

Paris, November 14, 2012

## **RTE's answer to the public consultation launched by ACER regarding Consentec's draft final report on the "Review of the ITC annual cross-border infrastructure compensation sum**

RTE welcomes this work from Consentec as a clear analysis of the scope of ACER's opinion to be delivered to the European Commission. Moreover, the various interpretations Consentec has proposed on European regulations (§2.2.2 and 2.2.3, and 3.2.1), and on the prioritization of the goals of the European Commission, are coherent with our view that the topic is complex and needs to be analyzed as an incentive to reach these European goals, in a global view of the European electricity sector.

RTE would like to thank ACER for this opportunity to express its views on ITC.

A first point to keep in mind is that, according to Kirchhoff's laws, **physical flows in a meshed network merge the effects of both internal and external generation and load patterns. These do not only result from commercial exchanges between bidding areas but also from energy transactions within a bidding area.** Therefore, the link between physical flows and commercial exchanges often appears to be quite weak. It is thus nonsense to consider that an import at a border and an export at another one result in a physical flow transiting all over the country. It is also nonsense to consider that all loopflows in the meshed network result from exporting or importing balances. The current situation of "German flows" through Poland and the Czech Republic is a good example of such a case.

Historically, the CBT (former name of ITC) mechanism was designed to address a concern of the Florence Forum of Regulation of 1999: the transaction-based transmission fees induced an inefficient pancaking effect. To cope with this issue, the first CBT mechanism was launched in March 2002 by 8 countries<sup>1</sup>. However, at the same time, new market-based capacity allocation mechanisms were designed to replace the long-term commercial agreements. These new mechanisms (auction or market-coupling mechanisms) represent a transparent, efficient and non-discriminatory market and, as such, are meant to cover the cost of the capacity sold: capacities are developed until marginal costs overcome gain in social welfare. **In this view, capacity allocation mechanisms and the current ITC mechanisms covers twice the costs induced by flows resulting from commercial exchanges between bidding zones.**

Generally speaking, before discussing the Consentec report on the size of the infrastructure fund, RTE is convinced that the definition of costs effectively occurred must be first addressed to comply with **the letter of ITC, namely a compensation for net costs really incurred.** This implies to determine carefully the flows basis to take into account, given the complex link between physical flows and commercial exchanges and the benefits induced by commercial exchange through capacity allocation mechanism. In the current framework, RTE believes the current ITC infrastructure fund

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<sup>1</sup> Namely Belgium, Switzerland, Germany, Spain, France, Italy, Nederland and Portugal.

leads to a **disincentive to attain European objectives**, namely sufficient investment and an Integrated European Market. **This disincentive increases with the amount of the fund.**

As a consequence, **RTE would advocate for an ITC infrastructure fund to be set to zero euro** during the drafting of the “*network code on rules regarding harmonized transmission tariff structures including locational signals and inter-transmission system operator compensation rules*”, as provided in the article 8-6-k of regulation 714-2009 and in the ACER 2013 work plan.

This strategy would also give the Agency some time to answer the request of the 22nd Florence Forum regarding a possible enhancement of the current mechanism to tackle issues raised by “unallocated loop flows”<sup>2</sup>, even if, according RTE’s opinion, local solutions should be first considered to fix these local issues.

The comments made below on Consentec report are therefore **mainly methodological comments but do not mean that any improvement of the methodology can be satisfying for RTE as long as the abovementioned flaws of the mechanism leading to an inefficient double compensation are not addressed.**

### 1) Has Consentec’s study considered a sufficient range of potentially suitable options for assessing the ITC infrastructure fund? What other options do you believe should be included in the assessment?

Consentec mainly focuses on one method, based on the assumption that international transits and national consumption use the same amount of assets per MWh consumed and exchanged. Three variants then mitigate the effect of this assessment on the size of the fund.

The first option that should be assessed is to **adapt the GTS per voltage layer**. The Consentec method experiences huge changes by changing the depth of the network considered: the magnitude of the ITC infrastructure fund can be divided or multiplied by two or three by considering more or fewer voltage network layers. This drawback of the method can be corrected by multiplying the total valuation of each network layer by the part that the transit represent for this given network layer.

The formula then would be

$$\sum_i \text{valuation of network layer } i \times \frac{\text{transits in network layer } i}{\text{consumption} + \text{transit in network layer } i}$$

instead of

$$\sum_i \text{valuation of network layer } i \times \frac{\text{transits}}{\text{consumption} + \text{transit}}$$

Physically, this option is justified by the fact that a given national transit is first transmitted by the EHV layers, and then by the lower voltage layer until its final consumption. Thus, the consumption of a given voltage layer bears a part of the cost of higher voltage layers. Contrary to this national consumption pattern, all international transits only use the transmission networks, and can be

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<sup>2</sup> Loop-flows not resulting from capacity allocation mechanisms.

considered on the first order to stay on a given layer<sup>3</sup>. Then, **the cost of others layers must not be borne by this transit.**

A second point regarding the GTS is that **import and export is also a function of transmission network.** Then, the formula of GTS should be

*transits on layer i / (consumption + transits, imports and exports ensured by layer i).*

Regarding LRAIC, **historical costs and adequate return should be considered as variants**, as expressed in our answer to Question 7.

Another evolution of the Consentec method could be to take into account the **situations where transit flows diminish the use of assets**, as observed in the result of losses calculation for the ITC losses compensation mechanism.

Regarding congestion rents, as developed in our answer to question 5, two others can also be considered as options: **100% of assets financed by a European source** (congestion rents or European grants) to be subtracted from the assets to be compensated by the ITC infrastructure fund (to avoid wrong incentives to investment, see our answer to Question 3), and **congestion rents to be deducted from the ITC compensation to be received**, in accordance with Article 13.6 of Regulation 714-2009 which states that "*Benefits that a network incurs as a result of hosting cross-border flows shall be taken into account to reduce the compensation received*".

Finally, the history of ITC shows that **many other methodologies are possible to assess an ITC infrastructure fund**: AP, MP, IMICA, the proposed Consentec method.

A broader, second opinion on ITC infrastructure fund, focused on **a clear inventories of possible methods and their pros and cons** could then be a useful first step, once compensation and contribution redesigned to address the issues raised by the current mechanism, to decide the correct methodology to adopt, **with due regard to European policy goals to promote**. In this view, RTE is presently performing a complementary study to the Consentec one and is ready to communicate it to ACER once it will be finished

## **2) Are the criteria adopted to assess these options and their application to the identified options appropriate? What additional or alternative criteria do you think should be applied?**

RTE obviously agrees with Consentec's criteria that these options must respect the current and foreseen legal framework. Regarding Consentec's criteria of simplicity, RTE believes that this criterion should be used as an Occam's razor criterion: in front of two different relevant options, the simplest should be applied. But requiring *ex ante* a simple solution can lead to misinterpretation: the business of electricity transmission is not simple and needs huge calculation to be efficiently run. Abusive simplification can lead to mistakes with huge consequences on markets and domestic consumption.

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<sup>3</sup> In fact, for large countries, the fact that impedance is lower in higher voltage layer tends to concentrate transits on the EHV network layer. This means that the GTS on the 400kV could be increased, and lower voltage network layer GTS could be lowered.

RTE believes that three other criteria would be beneficial to add:

- **A proportionality principle:** RTE believes the proposed valuation of ITC infrastructure fund questions the very notion of compensation as required in both regulations (EC) 714/2009 and (EU) 838/2010. According to RTE's understanding of general principles of laws, compensation must be granted any time that an economic operator suffers a loss or incurs damages, but cannot overcome those damages effectively incurred. Thus, **the ITC fund shall aim at compensating the costs induced by the international transit<sup>4</sup> without overcoming it.** The question to address is then to define which part of these costs is not covered by the capacity allocation revenues. Going beyond this residual amount would imply that the ITC covers more than the damage actually incurred, and thus would appear as a violation of the principle of proportionality, as defined in the Article 5 of the TEU.

A reference to the costs to be covered is made in Article 14 of Regulation 714/2009: "*charges applied by network operators for access to networks shall [...] reflect actual costs incurred*". Regarding capacity allocation revenues, enhanced capacity calculation and allocation methods foreseen in the future network code on capacity allocation and congestion management will better take into account physical flows resulting from commercial exchanges and their impacts on affected networks (physical constraints). Congestion revenues will then constitute a more accurate (reflective of the physical constraints limiting exchanges) and efficient (market-based) coverage of costs incurred as a result of hosting cross-border flows of electricity on national networks.

- **An incentivization criterion:** ITC costs and revenues change the repartition of costs and benefits of assets throughout Europe, and the consequence of these changes on the incentives of TSOs, NRAs and national administrations to build the target model of an Integrated European electricity Market should be assessed (see the answers to Questions 3 and 5 below);

- **A principle of coherency with generally approved accounting principles:** assets should be depreciated, and a clear methodology should be developed to ensure that no assets are remunerated twice (see answer to Question 3 below).

### 3) Of the options identified by Consentec, do you have any preferences? If so, please provide reasons for your preferences.

As explained above, RTE believes that the current ITC mechanism cannot compensate efficient infrastructure costs and that any increase of the fund would increase the inefficiencies of the mechanism.

From a methodological point of view, the incremental and restricted absolute variants suffer two main drawbacks:

- **Regarding the incremental method, decommissioning is not taken into account**, which means that an asset decommissioned during the 100 M€ depreciation period will be paid twice. To our understanding, while the new asset increases the fund according to its full LRAIC valuation, a decommissioned asset should lead to a decrease of the fund by its

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<sup>4</sup> On this topic, we strongly disagree with the Consentec statement: "*precise cost recovery has lower priority for ITC*" (p. 16).

remaining economic value. This is not done in Consentec's method, which obviously leads to a double remuneration of assets.

- **Regarding the restricted absolute method**, RTE does not understand the economical meaning of the method. By considering as a start value 1958 (Treaty of Roma), which is seen by many as the birth of Europe, one would obtain the fund value of 1.67 G€ in 2011, although by considering the year of entry into force of the regulation 838-2010 leads to 32.5 M€. **A mere change of the parameter leads to a change of the result in a ratio of more than 50** which is, according to RTE's opinion, a huge drawback of a method of valuation.

Absolute can be seen as one logical way (among others, as developed in our answer to Question 1 above) of assessing the ITC fund, but:

- **the rate of return (RoR) of LRAIC valuation of assets needs to be adjusted to ensure that the product "LRAIC x RoR" is coherent with sum of cost of capital (plus 2% OPEX<sup>5</sup>) of the total European Network**, in order to comply with the above mentioned principle of proportionality;
- the methodology on depreciation should be better explained: the formulas, page 22 to 24, include no depreciation, so assets are compensated until decommissioning, as confirmed by Consentec during the workshop. However, Figure 4.3 on page 33 of the report shows that the LRAIC valuation of assets changes with depreciation time, in a magnitude compatible with depreciation charges covered by the ITC infrastructure fund. If so, this would be a double payment of assets: **one through interest ad vitam aeternam, and a second through depreciation charges**. RTE believes that assets should be depreciated and double payment of assets should be avoided in coherency with our request for a coherent accounting principle criterion, and with Article 13.3 of Regulation 714-2009 which states that "Compensation payments shall [...] **reflect costs actually incurred**";
- **European grants and congestion rents need to be deducted from the ITC related assets** (i.e. after the multiplication by the GTS factor), otherwise national transmission sectors would experience wrong incentives to use this source of revenues. In the current Consentec method, for domestic consumers of beneficiary countries, a domestic asset financed this way leads to future tariff decreases, as 93% of the cost increases future ITC infrastructure revenues. Conversely, for domestic consumers of contributing countries, a domestic asset financed this way leads to future tariff increases, as 93% of the cost increases future ITC infrastructure payment. This is obviously an over-incentives for beneficiary countries and **a disincentive in contributing countries to develop assets financed through European grants and congestion rents** ;
- **Generally speaking, the inclusion of a given TYNDP investment in the valuation of the ITC infrastructure fund should be decided by the relevant Member State, to prevent the disincentive caused by its possible adverse effect due to future ITC payment;**

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<sup>5</sup> As proposed by Consentec (page 17).

- **Connection assets should be excluded from total assets** (i.e. before the multiplication by the GTS factor), as they obviously experience no impact due to international transits. This class of assets has led to minor error in the past, but increasing connections of offshore wind farms makes this bias more and more important;
- As stated in our answer to Question one, the valuation applied by Consentec should be corrected to take account of the fact that **some international transits diminish the use of transmission assets rather than increase it.**

#### 4) Are the assumptions adopted for the illustrative numerical analysis appropriate? Considering the practical limitations of availability, what other data or assumption do you believe should be used in such analysis?

RTE believes that ITC data regarding losses, and especially snapshots and losses calculation results, can help Consentec to obtain results more coherent with the costs of networks, as determined by NRAs and required in Article 13.3 of Regulation 714-2009.

#### 5) How do you believe the different parts of the congestion revenues should be treated in calculating the ITC infrastructure fund and why?

According to RTE's opinion, the analysis of the interpretation of Article 13.6 of Regulation 714-2009 where benefits of transits are congestion rents in page 10 of Consentec's report is not convincing. If a clear methodology had been adopted in the past to fix the 100M€ current fund size, this methodology would have been used to reassess it, and ACER would not have asked Consentec to develop a methodology. Moreover, Consentec argues that if this interpretation is valid, the infrastructure fund would not have been static. Indeed, the fund size has not been static in the past, as it has evolved from 117M€<sup>6</sup> to 300M€ before decreasing in 2010 to 100M€. Furthermore, in any case, Consentec proposes a dynamic fund, totally coherent with this interpretation.

To our point of view, at least 3 methods could be tested:

- The Consentec method which considers that 7% (the GTS factor) of the assets financed through Article 16.6 of Regulation 714-2009 must be excluded. However, as explained in our answer to Question 3, this method leads to wrong incentives to develop assets;
- An alternative method, considering that the assets financed through Article 16.6 of Regulation 714-2009 must be excluded from assets to be compensated through ITC;
- An interpretation of Article 13.6 of Regulation 714-2009 considering that compensation of costs incurred is calculated and then compared to the revenues collected through congestion revenues. The part of the compensation that can be funded through congestion revenues is funded this way (Category (a) of Article 16.6 of Regulation 714-2009) with the remaining part

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<sup>6</sup> Size of the 2003 CBT fund, before the introduction of the losses compensation mechanism

funded through a contribution of the responsible for the cost incurred<sup>7</sup>. This can be done on a country-by-country basis or by treating Europe as whole.

Another point that needs to be discussed is the fact that Consentec completely excluded these Category (a) costs. To our understanding, these costs are OPEX, included in the infrastructure compensation as described on page 17 of the Consentec report and, thus, must be considered in the amount of assets' costs already covered by another source than national tariffs.

A general comment on Consentec's interpretation of legal framework is that **once different interpretations are recognized, they all have to be economically assessed**. To RTE's understanding, only the European Commission or the European Court of Justice can assess these legislative interpretations.

### 6) Do you agree with Consentec's assessment and the preliminary conclusions on the options for determining the ITC infrastructure fund?

As expressed above, we cannot agree with Consentec's assessment and their preliminary conclusions as we believe that ITC infrastructure mechanism leads to wrong incentives and, as such, needs to be set to 0€ to lower perturbation from market equilibrium.

Another concern is that Consentec study **allocates costs of infrastructure between two uses of the network**, international transits and national uses, **according to two different references of costs**, regulated ones and LRAIC. An assessment of this method with the criteria mentioned in our answer to Question 2 would be beneficial, as **no national tariffs in no country allocates costs with a similar method**, i.e. by sorting flows based on their origins.

Moreover, we believe that only one option was investigated, with three methods to mitigate it with the current ITC infrastructure fund amount. We believe the method used by Consentec to give more "reasonable" results<sup>8</sup> if the suggestions in this answer are taken into accounts, but others methods should also be investigated (see our answer to Question 1).

Ideally, the current ITC infrastructure mechanism should be replaced by a more "market-compatible" mechanism, which gives correct incentives for the completion of the European internal market in electricity. Such a mechanism will have to consistent with several relevant related topics which are briefly exposed under point 8.

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<sup>7</sup> Which are not necessarily net importers and net exporters, but "*the operators of the transmission systems from which cross-border flows originate and the systems where those flows end*", as stated in recital 11 of regulation 714-2009. In the current European markets, a balanced country commercially exports some flows and imports some others at the same time.

<sup>8</sup> Consentec report, page 43: « obtaining reasonably sound cost figures could be the decisive criterion... »

## 7) What are your views regarding the suitability of using LRAIC to determine the ITC infrastructure fund? Do you consider the LRAIC proposed by Consentec appropriate?

LRIC was used during the liberalization of telecom sector for three main reasons:

- Telecom networks are essential facilities;
- Telecom networks have experienced a very strong negative price deviation during recent years (1Tb is transmitted at a lower cost with new optic fiber than with old copper networks); and
- These LRIC costs were used to propose transparent, competitive prices to new entrants (asymmetric regulation) to introduce competition and bring new services and innovation in this sector.

Contrary to the telecom sector, the electricity transmission sector has experienced strong volatility and a huge positive price deviation in recent years which means that LRIC costs evolve far faster than inflation. In this context, the asymmetric regulation applied in telecoms would have led to regulated costs being adopted to avoid new entrants experiencing a higher cost than the incumbent which is obviously a barrier to entry.

Moreover, in the ITC contract, LRAIC is not used for new entrants, but for a contract between TSOs that are local monopolies.

Finally, the Consentec report shows that the national LRICs vary in a ratio from 1 to 10, and that this amplitude continues to grow. There is no explanation for these differences.

Given this, we do not see what makes LRAIC suitable for the transmission business. However, this reference to LRAIC could be seen under certain circumstances as being not proportional, as they sometimes do not reflect the real costs incurred by TSOs when hosting cross border flows.

Considering the asymmetric aim of LRAIC in the telecom sector and the fact that compensation cannot exceed cost really incurred, we believe **the rate of return of the assets valorized through LRAIC should be adjusted to assure that the return of the total European assets is below the sum of cost of capital (plus 2% OPEX) of the concerned TSOs.**

## 8) Are there any other issues that you believe should be taken into account in this review? In particular, how do you believe the on-going wider developments in the European energy market and regulatory arrangements should impact the ACER's proposal on the infrastructure fund?

As stated above, RTE believes these items are of foremost importance, as the ITC infrastructure fund is an administrated financial mechanism which can have negative effect on the completion of the internal electricity market.

RTE would like to stress the link between these several different debates within Europe:



- ✓ The debate launched within the Florence Forum about cross-border redispatching including cost-sharing arrangements,
- ✓ The distribution of congestion income mentioned in the draft CACM network code,
- ✓ The sharing of investment costs between different countries proposed by the Infrastructure Package,
- ✓ And of course ITC infrastructure and losses funds.

All these elements are network or system charges or revenues: when occurring within one country, there are already clear and transparent rules on the way they are allocated among national users to avoid discrimination.

Today at the European level, there are no similar general rules even if the recent THINK report “EU involvement in Electricity and Natural Gas Transmission Grid Tariffication” could give a first input to launch an in-depth debate to avoid incoherent approaches on these costs and revenues sharing topics.

RTE would like to underline that this simply calls for **the application of Regulation 714/2009 which asks for a network code on “rules regarding harmonized transmission tariff structures including locational signals and inter-transmission system operator compensation rules” (Art. 8-6-k)**. RTE then welcomes the fact that the European Commission and ACER have retained as a priority to work in 2013 on “rules regarding harmonized transmission tariff structures and/or investment incentive”<sup>9</sup> and asks for the assessment of the size of the ITC infrastructure fund to be treated then.

The **interference between the European Infrastructure Package (EIP)**, which is an *ex ante* mechanism to share costs, **and the ITC mechanism**, which is an *ex post* mechanism is obvious, but its treatment is not straightforward, especially because the EIP only takes into account PCI, which is a small part of the EHV/VHV network, while ITC considers all network layers above 200kV (and can even consider lower voltage layers: see pages 27 and 28 of the Consentec report).

The **introduction of more coordinated capacity allocation mechanisms like flow based market coupling** (expected by the end of year 2013 in the CWE area) will lead to a deep change in the distribution of the benefits of transits. In accordance with RTE’s opinion that ITC mechanism must not disincentivize actors from quickly developing an efficient internal market, we believe that this change in the distribution of benefits from international transits should lead to an adaptation of the ITC infrastructure mechanism, in accordance with Article 13.6 of Regulation 714-2009.

The **development of RES and unplanned flows** in some area can also lead to modification of the ITC mechanism, as expressed by the 22<sup>nd</sup> Florence Forum. We believe that this issue can be addressed as a part of the “incentivization criterion” we advocate for in our answer to Question 2.

According to RTE, **these huge changes in the distribution of costs and benefits from international transits would justify an evolution of the current ITC infrastructure mechanism before changing the size of the fund.**

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<sup>9</sup> Commission Decision of 19 July 2012 (2012-413-EU) and 2013 Work Program of the Agency for Cooperation of Energy Regulators.

RTE, once again, thanks ACER for this opportunity to share its view and stays at the disposal of ACER and Consentec regarding any point of this answer. We believe that the ITC mechanism is a very complex issue in a fast moving environment, and we would be pleased to develop any point of this paper to better express our view and discuss our interpretation of facts and data.