



# Appraisal of the Icelandic Electricity Market and Regulation

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Conducted by the Norwegian Water Resources and Energy Directorate

**Erik Normann Drevdal, Tore Langset, Nils Martin Espegren**

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## Introduction

The Norwegian Water Resources and Energy Directorate (NVE) has been asked by the Icelandic Ministry of Industry, Energy and Tourism (the Ministry) to conduct an appraisal of the Icelandic Electricity Market and Regulation.<sup>1</sup>

NVE gladly accepts this opportunity to contribute to and exchange views on important issues regarding efficient electricity market regulation and monitoring.

## Background and Mandate

The Icelandic Electricity Act no 65/2003 (the Electricity Act) entered into force on 1 January 2005. With it, the Icelandic electricity market was liberalized, and a number of new requirements were conferred on both authorities and market participants.

The Ministry and the Icelandic National Energy Authority (NEA)<sup>2</sup> respectively have expressed their wish for NVE to conduct an independent appraisal of the Icelandic electricity market and regulation, as the new legislation has now been in force for some years. During our meetings in Iceland, we were also informed by market players that the appraisal is rather requested due to significant dissatisfaction among both authorities and market players with the effect and enforcement of the new act. In any case, said possible disagreement as to the motivation behind the request for an appraisal, has not had any influence on our work.

NVE's mandate is as follows:

1. Monitor whether or not law and regulation are compatible with the internal electricity market and corresponding directives and regulations, especially regarding both TSO and DSOs
2. Monitor methods NEA applies to keep up surveillance
3. Monitor in what way companies are affected by NEA's surveillance
4. Monitor communication between NEA and Ministry

Prior to our visit, the Ministry confirmed that point 1 relates to whether Icelandic law and practice seems to comply with the electricity related parts of the Third Energy Market Package.<sup>3</sup> The Ministry, however, informed that focus should be on points 2-4, as considerations relating to point 1 should mainly be carried out by the Icelandic authorities, in coordination with the EFTA Surveillance Authority (ESA). As a result, we do not touch upon point 1, apart from pointing out certain observations on possible compatibility or non-compatibility.

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<sup>1</sup> Cf. letter from the Ministry as of 15 March 2011

<sup>2</sup> Orkustofnun

<sup>3</sup> I.e. Directive 2009/72/EC, Regulation (EC) No 714/2009, and Regulation (EC) No 713/2009

## Method and Organization of the Appraisal

The appraisal has been conducted on basis of separate meetings in Iceland with the Ministry, NEA, the transmission system operator (TSO),<sup>4</sup> and a number of distribution system operators (DSOs)<sup>5</sup> respectively.<sup>6</sup> In addition, NVE received from the Ministry a limited number of documents<sup>7</sup> to be reviewed prior to our visit in Iceland.

In NVE's view, all meetings were constructive and informing. Top management and staff of both authorities and market participants contributed to the said by providing us with what we perceived as their frank reading and opinion of the Icelandic system and practice. It is our general impression that the level of dedication is high, and that there is an understanding of common goals and purposes of the regulation, despite examples of apparent disagreement and dissatisfaction among authorities and market participants.

NVE has conducted the appraisal with due consideration to the necessity of professionalism, balance, confidentiality, and frankness. However, NVE assumes no responsibility for any loss connected to the observance or use of the content of this report, including any recommendations or statements it might be construed as containing.

NVE has not been able to dig deep into our task. We have had a very limited time at our disposal both for preparations, meetings and subsequent assessments. The meetings were relatively short compared to the potential scope of the task. Further, all though being informing and relevant, number, scope and depth of documents at our disposal have been limited. As an example, we have not been able to review English versions of any administrative regulation or any other legal document except for the Electricity Act. Moreover, prior to our meetings in Iceland, we did not have at our disposal a consolidated version of the Act, taking into account latest amendments.

Further, NVE has no certain knowledge of the actual events or other facts underlying statements presented during meetings in Iceland or in the documents dispatched to us prior to our visit. While having been presented with considerable amounts of interesting and justified information, we have also received both diffusing and contradictory particulars. Our report is based on immediate impressions from abovementioned unproven sources, and, thus, it must be read as an overall description of NVE's immediate impressions only. We cannot guarantee that content of the report is based on actual correct facts, nor can we guarantee the robustness of the conclusions drawn or

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<sup>4</sup> Landsnet hf

<sup>5</sup> HS Veitur hf, Orkuveita Reykjavíkur, Norðurorka hf, and RARIK ohf

<sup>6</sup> The following meetings were held during our two day visit to Reykjavik: (1) Meeting with the Ministry on 19 May 2011 from 09:00 to 10:30, (2) Meeting with Orkustofnun (the Icelandic National Energy Authority, NEA) on 19 May 2011 from 11:00 to 16:00, (3) Meeting with HS Veitur hf (DSO) on 20 May 2011 from 09:00 to 09:50, meeting with Orkuveita Reykjavíkur (DSO/ producer/supplier) on 20 May 2011 from 10:00 to 10:50, meeting with Norðurorka hf (DSO) on 20 May 2011 from 11:00 to 11:50, meeting with RARIK ohf (DSO) from 12:50 to 13:40, and meeting with Landsnet hf (TSO) from 13:50 to 15:40. In addition, a wrap-up meeting was held with the Ministry and NEA on 20 May 2011 from 16:00 to 17:20, at which NVE presented its preliminary findings and observations.

<sup>7</sup> The following documents was dispatched to us by NEA, and briefly reviewed prior to our visit:

(1) "REGULATION OF THE ELECTRICITY ACT NO. 65 2003 IN ICELAND", (2) "ENERGY CHAPTER QUESTIONS SUBMITTED FOR THE APPLICATION FOR MEMBERSHIP OF THE EU", (3) "ELECTRICITY ACT 65/2003", and (4) "REPORT ON REGULATION AND THE ELECTRICITY MARKET 2010"

recommendations made. NVE assumes even that some of our recommendations may already be complied with.

That said, and all though we have not been able to make well-supported observations, nor able to draw substantiated conclusions, we nevertheless have conducted a sincere assessment of the Icelandic system and practice. Moreover, we do hope that our report contributes to improvements of possible faults or weaknesses in the Icelandic system.

## Advantageous Conditions

We have found a number of favorable conditions in the Icelandic system, some of which appears to be even more advantageous than corresponding European or Norwegian practice.

In the following, we present a non-exhaustive outline of such conditions. Please note that, in addition to those mentioned below, there are certainly other favorable aspects of the Icelandic approach as well. For now, however, we choose highlighting the following:

- **Abstention from Derogations and Opening of Market**

We are of the impression that Icelandic authorities are determined to pursue the development of a well-functioning system based on common European principles of effectiveness, security of supply and consumer protection. Iceland has proved their good intentions inter alia by abstaining from derogations from the second Electricity Directive,<sup>8</sup> even if Iceland could have decided not to apply its main provisions regarding DSO unbundling and/or decide to apply for extensive derogations from the Directive's provisions regarding TSO, DSO and NRA designation, unbundling and tasks.

Both the Ministry and NEA have expressed their intentions to continue applying EU Energy Market legislation, incl. the third Electricity Directive (the Directive),<sup>9</sup> and including provisions, from which derogations may be attainable. An example showing the Icelandic dedication could be a reported bill of law for new and stricter rules on DSO ownership unbundling, adoption of which by the Icelandic Parliament, could lead to an even more effective unbundling of DSOs than provided by the Directive.<sup>10</sup> Moreover, said proposed rules may also improve unfavorable conditions with regard to lack of functional unbundling of DSOs<sup>11</sup> or possibly also other sources of possible discrimination.

Further, Iceland has opened their market in the sense that all customers are free to choose between available suppliers of electricity. According to documents and statements made by the Icelandic authorities, Iceland opened up their market, de jure on 1 January 2006, de facto in April that same year. In any case, the opening up of the market is well within the deadline of the second Electricity Directive, which is 1 January 2007.<sup>12</sup>

The said is, however, without prejudice to our impression that the electricity wholesale market in Iceland may suffer from lack of competition, especially with regard to transparency. Inter alia, we have noted that electricity is not available for sale to all suppliers at the same price. Hence, a producer integrated in some way with a supplier, may offer more advantageous terms and conditions to that supplier.

We have noted that prices on the retail market have become more similar after opening of the market. In other respects, however, we are not in a position to comment on the functioning of the

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<sup>8</sup> Directive 2003/54/EC

<sup>9</sup> Directive 2009/72/EC

<sup>10</sup> Cf. Article 26

<sup>11</sup> We are informed that all but one DSO are legally, but not at all functionally, unbundled from generation or supply units within the same integrated undertaking. On the other hand, all but one DSO have their own webpage separated from the webpage of the integrated supply unit.

<sup>12</sup> Cf. Directive 2003/54/EC Article 21 paragraph 1 point (c), cf. Same deadline is repeated in the third Electricity Directive, i.e. Directive 2009/72/EC, Article 33 paragraph 1 point (c)

competition in the retail market, including on the possible occurrence of coordinated behavior among suppliers or other possible obstacles to competition.

Thus, and as touched on above, our appraisal does not include evaluation of the level of competition on the Icelandic electricity market. Moreover, we presume that Icelandic authorities and market participants bear in mind the importance of competition as a mean to obtain efficient exploitation of the energy resources, within desirable limitations, and, with that, low prices to consumers.<sup>13</sup>

- **Upcoming Spot Market**

NVE has learned that a spot market is soon to be launched.

NVE supports this. A working spot market could be an important instrument for efficient utilization of grid capacities, provision of transparent prices, and promotion of competition, all being important conditions for a well-functioning electricity market.

- **Unbundling of Accounts and Auditing**

We are informed that it is conferred on all market participants a duty to separate accounts of distribution and production/ supply respectively. Both authorities and all market participants, with which we have met in Iceland, states that Iceland has a well-functioning system of external audits, purpose of which is partly to monitor the fulfillment of said requirement.

We have been informed that such auditing takes place once a year at the premises of two vertically integrated undertakings. Further, the same auditor is barred from auditing the same market participant twice. On the other hand, the same accountant firm is not prevented from the same. All but one of the market participant with which we have met, expressed that they have been audited in accordance to abovementioned principles, and market participants say they support the auditing regime.

NVE supports the requirement of separation of accounts and the apparent successful auditing scheme. Moreover, it is our immediate impression that Iceland fulfils the Directive's requirement as to separation of accounts,<sup>14</sup> at least with regard to the carrying out of external audits as described above.

- **Setting up of Appeal Committee**

We are informed that Iceland has set up an independent Appeal Committee. All interested parties may file complaints on NEA decisions relating to TSO or DSO activities, as well as decisions relating to tariffs, to the Appeal Committee. The Committee is composed of three members holding legal competence, and we are informed that the Committee's decisions are formalized to allow for judicial review.

NVE supports the setting up of an independent appeal committee. At this point, Iceland may serve as an example, as such favorable instrument is yet to be established in Norway. Moreover, it is our immediate impression that Iceland, thus, complies with the Directive's requirement of ensuring

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<sup>13</sup> Cf. also Iceland's obligations according to the EEA Agreement Articles 53 and 54, and the EEA adapted versions of the EC Merger Regulation and Regulation (EC) no 1/2003

<sup>14</sup> Cf. Article 31

suitable mechanisms at national level under which a party affected by a regulator's decision has a right to appeal to a body independent of the parties involved and of any government.<sup>15</sup>

The abovementioned is without prejudice to our impression that the Appeal Committee may not always enjoy a reputation good enough to be used and respected. Some market participants have stated that Committee members do not possess the relevant knowledge and, even so, does not seek necessary expert assistance in order to comprehend technical or economic conditions underlying a justifiable legal assessment. According to one market participant, the Appeal Committee appears as a "joke". The market participant exemplified that the Committee, in one case involving that market participant, only interviewed the NEA and the market participant involved prior to finding for NEA through an unjust decision, even though, in the view of the market participant, the lawyer acting as contact person towards the market participant, apparently did not understand the circumstances of the case. We regard it as out of the scope of our task to confirm whether such views are fair or reasonable. However, we would like to underline the importance of ensuring that the appeal committee has the right competences or access to such competences that they may be lacking.

- **Upcoming TSO Ownership Unbundling**

Most market participants state that the TSO should not be owned by anyone holding an interest in generation or supply of electricity, as this may lead to discrimination. Some emphasizes that the TSO is dedicated to uphold the independence of its own board members from the shareholders. At the same time, centrally placed representatives of authorities and market participants respectively, stress that it may sometimes be challenging to maintain de facto independence. In addition to the annual general meetings, other meetings have taken place involving both shareholders and the board of the TSO, as well as the top management of the TSO. Such meetings are, however, said to be extraordinary.

Further, it is NVE's initial impression that Iceland would not comply with the Directive's requirement as to TSO unbundling<sup>16</sup> if the current ownership structure is upheld. Inter alia, it appears problematic that a company involved in generation of electricity, is holding the majority share of the TSO. Even without prejudice to the requirement of the Directive, it may also be problematic that other TSO shareholders are involved in generation and supply of electricity. Moreover, it may give rise to concerns that board members are appointed by the shareholders and that the shareholders appear to have, at least, some influence on the running of the TSO.

On basis of the said, NVE doubts that today's ownership structure contributes to a well-functioning electricity market.

However, NVE has been informed that Iceland intends to transfer the ownership of the TSO to the Icelandic state as of 1 January 2015. As indicated above, NVE considers such unbundling favorable. Moreover, we support Iceland's apparent choice to apply EU's preferred TSO unbundling

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<sup>15</sup> Cf. Article 37 paragraph 17

<sup>16</sup> Cf. Article 9 paragraph 1, which applies in the EU from 3 March 2012. Please note, however, that Iceland, most likely, may choose to apply provisions prescribing other unbundling alternatives, cf. Article 9 paragraph 8 and 9

alternative.<sup>17</sup> Said choice signals that Iceland is determent to pursue the most effective regulation of the electricity market, regardless of whether EU legislation allows for a less efficient approach.

Our abovementioned support of the proposed transfer of TSO ownership is without prejudice to Iceland's possible non-fulfillment of the TSO unbundling requirement in the period between the implementation deadline set out in the expected EEA Joint Committee Decision on implementation of the Directive into the EEA Agreement, and 1 January 2015.

- **Separate NEA Budget Allocations**

We have been informed that NEA's budget as to regulatory tasks is decided by the Parliament and that neither the Ministry nor the market participants have any deciding influence on the adoption of it. Some market participants, however, claim they might have a limited saying when the fee is set, but it is our impressions that such influence is very limited, as it should be.

Without prejudice to the suitability of the fee conferred on market participants for the coverage of costs related to NEA's regulatory tasks, NVE supports the arrangement that NEA's budget is adopted by others than the Ministry and the market participants.<sup>18</sup>

It is mentioned that points have been made by market participants as to the spending of the fee collected from market players for the coverage of costs related to NEA's regulatory tasks. Allegedly, NEA is not able to give an account of how the fee is spent, and it is suspected that the fee is not always allocated correctly from the Ministry to NEA. NVE notes that there are different views on said, and we are not in a position to take a stand. However, we recommend a high level of transparency as to the spending of the fee, in order to prevent the building up of distrust towards the arrangement.

- **Top Management of NEA Appointed for Fixed Term**

NVE is informed that NEA DG is appointed for a fixed term of five years. According to NEA, the DG may not be relieved during the fixed term unless he does anything "criminal".

It is an important element of regulator's independence that political authorities or others are not able to relieve top management of the regulator, unless under extraordinary circumstances. Otherwise, those holding the powers to relieve the top management, would be able to control it by threatening, directly or indirectly, to use said powers in case the regulator does or does not act in a certain way.

Thus, NVE supports the Icelandic scheme, which does also seem to be in line with the Directive.<sup>19</sup>

- **Public Electricity Price Comparison**

NVE has been informed by NEA that NEA, together with the Icelandic Consumer Agency, operates a price comparison website. Such comparison may increase supplier switching by equipping customers with easy access price information.

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<sup>17</sup> I.e. the apparent choosing of compliance with the unbundling provisions of Directive Article 9 paragraph 1, even though Iceland, most likely, could choose other alternatives of TSO independence, cf. Article 9 paragraph 8 and 9

<sup>18</sup> Cf. Article 35 paragraph 5 point (a), cf. recital 34

<sup>19</sup> Cf. Article 35 paragraph 5 point (b)

In Norway, such price comparison is carried out and published in a similar way by the Norwegian Competition Authority, ensuring also that considerations are made as to whether the price comparison enables market participants to co-ordinate their actions and behavior in a way that is harmful to competition.

- **Involvement of the Icelandic Competition Authority**

NVE has been informed that NEA and the Icelandic Competition Authority are supposed to cooperate inter alia to promote competition in the electricity markets. We are informed that NEA has made attempts to engage and initiate such cooperation with the Iceland Competition Authority.

In our view, such cooperation may turn out beneficial to the functioning of the electricity market. Further, such cooperation is required by the Directive,<sup>20</sup> all though only within the framework of national regulatory authorities' independence.<sup>21</sup>

Unfortunately, the Icelandic Competition Authority has allegedly not responded to NEA's requests, reasons of which may include, according to information gathered at our meetings in Iceland, that the Competition Authority does not hold any specific competence regarding the electricity market.

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<sup>20</sup> Cf. Article 37 paragraph 2, 2<sup>nd</sup> subsection, Article 37 paragraph 4 point (b) (ii) last sentence, and, Article 37 paragraph 1 points (j), (k) and (o)

<sup>21</sup> Cf. Article 35 paragraph 4

## Potential for Improvement

All though the Icelandic system, in many respects, appears to be fairly advanced and well-functioning, we have made some findings that may indicate certain disadvantages within the system.

In the following, we present a brief overview of these apparently disadvantageous conditions and provide appurtenant suggestions as to possible improvements.

Please note, however, that we cannot rule out the possibility of having over-looked or simply not been informed on other conditions of equally or even less advantageous character than those touched upon below. Thus, the below-mentioned should be read as a non-exhaustive list of suggested improvements to a selection of possibly worrying conditions.

- **Strengthening of NEA Human Resources**

All market participants presented opinions on NEA's human resources.

All market participants, with the exception of two, expressed that they have an overall good relationship with NEA. One market participant claimed that communication with NEA is satisfactory, that NEA has been fair when explaining requirements of the new Electricity Act, and that the market participant and NEA always come to conclusions when discussing an issue.

However, all market participants expressed some degree of dissatisfaction as to all or certain parts of NEA's regulatory operations. All market participants tell that they never have received the Income Possibility Curve from NEA as required by the Electricity Act Articles 12 and 17, and all were dissatisfied with slow review of annual reports. Others stressed that NEA leaves the market participants with a very low level, if any, of certainty as to what is expected from them, and that the new Electricity Act and its regulations not in any way live up to expectations. One complained about extremely poor communication skills among NEA staff. Finally, it was underlined that NEA's inadequacy neither is nor was due to the financial crisis.

Some market participants blamed the abovementioned on other factors than the number of staff. It was stressed that what is needed, is mainly to prioritize and rearrange resources differently within NEA. While acknowledging benefits to the TSO and DSOs of a low fee, one market participant claimed that the two persons supposed to be dedicated to regulatory tasks today, should be able to carry out all regulatory tasks in an acceptable manner, provided that existing management, staff and organization are made more efficient.

All though to different extents, all market participants raised concerns as to the on-going replacement of the entire staff. Some emphasized the need for representation of all relevant professions, i.e. at least engineers, economists and lawyers. Moreover, all were somewhat worried that employment of staff lacking experience from the energy sector might lead to a less efficient regulator. Some market participants were very dissatisfied with the expertise of today's NEA staff.

While sharing the view that efficiency and expertise should be improved, more than one market participant claimed that NEA, in any case, is understaffed, and that understaffing may be an important reason for the dissatisfactory performance of regulatory tasks. According to one market participant, today's staffing would have been quantitatively insufficient, even if the staff had been more experienced. One market participant stated explicitly that he is willing to pay a higher fee in

order to improve the regulator's ability to perform its regulatory tasks. That market participant went on to stress that a more competent and active regulator is preferred over continued insufficient performance and unforeseeable actions, even if the former should lead to a stricter surveillance regime.

Based on the above, it is NVE's immediate impression that resources currently available for the carrying out of NEA's regulatory tasks are insufficient. In order to meet present and on-coming challenges and to improve NEA's ability to perform, in an efficient and effective manner, the considerable number of regulatory tasks conferred on the national regulator, we recommend that the number of staff exclusively occupied with regulatory tasks, is at least doubled.

That said, one should not read abovementioned as anything else or more than an inexact indication of what appears to be needed to improve certain possible insufficiencies in today's handling of regulatory tasks.

Further, in addition to increasing the number of staff designated to regulatory tasks, NEA may need to intensify its efforts as to qualifying and educating its staff, regardless of the number of staff in place. This may include a more frequent participation of NEA staff at international conferences, workshops, seminars, and/or educational programs, as well as exchange of competence with foreign national regulators, either bilaterally, or within the framework of international institutions.

For the time being, the most relevant regulatory formal co-operations regarding economic regulation of DSOs/TSOs are the CEER Efficiency and Benchmarking WS which has 4-6 meetings per year, and the NordREG Network Regulation WG which has 1-2 meetings per year. We propose that NEA considers participation at these forums.

There are several relevant conferences, workshops and educational programs every year, and examples of such are the activities organized by the Florence School of Regulation or CEER/ ERGEG. We assume that NEA staff may benefit from participating in some of those.

In relation to the said, NVE wishes to underline the importance of providing for NEA management, staff and resources which are, in size and ability, as equal as possible to the management, staff and resources of the market participants. Such equality of strength may contribute to increased respect for the regulator among market participants, in turn leading to a higher level of compliance among market participants.

Thus, in addition to abovementioned measures for the improvement of NEA staff's competence, NEA may, while taking into account the need for impartiality and NEA independence, also consider attracting staff already holding experience from the energy sector. Whether NEA is successful in attracting highly qualified staff, may rely on NEA's determination and ability to invest economically in its staff, both with regard to education and improvement of personal skills, and with regard to salary and other core working terms and conditions.

One may, however, sense a general notion among European political authorities that the salary level of government staff should be lower than the level offered by the subjects of their surveillance. To a certain extent, NVE, as most other Norwegian government departments, suffers from that notion as it is put into practice. On the other hand, to gifted staff or candidates, NVE tries to offer as good and tailored conditions as possible, and we do experience that it may work, even if private companies are

able to offer a higher salary. Hence, if NEA strives to make working terms and conditions more competitive, and makes that show to current staff and possible candidates, it may be a well-working tool to decrease staff turnover.

- **Visible, Clear, Consistent, and Efficient NEA**

Some market participants are overall satisfied with NEA. Others, however, ask for a more visible, clear and consistent approach. Some complain about unpredictable decisions, and some blame the unforeseeability on a lack of consistent NEA practice to be complied with by all NEA staff. One market participant said there is no plan for NEA's approach, and that he feels that NEA decides at random from day to day. In addition, certain market participants would like to see a more active presence of the NEA Director General (DG), at least at high level meetings, in order for NEA to level with market players and other authorities.

NVE has been informed that market participants, in a couple of perceived exceptional cases, found it necessary to contact the Ministry directly to discuss the preparation of decisions or tasks which are conferred upon NEA. Allegedly, one market participant even found it necessary to assist NEA in the carrying out of its tasks, urge or instruct a certain outcome, or simply prepare NEA's decision. According to the market participant in question, their unorthodox approach was due to NEA's insufficient capacity and competence. Reference was also made to the possibility of the Ministry informally instructing NEA as a result of the market participant urging Ministry to intervene.

Abovementioned market participant also complained about uncertainty regarding who is preparing administrative regulations. Allegedly, such regulations are sometimes prepared by that market participant, sometimes by others who may be unknown to the market participant, and sometimes by the authorities. The market participant expressed frustration over lack of consistency in the designation of the preparation task and was concerned that it could increase the impact of lobbying. It was added that NEA, or the Ministry, with the extensive assistance of NEA, should be best placed to prepare the legislation, but that insufficient staffing and competence of NEA could contribute to the disorderly and over-complex situation.

Finally, some complained that NEA's form of procedure is too slow and that it takes too long for NEA to come to a final formal decision.

It is NVE's impression that abovementioned has lead to or is a signal of lack of respect for the regulator. Such lack of respect may increase risk of unwanted market participant behavior, including unpredictable approaches taken by the market participant towards the authorities. Thus, NEA should seek to build up an increased level of respect for the regulator by acting in a visible, clear, consistent, and efficient manner. If the regulator, on the other hand, gives market participants a reason to believe that it lacks competence, visibility and/or consistency in its actions, the respect for the regulator may fall to unacceptable levels.

Respect for the regulator may be increased through establishment or improvement of a consistent decisive NEA practice and a more visible participation by the NEA DG, especially when meeting with high level representatives of other authorities or market participants' top management or board. In addition, we wish to stress the importance of efficient, speedy and non-discriminatory case handling, to prevent unacceptable delays and dissatisfaction, and to promote efficiency, pursuant to the purpose of both the Electricity Act and the Directive.

- **Formalized NEA Decisions and Communication**

NVE is informed that NEA is not consistently formalizing its decisions or other communication with authorities and market participants. Several market participants have raised concerns as to informality and lack of clarity in NEA's communication. One market participant used very strong words to describe what he viewed as worrying poor communication skills among NEA staff.

As an example, however, of a fairly adequate approach from NEA's side, market participants have pointed at NEA's approval of tariffs. When approving tariffs, mostly in time, NEA does appear consistent in use of written form and timely replies, but tend to abstain from stating clearly that the tariff is approved, and rather just states that NEA does not have any comments to the tariff. Moreover, NEA, allegedly, leaves out any reference to legal basis for its approval.

As for other cases, however, it is said to exist an even less consistent and robust practice with regard to formalities.

Inter alia, we have been informed that NEA decisions or enquiries are not always made in writing, that it is not always specified whether NEA is making a decision or not, that market participants are not always informed about relevant NEA decisions, and that NEA decisions may be very poorly reasoned. Further, we have been informed that NEA communication is not always signed by head of the relevant unit, or, if appropriate, by NEA DG, that reference is not always made to legal basis for NEA's decision or other action, and that NEA does not always seek and obtain confirmation as to whether they are communicating with a person legally representing the market participant in question.

NVE has learned that both NEA and market participants have experienced cases in which they have been unable to appeal or enforce decisions due to lack of formality.

In light of the situation, market participants have expressed to NVE a strong wish for more formalized NEA decisions providing for clarity and, if necessary, appeal and judicial review. Fulfillment of such requirements of form is, by many market participants, viewed upon as more important than the content and outcome of the decision.

Based on abovementioned, NVE recommends that NEA always makes sure that communication with other market participants and authorities is formalized in accordance with below list, at least to the extent necessary to provide for notoriety as to the grounds for any past or future decision, and to the extent necessary to provide market participants with clarity as to what NEA wants, does, orders, demands, or imposes in the case at hand. This means that, inter alia, all communication having a potential impact on market participants' rights and responsibilities should be formalized.

To obtain an acceptable level of formality, NVE recommends that, inter alia, the following points are complied with:

- As a main rule, communication having a potential impact on market players' rights and responsibilities, shall be in writing
- Meetings, at which communication takes place which may have an impact on market players' rights and responsibilities, should, if appropriate, follow a preset agenda; and, in any case,

main points from the meeting should be documented through minutes to be agreed by all meeting participants

- NEA shall make sure that communication with market players goes through person(s) legally representing the market player in question
- No communication shall leave doubt as to whether NEA, by the communication in question, makes a decision or simply just puts forward a request, provides information etc.
- All decisions and other enquiries shall include a consistent and proper reference to any relevant legal basis for NEA's decision or other action
- All decisions shall be accompanied by adequate reasoning of and grounds for the decision, inter alia to facilitate appeal and/or judicial review
- All decisions shall include information on the right to appeal
- All decisions shall be signed by an empowered representative of NEA, preferably by two NEA representatives, one being superior to the other, and, in important cases, by DG

Please note, however, that, abovementioned formalities may be complemented by communication of a more informal kind, as such informal approach may be successful and therefore desirable in many cases. Naturally, not every phone call or informal discussion should be replaced by a formal letter, and in many cases, NEA may wish to try the "soft" way first. Such informal approach may be an option as long as NEA does not use or refer to any of its powers.

However, to facilitate a lawful procedure before all administrative instances, to provide for judicial review, and to arrange for subsequent evaluations or inquiries, it may prove necessary to formalize all communication having a potential impact on market participants' rights and responsibilities. Thus, formalization may contribute to increased respect and understanding for NEA's actions and decisions.

Finally, NVE recommends the setting up of annual or bi-annual high level meetings between NEA and the TSO. Purpose of such meetings should be to meet regularly without necessarily being in the middle of a discord on a specific issue. The meetings could rather serve as an arena for discussions of issues on an earlier stage, before those issues evolve into conflict.

NVE recommends that such meetings are formal, that a pre-set agenda is prepared and complied with, and that minutes are approved by both parties.

- **More Use of Inspections and Better Monitoring**

Both NEA and all market participants state that NEA does not at all conduct site inspections. All surveillance is carried out "behind the desk", with the exception of the auditing carried out by external consultants to monitor the separation of accounts.

Some market participants even claim that NEA does not have any control over important market participants. According to one market participant, the TSO is allowed to be managed horribly, on a continuous basis, without necessary interference from NEA.

Reportedly, NEA has visited some of the market participants, but purpose of such visits has never been formal inspections. The visits have rather been informal, e.g. excursions, all though occasionally involving discussions between NEA and the market participant on regulatory issues.

NVE is of the impression that it could be favorable to introduce formal site inspections as a central mean of obtaining a more efficient surveillance and fulfillment of the Electricity Act and appurtenant regulations. In addition, such formal inspections may increase the level of respect for, and perhaps trust in, the regulator and the regulator's decisions, a notion of which is shared by some market participants. Market participants state that trust in the regulator has been present in the past, not because previous decisions usually turned out to be favorable to the market participant in question – allegedly, they very seldom did – but rather due to respect for a regulator showing persistence, decisiveness, determination and knowledge. Some market participants state that NEA does not anymore hold the abovementioned qualities, but welcomes formalized inspections as a means of restoring trust and respect for NEA.

The abovementioned is without prejudice to NVE's impression of a well-functioning surveillance regime with regard to the unbundling of accounts requirement, as pointed out above.

As a main rule, NVE prefers using our own staff for surveillance in general, and inspections in specific, as external competence being both qualified and independent may be hard to find. However, NVE does procure external competence with regard to research and general studies. If limited resources prevent NEA from carrying out inspections using their own personnel, NVE may still recommend the use of external consultants, i.e. if such external assistance is needed to make sure that inspections and other monitoring tasks are carried out. It is NVE's immediate impression that today's practice regarding external audits of market participants' separation of accounts, may serve as an example for coming monitoring arrangements. However, it may be a good idea that NEA staff accompanies the external consultants for the sake of building up their own competence.

In any case, NEA should always see through that NEA and the external consultants remain independent from all market participants in their carrying out of monitoring tasks.

In order to fulfill the purposes of the Electricity Act and the Directive, as well as to facilitate respect for NEA and maintain necessary order and compliance, NVE recommends that all inspections are carried out according to a pre-fixed schedule and plan, including a check list of factors to be inspected. Following every inspection, a report, possibly pursuant to a standardized format, should be prepared. The report should set out all findings, at least with regard to non-fulfillment of requirements, and include NEA's decision regarding within what deadline and, where appropriate, how the market participant is obliged to bring conditions back into a lawful state.

Finally, NVE would like to stress the possible advantages of coordination between all relevant surveillance authorities. In relation to that, one possible improvement could be coordination between NEA and Icelandic fire departments with regard to the latter's monitoring of compliance with security of supply requirements. As for now, NVE has learned that fire departments do not have any duty to report to or coordinate with NEA.

- **Establishment of More Effective Sanction Powers and Increased Use of Current Powers**

Today, NEA has the power to impose daily fines on market participants not fulfilling their duties pursuant to the Electricity Act or appurtenant regulations. According to the Electricity Act Article 26, a daily fine may range from ISK 20 000 to ISK 500 000, leaving market participants with a certain foreseeability as to the costs of their infringement.

When imposed, a daily fine is a sanction related to behavior in the future, and the purpose of it is to compel the market participant to restore a lawful practice. However, NVE holds the view that such sanctions may sometimes be insufficient to fulfill purposes of the Electricity Act and the Directive. Thus, in addition to daily fines, NEA should be assigned powers to impose penal sanctions related to behavior in the past, i.e. e.g. a power to impose a fine for infringement in the past, regardless of whether the market participant now or later re-establishes a lawful practice.

In Norway, NVE holds said powers to impose penal sanctions in case of serious infringements of requirements considered especially important.

Further, we have been informed that NEA does make use of its current powers to impose daily fines on market participants. However, powers are used mainly in cases of non-fulfillment of data reporting obligations. In other cases, NEA appears to confine itself with other approaches, such as the demand for answers or similar. Further, from our meetings in Reykjavik, we get the impression that NEA is somewhat reluctant to make use of its current powers, and that this reluctance may in itself contravene with an effective sanctioning of infringements.

That said, NVE recognizes that, in certain cases, abstention from using daily fines may be justified, e.g. where demolition of an illegal installation is unjustifiable according to environmental, technical or economical principles. In such cases, the abovementioned needed powers to impose penal sanctions for past infringements could be an adequate sanction.

As for other cases, however, NVE holds the immediate view that NEA should be less afraid of using their powers. In all cases of suspected or documented breach of any requirement to which there is a sanction power connected, NEA should rather be more willing to approach market participants in a formal way, to use NEA powers to demand information, order re-establishment of lawfulness, refer to NEA's powers to impose sanctions, and, if necessary, to impose sanctions such as daily fines consistently in all cases of breach.

Still, as a complementary means, NEA may continue using its apparently widely used practice of choosing a more informal or "soft" approach, if such approach is deemed effective in a certain case. A "soft" approach may include discussion with relevant market participants rather than immediate use of sanctions.

Said "soft" approach is supported by some of the market participants with which we have met, but strongly criticized by others as being too soft and not suitable, at least not as the only way of approaching market participants' breaches of duty.

NVE does not on principle refuse a "soft" approach. However, in some cases, the regulator may obtain a better solution by acting formally and decisively, and by making use of their powers to

impose sanctions. Moreover, in the long run, NEA must make use of its powers to convince market participants that NEA's sanction powers are a real threat to unlawful behavior, as well as to increase the level of respect for NEA in general. Thus, formal or informal discussions should be used only as an additional means, complementing, where appropriate, the use of formal notices, orders, and, if necessary, daily fines.

In any case, NEA should make sure that sanctions, such as daily fines, are imposed in a non-discriminatory and consistent way, to facilitate market participants' respect for and compliance with NEA decisions.

- **Publishing of Decisions, Reports and Activities**

NVE has been informed that the only document published by NEA, is their annual regulator's report. Inter alia due to respect for possibly confidential information, NEA does not publish any of their decisions. NEA does, though, organize consultations prior to awarding concessions, purpose of which is assumed to be the collection of the public's view on the upcoming award. However, the consultation is organized so that relevant documents are made public only through a journal which no one reads. Thus, no external input on such consultations has ever been given.

Despite of abovementioned practice, NVE has been informed that NEA is obliged by general Icelandic law on the publication of government documents, to ensure that such documents are made available to the public, as long as confidentiality of trade secrets and personal information is secured.

Publishing of NEA documents should be regarded as an important contribution to fulfillment of the basic right to access NEA documents. Further, such publishing may contribute to increased interest, respect and credibility for NEA, as well as to a higher level of compliance among market participants. In light of the said, NVE finds it a bit strange that NEA chooses not to publish any document except for abovementioned annual report.

All market participants inform that Icelandic media's interest in NEA's, TSO's and DSOs' activities is quite sparse. Some focus has been directed towards the largest DSO, but significant and frequent raises of tariff have not resulted in any media interest, by which some of the market participants are surprised.

The Norwegian experience shows that publishing of NVE decisions creates a significant interest from the media, at least local media based in areas directly affected by the NVE decision at hand. The media contributes to putting companies in breach of regulations, in a bad light. The threat of being put in such bad light, may, in turn, prevent infringements. Thus, it is our recommendation that NEA commence the publishing of all NEA decisions. In addition, all relevant news on NEA activities, including press releases on recent inspections and other monitoring activities, should be published at least on NEA's website.

NVE is informed that NEA does not regard under-staffing as a barrier to reviewing documents up for publishing, in order to spot and delete any confidential information from the published version of the document. Hence, NVE assumes that said would not prevent NEA from publishing all decisions and other relevant documents and information.

Finally, we would like to stress that public access to documents contributes to the level of transparency needed for a well-functioning electricity market regardless of whether the document is

held by NEA, the Ministry or a state-owned undertaking not subject to competition. In relation to the said, NVE is surprised to learn that documents held by state owned undertakings is exempted from public access per se, even if the state owned undertaking is the holder of an exclusive right to own and/or operate a transmission or distribution system within a certain area.

- **Clarification of Roles and Responsibilities**

NVE has been informed that both the Ministry, NEA, and the market participants have done their utmost to comply with requirements and good practice as to their roles and responsibilities. All the same, representatives of both authorities and market participants have expressed their deep dissatisfaction with how certain governmental bodies and/or market participants act in terms of their roles and responsibilities.

Said dissatisfaction relates, inter alia, to examples of unorthodox and alleged unacceptable communication and actions taken by and between governmental bodies and market participants.

More striking allegations involve claims that certain market participants are favored at the cost of others, inter alia as a result of extensive and successful lobbying against the Ministry. Moreover, it is claimed that NEA is unofficially, informally and, to an unacceptable extent, instructed by, or under far-reaching influence of, the Ministry. One market participant holds the impression that the Ministry is instructing NEA in details. Another considers the Ministry and NEA as one body, in practice.

Some describe abovementioned unorthodox communication and actions as necessary due to extraordinary circumstances, such as the failure of NEA to carry out its tasks. Others have described it as outrageous, beyond professionalism, and well beyond acceptable limits.

NVE does not conclude in any direction, neither as to the reliability of abovementioned information, nor as to the reasons for any dissatisfaction. However, NVE holds the view that the bear existence of such strongly felt dissatisfaction and, to a certain extent, disbelief as to the ability of Icelandic energy authorities to provide independent, qualitative and non-discriminatory administration and service, suggest that there is a pushing need for renewed specification and implementation of well-defined roles and responsibilities among the different governmental bodies and market participants.

In order to facilitate respect for the regulator, NVE holds the view that roles of all involved parties, including the Ministry, NEA, the TSO, all DSOs, producers and suppliers, should be specified, made clear to market participants, and respected in practice.

Said should involve the establishment of a common notion that all communication between authorities and market participants goes through NEA, not the Ministry. This is especially important if communication regards issues which may be subject to a NEA decision, regardless of whether complaints on the relevant decision is to be handled by the Ministry or another body, such as the Appeal Committee.<sup>22</sup>

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<sup>22</sup> If the appeal is decided upon by the Ministry, the Ministry should not interfere with the first instance assessment. If the appeal is decided upon by the Appeal Committee, and the NEA decision is made pursuant to a regulatory power according to the Directive, cf. inter alia Article 37, the same applies, as the Directive's requirement as to regulator independence, cf. Directive Article 35 paragraph 4, most likely will apply. According to the Directive, NEA is not to take instructions from any government.

- **Income Cap Decision on Time**

All market participants, even those being generally satisfied with NEA, complain that NEA's income cap decisions arrive too late. Some blame NEA for not being efficient enough, while one market player believes the delay is due to the Ministry's slow handling of an expected amendment to the Electricity Act.

In any case, all market participants tell that they never have received the Income Possibility Curve from NEA as required by the Electricity Act article 12 and 17. The Income Possibility Curve for a year is to be submitted to the DSOs/TSO by NEA in October the year before. Some market participants state that, in order to be taken into consideration when the TSO or the DSO is setting its tariffs, making its investment and other budget related decisions for the following year, the Income Possibility Curve should be presented in due time. Several of the DSO's informed that the final decision, which is to be received in April the year after, sometimes was received too late.<sup>23</sup>

One market participant stated that it is impossible to make investment decisions as long as the income cap decision arrives as late as it does today. However, some market participants also showed that their own calculations prior to the tariff determination often do not differ considerably from NEA's decision more than a year later.

The Income Possibility Curve should be calculated by NEA and submitted to the TSO/DSO in due time and in accordance with the provisions in the Electricity Act and regulation. Ideally, calculation of income cap for the coming year should be finalized and dispatched to the TSO or DSO in question early enough for the TSO or DSO to take it into consideration when preparing its budget and tariffs for the coming year.

- **Distinctive Characteristics of the Economic Regulation**

Due to the lack of English documentation, we have not been able to assess the current income cap regime fully. Even if we had assessed it, the time we have had to our disposal would not have been sufficient for such an assessment. However, we do not have the impression that there is a general view that the current regime is unsuitable, even though some of the network companies expressed some concerns about the regime.

Several companies express that the current income cap regime is lacking any incentives for efficiency improvements, since cost reductions in the current regulatory period would lead to lower income caps in the next period. Several of the companies have reduced their cost recently to cope with the financial situation on Iceland. The cost reduction increases their profit, and, hence, their cash-flow, in the current period, but this benefit will be lost in the next period.

On basis of our knowledge about the income cap regime in Iceland, we do not agree with the network companies. It is generally accepted that income cap regulation provides fairly strong incentives for efficiency improvements, and, the longer regulatory periods, the stronger incentives. In our view a shorter period than 5 years should be avoided.

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<sup>23</sup> We got the impression from the companies that they are supposed to receive the Income Possibility Curve in October every year for the tariff decision for the next year. However, it is not stated in the Electricity Act that this should be done annually at a specific date. Is this something that is specified in any regulations?

Several of the network companies say that they have reacted to the income cap regulation by reducing costs to increase their profits and cash-flow. This is exactly what incentives are about, and, as such, the regulation is working as presupposed. Some of the companies expressed concerns about the income caps in the next period. They said that they might have reduced their cost below a sustainable level, and that the result will be that the income caps will be too low in the next period. We cannot see that this should be a problem in general. The network companies have chosen to take out more profit and cash-flow in the current period than sustainable, and, hence, they have to 'pay back' in the next period. The income cap regulation will work against efforts to increase costs above an efficient level in the next period. The outcome would most likely be that the companies will be more cost efficient in the future.

However, there might be situations where the financial crisis impacts the network companies in an unforeseen way, and that might require special attention from a regulatory perspective. If any such circumstances, it would most likely be related to cash-flow problems. We assume that this will be dealt with when determining the cost of capital allowed in the income caps.

Some companies expressed that the 10% efficiency requirement that NEA tried to impose on the income cap for 2010 was rather tough and lacked any reasons. We were informed that the basis for the 10% was a governmental decision that all governmental bodies should reduce their costs with 10%, and that NEA found that this also could be imposed on the TSO and DSOs. We do think that the reasons for this decision is too vague, taking into consideration that this is capital intensive industries with huge amount of sunk cost, compared to the public sector. A general efficiency requirement imposed on the industry should probably be far less than 10% per year. However, for single companies, this might be suitable, but only after assessing the cost level in the company. We recognize the difficulties of performing benchmarking in Iceland, due to the few numbers of domestic companies. An alternative might be letting external consultants assess the possibilities of cost reduction in each company and fix an individual efficiency requirement based on this. The costs of hiring consultants may be significant.