

POLICY ASPECTS of WHOLESale MARKET OPENING IN THE ENERGY COMMUNITY

Policy Paper – Draft for Discussion *prepared by the Energy Community Secretariat*

1. INTRODUCTION

The purpose of this Policy Paper is threefold:

- to provide a **political backup of the Contracting Parties** to the wholesale electricity market opening process in the Energy Community and to put the political focus on this matter;
- to bring the **scope of policy measures** aimed to support an open wholesale electricity market in the Energy Community to the attention and agreement of the Contracting Parties;
- to provide the Energy Community a **monitoring and benchmarking platform** for the implementation of a competitive wholesale electricity market environment.

The Policy Paper refers to policy measures which need to be taken by each Contracting Party locally – within its own legal and regulatory space. The measures however, should refer either to the internal wholesale trading instruments of that Party, or to the aspects of the Party in development of external (regional) electricity market environment.

The Policy Paper is drafted in supplement of other strategic documents relevant for different aspects of the wholesale electricity market in the Energy Community, in particular the *Regional Action Plan for Market Integration in South East Europe*. In that respect the Policy Paper may include specific *Local Action Plan* for each Contracting Party as recommended by the WMO Study – subject to subsequent gap analysis.

2. BACKGROUND

The establishment of an integrated market in natural gas and electricity in the Energy Community, based on common interest and solidarity is one of the core targets of the Energy Community Treaty¹. This determination is present even in earlier statements and declarations of the Contracting Parties, most notably in the Athens Memoranda of 2002 and 2003.

The process of development of a competitive electricity market within and among the Contracting Parties is continuously supported by the Energy Community. A number of policies in support of its practical implementation are embedded or indicated in the Treaty, in the relevant acquis and in several subsequent decisions of the Energy Community Ministerial Council. Each Party has benefitted from the technical support for studies, custom gap analysis and assistance for drafting the legislation provided within the Energy Community. A number of regional projects and studies on regional level have been developed by the Energy Community and the Donors' Community targeting this matter. Important studies and measures have been developed by the ECRB as well.

Substantial advancement is registered in the legal framework of all Contracting Parties compared to the conditions from several years ago. The structure of the electricity sectors has been modified. All Parties established authorities for regulation of the electricity market and progressed in development of

¹ http://www.energy-community.org/portal/page/portal/ENC_HOME/ENERGY_COMMUNITY/Legal/Treaty.

corresponding enforcement tools. Various policies have also been implemented for supporting this process in all Contracting Parties.

Despite all positive trends, the deadline for opening of the electricity market for all non-household customers has passed without the expected effects. Even slightly sophisticated trading patterns such as day-ahead market and balancing market are yet to be introduced. Acknowledging the efforts and recent progress made in the establishment of a common platform for cross border capacity allocation, no reliable deadline can be confirmed for regionally coordinated auctions in the Energy Community. At the moment there is no commercially available power exchange or other kind of organized platform for liquid electricity trading across the Region. Large industry is typically the first (and only) customer practically eligible for free purchase of electricity. Full and continuous electricity supply at regulated prices is available to the commercial, eligible customers to a prevailing extent. Regulated cost of electricity supplied to the end-customers under the umbrella of public service is often below the average wholesale market price. Access of a new supplier to the market and access of the eligible customers to new suppliers is hardly supported. The incumbent, state-owned generation is typically regulated, concentrated and dedicated to the “public supply” thus imposing market dominance, averting competition and distorting cost-reflectivity of tariffs and stability of market prices. Preserving the supply within the national or the system borders discourages potential investors, often involving state aid and fostering policies which apply protective approach to the “national” market and “national” approach to the regional market. There is no reliable surplus of generation capacity capable to support liquid competition on the market and most Contracting Parties are net importers of electricity. Cross-border exchange of electricity is sometimes not sufficient and load shedding schemes are still applied. Indigenous generation capacities are becoming progressively outdated and incompatible with the environmental requirements.

These and other digressions in the development of a competitive market environment require serious considerations, comprehensive treatment and carefully balanced policies.

3. APPLIED POLICY CONCEPT

A *Policy* in the context of this Paper outlines a set of coordinated measures taken by the authorities (energy ministries and regulators in the first place), aimed to have a specific effect on the practical functions within the electricity sector and support one or several aspects of the market environment.

In order targeted effect to be sustainable and reproducible, the Policy measures need to be supported by the Law, to be coherent with each other, feasible for the authorities, applicable for the stakeholders and to embed the principles of non-discrimination and transparency. The policies further need to be adaptable and to be subjected to monitoring, reconsideration and adjustment. Policy measures are often multidisciplinary and require coherent support from all relevant authorities in the related sectors of the economy. Policies require availability of sufficient resources – financial and human alike. Above all, successful implementation of a Policy requires allocation of sufficient administrative capacity and sustained political focus.

The administrative concept (building on the legal one) derives from 2 sources:

- Diversity of interests and priorities in the process of electricity market liberalization (which includes the opening of the wholesale electricity market) – such a process must resolve potential conflicts, find and support possible (compromising, partial or phased-out) solutions, resolve potential exemptions and fill other gaps in the practical implementation which are not fully supported by the mainline legal and regulatory platform; and
- Complexity of the market environment – where transposition of the *acquis* in the legal and regulatory framework is a prerequisite but eventually not sufficient step (or measure), and the process of implementation of a competitive market environment at some point must include interdisciplinary measures of predominantly financial, social, environmental, legal or technical nature in order to fulfill the targets.

This bottom-up approach is paralleled by the (top-down) obligations for the Contracting Parties imposed by the Energy Community Treaty. The Article 2 [Title I] outlines the scope of targets to be achieved by the Energy Community. Therein, “...to develop Network Energy market competition on a broader geographic scale...” [Article 2(1-e)] is stipulated in parallel with other such targets, referring to “...creation of a stable regulatory and market framework capable of attracting investment...” [2 (1-a)], and to “...creation of a single regulatory space for trade in Network Energy...” [2 (1-b)], as well as to enhancements of the security of supply, improvement of the environmental situation and use of energy efficiency and renewable energy, including to “...set out the conditions for energy trade in the single regulatory space...”. Evidently the context of the Treaty implies obligations for practical results of the underlined reforms rather than formal legal transpositions.

Following the structure of the Treaty, the targets are supposed to be met through various activities of the Energy Community outlined in Article 3, organized in three groups according to their domain. The “...extension of the *acquis communautaire*” (on energy, environment, competition, renewable energy – and security of supply as later expanded by the Ministerial Council) is one such activity imposed over the Contracting Parties [Article 3(a), Title II]. Notwithstanding that this is the fundamental set of activities for implementation of the Treaty by the Contracting Parties, it can by no means be observed as the single and only legal obligation in that respect.

Another set of Energy Community activities target the territories of the Contracting Parties and of some neighboring EU Member States, and include obligations for setting up “...the mechanism for operation of Network Energy markets” [Article 3(b), Title III], in particular related to:

- (i) Setting up of a specific regulatory framework permitting the efficient operation of electricity markets across these territories;
- (ii) Creation of a single mechanism for the cross-border transmission of electricity; and
- (iii) Supervision of unilateral safeguard measures.

The above set of measures should include policies for security of supply, public service obligation, universal provision of electricity, demand management, securing fair competition, reforms of the electricity sector – increasing the level of payments and affordability of electricity prices, compatibility of market designs, support to recognition of licenses and free establishment of companies, fostering the use of renewable energy sources and energy efficiency, as well as targeting coordinated management of unilateral safeguard measures in case of sudden crisis.

Third and last set of Energy Community activities encompass the Territories of the Contracting Parties and the EU member States and target “... the creation of a single energy market”. Activities should be focused on coordination of mutual assistance in case of serious disturbance or external disruptions in the supply. The measures should also reflect the achievements of a common external energy trade policy, including prohibition of custom duties, quantitative restrictions and equivalent measures, as well as some aspects of common regulation of imports and exports of Network Energy to and from third country markets.

Finally, in addition to whatever requirement linked with the implementation of the *acquis* is otherwise stipulated, the administrative platform of the Treaty includes a general obligation stipulated in Article 6:

“The Parties shall take all appropriate measures, whether general or particular, to ensure fulfillment of the obligations arising out of this Treaty. The Parties shall facilitate the achievements of the Energy Community’s tasks. The Parties shall abstain from any measure which could jeopardize the attainment of the objectives of this Treaty.”

All in all, the policy framework enforced by the Treaty includes:

- (i) Comprehensive and thorough transposition of the *acquis* (as stipulated in the Treaty and later updated and/or expanded by a decision of the Ministerial Council),
- (ii) Legal and regulatory enforcement of the *acquis* – through development of a coherent secondary legislation including required regulatory rules (as stipulated in the *acquis* itself); and

- (iii) Practical implementation of the Treaty – through a broader set of measures aimed to support the practical implementation of the *acquis* and the establishment, development and operation of a coherent and functional market environment (as stipulated in the Treaty).

The above pattern is applicable in the implementation of each segment of the Treaty including liberalization of the electricity market.

From the standpoint of establishment and operation of a wholesale electricity market, there are arguably three groups of applicable measures distinctive by their territorial aspects, provided in Table 1:

| | | Referential Sources | Implementation | Application |
|---|---------------------------|----------------------------------|-----------------------|-------------------------------|
| 1 | Local Policies | Treaty, Energy Community | Local level | Local level |
| 2 | Regional Policies | Treaty, ENTSO-e Energy Community | Local level | Regional level |
| 3 | Market Integration | Treaty, ENTSO-e Energy Community | Regional level | Local level Regional level |

Table 1 – Types of measures according to their territorial relevance

All measures are dedicated for implementation by the Contracting Parties and influence their market environment hence all of them have both types of local component – in their implementation and in their application. The classification applied herewith reflects their critical territorial relevance.

The first two types of policies reflect the scope of measures implemented on local level. Both kinds of measures stem from the Treaty. In addition there exist measures outside the Treaty, agreed by the Contracting Parties and enforced by the Energy Community to be implemented on local level (one example being expansion of the *acquis*), with either local or regional relevance. Such measures, structured into Local or Regional policies according to their relevance, are under consideration in this Paper.

The third set of measures, conditionally referred to as “Market Integration” relates to the set of measures which follow the basic targets of the Treaty but in practice outgrow its specific requirements. Such measures are agreed and implemented on a regional level and in coordination with the broader process of integration into the EU Internal electricity market. Their application in most cases has critical relevance on regional level, but sometimes also on local level (e.g. ITC Agreements). This kind of measures is treated in the *Regional Action Plan for Market Integration in South East Europe* and is not further elaborated in this Paper.

Following the aspects of territorial relevance, the Regional Policies (and Market Integration measures for that matter) include an additional consideration. The recent accession of *Moldova* (2010) and *Ukraine* (2011) to the Energy Community, while not imposing any modification of the Local Policies for these Parties except with respect to the applied implementation calendar, possibly introduce the need for selective treatment of these Parties with respect to the regional context of the Treaty. Consequently, for each of these Parties there is a potential need to consider additional measures addressing the geographical and technological factors which are distinctive for these two Parties, in order to maintain the required coherence of the regional components of the Energy Community.

Other modifications in the policy approach might be needed pursuant to possible introduction of the obligation for implementation of the *Third Energy Legislative Package* in the Energy Community.

4. REVIEW OF THE MEASURES UNDER THE TREATY

As it is indicated, the structure of the Treaty obligations basically follows their territorial relevance thus distinguishing three basic geographic domains, each with specific enforcement criteria and scope of relevant measures outlined in one of the Titles II, III and IV.

Introducing these Titles under the above Policy Concept, one can provide the following structure of measures relevant for opening of the electricity market, as enforced by the Treaty:

4.1 Local Policies

4.1.1 TITLE II

- a. Full legal compliance with the relevant acquis on **electricity** and **competition** including immediate eligibility status of all non-household customers (Chapters II and IV);
- b. Development of coherent **regulatory framework** and secondary legislation for enforcement and monitoring of the transposed legal provisions as applicable, including calendar for implementation (Chapters II and IV);
- c. Due legal compliance with the acquis on **environment** and **renewables** including action plans for further phased transposition (Chapters III and V).

4.1.2 TITLE III

- d. Transmission grid codes in compliance with the acquis – including sustainable and cost-reflective **third party access** rules, grid operation rules, adequate treatment of losses and ancillary services, effective use of transmission capacity, long-term investment planning in transmission, balancing rules, transparency and availability of operational and commercial information, etc. (Article 28);
- e. Mechanisms for enhancement of **security of supply** – long-term demand forecast and generation adequacy including strategy for investment in new generation capacity covering diversity of primary sources and transport routes, plans for refurbishment and decommissioning of old capacities, options for renewable energy penetration and use of CHP generation, prospects for reduction of energy intensity (Articles 29 and 35). In particular, full legal compliance with the acquis on **security of supply** pursuant to the relevant Ministerial Council decision;
- f. Measures related to **electricity supply to end-customers** – specific obligations for public service, quality of service, supply contingencies, protection of customers including socially vulnerable customers and evasion of energy poverty, energy efficiency and demand management, collection rate, treatment of losses, tariff methodologies, transparency, treatment of cross subsidies and state aid (Chapter IV).

4.1.3 TITLE IV

- g. Measures for removal of all non-compliant **administrative levies and quantitative restrictions** on exports and imports of electricity (Article 41), reduction of all unnecessary administrative procedures or corporate preconditions for cross-border trade of electricity;
- h. Measures required for the **establishment of local electricity markets** consisting of platforms for all commercially viable forms of trading, including day-ahead trading and adequate balancing responsibility, development of corresponding market rules, establishment of market operator and settlement agent as applicable (Article 42);
- i. Measures required for **supporting the local electricity market operation** consisting of gradual unbundling of domestic generation (enabling cost-reflectivity and transparency of prices and effective control of subsidies and state aid as well as providing capacity available to market participants), measures for purchasing energy for losses, balancing and ancillary services

through market instruments and measures in support of access to market for new suppliers and their withdrawal (Article 42).

4.2 Regional Policies

4.2.1 TITLE II

- j. Measures for **adaptation of the acquis** to the non-EU institutional framework (Article 24);
- k. Measures for adoption of **new acquis** – III Legislative Package, New RES Directive (Article 25);
- l. Measures on cooperation, coordination and participation in ENTSO-e and ACER activities – including on cooperation in implementation of corresponding rules and criteria for **security of network operation** (Article 23).

4.2.2 TITLE III

- m. Development of a regionally coordinated market-based allocation of **cross-border transmission capacity** and congestion management (Article 28);
- n. Measures related to **compatibility** of electricity market designs, reciprocity and mutual support of trading licenses and free establishment of companies (Article 34);
- o. Common policy for coordination and support for **investments** in new electricity generation – penetration of new renewable energy sources, environmental incentives, certificates of origin, renewable energy targets and investment support schemes, etc;
- p. Measures related to coordinated treatment of **safeguard measures** in case of sudden crisis and protection of market conditions in such cases (Chapter VII).

4.2.3 TITLE IV

- q. Measures required for **establishment of a regional wholesale electricity market** consisting of commercially viable forms of trading based on rules and principles compliant with the targeted EU internal electricity market (Article 42) including market model and rules, market operator;
- r. Measures for **operational support to regional electricity trading** (Article 42) including operational platform for regionally coordinated NTC calculation and cross-border capacity allocation, platform for coordinated operation of power exchanges in the region, commercial settlement agent (clearing house), regional dispute settlement authority, etc.;
- s. Common policy for treatment of exports and imports of electricity to / from third countries in compliance with EU principles (Article 43);
- t. Workable measures for mutual assistance in the event of disruption of electricity supply (Chapter IV).

5. POLICY TARGETS

In absolute terms it is difficult to isolate any set of aspects covered by the Treaty which are not related to the development and operation of an open electricity market (and for opening of the wholesale electricity market for that matter). Consequently, the implementation of the Treaty itself could be considered as an umbrella policy. Notwithstanding the possibility and existence of market-based electricity trading in the Energy Community without any specific regard to the Treaty, the establishment and sustainable operation of any kind of liquid trading platform would have to tackle most of the questions elaborated, directly or marginally, in the Treaty. Furthermore, a number of measures which are enforced by the Energy Community Ministerial Council in the context or in supplement of the Treaty also supports the opening of the electricity market and are subjected to due diligence.

In order to provide effective policy management platform for implementation of the Treaty (and in that context for liberalization of the electricity market) it is essential to cluster the measures linked to a specific target (or a set of correlated targets) in order to manage and monitor the consolidated outcome.

Arguably, five distinctive clusters of policies are identified through their broader targets and referred to herewith. The clustering model follows the familiar logical structure of the *acquis*. All of the policies include local policy measures however three of them are of predominantly local relevance while the other two include critically relevant regional measures.

5.1 Legal Compliance

Arguably, as broad as it looks, this is still a clearly local policy. The implementation of the Treaty and the *acquis* does include critical regional components however the measures seeking their full compliance are reflected on local level.

The compliance with the *acquis* extends over all the provisions of the Treaty due to the fact that each provision and its underlying measures need legal enforcement. The implementation of the Treaty requires full legal compliance as an intrinsic target so it represents a cluster. Nevertheless, it can be assumed that some measures (a, b, c, d, e, j, k, l, m) have the legal compliance with the *acquis* as their critical target.

In this context it is important to notice that the policies for reaching legal compliance are treated in THIS context only – which means that every other group of policies treated herewith will target its pivot priority and related practical measures WITHOUT addressing the question of the legal compliance of the framework backing up the practical implementation.

Achieving full compliance with the *acquis* is an iterative process including several rounds of approximation. Improving the state of compliance of the primary legal acts governing the energy sector is a fundamental activity in implementation of the Treaty and liberalization of the electricity market. At a glance it might even look as hardly a matter of state policy. However, the noteworthy difference in the state of compliance between the legal frameworks of different Contracting Parties puts it exactly there.

The referent EU *acquis* is available in two basic modules: (1) Directives – which need to be implemented through the domestic legal framework in each EU member State and consequently in the Contracting Party, and (2) Regulations, which are pre-enforced in the EU and the Member States are committed to them automatically, but still have to be transposed and implemented in the legal framework of the Contracting Party in the same manner as the Directives. Any other legal act which could become subject to implementation pursuant to a decision by the Ministerial Council must also go through this process.

The implementation of the *acquis* can be conditionally structured in three phases:

- (i) **Transposition** of the provision in a primary legal act. Transposition is semantic transfer of the relevant legal matter into a local legal act causing identical effect in the targeted legal framework (not necessarily transcription or translation of the language from the original act). The transposition includes full appreciation of the overall structure of the targeted legal framework and understanding of the required legal effects. The legal transposition usually includes minimum required stipulation in the broadest workable framework – the details are further derived in secondary acts. It is important to make sure that the process of enforcement is also legally supported.
- (ii) **Enforcement** of the transposed provision through related stipulations in one or more secondary legal acts. Enforcement needs to be exhaustive with respect to the legal matter, and to resolve conditions for exemption, disputes, complaints and appeals, cases of disobedience and penalties, as well as instruments for supervision, reporting and approvals, as applicable. The enforcement phase includes specific measures aimed to assure the level of confidentiality, transparency, non-discrimination, and to resolve possible conflict of interest.
- (iii) **Practical implementation** of the provision includes development of a set of support measures (as stipulated in the legal acts), required for the provision to yield its full legal effect. This phase

should encompass criteria for sustainability, reciprocity, flexibility and instruments for feedback to the next iterative phase. The practical implementation deals with management and allocation of resources, imposition of tasks and responsibilities, coordination among the authorities, etc.

All three phases are observed from the aspect of compliance – the first two through direct appraisal of the corresponding acts, while the practical implementation is assessed through monitoring of the practical effects and benchmarking.

The criteria for legal compliance of Ukraine and Moldova do not differ from those applied to the rest of the Energy Community however their recent accession requires specific measures and sustained political focus aimed to bring the pace of reforms in line with the commitments from their Accession Protocols and with the developments in the other of the Contracting Parties – in particular with respect to the legal framework related to market integration and the measures and priorities applied on the regional level. Measures for increased transparency and efficiency of the administrative environment also deserve special attention.

5.2 Customer Rights

This is another example of a Local policy. Measures targeting rights of the customers reflect on regional level only in the context of cross-border trade of electricity which is focused through a separate cluster of policies. The Treaty refers to this policy priority mainly in the item (f).

There are three basic aspects to be approached with respect to the treatment of customer rights:

- (i) **Public Service** is one of the overly used categories in the treatment of customer rights, unfortunately in most cases implemented and applied on the margin of compliance. One typical mistreatment is the lack of sufficient distinction between public company and public interest. Notwithstanding the existence and the disputable relevance of the public component in the corporate structure of the sector, this should be addressed only in the context of the market structure (treated separately). Public interest on the other hand, has to abandon the superficial context linked with the cost of supply which is a mere exemption from the market relevance and does not work in anybody's interest (which is another example of existing misuse of the concept). On the contrary, the public interest has fundamental and much broader scope of relevance which should include measures treating such aspects as environmental protection and prevention of climate change, energy efficiency and demand management, long-term security, availability and sustainability of the supply, safety and quality of supply services, accessibility of required investments for infrastructure, availability of information on the price structure, social dialogue, etc.
- (ii) Customer rights for **Universal Supply** of electricity belong to another platform for exemption from the default market conditions – applicable to specific classes of customers (households, and small customers identified through adaptable and applicable criteria which do not impede the liquidity of the market). Measures for universal service need to focus also on the concept of customer protection rights – having in mind ALL customers' rights (including of eligible ones), and including measures for support of switching the supplier, last-resort supply, transparency, availability and quality of information linked to for switching, information on the origin of electricity, etc.
- (iii) Protection of the **Socially Vulnerable Customers** is the third segment of treatment of customer rights which is available ONLY to a closed group of customers identified and periodically scrutinized on their eligibility for such protection. The measures should be temporary, and must include high level of transparency and efficiency. Usually rely on socialized subsidies or a form of state aid. Most common misinterpretation relates to the use of consumption-sensitive cost patterns ("Block-tariffs") which are available to ALL customers and do NOT belong to this category of measures but rather to demand-management (energy efficiency) ones. Financial protection needs to be accompanied by other support measures related to energy efficiency and

energy savings as well as measures targeting alleviation of energy poverty (on a broader policy level).

The measures in the context of customer protection are closely linked with other kind of policy priorities related primarily to security of supply – such as measures for application of curtailments (load shedding), measures for improvement of collection rates and measures for reduction of losses in the network (in particular non-technical losses) and elimination of electricity thefts.

With respect to Moldova and Ukraine, the underlying criteria related to customer rights do not differ from those applicable to the other Contracting Parties. Specific policy measures could be considered however addressing the need for faster and more efficient reforms in order to bridge the gap caused by the deferred accession.

5.3 Supply Conditions

Policy measures related to supply (including, but not limited to security of supply) are substantially related to the regional context at least in three aspects:

- Trading platforms and access of third countries,
- Interconnection infrastructure, and
- Mutual assistance in cases of disruption

In all of these aspects it is linked to the applied policies which are primarily focused on the cross-border exchange of electricity, and the above aspects are treated in the context of the measures relevant for that particular priority. The customer supply again could be considered as a dominantly Local policy. The Treaty is treating the measures related to supply mainly in (e, f, h, i, l, o, p, s, t) herewith.

The supply conditions are considered in a dual context – as a general priority for security of electricity supply (in terms of availability and sustainability), and as particular conditions of electricity supply to final customers (in terms of accessibility and affordability). In both cases policy measures are applicable, covering the following main areas:

- (i) **Balancing the demand** of electricity includes several substantial policy aspects such as long-term demand forecast, investment planning, diversity of primary sources and use of renewable sources, availability of local primary sources, generation adequacy, the process of refurbishment and decommissioning, and access to electricity markets. One sensitive area is the use of state aid which may come as a direct one – including interventional imports of electricity, as well as implicit forms of state aid applied through lack of unbundling and transparency of generation costs (e.g. cost of mining) and cost of network losses (level and conditions for covering such costs). Another such area is the treatment of bad debts of the state-owned companies as well as the rate of collection and level of theft of electricity (non-technical losses). On the other end, this area of measures encompasses development of investment climate including reliable information and effective and transparent procedures for new generation capacity authorization and tendering. The safeguard measures in case of sudden crisis are treated in the context of their limited (negative) impact on the free market operation.
- (ii) **Cost-reflectivity of prices** reflects the area of customer supply. Measures are introduced to complement for the inefficiencies of still underdeveloped market conditions and lack of liquidity. One general mistreatment is the availability of electricity supply under regulated prices for all customers including the eligible ones. Regulation of the supply is certainly a divergence from the market and undermines conditions for competition and liquidity of the market – in this respect it must be treated as an exemption rather than a rule, and to be made available under restricted and closely supervised conditions. On the other hand it is ultimately important to develop every possible measure in support of liquid market operation – including for support of easy access to the market for new suppliers and eligible customers (switching platform) and measures for customer support in the transitional period. The cost-reflectivity itself cannot replace effective market supply under competitive conditions however it can be used as a measure to minimize

the damage to the market imposed by the regulated costs of supply, and must reflect all aspects of the sustainable development and effective transposition of costs. Affordability of electricity is related to the set of measures referred to under the focus of protection of customer rights. Elimination of cross-subsidies between different classes of customers is another sensitive and badly required policy target.

The security of supply further encompass security of network operation, as well as adequate transposition of costs related to the use of transmission and distribution networks including balancing and ancillary services and required investments, in the corresponding tariffs.

With respect to Moldova and Ukraine, regardless of any existing regional priorities critically relevant to this issue the underlying criteria related to security of electricity supply and to conditions of supply do not differ from those applicable to the other Contracting Parties. Specific policy measures could be considered however addressing the need for faster and more efficient reforms in order to bridge the gap caused by the deferred accession.

5.4 Local Market Structure

Development of effective local market is a logical (and formal) prerequisite for the process of regional market integration. The main downsides in this respect are:

- the existence of small and fragmented markets (save for Ukraine), and
- general deficit of available generation capacity

Both factors practically eliminate the possibility for establishment of efficient competition on local level. Nevertheless the local market is still the initial step, required primarily in order to establish in each jurisdiction a compatible market framework, coherent market structure and conditions, as well as policies for support of market operation and market integration.

The Treaty is generous in provisions related to the local markets, the main of them being reflected in (d, g, h, i, n, p, q, r). Again, the main aspects of regional integration of the local electricity markets are reflected in the policy focused on regional (cross-border) exchanges of electricity and in the context of integration to the EU internal market, rather than within the scope of this policy priority. Having this in mind, the Local Market Structure does contain critical measures applicable on regional level.

The measures related to development of applicable market structure can be approached in the following context:

- (i) **Unbundling** is the main policy derived from the precondition for easy access to the market and the common infrastructure for all (new) market participants, and implementation of the principle for non-discrimination. Evolving from integrated and closely regulated supply platforms, the electricity sectors of the Contracting Parties need to observe and develop functional and legal unbundling as prerequisites, as long as the adverse effects on competition become insignificant. The unbundling starts with the transmission network and includes the support of third party access. Its further progress should be considered having in mind unbundling of all network services (regulated) from the competitive activities of generation and supply. Further steps could be consider to allow effective penetration of the process of unbundling in the supply (regulated from market-based) and in the generation, which is highly concentrated and still dominantly regulated activity. Another aspect is unbundling of accounts as well as unbundling of costs of services in the generation and transmission – all of these are needed for effective cost-reflectivity in the first place.
- (ii) The establishment of **Market functions** requires another set of measures which encompass support for supplier switching, market-based balancing mechanism and provision of ancillary services, as well as effective financial settlement mechanism. Again we could consider relevant to include the supplier of last resort with understanding of its limited and temporary role to support the feasibility of the switching mechanism and not to substitute it. In each of these functions the criteria for eligibility are relevant only in the transitional phase before full

liberalization – notwithstanding the need for legal compliance in this respect the practical implementation should focus on policies aimed to support the free trading part of the supply. The development of more sophisticated trading platforms is considered in another context.

- (iii) **Market Monitoring** is an “outsourced” aspect of the market structure placed outside the market itself (performed by an independent regulatory authority) but equally relevant. The principles of unbundling and transparency come as prerequisites for this function, as well as the platform (rules, terms, rights and responsibilities) for monitoring, reporting, penalty and complaints. The scope of monitoring is another disputable question as is the criteria for reporting – in any case the policy should apply measures yielding relevant and applicable results. Market concentration (in generation as well as in the supply) is one such aspect subject to monitoring. Transparency in the reporting is equally relevant as in the monitoring. Penalties need to be effective, and cooperation (sharing the competences and powers) with the competition authority in this respect could be a feasible option.

As it is obvious, the electricity market should not be observed by the policy makers only as another means for supply of electricity to customers (i.e. as alternative to the regulated supply whenever applicable). On the contrary, the positive effects of the electricity market include those not available through regulated mechanisms – provision of correct locational signals to the investors is one such example.

The liquid electricity market is linked with abundance (i.e. excess) of generation capacity and available transmission capacity – if this is not provided it is difficult to expect the market structure alone to provide the required effect on the prices. Therefore the policies targeting development of the investment climate and support of new investments in generation capacity (relevant also for the security of supply) should be considered among the basic criteria when deciding on the market development policy priorities as well.

With respect to Moldova and Ukraine, regardless of any existing regional priorities critically relevant to the development of their local electricity markets the underlying criteria applicable in the Energy Community do not differ from those applicable to the other Contracting Parties. Specific policy measures could be considered by these Parties addressing the need for faster and more efficient reforms in order to bridge the gap caused by the deferred accession.

5.5 Cross-border Exchange

The cross-border exchange of electricity stands here in reference of all policies which include activity with the named effect. This set of policies relates primarily to cross-border trade and the regional aspects of wholesale electricity market liberalization, and encompass most of the dominantly Regional policies of the Treaty, namely (d, e, g, l, m, n, p, q, r, s, t). The same matter however is covered in the context of the regional action plans, outside this Paper. Consequently, the policy elements treated herewith reflect those aspects which are of critically local relevance.

Three basic areas of consideration are relevant for this policy targets:

- (i) Alleviation of any **Export / Import Taxation** and any other administrative measure with the same effect - the policy is derived from the principles of free trade which also include elimination of any technical barrier to trade or quantitative restriction. The policy is of crucial importance and its effects can be detrimental for the market under conditions of insufficiency of the supply (i.e. generation).
- (ii) Another policy aspect relates to the development of a **Regional Trading Platform** for different products and time horizons. This also includes market-based methods for allocation and use of cross-border interconnection capacity, and development of regional balancing mechanism and ancillary services market. The policy in this context also reflects the local component of each relevant regional measure including establishment of an ITC mechanism, availability of information and criteria for transparency, establishment of various regional mechanisms for power trading and consequent steps for regional market integration.

- (iii) This area also reflects the measures aimed for development of a platform for **Mutual Assistance** in the event of disruption of the electricity supply – in a broader context and in supplement to the mentioned ancillary services market.

The regional policy measures include strong consideration if the process of coordination, solidarity and mutual assistance among the Contracting Parties.

The above policy aspects come as a general framework and do not specify measures applicable in the local policy context, required or aiming to support the activities indicated, specified and implemented on the regional level in the process of implementation of the Regional Action Plan for Opening of the Wholesale Electricity Market in the Energy Community and its integration into the EU Internal Market.

As it is previously indicated in this document, Ukraine and Moldova need to consider additional priorities and policy measures aimed to overcome their deferred accession as well as their inherent distinctions from the South East European electricity market environment. The later is particularly important in the context of the regional policies with critical relevance for regional market integration. This process needs to include measures for effective administration and closer horizontal cooperation of national operators and authorities with the Energy Community and the relevant EU authorities (including ENTSO-e and ACER).

6. GENERAL POLICY FRAMEWORK

General pre-conditions for effective development and implementation of policies level are:

- (i) broad public awareness of the targets and required measures, the regional processes and required local measures;
- (ii) internal political consensus and focus on the policy priorities, common level of cooperation;
- (iii) adequate administrative capacity for implementation (by each Party)
- (iv) overcoming differences in local economic development and conflicting interests of different stakeholders participating in the process

In particular, the policy framework should include two general aspects which need to be considered.

6.1 Policy Priorities

Implementation of any policy includes a set of inherent conflicts between different measures of the same or related policies. The main source of such conflicts lies in the definition of the policy targets, and in each case of conflict there is a need to take a decision on:

- the priority aspects with respect to the conflicting measures, or
- a compromise between the expected outcomes from each of the conflicting measures.

This conflicting effect is continuously present or revisiting the policy platform in several typical aspects. Examples of such conflicting policy aspects are:

- Security of supply versus cost of supply
- Open access toward the markets versus dependence on imports
- Predictable regulation versus effects of competition
- Investment risk versus cost of guarantees
- Effective technology versus efficient economy
- Energy savings versus energy revenues
- Refurbishment versus new development

In response to such conflicts it is prudent to develop a predictable set of rules and criteria which should be applied in resolving the conflicting events.

6.2 Administrative Capacity

Another crucial aspect for the successful performance of the policy framework is linked to the level of resources allocated on implementation of the policy. In this context there are three aspects of the resources:

- Financial resources
- Human resources
- Administrative capacity

In particular, the administrative capacity engaged with the implementation of a policy is of crucial importance, reflecting not only the number of man-hours or availability of engaged administrative staff and its expertise but rather the capability of the administrative apparatus to bring the required decisions and the political focus allocated to the policies at hand.

7. NEXT STEPS

In this context the proposal to the PHLG is to support the following next steps:

- **update of the proposed approach according to comments and proposals (the Contracting Parties, the Secretariat)**
- **individual gap analysis and draft Local Action Plan for each Contracting Party in annex to the Policy Paper in line with existing deadlines (the Secretariat, the Contracting Parties)**
- **regional gap analysis focusing on Moldova and Ukraine and proposal of specific measures for each Party targeting faster integration on regional level and the EU Internal Market (the Secretariat)**
- **Adoption and implementation (the Contracting Parties), monitoring, advice and assistance (the Secretariat, EC)**