<%@LANGUAGE="VBSCRIPT"%> <% Dim Recordset1 Dim Recordset1_numRows Set Recordset1 = Server.CreateObject("ADODB.Recordset") Recordset1.ActiveConnection = MM_ifiec_STRING Recordset1.Source = "SELECT * FROM electricity ORDER BY volgorde DESC" Recordset1.CursorType = 0 Recordset1.CursorLocation = 2 Recordset1.LockType = 1 Recordset1.Open() Recordset1_numRows = 0 %>

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Working document

Directive 96/92/CE of the European Parliament and the Council concerning common rules for the internal market of electricity

STRANDED INVESTMENTS, COST RECOVERY MECHANISMS AND MARKET ORGANISATION DEROGATIONS under Article 24 of the Directive

KEY MESSAGES & CONCLUSIONS

For IFIEC Europe, the risk posed by transitional regimes (Art. 24) is the postponement of effective implementation of the Electricity Directive in the EU for up to a decade, with potential market distortions emerging as the result of an overly-generous interpretation of the stranded cost principle.

Specifically, the allowance of stranded cost recovery schemes, in unreasonable terms, will result in significant economic burdens for eligible customers that impede the development of national and cross-border exchanges. This would not only jeopardise investment decisions by European Industry, already facing intense global competition; it would also be contrary to the fundamental objectives of the internal energy market.

Stranded costs should be carefully ring-fenced and recovery schemes should be strictly monitored and subject to periodic review by designated regulatory or other public authorities. Excluded from allowance should be: transmission assets, excess power capacity beyond certain limits, investments & commitments made post-1989 or amortised assets; costs arising from political decisions; restructuring costs arising from deregulation.

As an overall control, cost recovery schemes should have a capped impact on customer accounts.

During the whole course of the liberalisation debate, the problems associated with stranded costs have been well known. IFIEC Europe considers that it would be unfortunate to introduce, at this late stage, support schemes whereby a political solution could be achieved at the expense of economic reality.

Discussion : IFIEC EUROPE preliminary recommendations

The Electricity Directive (Art. 24) provides the possibility for Member States to apply to the Commission for a **transitional regime** where "*commitments or guarantees of operation given before the entry into force of this Directive may not be honoured on account of the provisions of this Directive*". *The transitional regime should be* "*of limited duration and linked to expiry of the [above] commitments or guarantees*", which remain to be defined. In particular, the Directive states that the transitional regime may "*cover derogations from Chapter IV* [transmission system operation], *VI* [unbundling, transparency] *and VII* [access to system].

In the comments below, IFIEC Europe seeks clarification of and proposes limitations to the stranded cost recovery principle and proposes recommendations to the attention of the Commission and national public authorities who have been charged with the important responsibility of interpreting and applying provisions under Art. 24.

Stranded cost recovery examples

Previous experience, in the USA and in England & Wales, has shown that there is potential to define stranded costs at the level which will impact competitive entry for a considerable period into the future.

- **USA**

The concept of stranded costs was first developed in the USA, particularly for private power generation assets that were rendered obsolete or uneconomical as a result of regulatory reform to introduce competition to the power supply market.

All private industries generally have to recognise regulatory risk associated with the changing business environment. In the case of the US electricity supply industry, however, it was decided that the high fixed costs of this sector, along with its obligations to ensure supply security, justified incentive measures to balance market reform. Consequently, the US federal law introduced the principle of open access with a provision for recovery of stranded costs.

More recently, at State-level in California, the excesses of the cost recovery principle has led to a highly contentious situation involving established utilities, consumers, market entrants and State government and judiciary authorities. Consumer groups are lobbying for regulatory reform in order to correct the economic hardship of cost recovery charges that have been passed through to them in their electricity bills. New market entrants are also claiming that the cost recovery mechanism has given unfair advantage to established local players.

- **ENGLAND & WALES**

In England and Wales, when the electricity supply industry was both privatised and deregulated in 1990 three types of stranded costs were recognised:

a. assets which were sold at market value, rather than real book value,

b. high-priced coal costs (passed on to the captive market),
c. special compensation for nuclear and renewable generation (via the fossil-fuel levy).

It was planned that the latter two elements would impose themselves on the market for five and eight years, respectively. In principle, none of the mechanisms designed to finance such stranded costs were to have an impact on the market price for competitive entry into the generation market, since they were collected on final consumer bills.

From an industrial energy user point of view, the main impact was the imposition of the 10% Fossil Fuel Levy, which was a considerable burden to bear.

European Union Perspectives

In the "*Report from the Commission to the Council and the European Parliament*", circulated in May, 1998, it was noted that twelve Member States have applied for a transitional regime (Art. 24 of the Directive), and that the Commission will prepare a decision in each case before Feb.20, 1999.

Notwithstanding the Commission's obligation of confidentiality vis à vis Member States, IFIEC Europe strongly urges the Commission to develop transparent, specific criteria as a basis for evaluating Member State applications for transitional regimes, including possible derogation from certain provisions of the Directive.

- ***RING-FENCING STRANDED ASSETS***

For the purpose of the Electricity Directive, stranded assets are considered to be non-amortised investments as a resultant of regulatory reform required by the Electricity Directive.

Member States should be asked to ring-fence such assets as clearly as possible. This may be difficult to achieve because of the lack of a pre-existing unbundled cost base. This underlines the importance of Chapter VI of the Directive concerning unbundling and transparency and the need for the Commission to avoid granting derogations to this chapter, whenever possible.

In the case of privately owned assets, investments decisions are generally made by company management, who assess the business risks and opportunities of new capacity, plant modernisation or extensions, and operation improvements. Cost overruns can result from strategic planning errors, lack of internal cost-control, obsolete or extravagant technical specifications, etc. Such investments can also be influenced, directly or indirectly, by political decisions relating to technology and fuel mix choices or general interest requirements. In this case, decisions are not necessarily based on least-cost criteria, and may, or may not, carry above-average risks.

In the case of state or publicly owned company assets, it should be determined whether such investments have been recovered through the direct and/or indirect advantages of the monopoly regime.

- ***DOCUMENTING AND MONITORING SUPPORT SCHEMES***

Member States should be required to itemise, justify and document requests for support schemes before the Commission gives its consent. If full cost recovery were allowed, incentives to transform stranded investments into profitable ones would be destroyed, to the detriment of those who are forced to pay for these stranded costs. More generally, full cost recovery could also be a disincentive to move forward with competitive market reform. In order to avoid this, IFIEC Europe suggests that cost recovery allowances be subject to Member State performance in terms of achieving full implementation of the Electricity Directive; allowances could be suspended where unjustified delays or difficulties arise.

Mechanisms for financing stranded costs must be transparent, with fair cost allocation among all relevant parties. In particular, they should not influence the transmission fee.

Cost recovery under Art. 24 should only be considered for assets exposed to competition as a resultant of regulatory reform under the Electricity Directive. Where cost recovery concerns particular generation plant, options for asset sales should be pursued. In addition, recourse to specialised industrial risk insurance should be considered, if possible.

Governments, in assessing stranded costs and financing their recovery, must:

- be required to ensure such costs are associated with generation assets only,
- be restricted from adding such costs to end-consumer bills,
- be restricted from charging such costs to transmission or distribution use of system charges,
- limit the impact on customer accounts.

IFIEC Europe recommends that assets, such as the following, should be **<u>excluded</u>** from stranded cost recovery schemes:

- excess capacity beyond certain limits (possibly 20%),
- investments & commitments made post-1989 or amortised assets,
- costs arising from political decisions, such as technology choices (renewable, CHP or other "assimilated" energies); fuel choices (nuclear, coal…), public service obligations, etc.,
- restructuring costs arising from deregulation,
- transmission assets.

Transmission assets, in particular, should be excluded because transmission remains a "de facto" monopoly with a relatively low level of risk.

Citing regulatory risk in claiming for the recovery of stranded assets would seem particularly problematic in the case of publicly-owned companies, where public authorities have agreed to market-opening; such costs, where identified, should be met through national budgetary mechanisms.

In all cases, it should be prohibited to earn a return on declared stranded assets for the duration of the cost recovery period.

Once recovery schemes have been granted, it is important to undertake strict monitoring with periodic reviews to check real values against estimated costs. If, for example, provisions that have been set aside are found to be excessive, there should be a mechanism by which the surplus is reimbursed or by which the duration of the transitional regime is shortened.

IFIEC Europe suggests that an independent follow-up committee be set up in order to co-ordinate the formal monitoring of stranded cost allowances and support schemes.

- ***AVOIDING MARKET BARRIERS***

Where a barrier to market opening is feared, appropriate involvement of anti-trust and competition authorities should be ensured to test conformity with Competition Law (Art. 90).

An overly-generous allowance for stranded cost recovery will offer incumbent energy suppliers an unfair competitive advantage over new entrants and therefore create market distortions that will inevitably lead to contentious situations.

<% Recordset1.Close() Set Recordset1 = Nothing %>