ERGEG Call for evidence on incentives to promote cross-border trade in electricity

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A EURELECTRIC response paper

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EURELECTRIC Response to ERGEG Call for evidence on incentives to promote cross-border trade in electricity

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EURELECTRIC Response to ERGEG Call for evidence on incentives to promote cross-border trade in electricity

EURELECTRIC welcomes ERGEG's Call for Evidence as it allows a discussion of how to set appropriate incentives for electricity TSOs to enhance cross-border trade possibilities for market operators and thus to contribute as much as possible to European market integration.

Our comments reflect the wish to promote an efficient internal market for electricity and to contribute to a sensible solution for issues such as:

- maximization of cross-border capacities across all time frames as required by Article 6 (3) of Regulation 1228/2003, respectively Article 16 (3) of Regulation 714/2009, and
- financial firmness of those capacities once allocated (on daily, weekly, monthly, quarterly, yearly or even multi-yearly basis)

Moreover, we support the introduction of incentive schemes for specific projects (i.e. market coupling, cross-border intraday and cross-border balancing markets) as a contribution to speed up the implementation of certain market integration initiatives which are urgently needed.

We believe the ERGEG paper is a very good starting point for debating possible solutions. However, we should avoid the risk of focusing too much on the theoretical side trying to identify the "ideal" incentive scheme and thus delaying the implementation of instruments which, even if by definition cannot be perfect, can surely represent a step in the right direction. In this context, we believe that some pilot projects could be launched in order to test the different proposed indicators and gain valuable experience for the future..

Last but not least, we share ERGEG's remark that market integration must also provide an increased security of supply. In this context, whatever scheme of incentive is adopted to support cross border trade, it should be avoided to prejudice network security.

1. **In the current regulatory and institutional framework could incentive schemes be a useful tool for promoting cross-border trade? If so, why?**

   We observe on many European borders that interconnection capacities available for trading have decreased over the recent years (this particularly applies to annual capacity products). Taking this shortcoming into account, and considering the natural information asymmetry between TSOs and regulators, we find the objective of introducing incentives to promote cross-border trade not only useful but also necessary. TSOs, which play a major role in facilitating cross-border trade, need to be economically encouraged At the same time, this does not mean that regulators should only rely on incentives: they should strive to reduce the information asymmetry and to improve transparency..

   Incentive schemes to promote cross border should be based on the level of achievement of determined performance indicators. It is clear that TSOs can not control completely the achievement of the established thresholds of performance indicators; however, their effort is a necessary (although not sufficient) condition for a successful outcome, and should therefore be encouraged via appropriate incentives.

Considering the above mentioned partial control that TSOs have on the promotion of cross-border trade, it should be considered carefully how appropriate would be imposing penalties in case that such thresholds are not achieved.

At the same time, if only positive incentives are established, there's a risk that the TSOs would privilege that specific objective that grants them a financial incentive at the expense of other targets (or geographical areas) where there are neither penalties nor rewards.

The same considerations apply to ongoing or planned projects such as a common set of auction rules, market coupling or cross-border intra-day markets which are urgently needed and could be incentivised to complete a timely implementation.

We are not of the view that a single indicator could and should cover all aspects. Although we acknowledge that this consultation has a specific focus on short-medium term, we believe that other "pillars" are needed, via separate incentive schemes, to ensure that TSOs have in their own interests the promotion of further market integration:

- **Short-term**: maximisation of cross-border capacities, optimal distribution of capacities across the different timeframes
- **Mid-term**: incentives for timely implementation of market integration projects
- **Long-term**: appropriate remuneration and regulatory framework for new grid investments with regional or EU social welfare benefits

However, it should be noted that the use of congestion revenues is fully regulated under Article 16 (6) of Regulation 714/2009. This means that any short-term incentive in a form of extra income for TSOs to be financed with congestion revenues requires an analysis of the mentioned article as stated under the paragraph 4.4 of the Call for Evidence and could need regulatory changes. EURELECTRIC therefore advises to amend this provision in the Regulation 714/2009 accordingly to allow the introduction of incentive schemes financed with congestion rents.

2. If not, which regulatory or other framework would be more suited to promoting cross-border trade?

We believe that TSOs' cooperation and market rules harmonisation should be encouraged to facilitate cross-border trading.

We also see opportunities to promote cross-border trade also by incentivising regulators to minimise the burden of licensing requirements[1] on traders and generators across Europe.

3. Do you agree with the features of an "ideal" incentive scheme? If not, why not? What features should an "ideal" scheme have?

We agree with the features proposed on this consultation.

[1] A quick and practical improvement, for example, would be the adoption of a common language (e.g. English translation) for all documents that refer to cross border trading.

However, we do not think that an "ideal" incentive scheme, as described in your consultation document, can be achieved for cross-border trade. There are too many external factors that TSOs cannot influence and situations are different around Europe. For instance, the picture under example 2 (page 25) indicates how social welfare increases with increasing cross-border capacity. However, the social welfare not only depends on the additional cross-border capacity, but also on the slope and the form of the NEC curves, these depend on their turn amongst other on the availability of the generation parks, on the fuel and CO2 prices, etc; all these factors are out of TSO control.

Where in one year, a huge additional social welfare might be created due to additional cross-border capacity, the next year, this additional welfare might disappear or be very limited after a new generation investment on one side of the border because this could completely change the shape of the NEC-curves and thus affect profoundly this potential incentive indicator. We would rather like to see incentives targeted to the most important issues.

An "ideal" incentive scheme should take into account the strong link between national and cross-border congestion management. The most important principle here is that there should be no discrimination between internal and cross border lines. The interactions between national and cross-border capacities are not purely theoretical. There are several examples (Australia, Nordel, France-Germany-Netherlands-Belgium).

The European Commission's 2007 sector inquiry recognised the link between national congestion and cross-border trade, and also noted that this was an area where further attention and investigation was required. Depending on a given cost allocation and/or incentive scheme the TSO can arbitrate between pushing congestions to the border or increase internal congestions. This is one of the shortcomings of having several TSOs in one synchronous area. The enclosed report by The Brattle Group provides some additional details on this point.

Similar issues arise when investment incentives are considered. A recent report on investment prepared by consultants for the German regulator recognised, but did not discuss in detail, the link between internal congestion and cross-border flows, noting that TSOs "might not have sufficient incentives to consider fully the potential for transmission investment that enhances cross-border flow"[2].

4. This paper presents "short-term" incentive schemes for improving capacity calculation and allocation methods. Should an incentive scheme address these short-term incentives together with longer-term incentives, e.g. for infrastructure investments? If so, how?

Obviously any short term incentive must generate an economic benefit to the system. So, if the introduction of a certain incentive implies some costs to be charged to the network users, they must be lower than the measurable benefits of the TSO's action to improve market integration.

[2] Frontier Economics & Consentec, 'Improving incentives for investment in electricity transmission infrastructure' November 2008, p.39.

Long-term grid investments incentives need to be financed through appropriate return on investments and, thus, grid charges. It might be reasonable to define a higher return on investment for projects with cross-border relevance which lead to a higher social welfare for a whole region or for the whole of EU. Furthermore regulators should ensure that such transmission investments can be financed with appropriate cost sharing schemes among the different countries benefiting from the investment[3]. A first step to facilitate the set up of such cost-sharing schemes would be the harmonisation of rates of return across the different Member States.

We believe that the ENTSO-E 10 year Network Development Plan is a good approach to identify the more urgent priorities for grid investments in Europe. In any case we think that long-term investments should be treated in a different consultation process.

5. **Which approach presented in this paper do you favour: an incentive scheme based on a single indicator of performance reflecting the efficiency of congestion management as a whole (Chapter 2), or one or several incentive schemes aiming at fostering one or several specific projects or topics related to congestion management (Chapter 3)? Why?**

   We believe that single performance indicators are too complex to be implemented and could potentially lead to distortions. There are too many external factors that TSOs cannot influence and too many different contexts in which TSOs operate around Europe. Moreover, these types of indicators would be intrinsically difficult to ensure a coordinated approach to domestic and cross-border-related incentives. If, for instance, we try to measure firmness of cross-border capacity, how can we ensure that this value is not increased at the expense of domestic firmness?

   However, we consider that the investigation of appropriate single indicators must continue, with the aim of designing an appropriate package of quantitative indicators to measure TSO performance, and we are willing to contribute in this process.

6. **Which, if any, of the indicators presented in Chapter 2 do you favour? Why? Do you have any alternative proposals for a single indicator of performance?**

   All of the incentives in chapter 2 have their drawbacks and may not lead to necessarily positive results. As previously mentioned, they are also difficult to integrate in a consistent manner dealing with domestic and cross-border congestion management, In the short term, we believe that project specific incentives (see question 7) can have a far larger effect on market integration than the ones described in chapter 2.

   However as already stated, this does not exclude that some pilot projects should be launched in order to test the different proposed indicators. This would allow acquiring experience on possible implementation complexities or unforeseen adverse effects, and eventually on how TSO react to such schemes.

[3] For this purpose, see also EURELECTRIC Report on Regional Transmission Investment Incentives – October 2008.

7. **Which, if any, of the incentive schemes presented in Chapter 3 do you favour? Why? Do you have any alternative proposals for a specific project or combination of projects which could usefully be incentivised?**

   EURELECTRIC considers that there is a set of specific projects or topics related to congestion management that should equally be encouraged through an incentives scheme, such as market coupling between countries or regions, continuous cross-border intraday market, cross border balancing, etc. Obviously the objective will differ according to the situation of each region (in some regions in which there is a market coupling in place, maybe the objective should be a continuous intraday or cross border balancing, etc).

   It is fundamental to ensure that these incentives schemes for implementation project, are fully in line with the planned achievement of the EU target models for 2015 identified by the European Commission within the Market Integration Design Project.

   The development of bottom-up initiatives by TSOs (and other stakeholders) will have to be incentivised in a consistent manner, in order to avoid overlaps or incoherencies. In this respect, the work initiated by the Project Coordination Group and brought forward by the Ad-Hoc Advisory Group to ERGEG (AHAG), will provide via its market integration roadmaps (for the moment regarding market coupling, cross-border intraday, and capacity calculation) an essential benchmark for prioritisation of projects and their expected target date of completion.

   The financial incentive could be subject to the implementation of the specific project before a certain date (set according to the roadmaps agreed by the stakeholders in the AHAG work) or with a certain degree of cost recovery. Once the objective/project defined is reached the indicator should disappear (once there is a market coupling between A and B the incentive to get it will disappear and perhaps should be replacing by other, e.g. cross border balancing). A proper weight should be given to each defined objective in the final formula in order to have a balance design.

8. **Despite the potential limitations of all indicators for implementing an incentive scheme, do you share the view that their publication before any incentive scheme is set could help promote the development of cross-border trade and represent a step towards increased transparency?**

   Yes, we believe that ex-ante publication of all performance indicators will set the basis to the incentives scheme design. Regulators and market stakeholders will have more information at their disposal to evaluate different contexts while TSOs may be encouraged to improve performance indicators to show their commitment in facilitating cross-border trade. Definitively the publication of the indicators will help promote the development of cross-border trade and represent a step towards increased transparency.

   This publication will also give more visibility to the fulfilment of the Congestion Management Guidelines requirements and of the objectives defined in the framework of the Market Integration Design Project.

9. If so, at which frequency and on which geographical scope (bilateral/regional/European) should these indicators be designed and published?

We recommend targets and incentives to be coordinated on a bilateral or, ideally, regional basis: since part of the incentive should also depend on the success of neighbouring TSOs this would encourage constructive cooperation among TSOs.

10. What would be alternative options for promoting cross-border trade?

A stronger focus on TSOs cooperation and prioritisation of specific projects at regional basis would result in faster development of market integration. Also accepting existing solutions rather than reinventing the wheel again would speed up integration and avoid unnecessary development costs. We recommend ERGEG and national regulators to develop clear regulatory schemes (e.g. on transmission tariffs and firmness of capacity) for the connection of merchant cables. Reduction of regulatory uncertainty can help the development of merchant cables and therefore promote cross-border trade.

11. ERGEG welcomes any additional contributions that could help regulators to define an incentive scheme aimed at promoting cross-border trade.

We recommend Regulators to remove any other potential disincentive for cross-border trade such as the current Inter-TSO Compensation mechanism, which creates some distortions among TSOs and Member States. The ITC mechanism has in EURELECTRIC opinion not been developed to create incentives for cross-border investments; however, in investment scenario analysis, the impact of the ITC mechanism needs to be taken into account. Moreover, the absence of a long term decision on the ITC mechanism serves as an uncertainty for transmission investment, and could be seen as a disincentive in itself to enhance cross-border capacity and therefore cross-border trade.

Finally, we recommend ERGEG to analyse the effectiveness of existing incentive schemes (e.g. the bonus malus scheme that was applied on the NorNed interconnector) before developing new incentive schemes.

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