

IFIEC Europe Comments to the Preliminary Report of the Energy Sector Inquiry of DG Competition on the Electricity Markets

IFIEC Europe (IE) represents the interests of industrial energy users in Europe for whom energy is a significant component of production costs. Energy prices therefore are a key factor for their competitiveness. In the following IE would like to comment on the main issues identified in the Preliminary Report concerning Electricity:

A. The EU Commission's Analysis

1. Concentration and Market Power

Due to the characteristics of electricity - non-storability, high inelasticity of demand, a very wide spectrum of production costs and physical transportation constraints or restricted transmission - electricity markets are highly susceptible to market dominance. And in fact, production assets remain largely in the hands of one or a few large operators, which stems from the pre-liberalisation concentration of generation. Further, the strong position of incumbent operators has not been eroded in a significant way by investments in generation by new entrants. On the contrary: it has even been strengthened by a still continuing wave of consolidation.

IE agrees with these conclusions by the Commission although we believe further analysis is necessary.

The report indicates substantial evidence for market power to influence the day-ahead price setting on certain power exchanges in the spot market. But it hardly addresses concerns about the effect of concentration in generation on price offered to consumers. This link should be examined carefully, in particular because electricity prices paid by most of our industries are based on such prices.

IE asks the Commission to take the following remarks into account in the further analysis of market concentration:

1. Producers are able to dictate price levels both for peak or base load. Electricity companies have imposed a commercial system where they do not compete for volumes. "In line with our margin-oriented sales policy, we focus on sales agreements with attractive margins. As a result, electricity sales to industrial and corporate customers decreased" (RWE – Annual Report, 2005).

Actual base load forward price levels above € 60/MWh exceed the fair price level of a competitive market. Historical full cost of large incumbent generators are well below € 55/MWh (for example RWE mentioned 24 €/MWh full production cost for 80 percent of its generation in 2005, see Annex. EDF with huge nuclear power assets and a lot of hydro should have an even lower production cost).

2. An argument often used by electricity companies to justify the current prices is that Europe needs huge investments to meet the demand. In some countries, e.g. France, new investments are not necessary for base load demand which seems to decline in these Members States (ie

French industrial base load consumption has been declining by 3.6 % in 2005 compared to 2004, and also another 5 % decrease in the first three months 2006 vs 2005) due to industrial plants closure driven by loss of competitiveness.

3. The report focuses on concentration in day-ahead markets (so called “spot” markets). It shows that many market players are active and the volume of trade is distributed among many players (p.123), but when evaluating market shares, the fact that large incumbents participate simultaneously as sellers and buyers is ignored. The report does not cover the level of concentration for different production technologies. This is particularly important as the price formation on these markets is based on the underlying generation fuel mix. As a matter of fact, the most highly concentrated segments of the European generation market are the “infra-marginal” segments (nuclear, hydro and brown coal).
4. The majority of producers have put their trading operations at the heart of their organisation. These operations control every transaction between production and sales making it easier to establish price-setting strategies. This has created a problem: the trading departments of the big electricity producers are the major players on both sides of the market: purchase and sales. They act simultaneously as purchasers for the account of the clients and as traders for their own account. The Commission should investigate these practices and verify whether they are compliant to competition rules.
5. By means of mergers and acquisitions electricity producers who formerly dominated national markets are getting in a position to exercise market power across national boundaries. This could reduce the downward pressure on prices expected of increased cross-border capacity. The report does not address this problem.
6. Prices of continuously traded standardised contracts for forward deliveries (mainly year-ahead contracts) do not reflect the supply-demand fundamentals in the forward period. The report does not evaluate this effect. Recent price fluctuations seem largely artificial producing unreasonable prices i.e. prices not related to anticipations on future production costs, system adequacy or operation conditions.
7. On one hand the Commission should thoroughly investigate capacity withdrawal practices and on the other it should check that hourly prices of spot markets do fairly remunerate the short-term volume risk. Independently of volume submitted to bilateral agreements or of forward trading previously performed, “spot” markets should reflect an efficient operation of available units. Capacity withdrawal shall be analysed in different time frames. First in the short term, a decision to keep off-line an available generation unit shall be based on sound economic principles in respect to competition law. Secondly, in the mid term: maintenance planning shall reflect an interest to guarantee a stable reserve margin along the year. An independent TSO can easily assess whether generators’ maintenance schedules contribute to or interfere with the system adequacy. And thirdly, permanent shutdown of power plants that have not been replaced with new technologies should be explained to competition authorities and regulators. The retirement of 4.000 MW net capacities in Germany between 2000 and 2005 seems to require further investigation. The reason why these MW have not been offered to other participants in the market should be also discussed.

2. Vertical Foreclosure and Vertical Integration

The Commission recognises that unbundling measures prescribed in the Directives may make it more difficult for vertically integrated grid operators to discriminate against newcomers. Nevertheless, discriminatory incentives remain, hence it can be expected that vertically integrated firms contrive new ways to favour their own affiliates to the detriment of competitors. Experience raises doubts whether existing or improved “Chinese walls”- provisions are sufficient to create non-discriminatory access to the grid.

The Commission sees long-term contracts between owners of generation resources and industrial consumers as a form of market foreclosure. First, it should be observed that retailers with no or only partial integration in the generation business are also considering the possibility to conclude long-term arrangements with producers (see, for example, recent announcement by UK Centrica of a conclusion of a contract with Drax Power). Long-term contracts are an integral part of the electricity market as a mechanism to form competitive wholesale markets. New entrants in the retail business cannot be successful if they do not have the commercial possibility to build a portfolio of resources. This is not acknowledged in the report.

From the perspective of large electricity users, such contracts allow for predictability and risk management. This is necessary for keeping in Europe electro-intensive industries but, furthermore, these long-term contracts should be beneficial from a security of power supply perspective. They facilitate investments decisions in generation through the introduction of a beneficial risk sharing principle (either capital risk as in the case of the Finnish nuclear reactor or fuel risk as in the case of new coal-based power unit in the Netherlands).

Furthermore, these long-term contracts can improve market integration when a dominant power producer sells the electricity to customers outside its domestic market.

3. Market Integration

The electricity sector liberalization should create a competitive European market, enforcing security of supply and competitiveness. In several Member States, an important solution for creating competition between producers is competition through imports. Also, the current level of congestion causes large price differences between countries and results in huge costs for industrial consumers and society as a whole. The economic value of this effect is not investigated in the report.

The inquiry detects elements that clearly show the failure of explicit capacity auctions to provide further market integration, but unfortunately the report does not emphasize the flaws sufficiently. Actually, congestion revenues are working as a negative incentive for TSOs to develop interconnections: the more congested a link is, the higher revenues they get. Even if generally speaking explicit auctions are an efficient method to allocate scarce resources, when applied to interconnections they do not contribute to integrate markets as they consolidate the existing price differences.

Concerning cross-border trade, the inquiry does not tackle the question of who is doing business on the interconnections. It would be interesting to identify the shares of different players importing and exporting into the different markets.

In some cases, estimated hours of congestion reported in the inquiry do not reflect large user's perception of difficulties to wheel power. Particularly transfer capacity at the French interconnection for Belgium is traditionally seen as very scarce while no congestion seems to be detected in the report (figure 60).

Market principles adopted across EU prevent TSOs from trading at the interconnections as they did before liberalization. TSOs are now motivated to be more conservative while fixing ATC in the interconnections and therefore congestions are higher. The cross-border capacity available to the market is limited due to inefficient bilateral decisions making by TSOs. Huge amounts of physical cross border capacity are reserved for loop flows and other purposes, resulting in congestion. TSOs should have other operational means to deal with these problems, such as re-dispatch or phase shifters. The costs of applying these alternative instruments are expected to be much lower than the effect of reduced interconnection capacity on market prices. The Commission should investigate the current process of decision making between TSOs and the lack of incentives to find efficient solutions when dealing with congestion and loop flows.

4. Transparency

Regarding transparency of the markets, availability of information is important. The fact that many countries publish only a limited number of statistics is worrying. Some market participants therefore will have more market information than others. This is especially the case for vertically integrated companies with generation and trading / retail. Despite unbundling provisions (which mostly affect unbundling of grids) it can be presumed that the trading branch of a vertically integrated firm has easier access to essential information than an independent trader / retailer. This is particularly important for information about maintenance of plants or unplanned loss of generation capacity. Asymmetric information creates an information advantage for integrated firms since they can act on such information before the information is made known to other market participants thus having an impact on day-ahead wholesale prices.

Although the lack of information is generally perceived as being a problem by non-incumbent market players, the inquiry should emphasise the fact that usually TSO independence correlates with the degree of information made available to the market. As an example, countries having a TSO independent from generators offer on their website a broad range of real time information (demand, plants production, interconnection usage, wind generation,...) while such information remains completely undisclosed in countries where a link exist between incumbent generators and TSO.

Below comments on price formation are also aiming to ensure a more transparent commercial behaviour by the owners of the power generation capacity.

The commission should ensure that transparency regulation is in balance with the risk of collusion.

5. Price formation

It is often argued that electricity prices are driven by fuel cost developments, but as the Commission correctly analyses, this is not the case. There are insufficient fundamental factors

stemming from primary energy costs (coal, lignite, nuclear, hydro) for driving up electricity prices as analysed in the report. Even the increase in gas prices cannot explain the steep rise in electricity prices. Instead the price increases can be attributed largely to the influence of the EU-emission trading scheme (ETS). This fact shows the enormous market power and influence on price as exerted by the dominant firms (generators) in the electricity sector.

The experience of industrial electricity consumers shows that base load wholesale market prices are not based on marginal costs, but rather on the full opportunity costs of marginal power plants including CO₂ windfall profits plus a significant mark up.

The report does not sufficiently tackle and underline the problem of windfall profits. However, today the existence of windfall profits as a result of EU ETS is no longer under doubt. Many studies conclude that opportunity costs caused by a cap & trade based ETS and grandfathering are passed through into electricity prices. Examples are studies made by McKinsey, IEA, Frontier, ECN, Gaselys Economic Research and UBS.

Also, electricity producers frankly admit to value opportunity CO₂ costs in electricity prices. This is the logical consequence of the current allocation system. They can realize that based on the established system in combination with their market power.

Various estimates conclude that these windfall profits result in additional profits for electricity producers of tens of billions of EUR annually. The European Emission Trading System was not intended to grant additional earnings to the electricity sector without any benefits to the environment. Such effects need to be stopped immediately to the benefit of the competitiveness of EU industry as well as to the integrity and attractiveness of EU ETS as a model for a more global approach.

B. IE's suggestions for improvement of the current situation

IE strongly suggests the following measures:

1. Concentration

In the short-term, measures are needed to reduce the current level of concentration in national markets. Remedies applied to reduce the negative effects of new mergers cannot reduce the current dominance of producers. Power release programs reducing market power in national markets are a concrete short-term solution. The regular use of appropriate VPP (virtual power plant) auctions can improve competition significantly. Regulation inducing implementation of regular VPP-auctions needs to be developed on EU-level.

In the longer term, the current level of competition must be thoroughly evaluated. The electricity sector in some ways is different from many other sectors: electricity can't be stored and delivery is grid dependant. Therefore, electricity markets are highly susceptible to market dominance. The preliminary results of the inquiry suggest that the current legal framework is insufficient to ensure a competitive electricity market.

An example of improving competition law is a cap on market share. It should be made possible to introduce caps for dominant generators. Any dominant player who controls, directly or indirectly, more than 20,000 MW of installed electricity generation capacity within the EU boundaries

should not be allowed to extend the capacity under its control, including imported capacity, beyond a 20 % market share in any relevant market.

2. Vertical Foreclosure and Vertical Integration

Although unlimited vertical foreclosure could be a potential threat to the market, it is also obvious that the electricity-intensive industry requires market arrangements that allow it to contract power at internationally competitive prices including access to long-term agreements. Therefore, electricity producers should be able to conclude competitive long-term contracts with industrial consumers. For example, the TVO - intensive users agreement in Finland allows a competitive price around 24 €/MWh without CO₂ emissions impact.

The Sector Inquiry needs to point out the importance of vertical integration of TSOs with electricity producers. This relation all too often is a negative incentive for TSOs to maximise cross-border capacity. Operational responsibility for transmission and distribution networks needs to be completely transferred to independent entities under regulatory scrutiny (regarding tariffs and access rights etc.). This should be applied to all grid operators including small distributors, who will have to find ways to cooperate efficiently. To guarantee the effective neutrality of the grids, measures of ownership unbundling should be seriously taken into account.

3. Market integration

IE underlines the recommendations in the Green Paper, published on March 8th, 2006. The market needs a European Grid, with harmonised rules. However, it also needs an independent European TSO - as proposed by IE in the form of a “Eurogrid Coordinator” - to tackle market integration problems.

An independent “Coordinator-TSO” on a regional level with its own responsibilities could be a first step in this process. Implementation of this “regional” concept should ultimately lead to the following:

- Each region is a “single price area” without internal border
- One “Regional TSO” should manage the international electricity flows and solve regional congestion, optimizing inter-connector investments and coordinating re-dispatching of generation

In the short term the cross-border capacity made available to the market can be increased by more efficient use of the physical capacity that is already in place. This is essential for reaching the goals mentioned in the Green Paper to create a European Grid. IE suggests some concrete solutions to achieve this:

- tackling loop flows with re-dispatching instead of huge cross-border reservations
- netting imports and exports
- adjusting for winter and summer periods
- introducing intra-day capacity (without reducing other capacities)
- regulate transparency of decision making

If the measures presented above do not solve congestion problems, then TSOs need to start up new investment projects as soon as possible to reduce congestion where necessary. The usage of revenues from congestion management can fund these investments. The report shows that only

about 25% of these revenues are used for that purpose. Regulation 1228/2003 appears to be insufficient; therefore a more precise prescription of their use is necessary. Priority should be given to investing the revenues to solve structural congestion problems through expanding interconnectors instead of lowering internal grid charges.

Also, a clear distinction should be made between increasing cross-border capacity available to the market (see above) and the system of allocating the capacity to the individual market players. IE is of the opinion that implicit auctions or “market coupling” can be more efficient regarding day - head capacity than explicit auctions. However, the national competition authorities must be able to monitor these “coupled markets” and intervene when necessary. For long term capacity explicit auctions can be used, but must be combined with priority rules for spending the revenues.

4) Transparency

In order to prevent possible insider trading practices, clear rules have to be applied to the electricity market as are provided in financial markets. Ad hoc information on market relevant data must be made available to all players at the same time. Sanctions for breaching these rules must be put into place and enforced.

5) Price formation issues

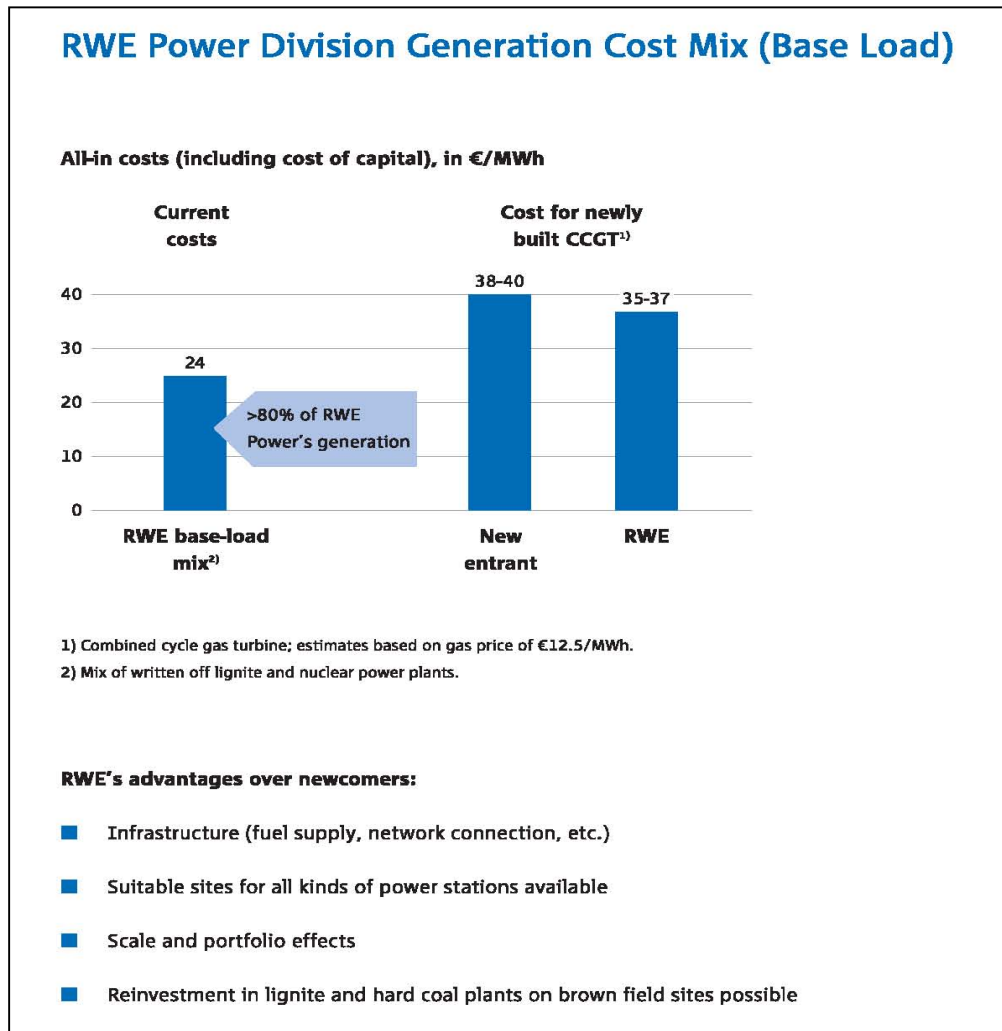
a) CO2 emissions trading scheme

The Commission needs also to acknowledge the issue of “windfall profits” and find immediate solutions to the benefit of the competitiveness of EU industry as well as to the integrity and attractiveness of EU ETS as a model for a more global approach. Adapting the trading system is essential for realising this. The elements causing “opportunity costs” must be removed. Also, the system must enable new entrance and have proper incentives for investments in clean technologies.

b) Price settings mechanisms and long term contracts

“Reference pricing” based on Power Exchange quotations that do not reflect the market fundamentals, is unacceptable for base load consumption patterns. European Power Exchanges today are highly illiquid and market actors are almost all linked to incumbent players. Electricity-intensive industry requires market organization that allows it to contract for its needs at internationally competitive prices including access to long-term agreements. Therefore, electricity producers should be encouraged to conclude competitive long-term contracts with industrial consumers. It is the case in Finland with the TVO - intensive users agreement which allows a competitive price around 24 €/MWh without CO2 emissions.

In contrast, long-term contracts between generation and trading companies affiliated should be thoroughly assessed in light of their possibly anticompetitive effects.



Source: RWE Facts and Figures, November 2005