EDF Trading Limited (EDFT) welcomes the opportunity to comment on the European Commission's report of the energy sector inquiry. We will not provide detailed feedback on all aspects of the report, but general remarks on what we perceive to be some of the key issues.

The sector inquiry focuses on important competition-related issues. Nevertheless, it is also crucial to consider that the competitiveness of energy markets is based on services provided by the network-based parts of the industry. Transmission and distribution networks are natural monopolies in the energy supply chain and require well-designed regulation. EDFT considers that while investigating competition issues is important, it is also vital to ensure transparent and non-discriminatory access to the infrastructure. This will allow more intense competition in the unregulated parts of the industry.

This point may be particularly pertinent to consider for the European Commission, in light of the fact that the energy liberalisation directives of 2003 come into full effect only in July 2007 and are not even implemented in some Member states. Therefore, applying competition law may not by itself lead to optimal results. Regulation of the natural monopoly parts of the industry is still needed and both the European Commission and national regulators will need to work together to implement effective regulatory measures that improve market functioning.

While we in general concur with the Commission that certain effects of vertical foreclosure and market concentration can be observed, we consider that some of the preliminary conclusions may need to be reconsidered in the following areas:

- Access to cross-border capacity through explicit and implicit auctions, and in particular the relative efficiency of the two methods for allocating cross-border capacity;
- Advocating the use-it-or-lose-it principle; and
- Price formation on power exchanges and through gas/oil price indexation.

In addition to commenting on these shortcomings, the Commission also asked for our views on the following important issues:

- Balancing markets;
- Long-term contracts;
- Unbundling; and
- Transparency.

1. Access to infrastructure and cross-border capacity explicit and implicit auctions

Non-discriminatory access to infrastructure and the possibility to transport energy across borders is fundamental for creating a competitive and integrated European energy market. This refers particularly to access to existing infrastructure. Electricity interconnectors or gas transit pipelines yet to be built are considered new infrastructure which may be exempted from certain access requirements. EDFT thinks that regulatory intervention for these merchant lines should be kept to a minimum to encourage long-term investments.

As analysed in the preliminary report, primary transit capacity on interconnectors, particularly for gas, is secured by incumbent operators, making it very difficult for new entrants to acquire capacity. With the Congestion Management Guidelines for Electricity and the Regulation on conditions for access to the natural gas transmission networks, the European Commission has already introduced legislative and regulatory measures to tackle this problem.

Access to gas networks

The wholesale gas markets are far less developed and subject to greater entry barriers than the electricity markets. As an example, current developments in the German gas market show that implementing a transparent and non-discriminatory access system is a difficult task and indeed one that requires close management and monitoring of the regulatory framework and conditions. This is, for instance, because the association representing the network operators has submitted drafts conditions for standardised access to the gas networks that, at this stage, contain several provisions which are not only detrimental to the creation of a competitive gas market, but are also not in line with the EU Regulation on conditions for access to the natural gas transmission networks, entering into force on July 1, 2006.

Against this background, we think that the European Commission needs to concentrate its efforts on regulatory measures, such as creating transparent and non-discriminatory access to the gas networks. Using competition policy may support and accelerate this process.

Implicit auctions are not per se the optimal solution for cross-border congestion

In the event of cross-border congestion on electricity interconnectors, cross-border capacity can be allocated through market-based or non market-based methods. The Commission's report presents an overview of two market-based methods: explicit and implicit auctions. The analysis gives details of the relative efficiency of the two instruments and as such, this represents a good first step to understand the differences between explicit and implicit auctions.

However, the Commission's analysis of the seemingly inefficient use of interconnector capacity gives only a partial explanation for the direction of flows observed in the data analysed. We consider that the reasons identified by the Commission - avoiding exposure to balancing prices and the different closing times of auctions and power exchanges – to explain some of the apparent inconsistencies (which the report, in our view, erroneously labels 'inefficient') do not represent the full story. First, market participants do not only trade on power exchanges, but also use OTC trades to manage their positions across borders. Second, they base their decisions to use capacity across a border on a number of other factors. For example regulations, like the obligation to prove physical flows in order to be able to claim tax benefits from transporting electricity from renewable sources. These and other reasons become far more important when the price spread is very small. As such, we cannot agree with the statement that implicit auctions are per se more efficient than explicit auctions, as we consider the analysis undertaken so far in the report is insufficient. We are happy to elaborate further on the reasons if required.

Furthermore, there are also disadvantages of implicit auctions which need to be considered:

- Capacity allocation only with implicit auctions may favour power exchange trading over OTC;
- The underlying sophisticated solutions for the calculation of market price differences may limit transparency of the auctioning process and also make it more difficult for regulators to monitor.

Explicit auctions are used to ensure market participants are able to hedge long-term price risks across market zones. Before introducing implicit auctions as the sole means to allocate cross-border capacity at congested borders, there needs to be a liquid financial market to allow market participants to hedge long-term price risks, e.g. through the purchase of financial transmission rights. Pending the development of these liquid financial markets, explicit auctions should be kept as an interim measure for long-term price hedging.

Another important aspect of managing congestion across borders relates to the incentives to build new interconnection capacity. Auctions allocate scarce capacity, but neither explicit nor implicit auctions will reduce physical network congestion or significantly improve the efficiency and functioning of the market. Only an increase of capacity can achieve this. Therefore, we consider that the debate and the analysis of whether explicit or implicit auctions are most efficient should not be at the centre of discussion. Instead, much more importance needs to be given to solving structural congestion, and this can only be achieved through regulation of the network part of the industry. For example, the Commission may instead wish to allocate more resources to resolving some of the following structural issues:

- Revenues from congestion management should be solely assigned to reinforce interconnectors or to build new ones, and only as a very last resort used to lower network tariffs;
- Planning procedures for construction of new interconnectors need to be streamlined so as not to present any unnecessary regulatory burden;
- National regulators need to cooperate for cross-country issues because network constraints within national transmission systems influence the capacity of cross-border interconnectors, or conversely, the building of new lines in one country may increase the cross-border capacity in another country;
- TSOs need incentives to optimise the transmission grid. They should not only make the maximum capacity available, but also guarantee the firmness of capacity. Only firm capacity allows market participants to hedge their transmission cost risks over time and different borders. One incentive could be to allow TSOs to earn a higher rate of return if

they manage the transmission system well. This requires monitoring by and coordination among national regulators.

2. The use-it-or-lose-it mechanism is not the long-term answer

Once capacity for transporting electricity is allocated, unused capacity is sometimes made available to the market through the UIOLI mechanism (use-it-or-lose-it). This was introduced to prevent hoarding of capacity and to give capacity from those who do not use it to those who will.

While UIOLI appears attractive at first sight, it has several drawbacks and does not improve market efficiency:

- To make UIOLI 'effective', an additional market that clears early enough to allow the re-allocation before the "real time" gate closure needs to be introduced. This creates a wasteful time lag (optimisation occurs too early), reduces the value and the efficient use of the capacity, and creates additional administrative burden;
- Furthermore, without penalties (e.g. for significant downward re-nominations), UIOLI will not work;
- Large penalties will in turn encourage uneconomic trades across interconnectors just for the purpose of using the capacity and avoiding the penalty.

Instead of advocating UIOLI, it is more important to improve the flexibility of secondary trading of capacity. Alternatively, use-it-or-sell-it (or use-it-or-get-paid) works better and can be used as an interim measure.

3. Price formation issues

Electricity prices are formed on power exchanges or in OTC markets through a number of factors, such as fuel prices, weather conditions, demand, and available generating capacity. As a result, we consider that it is wrong to suggest that increases in gas and electricity wholesale prices are caused by non-transparent price formation on power exchanges. While the execution of a large order in these markets may result in some short-term price distortions, market players do not have ability to distort prices over a sustained period of time. This is also true for many other markets unrelated to electricity.

Rather than focusing on the formation of prices, we think more emphasis should be placed on regulating access to and usage of the networks because this is where the current impediments to the liberalisation of energy markets lie. Only when there is transparent and non-discriminatory access to the network, full competition can develop on both the wholesale and the retail markets.

The indexation of gas prices to oil (and other) prices was used in the absence of stand-alone markets for gas, when pricing mechanisms were needed against liquid and trusted reference points. The wholesale markets profited from this indexation because it increased transparency and reliability of prices, made gas a tradable commodity, and consequently also enabled significant investment. This still applies in many parts of Europe.

It will take time for sufficiently liquid gas markets to develop, which would then allow moving away from oil-indexed pricing. An example where this has already happened is the UK, where the percentage of oil-linked gas prices has dropped with the development of liquidity on the trading point, the National Balancing Point.

Once functioning and liquid wholesale gas markets are present, market dynamics will change and linkages to the oil price may then over time be reduced. Until this is achieved, it is important not to stifle innovation by excluding or limiting any particular price indexation.

4. Balancing markets: TSOs need the right incentives

The right design of balancing markets is important for the development of effective wholesale electricity markets. Some key themes for developing market-based balancing mechanisms include:

a) TSOs should not reserve cross-border transmission capacity for balancing their systems. This reservation would be purely contractual and limit commercial trade across interconnectors. Priority should be given to commercial trades that contribute to increasing market liquidity.
b) TSOs may at present not face appropriate incentives for balancing, as they can freely choose between curtailing cross-border capacity (at "fixed" costs) and changing internal plant schedules (re-dispatch) to manage internal congestion. The effects can be demonstrated with the following example:

At the interconnector IFA between France and the United Kingdom, the TSOs jointly reduce the capacity of the interconnector after the day-ahead nominations. These frequent capacity reductions, which should be reserved for maintaining system security, actually facilitate the internal congestion management of the TSOs. The effects are twofold: First, liquidity of the cross-border intraday market is reduced because there is less capacity available. Second, balancing costs paid by market participants in France and the United Kingdom are distorted because they are no longer market-based. It is therefore important that cross-border capacity is not reduced because of internal congestion on the network of a TSO.

c) Market participants should have the possibility to trade imbalances on intraday markets with rolling gate closures, instead of risking being out of balance and therefore being obliged to pay imbalance prices. As an interim solution (pending the development of liquid intraday markets), market participants should be allowed to trade their imbalances prior to settling any residual physical imbalances. The TSO should have systems in place to facilitate such trade, e.g. by reducing the time between gate closure and real time flows.

5. Long-term contracts: Necessary for investment security

Energy is typically a long-term business and uses long-term contracts as an essential tool to ensure that capital-intensive investments can be undertaken. Undermining legitimate existing contracts would not only breach fundamental principles of property rights law, but would also reduce incentives to invest in the future and create unnecessary instability. Market participants must have the opportunity to enter into new long-term contracts as a way to manage risks, e.g. by locking in the prices for transmission. At present this is not possible across borders for periods longer than one year, which stifles cross-border competition.

6. Unbundling provisions are not implemented properly

The two liberalisation directives of 2003 require legal and functional unbundling of vertically integrated generation, transmission and supply companies. The aim is to enhance non-discriminatory access to the transmission network.

As has been rightly stated by the European Commission, implementation of the directives is incomplete, particularly with regard to functional unbundling. This causes fragmentation across Member states and makes it very difficult to assess the real benefits of the current unbundling regime that could be realised if it was fully implemented.

Ownership unbundling will not necessarily improve non-discriminatory access if there is a lack of effective measures regulating the network activities. National regulators should prioritise effective implementation of the existing legal and functional unbundling requirements to ensure market transparency and non-discriminatory access to the networks.

7. Transparency measures

Transparency is important to encourage the entry of new market participants and to support the development of efficient wholesale markets.

Given that there is already a significant amount of trading taking place particularly in electricity, market participants obviously estimate that the amount of information currently available is sufficient to trade with acceptable risk.
But of course, there is always room for progress. EDFT clarified in its answer to the sector inquiry questionnaire which specific information it considers important for a functioning wholesale market and thinks that significant improvements are possible in most markets across Europe.

When considering options for increasing transparency, it is very important that information requirements are harmonised across Member states and across fuels to avoid distortions between market participants (reciprocity). Publishing ex ante figures only in aggregated form or only indicating a range will help protecting commercially sensitive data of specific companies.