EFET response to

ERGEG's Call for Evidence on Incentive Schemes to Promote Cross-Border Trade in Electricity (E08-ENM-07-04)

We welcome and appreciate ERGEG's Call for Evidence as it allows a discussion of how to set appropriate incentives for electricity TSOs to offer as much as possible cross-border capacities and, hence, to contribute as much as possible to European market integration.

Our amendments reflect the wish to promote an efficient internal market for electricity and to contribute to a sensible solution for overdue 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 long-term.

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 cross border trading have decreased over recent years. This particularly applies to annual capacity products. Taking this shortcoming into account, we find any incentive to promote cross-border trade is necessary.

The same applies to accelerating the implementation of ongoing projects such as a common set of auction rules, market coupling or intra-day allocations for which TSOs could be incentivised (either positively or negatively) with respect to their timely implementation.

However, this does not mean that a single indicator should cover all aspects. Although we acknowledge that this consultation has a specific focus, we envisage that a comprehensive incentive scheme should comprise several criteria:

- **Short-term**: rewards for achieving maximisation of cross-border transmission capacity availability and optimal allocation of capacity across various timeframes (i.e. achieving a market-friendly range of transmission right maturities)
- **Medium-term**: project related incentives for timely implementation of congestion management improvements sanctioned or ordered by regulators
- **Long-term**: appropriate and sufficient remuneration of new investment in transmission infrastructure which relieves binding cross-border congestion

Short and medium-term incentive structures to promote cross border trade should be based around compliance with existing legal obligations on TSOs, arising from EU regulations and associated binding guidelines specific to electricity markets, as well as from EU competition, trade and investment laws. In this context it is worth noting that the Annex to Regulation 1228/03 (“the current Regulation”) sets out legal obligations on TSOs and goes beyond mere “objectives”. As a consequence, regulators must ensure that these legal requirements are reflected *ex ante* in the allowed revenues of the companies owning and/or operating the HV networks. For example, TSOs should already have the financial resources available to them to establish intraday markets since these are existing legal requirements. Incentive schemes should not be used as an excuse for failure to deliver on legal obligations, on the grounds that they are “not generous enough”.

Thus in the short term it is desirable that incentives be provided only for “over-performance” on the basis of agreed indicators, starting from current practices. This will provide a framework for the exchange of information between TSOs and regulators and lead to a better understanding of the improvements needed. Any such scheme needs to be based on simple indicators, that can be measured on a reasonably reliable basis and that focus on criteria under the control of the system operators.

Short term incentives could be financed by grid charges or congestions rents. In case congestion rents are used directly (rather than indirectly) it has to be clarified if that would be compatible with the IEM Directive and with Article 6(6) and Article 16(6) of the current Regulation.

Clearly, there will still be issues relating to information assymetry in designing the baseline indicators just as there is for ensuring that legal requirements are met. Initially it may be that TSOs are able to perform well against the targets set and this likelihood needs to be accepted by regulators. However TSO performance against targets will gradually reveal information about what is feasible and this will allow progressively more challenging targets to be established. Even the establishment and reporting on an agreed set of targets will begin to help increase understanding of what is feasible, irrespective of how the incentive scheme functions.

We agree that incentive schemes would provide a useful enduring solution as a complement to the existing binding requirements, which have proved difficult to enforce. It is true indeed that some structural counter-incentive effects may have to be relieved, if we want any progress to be made in a number of areas. One of these counter-incentive effects, for example, is that by increasing the volume of capacity offered to the market, TSOs both increase their risks and may even decrease the congestion rent. EFET has already proposed in the past various solutions in order to tackle this problem, such as the possibility for TSOs to buy-back capacity from the market before being forced to curtail. Another will be improved firmness, which will at once induce market participants to offer more money from the certainty they acquire and open the way for the introduction of complementary transmission products, such as flow obligations and options to interrupt. We believe, in sum, we have shown that quite a wide range of solutions could be implemented, in order to incite TSOs to improve their performance, without jeopardising network security.

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

Medium-term or long-term incentives need to be financed through appropriate regulatory revenues, to provide a suitable return on equity to TSOs. It might be reasonable to define a higher return on investment for projects with cross-border relevance, which lead to a higher availability to the market of interconnection capacity. Furthermore, regulators should monitor that TSOs give priority to those transmission investments, which can make a positive contribution to European power market competition on a cross-border basis.

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

In principle we agree with most of the features proposed with the following comments:

We have concerns that the "*designed to maximise consumer benefit*" criterion is too static a concept. Incentives may imply a cost to consumers in the short term but be beneficial in the long term. It has typically proved difficult for regulators to evaluate short term costs against longer term benefits or to "prove" the benefit of any particular action against a counterfactual.

We agree that the criterion "*controllable by TSOs*" is also an important feature, although the concept of controllability suffers from the potential information asymmetry inherent in the setting of incentives by regulators. Thus it will be crucial to check that apparently poor performance on any indicator is not falsely ascribed by a TSO to external factors, without a regulator being able to assess this explanation easily.

The idea that incentives should be "*applicable EU wide*" implies a co-ordinated approach across the EU or initially within regions. Even if incentives are not initially identical in every nation or region, there should be co-ordinated assessment by regulators concerned, or by ACER, of results.

Finally we have strong reservations about the criteria "*compatible with other national and EU priorities*". There will inevitably be conflicts and trade-offs between national objectives. **There may very well be striking clashes between cross-border trade objectives and RES generation priorities**, given the EU failure to harmonise subsidies for renewable output and to make instruments evidencing that output tradable on a European basis. **It is important that both regulators and TSOs defend their CB trade-related obligations when faced with any such clash in future.**

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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?*

We think that an incentive scheme should primarily focus on short-term actions which are the daily business of TSOs. Any other measures, such as projects relevant for market integration or investment, should be incentivised in a different way as described in our answers to questions 1 and 2. To state it clearly, **short-term and longer-term incentives should not be combined, in order to avoid a very complex incentive regime.**

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 prefer a simple, dual incentive parameter approach, as described in our answer to question 7.

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?*

As described above **there are many external factors that TSOs cannot influence, which make the application of indicators presented in Chapter 2 difficult.**

In theory congestion hours (2.1) could be a good indicator to evaluate which binding bottlenecks could benefit from improving the capacity allocation mechanism and might be further relieved by new investments, as explained in the example. Congestion costs (2.2) would be a good indicator of the market appetite for any such solutions. Social welfare (2.3) would be a good instrument to measure the added value of a proposed new capacity allocation mechanism, and in order to define priorities when there are conflicts between various projects. We thus believe that these indicators can be relevant in terms of regulation and decision-making, but would not be relevant as incentive criteria. **The parameters depend too much on market variations, such as the availability of generation assets and changing fuel prices, which can change radically the commercial flows and thus the congestion result.**

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

1. **Achieving maximisation of cross-border transmission capacity availability**
2. **Optimal allocation of capacity across various timeframes (i.e. achieving a market-friendly range of transmission right maturities)**

   <u>Justification for 1</u>:

Maximisation of cross-border capacities has a clear value to cross-border trade and can to a large extent be influenced by TSOs. A small improvement could increase available capacities across all timeframes (which can be a critical market benefit even if realised only for a few hours per day).

Justification for 2:
This incentive parameter would motivate TSOs to allocate as much capacity as technically possible to longer maturities such as year- and month-ahead. It would thereby contribute to a higher liquidity in forward markets and help to make price expectations converge.

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?*

We fully agree that publication of all indicators would be an incentive in itself and would represent a step towards increased transparency.

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

We recommend harmonised incentives to be applied to each individual TSO with an annual target. If highly inter-dependent mechanisms such as coordinated NTC or flow-based market coupling are applied, the incentives should be adapted accordingly at a wider level among regional regulators, in order to avoid negative impacts on other regional TSOs.

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

A stronger focus on project management coordination and reporting could also help to accelerate market coupling and intra-day implementation projects.