Lithuanian Free Market Institute in partnership with INESS

Response to public consultation process on a New Energy Market Design

based on Communication COM(2015) 340 final 15 July 2015

6 October 2015

OBJECTIVE OF THE CONSULTATION

The EU is aiming to transform the European electricity system and redesign the electricity market to empower the reach of the 2030 climate and energy targets and the leading role of the Union in the field of renewable energy. The changes are claimed to be necessary in order to meet "consumers' expectations, deliver real benefits from new technology, facilitate investments, notably in renewables and low carbon generation; and recognise the interdependence of European Member States when it comes to energy security". The Commission believes the transformation of electricity system and redesigned electricity market to have an added value to cross-border competition as well as to promote decentralized electricity generation (self-consumption and innovative energy service companies). The Commission's questions of the consultation are classified into three groups: (i) a new electricity market for the EU; (ii) regional cooperation in an integrated electricity system; and (iii) the European dimension to security of supply.

Summary of the Response

1. **A new electricity market for the EU:**
   - Introducing deregulation which allows real market price signal, including scarcity, shall become the core element of an integrated electricity market;
   - Only flexibility and autonomy of suppliers and consumers in managing price volatility by allowing diversified products and services based on dynamic pricing will ensure that the value reflects the actual scarcity. Facing with informative price signals increases incentives for innovation in entrepreneurial activities and technology, responsiveness to consumer demands, and management of consumption;
   - To prevent Member States from using capacity mechanisms, ,next to the prices reflecting scarcity, there is a need to remove the barriers to cross-border trade, including interconnections;
   - It should be noted that the development of interconnections and a full integration of renewable generators might cause overinvestment into infrastructure;
   - The EU shall not force any regulatory measures to the electricity market and its structure. Introducing mandatory regulatory requirements will threaten that regulation and regulators will prevent innovation and technology from evolving in the market.
   - Renewables shall not be seen as immature; therefore, additional public financial incentives are not needed to the market. Continuous subsidies are distorting the market, impeding competition, and will affect market signals, reliability of which will be of even greater importance in the integrated European Energy Market.
2. **Regional cooperation in an integrated electricity system:**
   - The European Commission should not take for granted that the Integral energy market necessarily implies centralised (at the EU level) decision making and justifies expanding roles of the EU agencies or harmonizing measures;
   - The European electricity system and electricity markets are under ongoing innovation and sufficient time should be left for the market as well as national authorities to adapt and offer solutions.
   - The Commission focuses too much on EU-level measures suggesting new and stronger functions to the EU agencies and bodies; there is a danger that EU institutional and regulatory frameworks will not evolve along with technology;
   - Voluntary regional and pan-European cooperation shall not be undermined.
3. **The European dimension to security of supply:**
   - According to Article 194(2) of the Treaty on the Functioning of the European Union (TFEU), Member States are entitled to choose the structure of energy supply and energy mix. Thus, it should be taken into consideration that Member States are responsible for security of supply;
   - The Commission's role in the European dimension to security of supply shall focus on the application of the EU Internal Market rules and the competition law, assessing whether national policy measures relevant to security of supply are justified, proportional and in line with the principles of free access to generation and networks, and undistorted competition. Moreover, questions of technical nature shall be discussed in cooperation between Member States and market players, including, but not limited to, national regulators and TSOs.

QUESTIONS

1. DELIVERING THE NEW ELECTRICITY MARKET FOR THE EUROPEAN UNION

1) *Would prices which reflect actual scarcity (in terms of time and location) be an important ingredient to the future market design? Would this also include the need for prices to reflect scarcity of available transmission capacity?*
It is welcoming that the Commission raises a question regarding real market prices, because market-based prices and actual scarcity of goods and services are the only informative signals that allow making decisions for market participants. The actual scarcity should not become just one more component of the price calculation formula/methodology, but imply a right of energy companies to offer diversified products and services based on customers' choice on what level of price volatility to accept. Dynamic pricing and the right to differentiate products are necessary to maximise the value of technological innovation.
2) Which challenges and opportunities could arise from prices which reflect actual scarcity? How can the challenges be addressed? Could these prices make capacity mechanisms redundant?
The actual scarcity requires flexibility and autonomy of the suppliers and consumers in managing price volatility. That would mainly include product differentiation, price differentiation, employment and use of smart technologies, implying (i) potentially more competition in the retail electricity market, (ii) entrepreneurial decisions and innovation in pricing, products/services and end-use technology, and (iii) de-centralized coordination of the electricity power industry. Therefore, the EU and its Member States shall make adjustments in existing regulation allowing these opportunities, and, in a way, take necessary measures to achieve full value of introducing prices reflecting the actual scarcity. To prevent Member States from using capacity mechanisms next to the prices reflecting scarcity, there is a need to remove the barriers to cross-border trade, including interconnections.
3) Progress in aligning the fragmented balancing markets remains slow; should the EU try to accelerate the process, if need be through legal measures?
The question imposes a pure wish "to do something". However, the tendency to institutionalize and define administration/governance units which need adjustments to certain economic contexts and technological changes is negatively affecting those units. In the present case, the acceleration of market or policy decisions would have negative effects on the electricity market structure both at national and the EU levels. Necessary changes in balancing markets need innovative technology-based solutions which are offered in competitive processes, analyse best-practice examples, etc. Therefore, the EU shall not take any legal measures, but to support the existing mutual cooperation and trust between national, regional and Member States' market players in the field.
4) What can be done to provide for the smooth implementation of the agreed EU wide intraday platform?
The intraday trading has been introduced recently. Therefore, sufficient time should be left for markets to adapt and offer their own solutions to develop the system. Introducing mandatory regulatory requirements will threaten that regulation and regulators will remain behind the evolving innovation and technology. ENTSO and ACER have provided a great platform for the developing frameworks for the intraday platform, coordinating the activities of national regulation authorities, TSOs and power exchanges for the practical implementation of the intraday markets. However, further development shall be left to market players, whereas the EU action shall be limited to ensuring transparency of governance in the intraday markets and the platform.
5) Are long-term contracts between generators and consumers required to provide investment certainty for new generation capacity? What barriers, if any, prevent such long-term hedging products from emerging? Is there any role for the public sector in enabling markets for long term contracts?
Long-term contracts *per se* have no negative sides as far as they are acceptable to private contractual parties in the electricity generation market. However, long-term contracts shall not become a tool for the public sector to favour certain (private or public) undertakings operating in the market or to put a price on the taxpayers.

Before making public intervention by means of large investments into infrastructure, the elimination of the barriers for interconnections and cross-border trade shall be the priority when solving the generation capacity issues.

6) To what extent do you think that the divergence of taxes and charges levied[1] on electricity in different Member States creates distortions in terms of directing investments efficiently or hamper the free flow of energy?

Private investment decisions are based on multiple conditions and determinants, not only on taxes and charges, as the revenue of the investment for an entity does not come from taxes or charges. Only governments and public undertakings lean on taxes and charges levied as a source of revenue. Due to the nature of taxes and charges levied on electricity, e. g. VAT and excise duties, finally it is always a consumer who bears the sums imposed. In case of VAT, according to Article 38 and Article 39 of the VAT Directive 2006/112/EC applied to intra-community trade of electricity, electricity supplied by a power plant from one Member State to a company for distribution in the second Member State, it is taxed in the second state, while private customers pay VAT to the Member State which supplied the electricity. Thus, in terms of investments or energy flow, divergence of taxes and charges levied are irrelevant as it is not the electricity companies who undertake the cost of VAT; unless it is understood as giving the capacity for governments to intervene into the markets by public spending, which shall be limited.

Taxation and charges, especially supporting energy and climate policies, are imposing higher consumer prices and harming the poor, because they tend to use older and less energy efficient products due to the issue of affordability. While the biggest issue for businesses is complex, time consuming and financial resources requiring divergent compliance procedures and administrative declarations among the different Member states, as well as instability of taxes and other charges.

7) What needs to be done to allow investment in renewables to be increasingly driven by market signals?

Seeing investment in renewables as an ultimate goal poses a threat of overinvestment. Any investment shall be assessed in terms of efficiency. Market players' unwillingness to invest into renewable is another signal that investments are not regarded as economically sound. Thus, public authorities shall take it into consideration.

On the other hand, investment decisions require stable regulatory environment. The form, structure, policy and regulation, and subsidy schemes of the energy market went through extreme changes in the last decade. Those changes made investors to delay their long-term investment decisions as well as attracted 'opportunistic' investment based on "subsidy" signals rather than the market. Therefore, the EU and its Member States should put efforts to re-created energy market conditions with information-rich environment where the market price is clear rather than shaded by regulation and subsidies.

All EU Member States bear the burden of implementing 2020 Europe's targets on renewables. However, according to Article 194(2) TFEU, Member States have the right to decide on their energy mix. Therefore, in order to ensure the potential of long-term investments more attention should be paid to renewable energy sources which are more common in particular Member States rather than promoting and focusing RD&D on certain renewable types (like solar and wind energy) at the EU level.

8) Which obstacles, if any, would you see to fully integrating renewable energy generators into the market, including into the balancing and intraday markets, as well as regarding dispatch based on the merit order?

Fully integrated renewable energy generators may cause overinvestment into infrastructure. The majority of national grids are not suitable for massive generation from renewables. Instead of looking for other innovative technology solutions, Member States and market players might undertaking large investment-requiring projects, e.g. those that will increase public spending and taxpayers' burden.

Also, arrangements of transmission and balancing system are hardly suitable for massive generation from renewables. As generation from renewable sources is regularly interrupted due to natural causes and since TSOs have the duty to prioritize renewable energy units (Article 16 of Directive 2009/28/EC), generators

[1] These may be part of general taxation (VAT, excise duties) or specific levies to support targeted energy and/or climate policies.

must have incentives to manage their outputs so they would not become a burden on the grid at the cost of consumers. TSO contracts with generators from renewable sources play a significant role in the situation at stake.

Traditional balancing systems are based on steady forecasts and stict arrangements, in a way penelizing generators and suppliers/buyers which have not arranged their contracts precisly before the established despatch. The system is unsuitable in the case of renewables as generation from renewable sources is not fully predictable and forecasted. Therefore, there is a need for quick transactions, and flexible/adjusted balancing system.

9) Should there be a more coordinated approach across Member States for renewables support schemes? What are the main barriers to regional support schemes and how could these barriers be removed (e.g. through legislation)?

Integrated energy market requires informative market signals. Unregulated, market investment and market price-based signals are the only signals valuable to energy market participants when making their decisions on investment or management of energy generation and supply, as well as selling and buying.

Both the EU and its Member States had to learn their lesson of subsidies and their consequences on the energy sector. Renewable subsidies (i) distort competition and market functioning, (ii) create a lack of regulatory stability, (iii) a vast public spending on renewables has left neither enough time for energy market to adapt, nor allowed the market signals to inform about the decisions necessary. Besides, renewables are not an immature industry anymore (the Commission emphasizes that renewable markets are not new in the Communication C(2013) 7243, final 5 November 2013) and Member States should not intervene in the functioning market.

Consequently, the Commission shall not encourage any renewable support schemes, but strictly apply competition and State aid rules assessing national measures to ensure barriers of trade or access to markets/networks, and competition in the market. Support schemes shall be limited to research and enabling the employment of the results of research funded by public funds for the use among Member States.

10) Where do you see the main obstacles that should be tackled to kick-start demand- response (e.g. insufficient flexible prices, (regulatory) barriers for aggregators / customers, lack of access to smart home technologies, no obligation to offer the possibility for end customers to participate in the balancing market through a demand response scheme, etc.)?

Demand-response starts from market price signals. The existing regulatory burden, large and changing schemes of subsidies, non-dynamic pricing and limitation on possibility to offer differentiated goods and services do not allow facing informative price signals and demolish incentives for innovation in entrepreneurial activities and technology, as well as prevent consumers from demand-responsive and management of their consumption.

2. STEPPING UP REGIONAL COOPERATION IN AN INTEGRATED ELECTRICITY SYSTEM

11) While electricity markets are coupled within the EU and linked to its neighbours, system operation is still carried out by national Transmission System Operators (TSOs). Regional Security Coordination Initiatives ("RSCIs") such as CORESO or TSC have a purely advisory role today. Should the RSCIs be gradually strengthened also including decision making responsibilities when necessary? Is the current national responsibility for system security an obstacle to cross-border cooperation? Would a regional responsibility for system security be better suited to the realities of the integrated market?

It should be noted that both CORESO and TSC have been established on voluntary basis for the cooperation between TSOs. The Regional Security Coordination Initiatives work as a scheme defined by TSOs, coordinating operational security data/analysis in a certain territory. Also, it is a great platform of discussions, research and modelling that provides valuable data, allows exchange of experience and uses the information for further decisions on the security of the system. RSCI is an example of market players' solution to the issues they faced in both, regulatory environment and new market developments.

Appointing new functions and responsibilities to existing public bodies must be considered carefully and justified not to impede the ongoing processes of innovation in system security and integrated electricity market in general. Attention should be paid to the fact that electricity markets are under rapid innovation. The regulatory and climate change targets and new technologies imply evolving structures of the market and other novelties relevant to the efficiency and security. Economic dynamism and technological change require non-static regulatory and legal concepts. Institutions which are designed for centralised control have no potential to evolve along with technology and innovation.

As the systems are in the ongoing innovation period, decisions made at decentralized level are the best solutions to accommodate the innovative solutions market has to offer in one or another region of the EU, or even in cooperation with the neighbouring countries. Voluntary cooperation and data/information exchange between national TSOs is so far the most efficient way to foster electricity markets as it allows market players to compete looking and offering more efficient and innovative solutions to ensure system security and other objectives of integrated electricity markets.

Besides, national TSOs already coordinate their activities through ENTSO which has EU legal mandate and functions in both, pan-European and regional level in the field of technical support to TSO, reporting and adequacy forecasting under Regulation (EU) 543/2013 – as a central information platform providing fundamental market data on generation, load, transmission, balancing, etc. Therefore, EU is doing enough to allow for national TSOs to manage system security efficiently.

12) Fragmented national regulatory oversight seems to be inefficient for harmonised parts of the electricity system (e.g. market coupling). Would you see benefits in strengthening ACER's role?

ACER should not be entitled to make directly applicable and binding decisions on the EU-level initiatives and cross-border issues, e.g. to become a new EU regulator. The EU primary and secondary law already provide measures to ensure correct and effective transmission, implementation and enforcement of the EU regulation into national laws, including, but not limited to (i) preventive initiatives such as Regulatory impact assessment (RIA), training member states' officials and judges in EU law, regular consultation between member state officials negotiating the implementation and enforcement of EU legislation, 'mutual recognition'; (ii) pre-infringement initiatives, like SOLVIT and EU-Pilot established by Art. 17(1) TFEU and Communication COM(2007)502 final; (ii) formal infringement procedures under Art. 258 TFEU for violations of treaty provisions, regulations and decisions, non-transpositions of directives, incorrect legal implementation of directives, improper application of directives or non-compliance with CJEU judgments. The Commission has not provided any evidence that those measures are not sufficient to ensure correct and effective implementation of the EU law. Moreover, if harmonized, regulation seems not efficient enough to achieve established EU electricity system goals and further regulatory decisions on electricity system should be left to Member States and national regulators and/or agreed by Member States at the EU level via legislative procedures, but not entitled to a new regulator to solve on its own discretion.

13) Would you see benefits in strengthening the role of the ENTSOs? How could this best be achieved? What regulatory oversight is needed?

ENTSO-E has a strong and clearly-defined role and its place in the regulatory framework. Its principles of conduct deriving from the Third Energy Package, Regulation (EC) 714/2009, Regulation (EU) 838/2010, Regulation (EU) 347/2013, Regulation (EU) 543/2013, provide practical tools for Member States and TSOs to implement EU internal electricity market and related goals. Coordination of TSOs' actions in the fields of transmission system operation, system development, market development and research, and actions to define processes of compliance with EU legislation, like network codes, infrastructure development plans, methodology making, data collection and analysis/reporting assist Member State and TSOs as a reliable source on decision making and regional and pan-European cooperation when implementing EU frameworks and policies. Thus, ENTSO's role should be preserved and not mixed with any other functions to ensure independent coordination of TSOs by means of research, and platform of data, reports and methodologies which serve for the implementation of the EU integral electricity market.

15) Shall there be a European approach to distribution tariffs? If yes, what aspects should be covered; for example tariff structure and/or, tariff components (fixed, capacity vs. energy, timely or locational differentiation) and treatment of self-generation?

The electricity market is under the ongoing innovation period due to technological change and economic dynamism. The innovation is relevant not only to the efficiency of networks, system security, smart grids and metering and intelligent appliance, but also the innovation in tariffs.

The Report of 28 January 2015 on Study on Tariff Design for Distribution Systems commissioned by DG Energy to the consortium of AF-Mercados, REF-E and Indra defines the distribution business providing that "technology and network planning methodologies are consolidated, implying limited uncertainty optimal investment decisions and ease of auditing by regulators" as well as that industry has a very diverse structure among Member States. Moreover, the Report emphasizes the impact of a variety of factors, other than regulation, to unit distribution costs, such as different quality of service required, loads served, proportions of distributed generation accommodated and operation in incomparable conditions (e.g. density of population, geographic constraints having impact on network design and operation.). Most importantly, the Report admits the ongoing "major changes" in distribution activity due to renewable generators, low-carbon energy, and the development of smart metering and smart automated appliances requiring to increase the capacity of distribution network, including more active and different-than-usual management of power flows, and implying the necessity for different investment approaches compared to the traditional ones. Consequently, the distribution industry will have to make decisions on innovation where "multiple options to achieve the same results are available" and innovative technologies will make investment, costs and performance less certain and requiring more flexibility in order to achieve the goals appointed to distributors in the energy market. Therefore, non-interventionist approach would allow potential innovation in terms of distribution and tariff types.

16) As power exchanges are an integral part of market coupling – should governance rules for power exchanges be considered?

It should be noted that Power Exchanges is still a very new part of the electricity market, thus, harmonized institutional arrangements would occur remarkably quickly without giving both markets and Member States time to adapt to changes and to test existing frameworks of Power Exchanges, as well as look for the best practices to improve them.

According to the EU regulation, Power Exchanges are of a twofold nature - market place and institution. As a market, it facilitates trading and determines bidding. As an institution, it participates in the market design, offers products and services, and competes with other Power Exchanges. The EU already has existing mechanisms under Internal Market rules, competition law, Regulation No 714/2009, Regulation No 1227/2011, etc. that enable supervision at both, the EU and national levels of power exchange activities, including their agreements with TSOs. Instead of looking for administrative and institutional frameworks for power exchanges, EU should work to enforce existing EU framework in order to eliminate barriers between bidding zones and to ensure a customer-oriented market coupling based on an "open market infrastructure", e.g. that capacity allocation and calculation mechanism (including regional cooperation agreements between TSOs) would be based on technical (laws of physics) and economic principles, rather than on political means and limiting access to generation from the neighbouring countries.

In this case, two options could be considered. Firstly, continuing the current voluntary approach (no additional EU action), or, secondly, creating a new European governance framework through a legally binding guideline of minimal level of harmonization of coupling arrangements maintaining the diversity of local/regional market arrangements and/or regulatory specifications.

3. THE EUROPEAN DIMENSION TO SECURITY OF SUPPLY

17) Is there a need for a harmonised methodology to assess power system adequacy?

The adequacy of the power system has two components: (i) the ability of the generation to cover the peak load taking into consideration generation availability and load level, and (ii) the ability of the transmission system to perform importing and exporting flows through interconnection. Thus, the adequacy of the power system is of pure technical nature. The task is fulfilled by national regulatory authorities, TSOs and governmental regulation. Whereas on the EU level, ENTSO annually collects and reports the statistical data and explanations that can be used to assess and forecast trends. In its Scenario Outlook & Adequacy Forecasts 2015, ENTSO indicates the focus on cross-border flows and the need for flexibility. Moreover, CEER also provides public data updates by benchmarking reports on the continuity of electricity supply.

CEER has undertaken an extensive research on adequacy assessment comparing existing generation adequacy assessments among Member States (*Assessment of electricity generation adequacy in European countries, Ref: C13-ESS-32-03, 3 March 2014*) and provided its recommendation (*Recommendations for the assessment of electricity generation adequacy, Ref: C13-ESS-33-04, 08 October 2014*). Even CEER promotes "coordinated approach in the design and implementation of policy instruments" in the field of system adequacy; however, the problems it firstly emphasizes are the lack of transparency in national reports, the lack of possibility to compare of national methodologies, and the reliability of data. These are the issues of reporting techniques, but not a lack of methodological assessment. Such issues can be solved using ACER and ENTSO in order to improve them. The issues of transparency in the national reports or data reliability/comparability in power system adequacy, that are of technical nature, shall not be solved by introducing new harmonised measures, but by encouraging innovation in technology and communication.

It should be noted that Article 194(2) TFEU provides that it is Member States' right to choose the structure of energy supply and energy mix. Member States are responsible for the security of supply and together with TSOs have enough power and competence to supervise and enforce this part of the security of electricity supply.

18) What would be the appropriate geographic scope of a harmonised adequacy methodology and assessment (e.g. EU-wide, regional or national as well as neighbouring countries)?

Article 194(2) TFEU establishes the right to Member States to decide on the structure of energy supply and choose its energy mix. Therefore, Member States shall decide on adequate methodology at national or regional levels, where regional level could also cover the neighbouring countries, if necessary.

19) Would an alignment of the currently different system adequacy standards across the EU be useful to build an efficient single market?

In order to foster an efficient single market, the EU should remain active in applying Internal Market rules and competition law to ensure that national policy measures relevant to security of supply are justified and in line with the principles of free access to generation and networks, as well as refrain from imposing priority to generation from the EU countries, excluding the neighbouring capacities.

20) Would there be a benefit in a common European framework for cross-border participation in capacity mechanisms? If yes, what should be the elements of such a framework? Would there be benefit in providing reference models for capacity mechanisms? If so, what should they look like?

Capacity mechanisms are a question of political and economic, rather than technical nature. As Member States are under pressure to implement challenging EU climate change and renewable targets, as well as investment needed to implement EU set of goals on the energy efficiency and interconnections, they tend to look for an interventionist approach towards the energy sector. The capacity mechanism is one of the tools under consideration. However, rewarding generation based on the value of capacity and not the output, e.g. paying for capacity and not the energy produced, potentially distorts competition and challenges the structure of the energy markets.

It is admitted that Member States vary in terms of problems and goals tackled by the capacity mechanisms, methodologies applied and their needs in general. Consequently, common European framework will not manage to cover all the issues and needs and will end up as additional regulatory burden on Member States. Also, market capacity does not lead to better security of supply. Furthermore, the EU should not allow impeding the long way energy market liberalization went through and give incentives to Member States to pursue further capacity mechanisms by establishing a common European framework.

On the other hand, the EU focus should remain on deregulation, removing market obstacles which blunt market price signals, as well as on the promotion of research and employment of smart technologies which empower market agents to be producers and consumers, buyers and sellers. Moreover, the focus shall remain on removing regulatory risks which discourage investors from making investments into the market. Also, the Commission should strictly apply competition law, State aid rules and Guidelines on State aid for environmental protection and energy 2014-2020, assessing the capacity mechanisms or *Altmark* criteria in case the capacity mechanism is modelled as a compensation for public service obligation of SEGI.

21) Should the decision to introduce capacity mechanisms be based on a harmonised methodology to assess power system adequacy?

Market capacity itself does not lead to securing continuous, efficient and affordable electricity supply, e.g. better security of supply. In general, capacity mechanisms as an interventionist approach to the energy market shall not be promoted.