international players.

The European Commission's latest progress report on the one hand states that "...the initial opening period of energy markets has largely been a success to date with, for example, electricity prices now being lower in real terms than in 1997...". It highlights as "the most important persisting shortcoming" "the lack of integration between national markets." ¹⁰ On the other hand, the European Competition Commissioner, presenting a preliminary report on the energy sector inquiry states: "we will act decisively to remedy the serious malfunctions identified on the energy market...". ¹¹

A survey by Eurobarometer, meanwhile, shows that general customer-satisfaction with electricity companies is very high, both in absolute terms and compared to other public utilities, such as mobile or fixed telephone services and public transport. ¹²

However, large energy-intensive customers have expressed concern about current price levels and the functioning of the market. ¹³

This criticism has certainly to be seen in the broader context of the different fundamental drivers of electricity prices: ¹⁴

- The cyclical component, which led to very substantial price decreases during the first years of liberalisation, linked inter alia to a situation of overcapacity
- The disappearance, in most countries, of the practice of artificial cross-subsidised pricing for industry
- The spectacular rise in fuel prices
- The inexorable increase in taxes and levies of all kinds, plus environmental costs.

Energy-intensive power users have raised concern over their current exposure to the volatility of wholesale markets, including the new CO₂ component. Their call for sufficiently stable long-term price signals and contracts must be taken into account and answered in a fully market-compatible way. ¹⁵

The overall conclusion is clear. The process of liberalisation has progressed but is still an ongoing business. Sustained efforts are therefore required to make progress on several important factors. Moreover, this progress is needed urgently in order to maintain momentum and confidence and to respond to the legitimate concerns of policy-makers, customers, and the electricity industry itself.

Two elements will be instrumental in achieving - or in failing to achieve - such progress:

- Speedy creation of regional markets as stepping stones to a European market and
- Speedy improvement of the consistency of the overall regulatory framework.

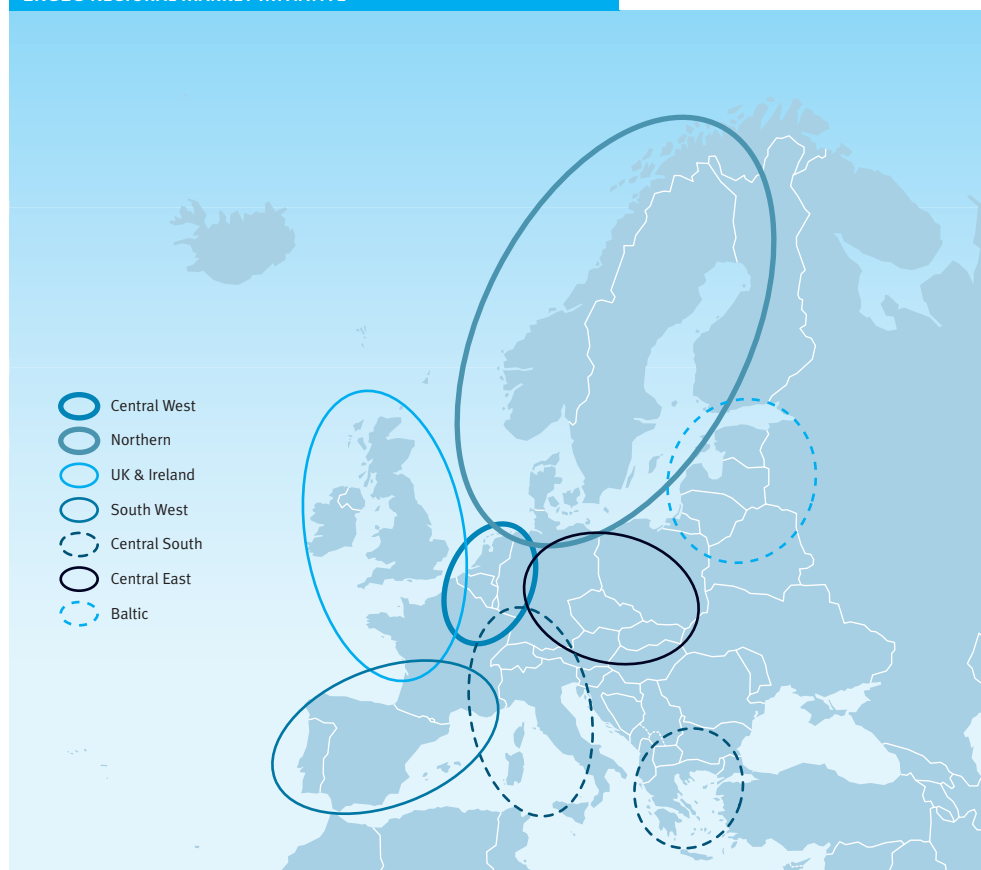
THE STEPPING STONE TO A EUROPEAN MARKET: REGIONAL MARKETS THROUGH AN ACTION- ORIENTED AND COOPERATIVE PROCESS

The European Commission launched in 2003 the strategy of developing markets first at regional level, judging as unrealistic the immediate achievement of a fully-integrated European-level market.¹⁶

This approach found general support, once it was clearly understood that the reality of overlaps between regional markets must be recognised and that consistency between regional market concepts is vital to facilitate their later integration. (Fig.1)

FIGURE 1

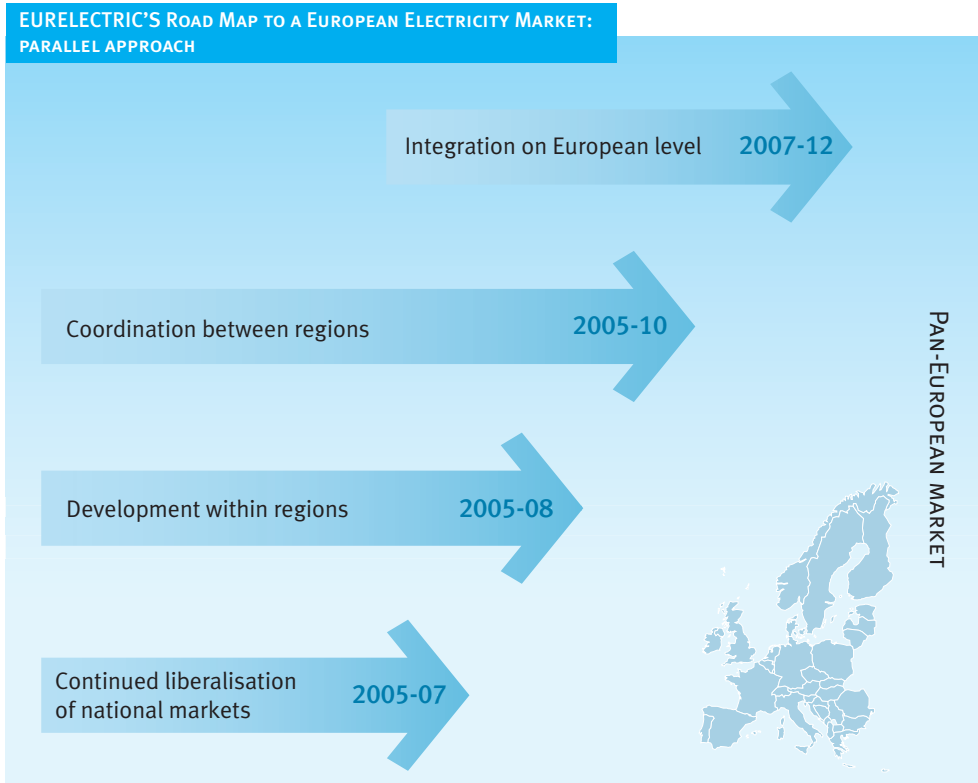
ERGEG REGIONAL MARKET INITIATIVE



Regional Markets according to ERGEG Regional Initiative

EURELECTRIC's *Roadmap to a Pan-European Market*¹⁷ is based on liquid wholesale markets as the key drivers to regional market development. The roadmap provides a detailed set of measures working in parallel to first dismantle the remaining barriers at national level through immediate and effective implementation of the European Electricity Market Directive; to achieve regional markets by 2009; and complete their integration on a European scale by 2012. (Fig.2)

FIGURE 2



EURELECTRIC's Road Map to a European Electricity Market

In parallel, European regulators' body ERGEG has also developed an approach and a vision on market evolution, based on similar concepts.¹⁸

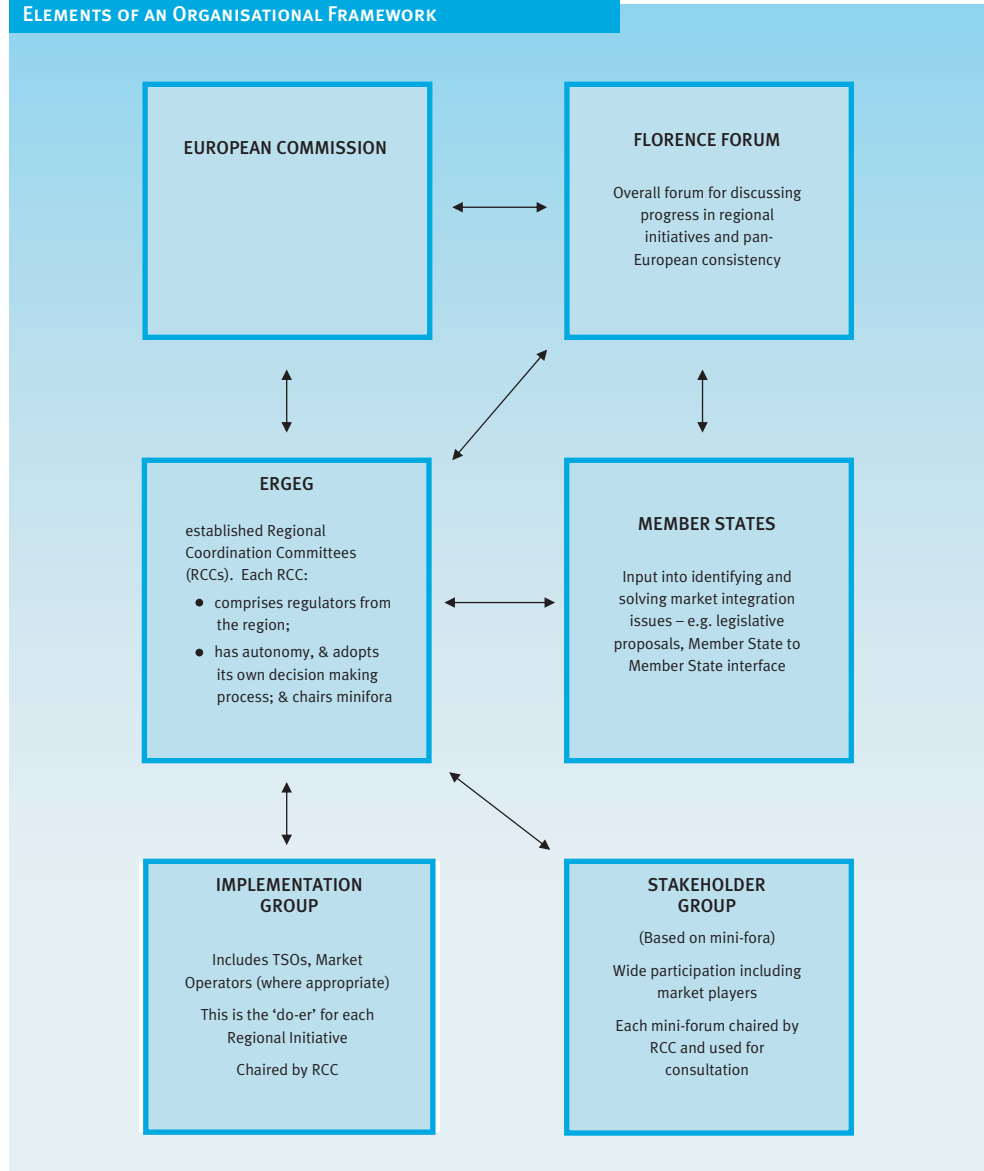
The European Commission, Member States, regulators and the electricity industry therefore largely agree on the importance of developing regional markets as a stepping stone to European integration.

However, the setting up of a process to make regional markets materialise started slowly. 2004/2005 saw "regional mini-fora" as one-off meetings with a single agenda point: transmission congestion-management. It was only at the Florence Electricity Forum of September 2005¹⁹ that a more thorough regional process was agreed.

ERGEG then launched "regional initiatives", with national regulators steering the process, accompanied by consultation and implementation structures:²⁰ (Fig.3)

FIGURE 3

**REGIONAL INITIATIVES
ELEMENTS OF AN ORGANISATIONAL FRAMEWORK**



Structure of ERGEG Regional Initiatives

These regional initiatives offer a unique opportunity for speedy progress, necessary action and implementation and therefore enjoy the strong support of the European electricity industry. But will they deliver in practice?

The first round of regional meetings ²¹ and the discussions in the Florence Electricity Forum of September 2006 ²² confirm and reinforce EURELECTRIC's opinion that the process can indeed deliver, but only if three key remedies are applied:

- **An ambitious agenda both in content and timing**
- **Steering with a European compass**
- **Cooperation with industry counterparts**

AN AMBITIOUS AGENDA BOTH IN CONTENT AND TIMING

The Florence Regulatory forum of September 2006 demonstrated that a wide consensus has emerged between policy-makers, regulators and industry on the priority agenda. The following issues should all be addressed – at European level where possible, at regional level where necessary – and with an ambitious timetable, expressed in months, not years:

- Development and integration of day-ahead, forward, intra-day and balancing markets
- Market transparency
- Effective unbundling of TSOs in accordance with the Electricity Directive
- Optimised use of existing transmission infrastructure
- Planning and operation of transmission grids from at least a regional perspective
- A role for market-based longer-term contracts to complement liquid wholesale markets.

These elements are vital for the market to function properly at regional level. They will moreover reinforce each other. For instance a regional approach to TSO work on grid planning, grid access rules, information exchange and market facilitation will strengthen TSOs' independence from any given power generation company.

A simultaneous and speedy approach to these key issues is therefore necessary.

STEERING WITH A EUROPEAN COMPASS

The current “regional initiatives” are steered by cooperating national regulators for each region. The European Commission, initiator of electricity market liberalisation and of the regional approach, is so far only playing an observer role in the process.

The regulators' initiative to take the leading role in the development of regional electricity markets confirms their strong commitment to an integrated European approach. However, national regulators have a predominantly national mandate. The second Electricity Market Directive contains one single and very general paragraph giving national regulators the responsibility “*to contribute to the development of the internal market and of a level playing field by cooperating with each other and with the Commission in a transparent manner.*”²³ Moreover, the agenda set out above is not necessarily covered by the competencies attributed to national regulators.

The conclusion therefore is that a much stronger role and involvement is required from the one institution that represents a purely European interest and has an encompassing competence: the European Commission.

COOPERATION WITH INDUSTRY COUNTERPARTS

Achieving the agenda set out above through new legislation or regulation at EU or Member State level is a process that can - and surely will - take many years, if indeed it is ever to come to fruition. This obviously does not fit with the need for urgent progress.

A fast track approach is however possible when for each of the aforementioned specific issues the relevant European authority - the European Commission or regulators

– enters into a direct implementation-oriented dialogue with the industrial players directly responsible for delivering on the issue, via their European associations.

Such a process of direct dialogue and cooperation would fully respect the need for consultation with any other stakeholders, would be based on full recognition of the public interest role of the public authorities, and would not hinder or delay the establishment of a firm legal basis whenever judged necessary. It would however provide an opportunity - on many issues a *unique* opportunity - to progress quickly on the basis of solid commitment.

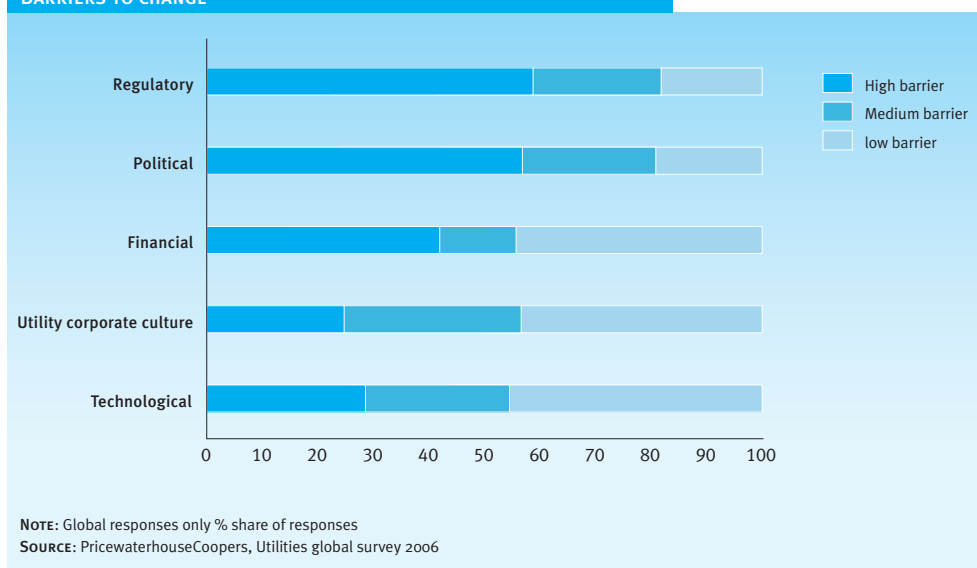
The route of rapid progress through implementation-agreements with industry should therefore be carefully considered. European power generators are ready, through EURELECTRIC, to make this approach deliver with effectiveness and rapidity, generation data transparency being an obvious first priority and test case.

NO INTERNAL ELECTRICITY MARKET WITHOUT AN OVERALL CONSISTENT REGULATORY FRAMEWORK

For many years the European electricity industry has been advocating a more coherent regulatory framework to develop a level playing field for the market, to improve conditions for investment, and to integrate environmental objectives into company strategies. Electricity companies and stakeholders have repeatedly identified regulatory instability or inconsistency as a key factor hindering market development and investments.²⁴ (Fig.4)

FIGURE 4

BARRIERS TO CHANGE



Survey of barriers to change addressed to senior executives of power utility companies worldwide

The key word here is “consistency” rather than expecting absolute stability. One cannot expect a static regulatory framework that does not respond to new developments. But the framework should nonetheless be robust, not subject to short term political oscillations and be consistent both between different policy areas and between different policy-makers involved in a given policy area.

Moreover, new regulation should never be put forward as a remedy for poor implementation of existing regulation. On this basis it is reasonable to expect an acceptable level of stability to emerge.

Consistency has a double dimension. On the one hand, there is need for consistency between different policy objectives so as to avoid aggregating incoherent or even conflicting policies and regulations. On the other hand, there is a need for consistency between the actions of different policy-makers at local, national and European level so that they all contribute to developing and implementing common policies and avoid hindering or contradicting each other.

Those familiar with the details of policy-making will be aware of the specific responsibilities of the European Commission and its various Directorates-General, the European Parliament, regulators, governments, national parliaments and administrations at national or sub-national level. For market participants, these distinctions are hardly relevant. What is relevant for them are the resulting obligations imposed by “government” as a whole.

The current inconsistencies either between policies or between policy-makers together form a formidable obstacle to the creation of a common electricity market, to improving the competitiveness of the European economy and to ensuring a sound investment climate. Some examples are:

- Incomplete implementation in many Member States of the 2nd package of energy market legislation
- Calls for new legislation before proper implementation of the existing package
- The different levels of market-opening in the natural gas market
- National reflexes with regard to “national energy champions”
- The persistence of regulated tariffs
- Failure to harmonise charges borne by generators to use the grid
- The near-impossibility of obtaining authorisations for new transmission lines
- The incomplete use of market-based approaches to congestion management
- Lack of coherence between the many policies and mechanisms related to the interface between energy and the environment
- Multiple national differences and the general dramatic increase in taxes, levies and support mechanisms weighing on electricity prices
- Differing national energy policies on access to and promotion of certain fuels and technologies
- Differing national policies to promote renewable energy sources and cogeneration, frequently neither least-cost nor market-oriented
- The short-term horizon of the EU Emissions Trading System (ETS)
- The lack of coordination between EU energy taxation policy and the ETS
- Differing national allocation plans for greenhouse gas emissions

Two elements are key to remedying this situation:

- **Political will**
- **A far-reaching initiative on “better regulation”**

POLITICAL WILL

A consistent regulatory framework in line with the goal of a European energy market can only be achieved if national governments and their institutions all work under the mottos “market” and “European”. *Market* development and *market* solutions must be preferred to non-market approaches as the most effective answer to Europe’s competitiveness agenda, to provide investments and find least-cost solutions to environmental problems. *European* solutions and *European* harmonisation must whenever possible be preferred to national policies or instruments, especially when these would lead to unnecessary costs or market distortions.

Unfortunately, as illustrated by the list above, the signals are not very encouraging at this stage. Many observers see a revival of national reflexes as a protective reaction to increasing concerns over energy supply security and rising energy prices. In contrast to this, there is nevertheless a growing consensus on the need for a more European approach to energy security as outlined by the European Council ²⁵, the Hampton Court process ²⁶, and the Green Paper on European Energy Policy. ²⁷ However, these initiatives have yet to deliver.

A FAR-REACHING “BETTER REGULATION” INITIATIVE

Improving the internal coherence of European and national policy-making on energy, environment and economic competitiveness is increasingly seen as a vital objective, as illustrated by the creation of the High Level Group on Competitiveness, Energy and the Environment. ²⁸ The Commission’s “Better Regulation” agenda can and should make an important contribution here. ²⁹

The systematic use of professional impact assessments prior to decision-making - not simply to rubber-stamp proposals - is an important tool for improving the quality and consistency of future regulation. The Commission is to be commended for starting the implementation of this tool, but it still needs development and, importantly, equal application at national level. ³⁰

Moreover, impact assessments will not be sufficient to bring about a satisfactory level of consistency in existing regulation. What is needed is an overall “better regulation” initiative ³¹ addressing the interfaces between policy in the fiscal, environmental, energy and competitiveness domains. This is by no means a small task. It calls for a comprehensive effort including at EU level several Commission Directorates-General and the involvement of member states.

However, the fact that the exercise is complex and can only fully deliver in the medium term does not reduce the need to undertake it. Such an initiative must be started up now. If not, European electricity markets will never be able to deliver in full.

CONCLUSION AND EXECUTIVE SUMMARY

Electricity market liberalisation is a process, not an event. Notwithstanding the progress already achieved, further sustained efforts are needed to accelerate progress on several key factors that together can ensure the satisfactory functioning of the market.

There is general consensus that the development of regional electricity markets is a necessary stepping stone to a European market. The current “regional initiatives” therefore provide a unique opportunity for rapid progress. However, in order to make them deliver with the necessary speed of action and implementation, vital remedies are needed, including the setting of an ambitious agenda both in content and timing, strong involvement and steering from the European Commission and cooperation with key industry counterparts to achieve “fast track” implementation.

Nevertheless, the market will never deliver in full without a broad regulatory framework that is robust, consistent and not subject to short term political reactions. The European electricity industry has for many years been calling for a more coherent regulatory framework to develop a level playing-field for the market, to improve conditions for investment, and to integrate environmental objectives into company strategies.

Such a consistent framework requires political will to prioritise market development and market solutions, wherever possible on a European scale rather than a national one. In addition, besides the implementation of professional impact assessments at European and national level for any new legislative proposals, a far-reaching initiative must be launched to address the interfaces between policies in the fiscal, environmental, energy and competitiveness domains.

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- 7 EURELECTRIC position paper “Towards one generic switching model in Europe” - April 2006
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- 28 Commission Decision setting up a High Level Group on Competitiveness, Energy and the Environment (2006/77/EC) – 8 February 2006 and First Report of the High Level Group on Competitiveness, Energy and the Environment “Functioning of the energy market, access to energy energy efficiency and the EU emissions trading scheme” – June 2006
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