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H U N G A R I A N C O M P E T I T I O N A U T H O R I T Y

**Executive Summary prepared on the basis of the draft report on the inquiry
into the Hungarian electric energy industry**

Budapest, 22 December 2005

1. After 1 January 2003 market forces are allowed to freely affect processes on the Hungarian electricity markets. However, the advantages and beneficial effects, which liberalised markets are expected to produce have not emerged to an extent experts believed they would.

2. Based on Article 36/A of the Competition Act the President of the Hungarian Competition Authority opened a sector inquiry in order to understand why the problems mentioned above arose and to prepare the necessary measures and suggestions. The aim of the sector inquiry was accordingly to find out about the factors that impeded the development of competition on electricity markets. In the course of the inquiry, 79 companies concerned of the electricity market with 39 of them being eligible consumers were solicited for their opinions.

3. The electricity sector is a special industry. As one of its most typical features it is a network industry, where the product i.e. the electric energy, cannot be separated from the transmission network, the transmission activity is a natural monopoly, the product cannot be stored in a large volume, so that demand and supply (production and consumption) have to be in balance in every moment. The consumer is physically connected with the supplier (transmission and distribution) network; the settlement of the accounts of consumption takes place on the basis of the consumption metered. For consumers purchasing on the free market, the cost paid for electricity is the sum of the price of electricity purchased on the free market and of the regulated system usage fee.

Findings of the inquiry

Findings relating to the regulation

4. Analysing the measures taken in the longer run in order to open up the electricity sector to competition, a continuous adaptation of the sector to the circumstances of the regulated market economy can be observed. The Act on Electric Energy changed three times in the period between 1989 and 2005. The regulatory model chosen is an important determinant of the mechanism functioning in network industries. The Act on Electric Energy and the other related statutes have changed in a way to progressively adapt the structure of the electricity sector to the functioning under the circumstances of the competitive market. However, even the last of the statutes on electric energy, Act CX of 2001 (which came into effect on 1 January 2003) was created on the basis of the full range public utility

supply philosophy. As its preamble states, the Act has been created to promote the development of a competitive market in electricity. The regulated price set by taking into account the security of supply and the justified costs stand has been put in the focus of the regulation. The public utility supply system maintains the previously valid 'single buyer' model (in which MVM, the Hungarian Power Companies Ltd. is almost the only company to buy energy for public utility supply from the generators and to resell it to electricity suppliers) and it gives exclusive supply responsibility to the public utility wholesaler and the electric energy suppliers.

5. As a very important measure for the development of the future competitive market, the regulatory environment facilitated market entry on the generation market. According to the applicable provisions, the generators with power purchase agreements (PPAs) on the Hungarian market are obliged, in order to secure public utility supply, to offer their product to the public utility wholesaler. Under this system the guaranteed quantity of electricity taken over by the public utility wholesaler amounted to 81-87% of the generation market in the years 2000-2004. In compliance with this scheme about 50% of the cross-border capacities available from imports was also reserved for the public utility wholesaler for public utility purposes. In this way the public utility wholesaler holds PPAs covering 95% of the total Hungarian demand.

6. Besides public utility service the Act also provides possibility to carry out market transactions under competitive circumstances. The Act declares a step-by-step market opening and states that the regulations in effect promote the development of the competitive market. The first step of market opening concerned the large consumers, the public lighting and under certain conditions the institutions of the local governments (altogether 212 consumers) which accounted for 33% of electricity consumption; in the second phase beginning from 1 July 2004, every non-household consumer became eligible customer (this opened the market to an extent of 65% and concerned 420,000 consumers). These consumers are entitled to leave the public utility electricity market and to satisfy their electricity needs from authorized electricity-traders through private law agreements. The third step will be the complete market opening from 1 July 2007 on.

7. The Acts on Electric Energy mentioned above created step-by-step all the institutions (regulatory authority, consumer protection authority, technical and safety supervision), which are necessary for the functioning of a market economy.

8. During the inquiry many observations about the applicable regulations and the functioning of the regulatory regime were received that highlighted those elements that impeded or currently impede the development of competition. These observations are dealt with in the report. It would obviously be useful to take them into consideration in the preparation of the new electricity market model and the new regulation, which will be framed with a view to Directive 2003/54/EC of the European Parliament and of the Council.

Findings relating to the functioning "market"

9. The investigation made it clear that on the liberalized electricity market in Hungary, the public utility market competes with the open market for the available capacities, and there

is another competition between the public utility price and the open market price. In comparison to those competitions, competition on the open market itself is less important.

10. In the Hungarian electricity-sector there are already independent players present that are able to operate on a competitive market. There is one dominant player (MVM) on the market, which is partially vertically integrated – because of the PPAs signed with the generation plants – that has interests from the level of generation to the level of trade. Furthermore, in August 2005 MAVIR (the Hungarian System Operator Company) was integrated into the MVM. The intention is to secure the independence of MAVIR by functional unbundling measures (until this moment it is not known in which way). During this decision making process the GVH was always of the opinion that in the case of a merger there is no perfectly reliable method of functional unbundling that could guarantee at least the neutral functioning of the system operation, i.e. neutral as far as the interests of the public utility on the one side and those of the competitive market on the other side are concerned. The system operator in its new position can obviously not be expected to promote the functioning of the open market segment.

11. One of the special characteristics of the Hungarian electricity market is that, mainly in the interest of the marketability of the shares of the generator companies (privatisation), as well as in order to facilitate the returns of the considerable investments, which served mainly the protection of the environment and were carried out between 1995 and 1998, to be made, the public utility wholesaler company made long-term contracts, which would expire in the period between 2012 and 2021. The problem with these long-term contracts in Hungary is twofold: 1) all of them are linked to a sole, state owned market player; 2) they provide a stable profit for the producers for a long run due to their rules on price setting¹. The wholesaler cannot directly act on the competitive market. However, it forecloses the market vis-à-vis eligible customers and retailers by its long-term contracts and due to its inherited dominance it is able to hinder progress on the free market.

12. During the inquiry process it became clear that the liberalisation was primarily based on import possibilities not exploited earlier, as well as on free cross-boarder capacities. All the competitive domestic electricity generators having lower price than the average price of the public utility, are switched by long-term contracts to the public utility wholesaler. Under the law the public utility wholesaler can release product volumes or generator capacities for the open segment of the market to the same extent as that of the exit from the public utility. The inquiry clarified that, for several reasons, the public utility wholesaler had released less capacity in comparison to what the market needed during the period under review. This fact originated, however, in a certain measure from the universal service obligation of the public utility wholesaler (the eligible customers can return to the public utility at any time), therefore, no changes can be expected in this field unless the system (the Act) would change.

¹ On 9 November 2005, the European Commission launched an inquiry under Article 87 EC to find out whether the results of the price fixing mechanism, included into the long-term contracts, the changes on the market, the compensation provided directly for the public utility wholesaler by the Hungarian State, as well as the selective advantages of the electricity generators coming from the long-term contracts are compatible with the regulations on state aid. This inquiry does, however, not concern the inquiries under Articles 81 and 82 EC (restriction of competition, abuse of a dominant position).

13. It is experienced that only those electricity traders became successful whose group held a licence for public utility. The majority of the market entries of smaller and independent traders was unsuccessful. The traders purchased the product mainly from imports, available through cross-boarder capacities and free generation resources of the neighbouring countries.

14. In 2003 the proportion of the customers purchasing electricity on the open segment of the market was approximately 20% of the annual national electricity demand (taken into consideration the market exits in different times during the year; 10% of the total electricity supply was purchased from the open segment of the market). In 2004 these rates increased to 26% and 20% respectively. It became obvious that the number of customers who intended to purchase electricity on the open segment of the market was much larger than the number of those which really did it. There was no available electricity supply at a reasonable price to fulfil their needs.

15. It can be stated with a high probability that entries to the open segment of the market were stimulated by the statutory provision, which provided a possibility of returning to the public utility segment after 6 months of the entry and brought about an obligation of admitting to this segment the customers, which switched over before. At the same time, this provision made the public utility wholesaler cautious in offering all that amount of the electricity supply for the free market which was purchased earlier by the customers, which entered the open market segment. This rule created an obstacle to the market development. In the meantime, this rule has changed: electricity customers are allowed to switch over in 30 days if the contract does not specify it differently and can switch back to public utility supply in 60 days.

16. Its likely that the public utility wholesaler took into consideration how high the amount built in into the system management fee to cover the sunk costs was and tried to set the capacity supply to the open segment of the market in a way which ensured that the sum of the sunk costs originating from it should not exceed the amount of that certain part of the fee applied by the electricity service provider. According to the data provided by the inquiry, the public utility wholesaler, which organised the open capacity auction, was able to sell the volume of electric energy in excess of what was demanded in the frame of public utility supply at prices which were 56%, 44% and 38% lower in comparison to the prices at which it purchased that volume, which were contained in the long-term contracts entered into by it and the generators. From 2005, the wholesaler increased the size of the capacity put to auction as a result of the existence of surplus capacities available to it.

Summing up

17. The regulation targeted the promotion of the creation of a competitive market. The proportion of the open segment of the Hungarian electricity market reached, in comparison to the total annual consumption in Hungary, 20% in 2003 and 26% in 2004. The rate of the customers switched to the open segment of the market / to the public utility electricity sector is an important factor, however, not the only one to measure the success. The majority of the customers, which became switched to the open segment of the market, concluded namely contracts with those traders which belonged to the same group to which the former public utility service provider of the consumer belonged. In addition to these traders, it was the trading company of the public utility wholesaler (MVM), which was

most able to achieve considerable success. The inquiry pointed out that the number of those, which intended to switch to the open segment of the market was even higher.

18. Following the liberalisation mainly imported electricity competed with the contracted portfolio of the public utility wholesaler MVM. The cross-boarder capacity, available on the free market, was fully utilised by the eligible customers. Within short after market opening, in March 2003 the switching over of customers already started. The inquiry stated that even more market entries would have been carried out if more electricity at reasonable terms had been available on the open segment of the market. Eligible consumers entering the open segment as a result of the liberalisation reported positive developments and considerable cost-savings they achieved (HUF 16,7 billion in 2003 and further HUF 38,0 billion in 2004).

19. Cost-savings on the competitive market in themselves, however, do not indicate the balance of the advantages and disadvantages originated from the market opening. The Hungarian Competition Authority was not able to precisely quantify the costs of the State administration and the different market players spent to the liberalisation. These costs, however, exist and reduce the net liberalisation profit of the society. In the case of a model from the competitive market point of view would make more profits through the market which were more favourable to competition, profits arising out of competition would be higher and the costs of the regulation would presumably be lower.

20. Practically, competition utilized the possibilities it could utilize in the frame of the current model. Though the second phase of the market opening doubled, in terms of the law, the size of the open segment of the market (i.e. approximately 65% of the Hungarian electric energy consumption may go through free trade channels) and the number of eligible customers which are able to enter the competitive market, became many times higher than before, the formation of a real competition could only be attained by changing the model.

Conclusions

21. The main conclusion to be drawn from the sector inquiry is that in a competition policy assessment, it is not reasonable to maintain the currently functioning model. Though the model was appropriate for competition emerging in the sector but it is, at the same time, an obstacle in the way of the formation of real competition. As a consequence of the Hungarian implementation commitment of Directive 2003/54/EC there is a chance to elaborate a new functional model, which could primarily take into consideration the interests of the consumers attached to competition and could abandon the concept of double vertical system. During formation of the novel model, it would be reasonable to rely on the findings of the sector inquiry in question as well as on the results of the sector inquiry of the European Commission. Such an accustomed approach should also be rejected according to which the interest of Hungary is market opening to an extent that is the least but still acceptable by the European Union. As a starting point of this work, it should be taken into account that competition is compatible with the important aspect of security of supply, moreover, security of supply is easier and cheaper to accomplish on a competitive market than in the case of lack of competition.

22. The dual vertical model is abortive already in the short run in respect of the formation of a competitive market and it is unable to generate durable efficiencies which consumers would be able to perceive. The constraints set to the supply on the open segment of the market generate an equation of the prices, consequently the competitive market does not affect the public utility market – in fact, competitive prices do not evolve for a longer period of time – but to the contrary, public utility regulated prices affect the prices of the competitive market. Through raising costs of cross-border capacity auctions the early price-advantage is disappearing. Competition being ostensible can be established of the fact that respect that those traders were successful on the open segment of the market, which were promoted by public utility suppliers and/or generators. Traders active on the free market do not compete first with each other but with those public utility traders or suppliers, which are drawn into the same orbit of interests, consequently they are active not in a well-fought market segment but in one conveyed to them.

23. The current system of long-term PPAs (in which 95% of the national production capacities and the cross-border capacities is connected to one market player, to the public utility wholesaler) hinder the completion of competition on the market. The performance of the functional model chosen and of the market structure (public utility and open segments of the market) created by the regulation which is based on the model may be improved to some extent only by further, powerful regulatory intervention. As a consequence of the market opening, which was based on the earlier not fully utilized cross-border capacities, trade in electricity by importing electric energy, which is cheaper than electric energy at the domestic price has been started. In order to enhance electricity trade it is necessary to bring competitive generation capacities to the open segment of the market.

24. PPAs are appropriate to restrict competition because they may result in market foreclosure, they unjustifiably increase prices in a causeless way, restrict consumers in choosing service providers and hinder market entry of potential wholesalers. As a general rule, the restrictive character of PPAs depends on two elements: the contracted volumes and the terms of the agreements. In a market where a considerable proportion of the production of power plants is contracted by PPAs to the former, dominant incumbent company (MVM), the cumulative effect of the agreements significantly increase the risk of the emerging of foreclosing effects on the relevant market.

25. According to the results of the sector inquiry, the PPAs currently applied on the Hungarian market hinder, in the present structure, further market opening. Actions should be taken in order to change the market structure stiffened by the PPAs and to renegotiate the PPAs. It would be feasible to investigate in the frame of competition supervision proceedings whether the system of PPAs is in compliance with the provisions of Articles 81 and 82 of the EC Treaty.

26. The in the first year manifested price-advantage of eligible customers, which entered the open segment of the market, ceased quickly to exist because the source of them was the cheaper import rather than a faire share allowed consumers of benefits resulting from efficiencies in Hungary. The price of the imports available only in limited volumes increased soon, parallel with a raise in tariffs of cross-border capacities, as a result of the scarcity of supply, which has degraded the price-advantage. In the first month of 2004, the reason of re-entries to the public utility segment of the market was mainly the aforementioned phenomenon.

27. One of the potentially most important sources of competition is the import of electricity. For various reasons, import has been able to act its part to a lesser extent in comparison to what may have been possible, as the infrastructure, which ensures inflow of import electricity (cross-border capacities, cross-border edges, internal network elements), and the current frames of access does not allow it to reach a higher extent. During the sector inquiry it was clarified that this may be the consequence of several reasons lying in the background.

28. The exploitation of cross-border capacities is not a purely Hungarian home affair by its very nature, consequently one of the conditions of the optimal, competitive use of these capacities is region-wide thinking together with the neighbouring countries or, at least, concerted regulation or strategic decision-making. As far as e. g. the cross-border edge, which is adjacent to Slovakia is concerned, the undertakings of the two countries having cross-border capacities claim to utilize these capacities in equal (i.e. 50%:50%) proportion. Accordingly, the import capacity, which is directly relevant concerning the Hungarian market opening and controllable by the Hungarian authorities and can be, in principle, transparently allocated under the Hungarian rules, is halved in this direction. Though import electricity can also be supplied to Hungary from the other part (the other 50%) of the capacity as a source but this happens in a manner, which is not transparent for the Hungarian authorities and market players. All these capacities could, however, be in common exploitation (for example by way of commonly organised auctions), which could ensure a much higher transparency. This could be attained, of course, only by cooperation of the two countries. This effect could further be improved by co-ordinated regional auctions and by the use of methods, which are based on actual flows, for the detection of free capacities.

29. Empirically, the system of capacity auctions should be further refined. The Hungarian Energy Office took actions from the outset in order to better exploit the capacities and ensure higher transparency and these actions resulted in efficiencies in the field of trade and consequently in higher competitive pressure exerted by the import. To support further progress, the relevant government decree would need to be amended.

30. The main impediment of import competition is not the limited size of the physically accessible capacities but the access to these capacities. The physical extension of the capacities is desirable and there is a need to ensure that the development and extension of the cross-border capacities provide benefits for the consumers rather than for one or the other of the market players.

31. The real benefit of the market liberalisation up to now is that a lot of the technicalities of the competitive market have become routine for the market players, and that amendments and legal interpretations supportive to the competitive market has gradually gained ground in the legal framework. The application of regulatory tools has also been encouraged. Another real benefit of the market liberalisation is of course that the cheap import could have been consumed at all, but only a small share of the benefits resulting from this has been allowed to the eligible consumers, because the scarcity of the import increases the prices. The increase in the cross-border auction fees and in the system-using fees shows that consumers can enjoy the benefits of the cheap electricity import only to a limited extent. The market opening did not bring any considerable improvement, as far as the requirements in respect of effectiveness is concerned, for the producers because, as a

consequence of the long term power purchase agreements, the development of the demand on the competitive market hardly concerned, could hardly concerned them. Significant efficiencies emerged at several power plants based on expectations of the owners and incentives given by the price regulation. Only the owners of the power plants enjoyed, however, the results of these improvements, the consumers did not get anything from the efficiencies. The MVM as the only public utility wholesaler remained interested in impeding the development of direct market contacts. When concluding the annual purchase contracts, the MVM renegotiated the price formulas of the PPAs with the aim to refine them and it put some efficiency pressure on the parties so that the MVM could attain certain reduction in prices. The renegotiations did not bring, however, any results as far as the release of the capacities is concerned.

32. The dual vertical model turned out to be a dead end for the liberalisation, so a shift in the model is necessary for the progress. Following the experiences received by the sector inquiry, the need for some arrangements (some refining of the regulation) has emerged, which could help in realizing certain improvement within the frames of the current model in the transition period until a new model will have been developed.

33. It is advisable to investigate in competition supervision proceedings whether the suppliers discriminated between eligible consumers depending on whether those consumers, at entering the liberalised market, had chosen a wholesaler from the suppliers holding or an independent one. It is also necessary to assess the sales of MVM on the liberalised market (if it favoured its own trader in a way that is not compatible with competition law or withdrew capacities unjustifiably referring to its public utility supply responsibilities).

34. The inquiry showed up that some of the suppliers had questioned their balancing contract obligation. In the GVH's opinion the total settlement of accounts on the system level can only be accomplished with the consequent application of the balance system. There are some basic principles of the balance system that must not be violated. One connection point can only belong to one balance. The balance system requires an exact and total metering and a strict planning; without these requirements an efficient schedule planning is not possible. The schedule planning requires the exact establishment of the consumers' demands (from the consumers' side and from the suppliers' side as well). The consumers' demand evolved by the schedule supports the exact planning of the exploitation of the capacities, and as a consequence, more liquid energy can be sold on the competitive market. Steps are to be taken for the stabilisation and completion of the balance system.

35. The GVH initiates that the experts of it and of the regulator, the Hungarian Energy Office (MEH) should review those regulatory arrangements of the current system that impede the development of competition, assess them and take steps to remove them in a short time. (One of the tasks may be for example the strengthening of the Commercial Code rules about the cession on time of the daily excess capacities of the public utility wholesale traders. A change in the high-level legal measures is necessary to eliminate the scarcity in domestic supply.)

36. Uncertain is the answer to the question whether prices decrease as a result of the liberalisation and further measures aiming at intensifying competition. The last unsuccessful auction may mean that there is not enough free capacity on the supply side

that could result in a decrease of the prices. There might still be some reserves but the significant part of the benefits of the efficiencies might have already been realised by the market players. There is no such market mechanism – i.e. efficient competition – that could secure that the decrease of costs would result in a decrease of prices as well. In the absence of such a mechanism, a decrease in consumer prices is not to be expected. It is also obvious, that the electricity prices in Hungary are significantly determined by the given world-market price of the main energy sources of energy production.

37. Crucial for the further development of the liberalised market is the existence of enough free and competitive production capacity, because the establishment of the supply market is also an important condition of the competition in the longer run. In order of this, the geographic market would need to be expanded to a regional one with the elaboration of a unified system of the rules. The building of power plant capacities, the framing of adequate market incentives and the further development in this way of the supply side towards the direction of the creation of a well-functioning competitive market would be important steps, the GVH believes. Several European institutions (as EURELECTRIC and ETSO) are working on building-up the long-term incentives, but until now without significant success.

Recommendations

A change in the model is necessary

38. In respect of the development of the competitive market, the dual vertical model is already in the short run unsuccessful, thus it is not suitable to generate noticeable and long lasting efficiencies which could be perceived by the consumers. The GVH, in order to facilitate the preparation of the model-change, deems it necessary and initiates that the Government – before the 2007 market opening - discuss and clarify all aspects and questions arising in connection with the shift to the competitive market model, including a substantial extension of supply, and a clear definition of the role of the supplier of last resort (universal service).

Effects of the long-term power purchase agreements

39. Based on the information collected in the sector inquiry of the GVH, it is presumed that the system of long-term power purchase agreements (PPAs) - taking into account the contracted capacities (which are connected to one market player, the public utility wholesaler) and the time periods - is not compatible with EC competition law. In this respect, the GVH will initiate competition supervision proceedings in order to evaluate the anticompetitive effects of PPAs, and to establish whether the deriving benefits exceed or not the harms caused by PPAs.

40. The system in its actual form leads to the foreclosure of the eligible customers' market and if left unchanged, finally to the decline of the competitive segment. The current structure considerably restricts the freedom of consumer choice. These factors heavily slow down, if not completely stop the development of the competitive segment in Hungary. One of the key elements of the competitive analysis is the assessment whether the PPAs and the market power of the parties are compatible or not with competition principles. The stronger is the market power of an undertaking party to the agreement, the

less is it likely that the agreement in question containing restrictions/limitations is acceptable in a competitive approach.

Forcing the capacity surplus to be put on the market

41. The MVM, in order to reduce its losses, must be interested in selling the surplus of its contracted capacity in a transparent way. Otherwise, the fees to be paid for the contracted but unused capacity must be borne by MVM and they cause financial losses. The provisions of Sections 6-7 of Government Decree 183/2002. (VIII. 23.) are intended to secure that MVM sell its contracted but unused capacity on the market. The sector inquiry showed that MVM did not release all its unused capacities that might have become available, but only a part of them which was enough to cover its sunk costs. The Hungarian Energy Office has to investigate the additional costs caused by the failure to sell the unused capacity and it has to report its findings to the price-authority in order to avoid the acceptance of these costs in the regulated price of electricity.

Creating a regional market

42. Attention must be paid to the initiatives that aim the evolvement of regional markets in Europe, furthermore, it is reasonable to support them. In this process the interests of consumers (including in a broader sense the interests of all market players) and not only those of the energy sector must be taken into account. The strategic governmental decisions relating to MVM (e.g. the privatisation of MVM, the proprietary separation of MVM and MAVIR (Hungarian Power System Operator Company) must be made from a regional perspective with regard to Hungary's role and interest in the region. In other words the pursued goal should be to have electricity import as a real alternative for Hungarian consumers, which can exert serious competitive pressure on Hungarian electricity companies.

Competition supervision proceedings assessing possible discrimination resulting from the dual vertical model

43. The GVH is preparing competition supervision proceedings dealing with factors distorting competition, including the existence of competition distorting relationships/contacts between the public utility wholesaler/service provider and the open market trader belonging to the same owner.

New rules on cross-border capacity usage

44. The GVH suggest to the Hungarian Energy Office to review how the transparency in use of the cross-border edges could be enhanced, including the creation of full publicity of all negotiations and agreements of the system operators.

45. The revision and amendment of regulations on cross-border capacity auction and on the auction system of capacity release of MVM seems to be expedient in order to improve competitiveness on the market. MVM must be obliged to sell its capacity for which there is no demand on the public utility market in a pre-calculable and commercially reasonable way.

46. For the sake of even more access possibilities to the free market for energy, the possibility of expanding the current cross-border capacity and the receiving network and transforming them from playing an ancillary role to assuming real trading responsibilities must be taken into consideration.

Increasing consumer awareness on the market

47. Based on the information supplied by the sector inquiry it is predictable that in the future periods of market opening the lack of market information on the consumers' side will appear increasingly. Should the large "industrial" consumers show a less pro-active attitude towards their consumer rights, such activity cannot be expected to be intensively carried out by smaller enterprises or even by household-customers. It would be essential, therefore – based on international experience – to increase customer awareness with the help of the Hungarian state and other organisations (as chambers and interest representations).

Competitive market analysis

48. This sector inquiry is based only on detailed observations of the processes of the first and general observations of them of the second year of the market opening. Therefore, it is necessary under the supervision of the Hungarian Energy Office to annually summarise in an independent report the developments on the open market. The report should cover among others the analysis of the electricity traders' activities, the quantitative and price data of capacity auctions, the market experience of eligible customers and of the restrictive elements of applicable regulations.

Creation of the ancillary services market

49. Due partly to the failure of the agreement renegotiations and partly to the transitional validity (until 31 December 2003) of the rules laid down in the Commercial Code there is no ancillary services market in Hungary. The MVM sold its ancillary services integrated in PPAs in a package to MAVIR, and MAVIR sold these services practically at "regulated prices" (at administrative /non-market/ prices contained in the Commercial Code) to the "balance-circle responsible"² persons. The basic problem roots in the PPAs and cannot be treated successfully on the level of the Commercial Code. It is very well visible that the voluntary renegotiation is not a successful solution of the problems, nor is in respect of the balancing market the system of secondary auctions. Taking into account the fact, that at the time being, MAVIR plays the role, in which the integrated MVM contracted the ancillary services, the possibility of separating the PPAs of MVM in to groups: to the group of those belonging to a public utility wholesaler (capacity and energy product) and to another belonging to MAVIR (ancillary services). The security of investments would not be affected by this arrangement. Presumably, the above solution would make the generation plants interested in transforming the ancillary services in compliance with the conditions of the open market.

² This very unfortunately worded term is commonly used in the sector in Hungary.