



Eurogas response to the European Commission Public Consultation of DG Competition's Interim Report of the Sector Inquiry on Capacity Mechanisms

6 July 2016

Summary

Eurogas, the European association representing the wholesale, retail and distribution of gas in Europe, sees great value in defining the right steps towards improving the way energy markets are working. Eurogas is fully engaged in this discussion as the European association that covers all the above activities for gas.

The findings of DG Competition's (DG COMP) Inquiry into Capacity Remuneration Mechanisms (CRMs), as well as how they will be tackled, will be a major contribution to the future design of the Internal Energy Market (IEM). Eurogas assigns great importance to this since it concerns the key question of maintaining sufficient adequacy levels while also guaranteeing a long-term investment outlook in power generation.

With the above in mind, please consider our key messages below:

- Eurogas has consistently asked for implementation of the Third Energy Package without delay. We are convinced that focusing on the existing legislation will result in real market integration. Specific actions need to be taken concerning the removal of existing political and regulatory distortions in electricity markets without delay. Essentially, this includes price caps, regulatory must-runs, and regulated end-user (residential and other consumer) prices.
- The application of various taxes and charges levied on electricity should also be considered in this context.
- Further integration of an increasing share of renewable energy sources (RES) is a strategic objective of the EU and needs to be addressed. Mature RES should be accountable for the costs they impose on the system just as any other mature technology.
- Eurogas is also uncertain as to whether price signals from the EOM will be sufficient to keep existing plants as backup for intermittent RES as well as trigger new investments for low carbon thermal generation. This legitimate concern needs to be considered, and addressed, sooner than later to avoid possible system risks or increased system costs.
- If the market does not deliver the appropriate signals for the provision of the required level of security of supply, CRMs can be part of a new market design to achieve a targeted level of adequacy and in order to deliver long term price signals. However, CRMs would have to be non-discriminatory and market-based, and respond to demand and supply signals. As also specified in our response to the DG ENERGY public consultation¹, Eurogas is of the opinion that capacity remuneration mechanisms (CRMs) can be part of the future market design under certain conditions and following specific criteria.
- Eurogas therefore welcomes DG COMP's positive assessment on the capacity remuneration mechanisms of the types of central buyer mechanisms and de-central obligation mechanisms presenting market-wide, non-discriminatory and market-based mechanisms.
- In what concerns the strategic reserve, it could serve as insurance for the energy market in extreme cases. However, as the report concludes, it does not solve underlying market

¹ Please find in annex the main points from our response to DG ENER's public consultation on a new energy market design

or regulatory failures and other measures will have to be implemented if the market is not delivering the appropriate signals to provide security of supply.

- As regards tenders for new capacities, Eurogas does not consider this an appropriate tool to address a structurally unfavourable market or regulatory situation or to steer investment towards low-carbon generation. Tenders fail to establish timely investment signals for new capacities, undermining ambitions to create long-term sustainable solutions and market functions.
- Therefore, both instruments are appropriate to address temporary issues only.
- It is also important that cross-border issues are considered and addressed in this context. Therefore, Eurogas is of the opinion that guidelines on cross-border participation should be elaborated by the Commission. For example, clarification is required on what should happen when scarcity occurs simultaneously when capacity is contracted both in the domestic capacity zone and abroad (in particular when part of it is contracted in a neighbouring Member State).
- Eurogas supports the view that a harmonised approach and methodology to assess overall generation adequacy is required, at least on a regional level. This will also require that the availability of the right portfolio mix, in particular the availability of flexible capacity, has to be examined before assuming that such capacity will in fact be present in any given market.
- Eurogas maintains its position (also specified in its response to the DG ENERGY public consultation on the new energy market design) that an economic assessment should be conducted, demonstrating whether plants are economically viable in the energy market context. We thus agree to the statements/findings in the Interim Report of DG COMP's inquiry about the adverse impacts of current policy choices by some Member States on gas-fired power generation – and the corresponding negative outcomes on new investments in more efficient and cleaner plants (such as gas-fired power plants) in several Member States.
- In what concerns the definition of a target adequacy standard, Eurogas sees the need for a common methodology to be applied in each Member State. At the same time, these decisions need to be coordinated at least on the regional level to avoid free-riding effects.
- However, a harmonised approach towards the achievement of supply adequacy might take some time and Member States should not be prevented from developing capacity markets when they are needed to address supply adequacy so long as they are based on competition, fairness, non-discrimination and transparency.

Please find an elaboration of the above points in the following section. We are interested to discuss and explain our points further and would welcome the opportunity to do so in the near future.

I. Give priority to allow the energy market to work properly

The discussion on the introduction of capacity mechanisms should not result in Member States slowing down their efforts to improve the energy market; indeed, removing existing distortions and implementing the Third Package need to be carried out without delay, as the first priority. The completion of the internal energy market is expected to deliver more integrated balancing markets and better functioning intraday markets both for electricity and for gas. Such an integrated approach is intended to be more flexible as well as create market and trading opportunities in Europe that could cope with an increasing share of electricity from variable RES. An integrated internal energy market would also improve market signals for investment in new and flexible generation capacity. The integration of day-ahead, intraday and balancing markets can positively contribute to the optimal use of the power system, resulting in competitive prices for end consumers.

Therefore, Eurogas advises that any current barriers and limitations to the energy markets should be removed in the interest of an integrated EU energy market. In particular:

- The integration of wholesale electricity and gas markets and their improved functioning to achieve the completion of the internal market as soon as possible must remain the priority of policy makers, regulators and involved stakeholders (ENTSOs, TSOs, Power Exchanges). More integrated balancing markets and better functioning intraday markets which adequately reward flexibility are central to this. Therefore, the European Commission should ensure that the requirements of the Third Package are fully implemented in each Member State and the timely progress of network codes is maintained.
- The European Commission should increase the pressure on Member States to remove existing distortions, such as regulated end-user prices, restrictions or unnecessary regulatory requirements on plant operations, and price caps and floors, in order to allow energy markets to have a chance to function properly. This includes:
 - replacing unjustified technical requirements (put on generators and other market participants through codes and regulation) with well-functioning markets
 - removing regulatory “must-runs” for power plants and the prohibition to exit the market
 - promoting price signals to allow closure of assets
 - promoting socio-economic optimal investment signals.
- Regulatory interventions affecting the power generation sector, such as a Robin Hood tax, should be avoided. Instead, the focus should be on developing fair competition on the basis of transparency.
- Europe must invest in developing sufficient cross-border capacity and overcome structural national congestion through grid development when this is economically efficient.
- Regarding the increasing market share of RES, to benefit from (and deliver benefits to) a smooth energy system and market, generation from RES should be fully integrated into the market with the same obligations as those of other market players, i.e. meeting scheduling, nomination and balancing requirements. Market integration also implies that the regulatory requirements (e.g. concerning costs of inter alia balancing grid access etc.) apply to all market participants equally (regardless of whether it is a thermal power plant, renewable energy source, electricity storage or a demand response operator). Electricity market should be fit for RES and prices should encourage demand-side

response so that market-based changes in demand contribute to wholesale market spot price formation.

- Free investment choice should be possible. Further, when operators come to the conclusion that plants are no longer profitable, they should be allowed to freely decommission or mothball their power plants.

II. System adequacy assessment on a European level to be targeted

The interim report concludes that a coherent and detailed generation adequacy assessment is required, “*showing the necessity of a certain amount and type of capacity as well as the timing and geographic extent of the adequacy problem is a critical step towards the identification of a particular capacity mechanism that may be compatible with state aid rules*”.² Eurogas supports a European harmonised approach and would like to propose the following issues to be considered in a European system adequacy assessment:

European harmonisation on the methodology – at least on a regional level

The power system in Europe is a highly interlinked network. Thus any risk from insufficient generation adequacy is likely to spread out and impact other countries. Therefore, a generation adequacy assessment principally within the ENTSO-E region should be targeted. An intermediate definition of regions should be drawn up in a first phase for those countries (or parts of countries) in which sufficient interconnection capacity exists.

Flexibility needs to be addressed

The availability of (short-term) flexibility should also be part of the system adequacy assessment. The system mix portfolio, the design and the functioning of the balancing markets might be an issue to monitor, as recurring blackouts are a real-time issue. Thus any assessment should transparently show the amount of balancing reserves contracted by the TSOs, and how these resources are used.

Economic outlook is a decisive factor for the assessment of future adequacy assessment

System adequacy assessments should not only consider a short but also a long-term view and take into account the possible capacity closures due to economic reasons, not only based on technical reasons. The economic, regulatory and political frameworks are crucial for investment and divestment decisions of market players. This necessary long-term adequacy perspective is currently not part of ENTSO-E assessment. Therefore, a purely technical system adequacy assessment as conducted today cannot drive the conclusion on whether a capacity mechanism is required. Eurogas suggests paying more attention to the regulatory, political and economic framework and conducting an economic feasibility assessment in collaboration with relevant stakeholders.

² European Commission (2016): Report from the Commission, interim report of the Sector Inquiry on capacity Mechanisms, p. 124.

Reliability standards to be coordinated

Another important element towards achieving a common methodology is to have a target adequacy standard in each Member State.

In principle, Member States should be allowed to set their own adequacy standards, provided they can justify them. As a starting point, adequacy quality levels that Member States want to achieve need to be adequately defined and formulated. However, the definition of standards in a Member State entails cross-border issues that need to be addressed at an early stage. When neighbouring markets aim at different adequacy standards, it is generally demonstrated that there is “free-riding” by a low-standard market benefiting from a high-standard market. Therefore, the adequacy standards of highly connected neighbouring Member States should be coordinated within a defined bandwidth to avoid these effects.

Harmonisation process should not be a show-stopper for planned CRMs

A harmonised methodology should be targeted. However, this might take some time and should not prevent Member States from developing capacity markets when they are needed to address supply adequacy. At a later stage, both the assessment and parts of the implementation may need to be adapted without creating undue regulatory risk.

III. Capacity remuneration mechanisms can be part of a future market design

The removal of current barriers and limitations to the energy markets is indispensable if the EOM is to function efficiently, and should be made a priority. DG COMP clearly favours the energy-only market and remains highly sceptical on the introduction of CRMs. However, there are doubts if today’s existing distortions will be removed and all pre-conditions and consequences of an EOM will be accepted so that prices beyond the forward markets will cover investment costs in thermal generation. Equally so, it remains a question whether the resulting prices will be sufficient to keep existing plants as backup for intermittent RES.

In this situation introducing a CRM is one approach to face the economic challenges of ensuring generation adequacy and to present a tool to bridge the missing investment signals from the EOM, thus ensuring a stable investment climate and delivering long term price signals. Flexibility should be adequately rewarded by the spot and balancing market, but if this is not the case the design of CRMs should also consider the flexibility needs of the system.

A CRM will create an additional market instrument to attract sufficient firm capacity to achieve the targeted adequacy of the system, if the EOM is not working efficiently. An adequate CRM would send earlier and longer-term investment signals compared with an EOM and would thereby reduce the risk of having a shortage in electricity markets. If the introduction of a CRM is considered, the market design should be based, as far as possible, on competitive elements to ensure efficient solutions. The aim should be a harmonised market design, at least, so that the market design is compatible with that of neighbouring markets to minimise market distortions and avoid overinvestment.

CRMs should be designed in a non-discriminatory and competitive way

CRMs should be designed in a competitive and efficient way, with the following requirements: CRMs should ensure the provision of the capacity needed to achieve an adequately functioning system. Flexibility should be adequately rewarded by the spot and balancing markets, but if this is not the case, the flexibility needs of the system should be considered in the CRM design. This is not the case, for example, if price signals such as price spikes and price volatility are not accepted and prices are capped, or if other interventions such as restrictions or unnecessary regulatory requirements on plant operations endanger the ability of the market to deliver the required flexible resources.

The requirements should be aligned with the advice of expert groups, and should consider imports from neighbouring countries to avoid any sub-optimal solutions and overcapacity.

The capacity price should be determined in a competitive way and should respond to the actual supply and demand of firm capacity. The objective of a CRM is to ensure the availability of adequate capacity. If revenues from the energy market are sufficient to cover also the fixed costs, the price of capacity should tend toward zero.

Existing plants should compete with newly built plants, as well as demand-response measures and electricity storage, for the most efficient and low carbon solutions.

The capacity market should be open to electricity undertakings operating in other Member States.

Predictability and reliability are essential preconditions for investors. Therefore, the creation of effective incentives for new investments, as well as reliable and transparent market rules, is essential to building confidence in the market. These rules should also determine in which market situation a change of market rules is required, and on which basis the change will be made.

Adjustments of the CRM as well as changes in the policy and regulatory framework that lead to stranded costs create additional risks for investors and existing operators, making them reluctant to invest. Therefore, the more self-regulating elements a mechanism offers, the fewer regulatory interventions will be necessary.

Politicians should consider the time lag (e.g. construction period) between the political decision and the effectiveness of the market reaction. Retroactive changes to the legal framework should be avoided. Therefore, Eurogas welcomes the positive acknowledgment by DG COMP of the two types of capacity remuneration mechanisms, being the central buyer mechanisms and de-central obligation mechanisms.

Gas-fired power plants suffer most from today's market distortions

The interim report recognises the negative impacts in particular on gas-fired power plants by current market distortions: *“Many unprofitable power plants plan to mothball or to close. In recent years this has become an issue especially for gas-fired power plants that have*

*generally become more expensive to run compared to lignite or coal.*³ Eurogas welcomes DG COMP's acknowledgment of the erosion of both the utilisation rates and profitability levels of gas-fired power plants, and that this impacts the business case of existing units and discourages investments in new plants, which in turn increases long term generation adequacy concerns. In this context Eurogas would like to emphasize the criteria laid down in the state aid guidelines in which preference should be given to low-carbon generators in case of equivalent technical and economic parameters.

Gas-fired power plants are particularly attractive to back up electricity produced by intermittent renewable energy sources. They are highly flexible and their CO₂ emissions are low. This position is in line with statements in the interim report: *"While the shift towards more renewable energy production is an intended development, it poses a challenge to security of supply if the result is the closure of, or lack of incentives to invest in, flexible power plants which are still needed to back up intermittent wind and solar renewable generation*⁴. However, during recent years an increasing number of gas-fired power plants have been leaving the market and new projects have been postponed or cancelled.

Although all 'conventional' capacities suffer from market distortions and the rapid influx of renewable energy sources, gas-fired power plants are the first to leave the market due to a shift in the merit order. Their fixed costs cannot be covered anymore in the face of decreasing operating hours and low prices in the spot and balancing market. Furthermore, it is evident that traditional price-peaks have been diminished due to the increasing influx of renewable energy sources.

The ongoing transformation of the EU energy system requires that investors anticipate wholesale prices becoming more volatile and that the number of hours with high prices to recover the investment costs will decrease. At the same time, this transformation (with real-time pricing and thus greater volatility in the market) will need to assure investors that high prices will be acceptable and that the state will not intervene in the market if scarcity situations occur. Depending on the investment appetite these increasing political and regulatory risks may result in a potential underinvestment, which could endanger future generation adequacy.

Eurogas is concerned that although the internal market for gas is growing more robust, the problems described above, whilst affecting the wider energy markets, have a particularly adverse impact on the gas market. They depress investment signals and negatively affect the outlook for gas.

This is not just bad for gas. It is an undesirable and counterproductive development for the EU's energy system and the achievement of the EU's energy and climate policy objectives.

The reduced operating hours of conventional power plants may also cause a more intermittent use of gas grid infrastructures and could have an impact on the profitability of other gas infrastructures (particularly underground storage facilities), which are necessary for the delivery of fuel to the power plants concerned at peak times. Moreover, a reduced

³ European Commission (2016): Report from the Commission, interim report of the Sector Inquiry on capacity Mechanisms, p. 8.

⁴ European Commission (2016): Report from the Commission, interim report of the Sector Inquiry on capacity Mechanisms, p. 8.

consumption by gas-fired thermal plants will increase the cost of infrastructure to be carried by other gas end-users. For these reasons, an impact assessment on the introduction of CRMs should concentrate on the electricity market but should also pay due attention to the gas market. Moreover, consideration should be given to bringing about a change in the merit order to ensure gas follows renewables.

Strategic reserve(s) may overcome security of supply concerns during a transitional phase but should not slow down efforts for developing a sustainable long-term solution

A strategic reserve might serve as insurance for the energy market in extreme cases. In particular during a period of disruptive changes and transformation, the strategic reserve may present an instrument of last resort for the TSO. The underlying assumption for the introduction of a strategic reserve is that the energy market will deliver the correct price signals for required investments. However, as the report concludes, it does not solve underlying market or regulatory failures, and other measures will have to be implemented if the market is not delivering the appropriate signals to provide security of supply. We thus agree to DG COMPs findings on this matter.

Nor is the strategic reserve an appropriate tool to address a structurally unfavourable market or regulatory situation or to steer investment towards low-carbon generation. A key priority for Member States should be to provide a sustainable and market-based long-term framework which allows required capacities to stay in the market. Such a framework should also establish timely investment signals for new capacities and should not require additional instruments. The strategic reserve bears the risk of functioning as a quick fix and undermining ambitions to create a long-term sustainable solution which addresses the underlying problems. Therefore, attending to the aforementioned concerns and considering that the legislation for a new market design is not likely to apply before 2020, a strategic reserve should not be part of a future market design.

Tenders for new capacity only undermine market functioning

Eurogas does not share DG COMP's assessment that tenders for new capacity could be an appropriate tool to address a transitional capacity problem. A tender represents a significant intervention in the wholesale market and may lead to loss of trust in market signals. Developing new capacity should be the consequence of economic signals, like scarcity prices or remunerations resulting from CRMs. Conversely, new capacity should not be the consequence of a politically initiated tendering process. Market participants will think it unlikely that a tender for new capacity is launched only once, and the investment market will be seriously damaged.

IV. Guidelines on cross-border participation should be developed

Cross-border aspects were not always considered when a CRM was introduced in the past. Guidelines on cross-border participation should therefore be developed by the Commission.

Eurogas does not support any specific model on cross-border participation, but has strong concerns that unbundling rules might be breached if TSOs participated directly in the capacity market and thereby directly competed with other market participants. The future

model should clearly distinguish between regulated operators and other market participants, independently of the allocation of congestion rents.

Eurogas has doubts about the possibility to take part in more than one CRM with overlapping time frames as proposed by DG COMP. Guidance and clear rules are required on how double marketing should be enabled without lowering security of supply.

Furthermore, clarification is needed on what happens when scarcity occurs simultaneously, in particular when part of the capacity is contracted in a neighbouring Member State: in this case, would the “contracts” for foreign capacity overrule the outcome of market coupling? Or would TSOs block transmission capacity to save their own market first?

In this context, a transparent set of rules for TSO-TSO cooperation to manage shared stress events needs to be prioritised by the Commission and ENTSO-E.

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Annex: Main points from the Eurogas response to the European Commission Public Consultation on a new energy market design

07 October 2015

Summary

- Eurogas, the European association representing the wholesale, retail and distribution of gas in Europe, sees great value in defining the right steps towards improving the way energy markets are working. Eurogas is fully engaged in this discussion as the European association that covers all the above activities for gas. To this end, our response to this public consultation answers most of the questions that concern a broad spectrum of activities.
- Eurogas supports the EU energy policy objectives for sustainable, competitive and affordable energy. We believe that the market is the most appropriate tool to provide the right signals for reaching these policy goals in an efficient way.
- *A priori*, it is important to ensure coherence in the treatment of the various and diverse activities from wholesale to transmission, distribution and retail services, covered in the questions of this public consultation.
- Eurogas also supports the increase of energy from renewable sources in a market-oriented way. However, to assess the effectiveness of the proposed measures, it is necessary to know how renewables are to be integrated into the market, i.e. how a major share of renewables would be combined with conventional capacities and how the pricing and investment mechanisms would function. The consultation paper is leaving this open.
- An important prerequisite for a new energy market design is that Member States remove existing political and regulatory distortions in electricity markets without delay. However, if the market does still not deliver the appropriate signals for the provision of the required level of security of supply, capacity remuneration mechanisms (CRMs) could be part of a new market design. The CRM should be non-discriminatory and market-based, and should respond to demand and supply signals.

Eurogas does not share the Commission's concern that CRMs per se are costly, distort the market and constitute subsidies for fossil fuels. If well-designed, the only difference to an optimal energy-only market should be the costs for the additional provision of firm capacity. These costs should be compared with the impact of existing national state interventions that are not market based and employed to avoid failures (e.g. obligations for grid and strategic reserves, prohibition of closures) and risks to the provision of reliable and affordable energy for European consumers and industry. A CRM can be an

appropriate measure to ensure the provision of the capacity needed for an adequately functioning system.

Flexibility should ideally be adequately rewarded by the spot and balancing markets, but if this is not the case, the flexibility needs of the system should be considered in CRM design.

- Eurogas shares the view that an EU-wide harmonised approach to assess overall generation adequacy is required. The availability of flexibility should be examined in an economic assessment demonstrating whether plants are economically viable in the energy-only market. A generation adequacy assessment should cover principally the ENTSO-E region, as the European networks are highly interlinked. An intermediate definition of regions will need to be drawn up for countries in which sufficient interconnection capacity exists.
- Changes in European electricity market policies as well as national policies on the energy mix impact the gas market and infrastructure. Therefore, an impact assessment of the proposed measures on the gas market should be part of this electricity market design.
- Finally, as this consultation tends to use electricity and energy interchangeably, future documents should distinguish more clearly between electricity and gas where they should be considered as separate fuels or their markets are different.

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