

## BDEW Position Paper

### **on ERGEG's Call for evidence on Incentive Schemes to promote Cross-Border Trade in electricity**

March 26, 2010

The German Association of Energy and Water Industries (BDEW) represents 1,800 members of the electricity, gas and water industry. In the energy sector, we represent companies active in generation, trading, transmission, distribution and retail.

## **General Remarks**

BDEW welcomes the opportunity to comment on ERGEG's call for evidence on Incentive Schemes to promote Cross-Border Trade in electricity.

As ERGEG addresses in the paper, market integration is the prerequisite for the creation of a single European electricity market. This objective has been adopted by the European Union for several reasons, all of which aim to optimise the efficient use of the existing European electricity infrastructures as well as its further development.

First, market integration allows for the use of resources at a European level. This leads to several types of efficiencies, since national consumption curves as well as national generation parks are complementary and reserve capacity can be shared.

Second, market integration fosters competition between suppliers as well as between producers on a regional and ultimately on a European level.

Third, market integration provides for greater security of supply, because national generation capacity can be used across borders.

TSOs are major actors in this process of market integration as they are responsible for the development of new methodologies to improve the efficiency in the use of existing infrastructure as well as for developing new infrastructure. With regard to the use of existing cross-border infrastructure TSOs are, according to Regulation (EC) 714/2009 and the preceding 1228/2003, in charge of calculating the cross-border capacities, allocating these capacities to the market and publishing the data related to these capacities.

In this sense BDEW shares the basic philosophy of ERGEG as set out in chapter 1.1 of the consultation paper. The same is true for the points raised by other stakeholders in chapter 1.3.

BDEW also strongly supports the influence of transparency on the methodology of calculation and availability and usage of capacities for cross border trading which this initiative will have. This will by itself have a positive impact.

## Specific Remarks referring to the questions of chapter 1.4 of the consultation paper

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

Presently, neither the current European regulatory framework nor national German legislation encompasses incentives for promoting cross-border trade. Despite being involved in several market integration initiatives (e.g. CWE) TSOs are not financially remunerated for this service which they provide to the market. TSOs have to recover their market development costs from predetermined and capped incomes, which means that a reduction of these integrating efforts would bring financial advantages. Establishing positive financial incentives might be an enhancement to the present regulatory framework. Market integration could be pursued more actively by rendering market development activities financially attractive for TSOs.

However, any incentive scheme would have to be implemented cautiously. Especially the indicators which would be used to measure TSO performance must be carefully chosen. It has to be acknowledged that many performance indicators will also depend on external factors such as the behaviour of other market parties.

This leads to the conclusion that positive incentives to TSOs on a moderate level might be a useful tool to enhance the current regulatory and institutional framework. Any adverse impact on system security should be avoided.

Ongoing projects such as the development of common sets of auction rules, market coupling or improving intra-day markets could be incentivised for their timely implementation. However, also all other partners in such projects like power exchanges and regulators have to do their share of work. In this context it has to be acknowledged that the project realization not only depends on TSOs. Other parties such as e.g. power exchanges are also involved. In order to avoid any unfair negative impact on TSOs, incentive schemes should exclusively consist of positive financial incentive payments.

However, we do not propose that a single indicator should cover all aspects. Although we acknowledge that this consultation has a specific focus, we even think that a comprehensive incentive scheme should include three pillars:

- **Short-term:** maximisation of cross-border capacities subject to the given technical constraints, optimal distribution of capacities across the different timeframes in case a clear preference from market participants can be identified.
- **Mid-term:** project related incentives for timely implementation.
- **Long-term:** appropriate and sufficient remuneration of new investments.

However, any financial incentive financed by congestion revenues will face the problem of being conditioned by regulation. This means that a financial incentive needs changes in existing regulation, which can cause difficulties in the implementation.

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

The promotion of cross-border trading in order to facilitate an integration of the European electricity market can not only rely on efficient cross-border capacity allocation. Sufficient and efficient use of cross-border capacities is only a necessary condition; external effects are also to be taken into account.

For the incentive regime, we see the following necessary framework:

**Long-term incentives** for investment need to be financed through appropriate return on equity rates and, thus, grid charges. It might be particularly reasonable to define a higher return on investment for projects with cross-border relevance which should lead to higher interconnection capacities. This applies particularly for borders where there is no interconnection yet or where the interconnection is not sufficient. Furthermore, regulators should monitor transmission investments with effective impact assessments and economic cost benefit analyses to ensure positive socio-economic outcomes from a European perspective.

**Mid-term incentives** would allow focussing on the implementation of specific projects which facilitate cross-border trading and consequently further market integration. This could apply to market coupling projects where market participants face frequent delays. It would be even more important to push ahead with intra-day projects. Even if not all responsibilities rest with TSOs, financial incentives will help to make the causes for delays more transparent for regulators. This kind of transparency can be expected to motivate the entities involved to find acceptable solutions in a more timely manner.

We furthermore see opportunities to promote cross-border trade by minimising the burden for trading companies to trade cross-border (e.g. remove licensing requirements where they exist). This could be easily implemented as a low cost measure.

It is also fair to say that the **Inter-TSO mechanism** must provide an adequate recovery of costs for TSOs which host transits. These costs as well as congestion revenues need to be treated in a reasonable and fair manner when setting revenue caps in the national environment. This is compliant with existing and future European legislation. Otherwise it may create an incentive to restrict transits or to lower available cross-border capacities.

## **3 Do you agree with the features of an “ideal” incentive scheme? If not, why not? What features should an “ideal” scheme have?**

The features are an appropriate starting point for evaluating incentive schemes. However, we do not believe that an “ideal” incentive scheme, as described in the consultation document, can be achieved for cross-border trade. Further indicators might be added in order to obtain a more comprehensive evaluation. One such indicator of particular relevance would be “impact on system security”.

Any negative influence of incentive schemes on this parameter should be excluded. On the other hand there are many external factors that cannot be influenced by TSOs. Targeting the most important issues might be better than linking incentives to a single issue.

In any case, it should be possible to backtest the indicators to demonstrate the applicability and its efficiency. BDEW supports a transparent process in the further development and proposes an early consultation on the final proposals to involve all parties.

**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?**

Yes. Long and short term incentives can be related. TSOs should be positively incentivised to increase market integration through market development activities (short term) and by providing the necessary infrastructure (long term). There are examples of positive long term incentives e.g. in form of capital cost surcharges on particular types of investments.

**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?**

The concepts of congested hours and of congestion costs seem to be hardly applicable to a system based on the flow based approach. This is due to the fact that at least the basic versions of both approaches as set out in chapter 2.1 and 2.2 are linked to bilateral markets. It would be worthwhile to explore how both concepts might be modified in order to fit into a flow based capacity calculation.

The social welfare criterion as described in chapter 2.3 is better suited for a multilateral environment which characterizes regional markets. As the report rightly states, the social welfare generated by cross-border flows within a region with several markets would be the sum of the social welfare generated by cross-border flows at each border within the region. The social welfare criterion might also give a meaningful incentive for proper investment decisions on additional interconnector capacity (or the removal of bottlenecks within a country). The main drawback of social welfare is the difficulty to identify the impact of individual parties on this indicator.

There are supporting reasons and counterarguments for both approaches. The main advantage of a single indicator is the clear focus on the overall aim “EU social welfare”. Several indicators can be used as long as they contribute to the overall target. While these indicators tend to be more (still not fully) controllable by TSOs, the extent of their contribution to the overall target is uncertain.

**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?**

BDEW has no clear preference for one particular indicator. "Social welfare" describes the ultimate target of market integration activities. The indicator "number of congested hours" should be implemented to avoid negative impact on system security. However, if this indicator is refused it must be clear that this indicator is extensively dependent on external factors (e.g. wind generation).

**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?**

We believe that incentives schemes could be a useful tool as TSOs take daily decisions related to cross-border capacities where trade offs have to be considered. Appropriate incentives would ensure that TSOs adequately prioritise cross-border trade.

The drawbacks of a pure capacity maximisation approach are rightly given in chapter 3.1. Additionally a TSO might be tempted to draw a problematic balance between network security and profit maximisation.

In regions which have not introduced market coupling or market splitting an introduction date for such a system as proposed in Chapter 3.2. may be a useful part of an incentivisation regime. Such incentives should consist of positive financial payments only. This would ensure that TSOs are not disadvantaged for delays caused by other involved parties. Furthermore, it is evident that it does not lead to further improvements in markets that have been coupled already.

A combination of incentive schemes by generating expressed in an index as described in chapter 3.5 may be a good approach. But it has to be acknowledged that it highly depends on information and experience gathered by regulators. It therefore may require experience that is not at hand up to now in order to devise, calibrate and administer such an approach.

We favour the following two incentive parameters to be combined to an index:

- **Optimisation of the distribution of transmission capacities among the different timeframes is very important for cross-border trade and can to a large extent be influenced by TSOs. Maximising long-term capacity that is auctioned as physical or financial transmission rights should be encouraged. The main drawback of this indicator is that some market participants might favour short term products.**

Explanation: This incentive parameter would motivate TSOs to allocate as much capacity as technically possible to long-term timeframes such as (multi)year- and month-ahead. It would contribute to a higher liquidity in forward markets and help to make price expectations converging.

- **Maximisation of cross-border capacities has a clear value to cross-border trade. The number of congested hours should be used as a very sensible proxy which an individual target value for each border. In a regional environment this parameter should be substituted by the indicator of social welfare.**

Explanation: As natural complement to the first parameter TSOs would be incentivised to improve their day-ahead capacity calculation, find economic solutions for cross-border redispatch etc. This could increase available day-ahead capacities (even for a small number of hours per day). However, this parameter is to a large extent influenced by external factors (e.g. wind generation). It also sets an indirect incentive to contribute to an acceleration of market coupling projects even if it should be incentivized separately.

These indicators could be combined into one index for cross-border trade.

## **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?**

The publication of indicators in a discussion phase might be helpful. This could help to promote the development of cross border trade and represent a step towards increased transparency and trust. It will also increase the understanding of specific TSO behaviour in order to facilitate a functioning market. However, it has to be acknowledged that resources are required to gather such information (personnel, IT). Therefore, the published information should be limited to such information that really brings value to market players.

As rightly stated in the consultation document in chapter 1.1.5. "The objective of a regulator is therefore to define an incentive scheme(s) that will achieve an optimal trade-off between all these different factors. It is highly probable that the goal will not be achieved with the initial set of incentives. For instance the European electricity market will look much different once the target models agreed in the Florence Forum will have been reached. Therefore it seems advisable to devise a learning incentive system and structure implementation in line with experiences on all effects.

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

The publication should take place in the discussion phase. The regional scope should comprise the market region for which the framework is being discussed. Thus, every TSO should have its own target within the same incentive scheme for a regional market taking in consideration also the inter-regional integration. Particular attention on avoiding conflicting provisions between the frameworks of different regions should be given.

Therefore, the incentive regime should be a harmonised framework based on one set of indicators that allows the calibration for individual TSOs.

While setting targets TSOs that are already contributed to a major extent to regional integration should not be discriminated vis à vis TSOs that just are going to prepare first steps for market integration.

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

The first great leap towards the integration of Europe's national energy markets was the launch of the Electricity Regional Initiatives (ERIs) through the European Regulators' Group for Electricity and Gas (ERGEG) in February 2006.

There have been a number of measures which have already improved the efficiency of the cross-border transmission and the transparency of its allocation.

- Improvements in auction rules: The auction rules have been revised every year to achieve common efficient rules for the capacity allocation.
- Improved transparency: The allocation is organised on common auction offices, organized on web platforms which has increased the transparency of the allocation.
- Increased product variety: The capacities can be bought on different terms (yearly, monthly, daily, intra-day).
- Improved liquidity: Acquired capacity can be resold on secondary markets.

### **10.1 Additional contributions that could help regulators to define an incentive scheme aimed at promoting cross-border trade.**

In the following we would like to address several points which we see as important in the definition of an incentive regime.

- Congestion cost is a good measure from a society perspective, but not a fair measure of TSO short term performance. This indicator is affected by merit orders on both sides of the border which are the major drivers for congestion costs.



- Social welfare generated by cross-border flows is a very good measure from a society perspective. However, this indicator is also dependent on external factors (e.g. change in demand and supply curves).
- Implementation of market coupling and cross-border balancing are important measures to improve cross-border trade. However, these measures are not related to the daily operations of TSOs. We therefore think that incentives in terms of a single indicator are not the best way for regulators to make sure that these measures are implemented.
- Details on price areas, including the existence or duration of price areas, percentage of time per year for every price area (e.g. existing in Nordic market) are very specific indicators for the Norwegian TSO and precipitation is more important than short term TSO actions for existence or duration of price areas.
- Annual congestion income for every TSO. Price levels are very important and in the Nordic case precipitation is more important than short term TSO actions for the annual congestion income.
- Annual countertrade costs for every TSO. Price levels and availability of power plants are very important and more important than short term TSO actions for the annual countertrade costs.
- Annual duration of normal transmission capacity per interconnection, percentage of time. This would be an appropriate option for an incentive scheme as TSO can influence this to a large extent.
- Annual price difference between bidding areas. TSOs can only influence this to a very limited extent short term. Furthermore, TSOs take such actions with market impact not to influence prices but to ensure system security.
- Price differences across the interconnections compared to transmission capacity. TSOs can only influence this to a limited extent short term.
- Reasons for capacity reductions per interconnection. It is interesting for regulators and market participants to understand the reasons, but it would be difficult to base an incentive scheme on this.

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