



MARKET PARTIES PLATFORM

Linking Energy Markets

View on next steps in enhancing electricity market functioning in the CWE region

Position paper

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1 Introduction

1.1 The CWE market as a key region for European integration

The CWE market or Pentalateral region comprises a large part of the European energy market and is a front-runner in achieving market integration. This means that step-by-step the electricity and gas markets will be managed and optimised from a regional perspective rather than country by country. This is already the case for the well- functioning CWE day-ahead market coupling, but it is also the plan to increase further the integration with CWE intra-day and balancing markets.

This process is very much in line with the European target to create ONE internal market for energy by 2014. This objective is highlighted in the opening clause of the Third Energy Package¹, which clearly states that *“the internal market in electricity, which has been progressively implemented throughout the Community since 1999, aims to deliver real choice for all consumers in the European Union, be they citizens or businesses, new business opportunities and **more cross-border trade**, so as to achieve efficiency gains, competitive prices and higher standards of service, and to contribute to security of supply and sustainability.”* The current drafting process of new European Network Codes by ENTSO-E is a direct result of the Third Energy Package which is aiming for harmonisation of European energy markets and the development of European cross-border energy trading.

As this integration process is still on-going, however, we observe the implementation of many different and uncoordinated national policy measures. These measures are mostly taken with national issues in mind (e.g. security of supply, environmental policies, competitiveness or social acceptance) without considering their effects on the development of the European energy market. Although in most of these cases a deeper integration of CWE intra-day and balancing markets would provide a faster and simpler solution, this is never considered by local authorities or national regulatory authorities. The non-harmonised national policy measures in the CWE region clearly create a very uncertain business environment for the future activities of European energy market participants. Especially as most of the market parties are already anticipating the creation of a single European market by 2014 and are already operating with an international scope.

¹ Directive 2009/72/EC of the European Parliament and of the European Council of 13 July 2009

1.2 Purpose of this paper

Members of the MPP² are committed to integrating CWE markets on every conceivable time frame (long-term, day-ahead, intra-day and balancing and competing on a European level. Integration of CWE energy markets is seen as a key step for European integration and it is for this reason that MPP members are worried about the above-mentioned, contradictory national developments. In our opinion the governments of the CWE countries (Austria, Belgium, France, Germany, Luxembourg and the Netherlands) should establish the benchmark for harmonization of energy markets and for the development of cross-border energy trading (long-term, day-ahead, intraday and balancing in Europe.

In this position paper, the MPP presents its view on the benefits of an integrated European electricity market and the features it could offer. While the MPP realises that political decisions will need to be made to organize certain national competences on a supra-national level, it is nevertheless confident that the CWE countries will resolve the current situation and set an example for the European Union in the harmonization and integration of its energy markets. With this in mind, the MPP would like to be certain that local measures are viewed from the perspective of an integrated market in order to avoid counter-productive results.

1.3 Outline

This position paper gives the benefits of a market-based solution and recommendations for next steps in the CWE market. Section 2 presents some of the merits of a market for electricity, followed by the importance of market integration in Section 3. Section 4 points out the achievements in the electricity market so far. Following brief observations on the nature of market interventions (Section 5), in Section 6 we outline our ideas on changes to be expected in the market. MPP recommendations for the CWE electricity market (Section 7) complete the paper.

2 Why a market for electricity?

2.1 Innovation and transition

The dynamics of a market offers clear advantages over a centrally planned industrial sector, especially where commodities such as electricity and gas are concerned. In particular,

² The Market Parties Platform (MPP) is a cooperation of energy industry associations in the CWE region, which includes Austria, Belgium, France, Germany, Luxembourg and the Netherlands.



liberalized markets offer consumers freedom of choice and competitive prices. These advantages are clearly identified in EU energy policy. Furthermore, well-functioning market mechanisms provide the most efficient path for the transition to creating a carbon-neutral society.

This is because in liberalised markets there is more room for initiatives and innovation than in regulated environments. In an open, competitive market, all market participants, including individual citizens, can enter the market and challenge existing business models. Of course not all of them will be successful: the learning curve is much steeper than in a system where ideas are rejected because they do not fit a defined plan.

2.2 Correct pricing brings efficiency

An efficient market will assign the correct price to a product given its level of scarcity at that time. It is important, therefore, that prices can be set without being subject to distortions. Competition will drive the price of a commodity down to its marginal cost under the prevailing market conditions. This price is the most efficient reflection of the market status of that commodity at a given time. Intervening in this mechanism can only lead to sub-optimal results and market distortions.

2.3 Clear roles and responsibilities

To facilitate efficient competition, it is also very important that there is non-discriminatory access to the electricity infrastructure, including transport and distribution grids. TSOs and DSOs provide a public service by delivering a firm product. Firm transport capacity ensures a level playing field for all users of the grid and is therefore very important. DSOs and TSOs face the challenge of facilitating a “smart” market in which all users can respond effectively to price signals.

The role of market participants is to comply with the contracts in the market. This includes meeting prices, volumes and capacity at agreed times. Customers are responsible for their consumption and its patterns. This can be covered by supply contracts in which the risks are hedged. Suppliers have to take care that they have the means to fulfil their contracts through the wholesale market. In the end, somewhere the required power will be generated based on the merit order of the generation facilities in the market. This means that all load and generation should be exposed to the full extent (including program responsibility) of the market. Only then can the market effectively address the risks involved.



3 Integrated markets enhance market functioning

3.1 Integrated markets essential for the transition to a carbon-neutral society

Integrated markets also ensure full access to the grid for all customers, fostering competition and new initiatives at a European level. Europe is facing the challenge of becoming a carbon-neutral society in the coming decades. This goal requires a change in electricity generation from primarily fossil-based resources towards renewable resources. Given the intermittent character of the latter type of generation, the need for flexible sources are essential for providing adequate back up. The most efficient way of using flexible sources of electricity is to create a market that is as large as possible. A larger market would allow equal access to the flexibility, and optimal use of the sources in the system.

3.2 Market integration is inevitable

Integrated markets are also very important from a spatial planning perspective. Renewable energy sources are often site-specific; hydro-generation (= naturally flexible source) is an obvious example. This is also becoming more and more the case for other large-scale conventional generation. While previously generation was planned close to consumption this is no longer a realistic option. Generators face difficulties when building large-scale generation close to cities, although the trend towards decentralized generation could relieve this to a certain extent. As decentralized generation also benefits from the efficiency of an integrated market, the connection of all available sources of electricity generation in an integrated market will become crucial in the coming years.

3.3 Large price zones are more efficient than smaller zones

A market is not a deterministic system. During discussions about the electricity market, there is a tendency to look only at the electric system and then only from the perspective of the techno-economic aspects of the infrastructure alone. The efficiency of the market is, nevertheless, also influenced by other parameters, such as liquidity, confidence, predictability, political decisions and price elasticity.

To maximize market efficiency, price zones should be as large as possible. When assessing price zones in Europe, the starting point should be one single European price zone. As a consequence, only structural congestions should define potential price zones in Europe. From that perspective, TSOs will be able to act as one in Europe and ensure free access to their grids to all European citizens. If, however, current national borders continue to be the starting point of the price assessment, maximizing welfare from the grid will never be achieved.



3.4. Market integration enhances RES integration

The growing share of intermittent RES (renewable energy sources) generation increases the need for flexible back-up generation capacity. The establishment of a well-functioning cross-border intraday market and the introduction of cross-border balancing markets will mitigate the increasing overall need for flexible back-up generation capacity. Indeed, improved cross-border intraday trading will lead to the situation where deficits and surpluses close to delivery will be eliminated by spot trading in a wider, international market. Real-time deficits and surpluses will be eliminated by balancing them in a larger market.

4 Market achievements so far

The first three sections of this position paper have been built around a theoretical analysis of electricity markets. Yet, European energy markets are also a source of practical achievements that have been realized on a variety of levels since liberalization was introduced. Interestingly, the MPP has observed better results in more competitive markets with lower levels of intervention than in less competitive ones. In this section we intend to briefly discuss these achievements in relation to the objectives stated in EU energy legislation.

4.1 Freedom of choice

Consumers have freedom of choice in a liberalized energy market. The market has obviously had to face a steep learning curve and not all initiatives have brought market success. Nevertheless, free access to the grid has resulted in newcomers with new strategies entering the market and this may have resulted in consumers switching to other suppliers. Nowadays, consumers are able to choose their supplier based on price and quality of service. Freedom of choice has also empowered consumers, creating opportunities for collective initiatives and aggregators, as well as providing other avenues of access to the market. This is now much easier than it was in the previous, regulated environment.

4.2 Business opportunities

Free access to the grid has created innovation and triggered the development of new business opportunities. Even in markets where there is only a low level of support for renewables, companies are offering new kinds of products to meet consumer needs. Aggregation service companies combine and optimise local generation and demand for consumers. New types of contracts are being developed. All these initiatives fuel further innovation and lead to a better matching of customer demands.



4.3 Efficiency gains

Competition has led to a more efficient use of assets. Generation is much more cost efficient than it was 15 years ago. Furthermore, market integration has led to a more efficient use of the network. Not only direct system efficiency counts in this respect: it is often forgotten that better matching of customer demand has also maximized efficiency gains.

5 About market interventions

Unfortunately, distortions of markets can be found in all countries of the CWE region. These distortions hamper efficient price formation. Examples of such market distortions include:

- regulation of wholesale and retail prices;
- support of RES schemes;
- socialisation of market responsibilities, such as program responsibilities;
- setting tariffs for system services instead of prices;
- establishing mechanisms for capacity remuneration (when volume and/or price is not market-driven); and
- subsidisation of fuels.

Although in the past there were often sound reasons for intervening in the market, with the growing maturity of the European energy market such interventions have become obsolete. Often the reasons supporting those interventions in the past have been forgotten. If such interventions are now considered to be “given” in the market, they usually lead to additional distorting measures being taken – in order to mitigate the negative effects of the initial intervention. Such a situation can only lead to an increasingly inefficient allocation of efforts and money.

6 Dynamic markets change and adapt

6.1 The electricity market will change

Markets have the ability to efficiently adapt to new circumstances. Looking at the development of the electricity market in Europe, it seems that it will evolve towards a market with lower predictability because of the effects of intermittent generation and the less predictable behaviour of participants. This situation will lead to highly volatile prices, often

including moments when the price of electricity will drop to very low levels, even falling as low as zero.

6.2 Markets will anticipate

If all market participants are exposed to the entire range of market risks, the unpredictable situation described above (Section 6.1) will not necessarily be a problem. All market players will find different ways to hedge their risks. Consumers, however, could be exposed to real-time prices or have to pay a premium for receiving a fixed price. Generators with intermittent sources will hedge their risk with contracts in order to give them the back-up and flexibility they need. Key in this situation is that parties have to meet all their market responsibilities to the fullest extent (which is already the case in some European countries).

6.3 Pricing the right products

Contracts or products in the market should also cover the (investment) risks of parties that deliver back-up and flexibility. Only if markets get the opportunity to solve these kinds of issues themselves, this leads to the correct pricing of the scarce good, which is essential in any open, developed economy. In the electricity market in the coming years, the main scarce good will probably be capacity. However, we should keep in mind that the development of dynamic markets is a slow process and that it is extremely important to let the market establish prices for the appropriate products. Capacity and energy products will co-exist.

Reflecting on this capacity pricing issue is the EURELECTRIC paper “RES Integration and Market Design: are Capacity Remuneration Mechanisms needed to ensure generation adequacy?” Its main conclusion is that most of the capacity remuneration mechanisms have actually been implemented in order to solve side-effects of other, past interventions in the market. Without those interventions, the energy-only market can be expected to deliver the right incentives for at least the medium term. For the longer term, capacity will become an increasingly scarce product that has to be priced appropriately.

7 MPP recommendations for the integration of CWE markets

The Market Parties Platform (MPP) would like to highlight the crucial role to be played by CWE governments and regulators in realizing the integration of European energy markets. Clear political leadership will be required in the promotion of the harmonization of CWE energy markets, a key step in achieving European energy integration. Our recommendations on the next steps to be taken are given in the following subsections.



7.1 Efficient use of the network: future regulation should oblige TSOs to act as one in Europe

Since it would be the most challenging change in the current practice, regulation of TSOs (via the European network codes) should be elevated to a regional level rather than retaining its current national focus. This will require harmonization of regulation in order to avoid perverse incentives for individual TSOs. Once this regional focus has been achieved, a truly integrated balancing market will be possible. Such an EU-wide balancing market could then be the basis for an integrated retail market within Europe. The size of an EU balancing market would help create a more liquid market, one in which maximum flexibility could be pooled. This flexibility is essential to be able to cope with the increasing frequency and volumes of intermittent generation. A common CWE transmission and system tariff should be considered in order to avoid endless discussions on cost sharing.

7.2 Enlarge price zones

Enlarging price zones delivers increases in efficiency that follow on from the greater competition that will develop. It is possible if TSOs are allowed to optimise on a regional level rather than on a national level. Of course, this will lead to discussions on congestion rent distribution and redispatch costs on a regional basis.

7.3 Establish well-functioning cross-border intraday and balancing markets

The establishment of a well-functioning cross-border intraday market and the introduction of cross-border balancing markets will mitigate the increasing need for flexible back-up generation capacity.

7.4 Let the market adapt

As we have already mentioned, the market will change with the increasing volumes of renewable electricity in the system. This will lead to different pricing mechanisms in the market. Most probably capacity or flexibility will become a scarce good and therefore attract a market value. Without interventions in the market, products will probably be created to reflect this scarcity. Interventions in the development of this market should most certainly be avoided.

7.5 Process recommendations

The European network codes will be subject to the comitology process during the coming years. MPP recommends that the CWE countries act together in order to realise ambitious legislation for a well-functioning integrated European electricity market.



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Market Parties Platform

The Market Parties Platform is a cooperation of energy industry associations in the Central West European (CWE) electricity market (includes the Benelux, France, Austria and Germany). MPP's aim is to actively promote the creation of an integrated CWE electricity market and realize efficient coupling with the surrounding regions. These steps will increase the efficiency of the market and therefore bring benefits to consumers of electricity in this region. MPP's activities are strongly linked to those of Eurelectric.

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