DG Competition Energy Sector Inquiry -

AEP[1] Response to the Preliminary Report

1. Main Points

- AEP agrees that more rapid progress is needed towards a competitive and integrated European energy market, and recognises the thorough analysis carried out by DG Competition.
- The Association believes that the coverage of the UK market is accurate and welcomes the positive nature of the Commission's comments.
- The Commission should focus particularly on implementing the existing liberalisation package, ensuring non-discriminatory access to networks and removing barriers to cross-border trade.
- Proper implementation of the unbundling provisions of the Electricity and Gas Directives is also crucial.
- Particular priority should be given to increasing liquidity in the EU gas market.
- Electricity interconnection and other network infrastructure should be built where cost-effective rather than in pursuit of arbitrary targets.
- Transparency levels should be raised to those in the most open markets.
- More needs to be done to ensure cooperation between Member States, regulators and TSOs.
- The European energy industry is facing a major investment challenge over the coming decades, as identified in the Commission's Green Paper; competition must be promoted within a stable regulatory framework which incentivises investment.

2. General

The Association of Electricity Producers (AEP) strongly supports the liberalisation of the EU electricity and gas markets and welcomes the Commission's continuing efforts in this area. In general, AEP finds that the DG Competition preliminary report is a thorough and well-researched piece of work, which identifies the main obstacles to a fully competitive market.

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[1] The Association of Electricity Producers (AEP) represents the interests of the electricity generation sector in the UK, with a membership of more than 100 companies. Between them, the members embrace virtually all of the fuels and technologies used for commercial electricity production, from coal, oil, gas and nuclear power to wind, wave and hydro and production from a wide range of waste products.

For these reasons, the Association has relatively few comments on the report. However, we would like to give a brief reaction to the coverage of the UK market, to some wider issues in the European market and to some points of detail.

If a fully competitive EU market is to be achieved, it is crucial that the existing liberalisation package is fully implemented by Member States. The Commission has an important role to play in monitoring implementation and should make full use of its competition powers to avoid anti-competitive practices. The Association believes that particular priority should be given to ensuring non-discriminatory access to networks and to creating more liquid gas markets.

3. Comments on UK Market

The Association is pleased to note that the report confirms the highly competitive nature of the UK electricity and gas markets. It is clear from the Commission's report that the UK energy markets score highly in terms of lack of concentration and levels of transparency. These conclusions are very much in line with recent analysis of the generation market by the Office of Fair Trading and of the energy retail market by the sector regulator, Ofgem.

The Association also welcomes the thorough analysis of UK wholesale prices carried out by the Commission. The report clearly demonstrates that the recent increase in UK power prices is closely correlated with the rise in wholesale gas prices and the introduction of emissions trading.

4. Issues Common to Electricity and Gas

Unbundling

The Association believes that unbundling of networks from competitive activities, and in particular the independence of the transmission system operator (TSO), are key elements in the development of the EU market. The successful markets in Scandinavia and UK have both ensured a level playing field by requiring a high level of separation of network businesses. Similar standards of independence and non-discrimination must be achieved throughout Europe.

DG Competition asks whether a requirement for ownership or "structural" unbundling should be introduced. In the UK, distribution and supply businesses have to be unbundled in accountancy, management and legal terms, but common ownership is permitted. AEP notes that these arrangements have facilitated very high levels of customer switching in the UK – over 50% of customers having changed from their original supplier. It can therefore be seen that high levels of retail competition can be achieved without full ownership separation.

Infrastructure Exemptions

AEP welcomes the text on exemptions (paras 219-225), which strikes a balance between the requirement to incentivise investment but also to avoid market foreclosure. It is important that the Commission continues to assess exemptions on a case-by-case basis, taking into account the level of competition in each market.

It is essential that the option of merchant interconnection is kept open, particularly in the case of capital-intensive DC interconnectors. Where projects are market-driven, regulatory intervention should be minimal if long-term investment is to be encouraged.

5. Electricity Issues

Interconnection

The Association can support the general approach to interconnection issues in the document, in particular the emphasis on better use of existing capacity. While recognising that the construction of new interconnectors in some regions would help the integration of the European market, the Association does not support arbitrary targets for interconnection, such as the 10% mentioned in para 487. In our view, transmission investment should be driven by economic need. New interconnection should therefore be justified primarily through cost-benefit analysis undertaken by TSOs or other developers.

Greater interconnection is only one of several approaches which can be used to promote competition and increase trade. Better management of the generating reserve, the closure of old generating plant, and the construction of new generating plant close to load centres can all have the same effect on interconnector congestion as the construction of new lines. Regulatory frameworks should provide incentives to respond to congestion with the most economic investments, whether in generation or transmission. Arbitrary intervention in transmission investment can distort the generation market and should be avoided.

In summary, the Association agrees that TSOs must have the right incentives to expand their networks, but does not think it sensible to aim for a set level of interconnection across the EU.

Transparency

AEP recognises that transparency is a crucial element in competitive markets and would like to see transparency requirements across Europe raised to the level of the most open markets. The EURELECTRIC Roadmap contains a number of proposals in this direction, which the Association supports.

DG Competition's analysis indicates that the UK's markets are the most transparent in Europe in terms of information published. Our view is that the

UK is fully aligned with the transparency principles set out in ERGEG's Guidelines for Good Practice on Information Management and Transparency.

Given the range of market structures across Europe, AEP believes that some flexibility should be allowed to market operators to deliver transparency principles in the way most appropriate to their markets. Any future European rules should take this into account.

Market-Based Capacity Allocation – Auctions/Market Design

The Association agrees that interconnector capacity should always be allocated on the basis of market-based mechanisms and very much welcomes the efforts made by the Commission in this direction, e.g. in the Congestion Management Guideline. However, we take issue with one element of DG Competition's analysis – the statement that implicit auctions are systematically more efficient that explicit auctions (para 511).

While implicit auctions may work effectively in mature competitive markets, they raise considerable issues of practical implementation. They require liquid markets on each side of an interconnector and a high degree of harmonisation of market rules, which would take a considerable time to achieve across Europe. Moreover, implicit auctions generally involve an organised day-ahead market and a monopoly power exchange provider and are difficult to reconcile with a predominantly bilateral model, such as that existing in the GB market. Bilateral trading has considerable advantages for market players in terms of flexibility and cost, and in the Association's view should be maintained as an option. AEP agrees with paras 513/5124 that greater harmonisation of market timescales and administrative processes will be needed in the future, but does not think that the Commission should attempt to standardise market design, e.g. by mandating power exchanges.

Explicit auctions of cross-border capacity have been introduced at a number of borders and are a good step on the way towards creating efficient integration of markets. While there is still a disparity in terms of wholesale market arrangements, such auctions offer a practical way forward. Explicit auctions also have an advantage in that improvements to the auction process can be introduced progressively, learning from experience and responding to market requirements. For example, the timing of auctions at different borders can be aligned and the bidding processes co-ordinated.

The Association believes that the allegedly inefficient allocation of capacity on the UK-France interconnector is related to different market timescales between the two countries rather than inherent problems with an explicit auction, as seems to be recognised in para 505. We would strongly recommend that EU action focuses on the full implementation of market mechanisms on interconnectors rather than on issues of detailed market design.

6. Gas Issues

The Association believes that it is vital that more rapid progress is made towards a liberalised EU gas market. Competition in the EU gas market has so far lagged far behind electricity, as the DG Competition report confirms. There are lower levels of market liquidity and trading in gas, and a less-developed framework for cross-border competition.

The Association acknowledges that long-term contracts are needed to underpin investment in gas infrastructure, and will continue to be necessary in the future. It is clear, however, that much of the EU gas market is foreclosed for a very long period (15 years+) by existing transit and downstream contracts. Some reserved capacity on pipelines remains unused and there appears to be considerable flexibility in the contracts, implying that there is more scope to release some capacity to the market. The Association believes that if gas-to-gas competition is to emerge, this issue must be resolved – new entrants must have scope to enter the market by purchasing capacity on non-discriminatory terms.

The differences between gas transit and gas transportation charges and access conditions can significantly inhibit competition and distort the market. The Association believes that increased transparency must be provided on transit as well as other pipelines and that use-it-or-lose it mechanisms must be established to promote increased efficiency. If TSOs are properly unbundled in line with the Gas Directive, they should have every incentive to maximise available capacity. It is also important that incentives are provided to develop an increase of the present capacity in some critical cross border pipelines.

Gas storage is a particularly important source of flexibility for power generators, since electricity cannot be stored and has to be produced in line with demand. It is crucial that third parties are able to access storage throughout the EU on a transparent and cost-reflective basis and therefore the Commission and Regulators must carefully monitor implementation of the Good Practice Guidelines.

7. Institutional Issues and Regulation

The report provides a comprehensive analysis of the EU energy market and the behaviour of market players, and identifies some major issues which need to be tackled. However, it must be pointed out that the EU institutions, national governments, regulators and TSOs must also work together more effectively if the goal of a single European market is to be fulfilled.

The current round of infringement proceedings shows that there have been a number of shortcomings in the implementation of the existing liberalisation package. Moreover, too little has so far been done to overcome barriers to cross-border trading, as shown by the slow progress towards agreeing the electricity Cross-Border Guidelines. The Association would like to see closer alignment of the powers of national regulators and greater convergence of regulatory approaches in the various Member States. Care must nevertheless be taken not to impose excessive regulation, which could have the effect of blunting competition. This must particularly be borne in mind in those countries which already have transparent and competitive markets.

8. Investment Frameworks/EU ETS

AEP is pleased to note DG Competition's announcement that the sector inquiry will be completed by the end of 2006. A concerted effort is now needed to realise the single European energy market, but the electricity and gas sectors must have a stable and predictable regulatory framework. Substantial investments in energy infrastructure will be required over the next twenty years and these will only materialise if market players are confident in the regulatory framework. Open-ended investigations could damage confidence, and it is thus helpful that the Commission has indicated a closing date for the inquiry.

The EU Emissions Trading Scheme is a particularly important factor in decisions about future generating plant investment. The Scheme has begun to have an impact in encouraging operators to move towards lower levels of carbon intensity. However, there are two pre-requisites for the Scheme to be successful: firstly, governments and regulators must avoid interference with the pricing mechanism, which explicitly aims to increase the costs of fossil-fuel use; secondly, longer timescales are needed if major investment in lower-carbon generation is to be stimulated. The current three to five-year cycles are much too short.

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