

Hungarian Energy Office

SUMMARY

of the Annual Report to the European Commission

Budapest, July 2005

The report includes the attending of the tasks that are specified by Paragraph (9) of Article 3, Article 4 and Paragraph (8) of Article 4 of the Directive 2003/54/EC and by Paragraph (6) of Article 3, Article 5 and Paragraph (1) of Article 33 of the Directive 2003/55/EC.

The Electricity Act CX (hereinafter the new VET) of 2001 and the Act XLII of 2003 on Natural Gas Supply (hereinafter the new GET) and the secondary legislation on their implementation prescribe the establishment of the electricity and natural gas market in Hungary. The modification of the mentioned laws so that the relevant EC Directives are implemented, was passed.

Regulation of the energy market, institutional system

The Hungarian Energy Office (the Office) is responsible for the regulatory tasks regarding the operation of the energy market. In case of both energy sources in the public utility sector, furthermore in case of the monopoly activities (system use, network requisition) that remains in the circle of the administrative charge setting, it is the price authority, the Minister of Economy and Transport that fulfils the relevant tasks, while the Office is responsible for the tasks related to price setting.

The competency and task of the Office are the licensing and supervision of electricity, natural gas industry activities and of district heat generation, dealing with customer protection and price setting. Since 2003 a primary task of the Office is the supervision and licensing related to the establishment and operation of the electricity and natural gas markets.

The Office played and plays a decisive role in the transformation of the energy sector, operation of the regulated market, foundation of the competition market, issue of operational licenses for market players, regulation of companies remaining in (natural or legal) monopolistic position, the supervision of market and the gradual extension of competition market.

The Office is an administrative organisation with independent tasks and competencies on a national level. The Government is responsible for its control and is supervised by the Minister of Economic and Transport. The Office is a legal entity, which operates as an independent budgetary organisation.

The Act IV of 1957 (since 1 November 2005 it is the Act CXL of 2004 on the general regulation of the administrative authority process and services) on administrative proceedings is standard for the proceedings of the Office with the difference that the deadline for administration is 90 days. A legal remedy in case of challenging the resolution of the Office is only possible by way of a judicial procedure. The court has the right to modify the resolution of the Office.

The Office has price preparation competency in the field of electricity and natural gas supply as well as of district heat generation, which is regulated in the law.

The Office in order to enforce the consumer interests attends customer protection tasks in co-operation with the General Inspectorate for Consumer Protection and with other the regional inspectorates for consumer protection. Within these activities the Office investigates customer complaints, co-operates with the non-governmental organisations, representing customer

interests. The office monitors the quality of service in order to provide the security of supply for customers.

Operation of the competitive electricity market

Following the limited opening of the electricity market on 1 January 2003 – for customers whose annual electricity consumption is above 6.5 GWh –, all non-residential customers can buy electricity on the competitive market from 1 July 2004.

A number of customers, however, are currently not supplied with metering equipment, which would enable – as a condition for market purchase – the schedule-based settlement. Consequently, they can only enter the competitive electricity market if their settlement can be solved. This is enabled by the (customer profile) settlement, which is based on a statistical analysis and on the consumers' electricity-performance demand curve.

Following the market opening on 1 January 2003, by the end of May 2003 the number of balance circles reached 11, while the number of eligible customers increased to 22. The number of customers entering the market was practically doubled by the end of the first quarter. By the end of 2004 altogether 85 customers entered the competitive market, whose annual consumption was 6 643 GWh, which is more than 20% of the total national electricity consumption. Providing eligibility for all of the non-residential customers multiplied the number of potential market entrants from 1 July 2004. By the end of 2004, 546 eligible customers purchased on the competitive market with 832 consumption sites. Their consumption was 24.84% (8 188 GWh) of the total consumption. After the first semester of 2005 928 eligible customers consumed at 1 413 consumption site 10 810 GWh, which is 31.54% of the total consumption.

The gradual market opening meant that two segments were operating in the electricity market; the public utility segment, supplying the public utility customers and the competitive market, supplying the eligible customers, entering the liberalised market.

The regulation of the electricity market extends to both elements of the dual (hybrid) market (public utility and competitive) model. At present, the trade between the public utility wholesaler and the public service providers, as well as the supply of the public utility customers runs at an officially maximised price.

The eligible customers on the competitive market can purchase electricity from the electricity wholesalers, from the electricity generators and can also buy by themselves from foreign sources (import). Within the frame of tendering it is possible to invite applications for the establishment of power plants. By issuing a decree in order to provide the security of electricity supply, measures have been taken with regard to the setting of storage levels of energy sources of power plants with a capacity of 50 MW or above. The free generation and cross-border capacities are sold on auctions. Within the frame of regulation the Commercial Code was modified, the load profiles were introduced; the acquisition, settlement and requisition of the ancillary services as well as its settlement price were regulated. The modification of the regulatory background became meanwhile necessary, because of the transformation of the mechanism regarding cross-border capacity distribution and the regulation of the network company tasks.

An important task of the Office is to enforcement of unbundling of activities, according to the conditions ordained in the rule of law, that will be implemented for the legal and managerial unbundling as well as soon as the new Act enters into force (mid - 2005).

The operation of the competitive gas market

The gas market was opened on 1 January 2004. The hybrid model conceptualized by the Gas Act implies the parallel operation of the public utility supply and the competitive market in middle term. With the sole exception of the household costumers all costumers (making up 2/3 of the domestic consumption) are eligible to choose public utility supply or to enter the competitive market. Public supply (public supply wholesaler as single buyer and the public suppliers) and the ancillary services (transport, distribution, storage) operate in an administratively regulated environment (access, basic services, price).

One can remark, that at the constantly growing requirements of the Hungarian gas market due to the high rate of temperature-dependent consumption, the peak-day consumption in the winter period can be four times as high as of the average daily consumption in the summer period. In case of household consumers this rate is seven-, eight-times higher. Underground natural gas storages are important tools for satisfying the fluctuation of the seasonal and daily demand. Storage peak-capacity is 44,2 million m³/day but in accordance with the growing peak demand, the storage capacity has to be extended. There will be an extension of 3 million m³/day in 2005. The growing demand of the costumer sector and especially of the power exchange sector makes necessary in middle-term the extension of the 42 million m³/day cross-border capacity of the country. There is no physical congestion in the cross-border capacities yet, but thanks to the growing demand in the Eastern direction line, contractual congestion has been developed.

While the natural gas capacity is growing year by year, the volume of the domestic production decreases. Thus the role of the import in gas supply already representing 70% continues growing. The present natural gas wholesaler has an import portfolio made up of TOP-type long-term contracts that satisfy the country-wide consumption in middle-term.

The transforming gas market beside the creation and implementation of the gas act makes it necessary to describe the physical operation of the gas infrastructure (transporting, distributing and storage systems) and the detailed regulation of the rights and responsibilities of the market players. The Grid Code that is to be constantly develop introduces the features of the co-operative systems and ensures the regulation of the binding of the capacities, the balancing and other questions coming forward during system usage. The Grid Code – in accordance with the Gas Act determines the capacity allocation techniques of the entrants (costumers) and the method of how to handle the problem of congestion.

The legal possibility for the market opening is given to all customers except for the household customers, but the number of entrants (costumers like chemical companies, middle-size industry players, heating plants, heating power plants) in the period starting with 2004 is altogether 23 and the share of their consumption does not excess 6-7% of the total consumption of the country and is sold by 3 commercials (total number of commercials is more than ten) After the opening of the market the majority of the eligible costumers stayed in the public utility segment.

Despite of the constant development of the regulatory background based upon the experiences and supporting the market opening (amended Grid.Code, entry-exit tariff-system, etc.) the scope of the opening on the gas market fall behind the results on the electricity market the

main reason being for this that as a result of the public utility price regulation the present risks are more predictable for the costumers than the risks on the competitive markets.

Supervision of the competitive market

Currently, the official price control operates in case of electricity consumers, regarding end consumer prices. At present any customer can choose to stay in the public utility sector and can also switch back from the competitive market (the actual switch back will be realised the latest six months after announcing this intention). This way the public utility sector currently functions as the price cap of the competitive market.

The price correction is carried out annually. The Office makes a proposal in this regard to the Minister of Economy and Transport who has price authority competency. Price modification within one year can only happen if due to electricity market events or other considerable regulatory problems it becomes unequivocally necessary.

The Office, within its customer protection activity, annually evaluates the indices relative to the quality of service and sanctions if necessary in case of deficiencies.

In case of operational disturbances in the natural gas system, the restraint of residential and certain community customers is only possible in case of force majeure. Industrial large consumers are categorised into 5 restraint groups. The first and the second groups include those customers to whom the occurring restraint does not cause any technological damage. In case of public utility natural gas customers there is no official price control.

The public utility end-user prices regulated officially are published in Ministerial Decrees. Prices, similarly to the previous practise, include the unbundled charges for system use. Consequently, the public utility charges, paid by the end user are supposed to cover the charge for system use that is related to public utility supply. The cost of the natural gas as a product is included on the import price level in the public utility prices.

Summary

The competitive electricity market operates from the beginning of 2003. The annual consumption of the competitive (free) market entrants was 30% of the total consumption of the consumer group in the middle of 2005.

Since the opening of the natural gas market at the beginning of 2004, the customers meet 6% of the demand on the competitive market, till the main part of the authorized consumers stayed on the regulated (public utility) market.

Regulators regulate the competitive market in appreciable part in accordance with the EU law with laws on the electricity and natural gas supply along with their modifications, accepted in June 2005.

The customer protection is ensured by monitoring the indices on the quality of service, by setting the guarantees services, by evaluating the results of measuring customer satisfaction, depending on the results by making provisions (penalty, strengthening of the regulation) and by the continuous handling of customer complaints.

The scarcity of adequate generation capacities on the competitive market can be pointed out from among the factors restraining the electricity market, due to the large proportion of allocated amounts for the public utility sector that have been contracted by PPAs. The natural gas market is characterized by the dominance of the incumbent wholesaler and the scarcity of eastern cross-boarder capacities.

The security of supply has not deteriorated in the past two years and there have not been any outages that would have affected the customers.