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IMPLEMENTING THE EU ENERGY PACKAGES

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Report on Conference Proceedings

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On May 14 experts from EU institutions, national regulatory authorities, energy companies and academic institutions convened in Florence for the annual conference of the Florence School of Regulation. The conference was devoted to explore the current state of affairs of the implementation of the European Climate Action and Energy Legislative Package containing measures to fight climate change and promote renewable energy which was adopted on 6 April 2009 by the European Council. It particularly took stock of the implementation of the Green Package, notably the revision of the EU Emissions Trading Scheme (EU ETS) and the Renewable Energy Sources (RES) regime. The conference introductory took the impact of the economic crisis on the market building process of countries in transient position into account.

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I. Impact of the Financial and Economic Crisis on the Market Building Process of Countries in Transient Position

The financial and economic crisis has special effects on those countries which are in the transient period of market building which is valid for most of the Energy Regulators Regional Association (ERRA) members. The development goes from state owned vertically integrated supply chain to restructured, unbundled energy industry under third party access rules with market-based energy prices. Most of them reached a certain level of wholesale competition, i.e. a legal/regulatory framework for opening the market, multi-player markets, new private investors and no regulated price on wholesale market. The present position of financial institutions in most ERRA regions is characterized by a waiting for new equilibrium on the financial market, limited latitude (freedom) of local private commercial banks (affiliates), i.e. limited availability of funding and a shrinking of a long term debt market.

There is a high risk sensitivity of banks caused by the country and/or political risk of transient economies, the regulatory risk of emerging energy markets (market building process), as well as general energy industry related risk elements such as CO₂ regulation, fuel prices, security of supply and regional market tendencies). Consequences of the new position of financial institutions in most ERRA regions are an anxious hesitation, e.g. investment programs are postponed (newly calculated financial conditions). There is furthermore a limited availability of funding, since only the best projects will attract financing. Such 'best projects' means in financial language a limited country and/or political risk, a limited fuel supply risk and a limited regulatory risk, but also a limited default risk.

Foreseeable effects are that the market building process will slow down and the establishment of new generation capacity will be postponed caused by a lack of finance; thus the capacity shortage will prevail after the economic crisis. Additionally, the new cross border network investment could be postponed caused by hindered regional market building. Finally, reliability and service quality will be reduced and cost of the transmission system operators (TSO)/ distribution system operators (DSO) are expected to increase.

II. The Implementation of the 3rd Package from the Point of View of the European Commission and Regulators

The 3rd package contains a new unbundling regime (transposition of respective Directives 30 months), powers and independence requirements for the national regulators and also addresses consumer protection. Furthermore, it deals with the issue of energy poverty, i.e. measures to address energy poverty and ensure supply to vulnerable costumers. Note, that the definition of vulnerable costumers was made with reference to energy poverty and to the prohibition of disconnection at critical times.

Finally, the establishment of the new agency for the cooperation of energy regulators (hereinafter ACER). The Agency's staff will consist in about 40-50 people, the annual budget will be around EURO 6-7 million. As regards ACER's resources it will depend on the work and know-how contributions from the national regulatory authorities. Candidates for its seat are for example Romania and Slovenia. The selection procedure for the director needs to start in autumn 2009 the latest. The ACER shall start operation 18 months after the entry into force of the respective Regulation establishing the Agency. ACER's competences include the taking of legally binding decisions on exemptions and access to cross-border infrastructures. Furthermore, the drafting of framework guidelines and non-binding guidelines on good practice and the provision of recommendations to the European Network of Transmission System Operators (hereinafter ENTSO) and to the European Commission on ENTSO's draft belong to its tasks. Finally it will be responsible for the annual work programme and the draft of the non binding 10 years development plan. Finally, ACER will provide opinions to ENTSO on the draft work programme, the draft non-binding 10 years development plan, the draft network codes and provide opinions to the European Commission on the ENTSO's statutes and draft rules of procedures.

The Commissions interpretation of the relevant case law, i.e. the *Meroni* doctrine has affected adversely tasks of the ACER vis-à-vis ENTSO's and governance agreements. This led to a split of roles and/or responsibilities between the Commission, the Board of regulators, and the Director of the ACER.

In order to improve the effectiveness and to avoid any necessary expenditure it is essential that the Board of regulators has the necessary powers to perform its "regulatory function" in an independent manner. The Board of Regulators must be in a position to provide overall guidance to the Director: there must be an assent of the Board of regulators for the selection and renewal/dismissal of the Director, and an assent of the Board of regulators prior to the adoption of opinions, recommendations and decisions. Furthermore, clear responsibilities between ACER/ENTSOs need to be defined and a clarification of enforcement

issues and eventually, the role of the Commission within ACER have to be clarified.

The 3rd package is particularly in line with the “best practices” and the “better regulation agenda” of European energy regulators which require that national regulators act independently of market interest and political influence. The same accounts for the process for appointing a regulator which should be open and transparent, with a term of office which is of sufficient length. The European energy regulators furthermore support a significant enhancement of the duties and power of the national regulatory authorities as regards for example the monitoring and reporting duties, the compliance and implementation of the agency and decisions of the Commission. In fact, a few amendments are needed which are greater precision in defining the respective responsibilities between sector regulators (energy, but also financial services) and competition authorities.

III. The Implementation of the 3rd Package from the Point of View of Electricity and Gas Companies

The Regulation on cross-border exchanges of electricity that is part of the 3rd package, approved by the European Parliament and the Council, in April and June 2009 respectively, establishes the ENTSO for Electricity in order to ensure optimal management of the electricity transmission network and to allow trading and supplying electricity across borders in the Community. The establishment of ENTSO-E in December 2008 was already ahead of approval and implementation of the 3rd Package. ENTSO-E is the newly-formed European Network of Transmission System Operators for Electricity, representing 42 TSOs from 34 countries. It becomes fully operational as of 1 July 2009 and replaces all former TSO associations in Europe.

Purpose of the association is the pursuance of cooperation of the European TSO's, the promotion of the TSOs' interests as well as an active role in the European rule setting process. Its main activities include the external communication on reliable operation, optimal management, sound technical evolution, and security of supply, meeting the needs of the internal electricity market and facilitating market integration. Moreover, the development and monitoring of network plans and network codes. Eventually, ENTSO-E promotes R&D and public acceptability of transmission infrastructure and provides for positions and consultation.

The supreme decision-making body of the organization is the general assembly where all the members are represented. ENTSO-E is headed by a Board with ten

members, representing the various regions of Europe. Subject to the Board, there is a Market Committee, System Development Committee and Operations Committee as well as a group for legal affairs, with all members having an opportunity to name their representatives to these. Functional and regional groups work under the committees.

IV. The Implementation of the Green Package: The Revisions to the EU ETS

The declared aim of the third package is a 20 % reduction in greenhouse gases and a 20 % share of renewable energy in the EU's total energy consumption by 2020. The main part of this package is comprised of revisions to the EU Emissions Trading Scheme (EU ETS). One crucial modification is a change in emission allowance allocation: as from 2013 onwards, more than 50% of the total cap will no longer be allocated to industry free of charge, but rather be auctioned off by Member States. Revenues could amount to 30-50 billion euro per year. Unlike under the current scheme where national emission caps were generously set by the Member States in their National Allocation Plans (NAPs), a harmonized EU-wide cap will be set in place. A linear decrease in the total number of allowances will also be observed.

In line with the demands of the industrial sector, which insist upon simple design, process predictability, equal access and transparency, the new Directive will require the Commission to adopt a regulation that ensures the auctioning is conducted in an open, transparent, harmonized and non-discriminatory way. Favored design is a static, single-round, sealed bid, uniform price auction that allows multiple bidding. The discussion assumed that the auction design differences (English, Dutch, Vickery etc.) are not vital to the result since the secondary market exists – and at least on the buying side these differences should not be problematic. A strong secondary market exists so price discovery is not a significant consideration. Holding and release of allowances by non-electricity companies will add to the EU Allowance Unit of one tonne of CO₂ (EUA) supply. Greater threats are interference in price formation, uncertainty due to lack of information on emissions data, and possible participation by the sellers in the market. Desired auction characteristics are a simple design and low transaction costs; process predictability (in particular the timing and frequency); and sequencing and the volumes available for auction. Moreover, fair and equal access and transparency for all eligible participants, and efficiency as well as consistency with other sectors including aviation. The avoidance of market

manipulation and interference is also paramount in this instance. With view at the revised scheme, however, concerns arose that the sudden move from almost zero percent auctioning to 100 percent will cause unintended effects, particularly with regard to borderline plants that are currently run for security of supply. The effects need to be examined in the respective policy-making process.

With regard to experience from the first two phases of the EU ETS, there is also concern that the phase III auction process will not start promptly. Moreover, a distribution method for free allowances will be established. The Commission will adopt EU-wide rules by the end of 2010, which will be developed under committee procedure (comitology). These rules will provide that allocations are based on EU-wide ex ante benchmarks.

Furthermore, it is noteworthy that the risk of carbon leakage is explicitly addressed in the new Directive. It includes provisions aiming at leveling the competitive playing field for European carbon-intensive industries in the event that no international agreement subjecting all countries to similar climate change mitigation measures is reached at the Conference of the Parties (CoP) in Copenhagen in December 2009. The decision on compensation measures will be made mid-2010 on the basis of a review of the situation which the Commission will present. In the absence of a global pact, a sort of "carbon equalization system" will be introduced which can take the form of additional free allocations or through including carbon-heavy imports from third countries in the ETS.

Concerning the market oversight provisions, the Commission monitors the carbon market and reports annually while the Member States report on auctions. There will be no price management, such as ceiling, floor or corridor, but some measures to deal with excessive price fluctuations. Depending on a positive outcome of Copenhagen, the Member States will continue to be entitled to meet part of their target by financing emission reduction projects in countries outside the EU through the Clean Development Mechanism (CDM) and Joint Implementation (JI). More certainty and predictability shall be reached by extending the right to use credits allowed in phase II to be used up to 2020. The operators will be able to use credits up to a minimum of 11 percent of NAP 2 allocations, which corresponds to roughly 6 percent of phase II and III caps and result in 1.6 to 1.7 Bt over 2008 – 2020. The design changes will apply as of the third trading period, i.e. January 2013. They will be implemented by the new 2009 ETS Directive as an amendment to the former Directive 2003/87/EC.

V. The Implementation of the Green Package: The New EU RES Regime

The declared aim of the third package is a 20 % share of renewable energy in the EU's total energy consumption by 2020 (8,5% in 2005). The Commissions' 2009 evaluation on the performance of the Member States for renewables shows only slow progress in developing renewable electricity for some countries. With six Member States increasing their shares by over 2% points over the last two years, the EU share of renewable electricity has increased by almost 1,5 % points. However, this disguises the recent poor efforts of some seven countries whose share has stagnated or actually declined. The European success in renewables energy is therefore too much in the hands of very few Member States. As an example, Germany already exceeded its indicative 12,5% 2010 target in 2007 with 14,2%. The future estimate for Germany for 2050 could be a 77% share. Conversely, the renewables share in the UK is below 2% and only restricted technology is shared. Thus, the UK will not be able to reach the indicative target by 2010.

Since 2004, the European Commission has countered with legal proceedings against Member States for non-compliance. It is problematic, however, that the duration of litigation and pre-court procedures especially in cases of environment can take 80 to 89 months (average 7 years). The poor progress and the infringement procedures also imply that the current legal framework is not sufficiently strong, which was one reason for the new Directive on renewable energy.

The new RES Directive needs to ensure progress: it sets mandatory national targets for renewable energy shares, including a 10% biofuels share in transport in 2020. Moreover, national action plans are required. It gives flexibility for the Member States to reach part of their target through statistical transfer and joint projects between Member States and third countries with existing or planned interconnector capacity. Moreover, joint support mechanisms between Member States are foreseen.

In order to reach the RES targets, Europe needs a fast track towards renewable-stable support systems and infrastructure deployment. By far the most successful system for support and most applied mechanisms seem to be the Feed-in systems. Conversely, quota and tradable certificate mechanisms were limited to trigger growth and price digression, and were only applied by a small number of Member States.

Challenges that are still to be overcome include ensuring grid access to transport the electricity in order to get land use consents for both generation and grid, and also to ramp up the supply chain in order to deliver both turbines and

connections. Another crucial challenge is the financing from investors and debt providers. Eventually, the cost-effective support mechanisms are necessary as well as the integration of intermittent generation into the market, maintaining short-term and long-term security.

Against this background, the role the regional initiatives can play in this process becomes visible: The electricity regional initiatives such as in the Baltic, the Northern, Central West, Central East, Central South, South West and France-UK-Ireland have been successful in bringing stakeholders together and achieving real change with regard to the improvement of congestion management, transparency and balancing. Their success was witnessed by the ERGEG's second report on coherence and convergence across the seven Regional Energy Markets, which provided an overview of the harmonization progress within the regional electricity markets.

The regional initiatives can provide concrete assistance not only with regard to common grid access arrangements, but also by supporting faster consent building for building new lines and generators and cost effective support mechanisms. Concerning RES roadblocks, the regional initiatives can help by means of market arrangements. They encourage harmonization rules. Wind power is more predictable when it is closer to real time. Thus, regional initiatives should be focused on day-ahead. However, this could create some problems in cases of significant intermittency.

There are considerable challenges for the transmission system operators in four areas. The first is priority access, i.e. the assurance that producers may sell & transmit the electricity whenever the renewable energy becomes available (feed-in tariffs) and to guarantee access, i.e. that all electricity sold and supported gets access to the grid (renewables in spot markets). Secondly, authorization procedures, coordination renewables and grid approvals need to be accelerated, i.e. the procedures should be proportionate and necessary and the Member States should take appropriate steps to accelerate the renewables and grid approvals authorization procedures for grid infrastructure, and coordinate the approval of grid infrastructure with administrative and planning procedures. A third important point is grid development. The Member States shall take the appropriate steps to develop transmission and distribution grid infrastructure including interconnections (between Member States and between Member States and third countries). A fourth point is the priority dispatch and minimization of curtailments. Priority to renewables insofar as the secure operation of the national electricity system permits, and appropriate grid and market-related measures should be given in order to minimize curtailments.

Emerging issues are obviously the national action plans, which are based on a European template and need to be notified by the Member States to the

Commission by June 2010. There are two important issues for transmission system operators (TSOs). One is European coordination: national plans should take special consideration to renewables integration into the grid, both within the country and considering neighboring countries. Second, with regard to the authorization procedures, acceleration of procedures and coordination between procedures is important. The ENTSO-E position on the Directive is characterized by emphasizing the need for stronger grids and interconnectors caused by the development of renewable energy. Transmission system operators need to be able to meet this demand. It is necessary to improve grid authorization procedures in order to coordinate grid and renewable energy plant authorization procedures.