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Electricity Market Design and Integration

Introduction

1. One of the initial (1990) aims of creating an electricity market was to reduce electricity cost to make European manufacturing more competitive internationally
2. Opening the electricity market to greater competition and transparency has been a long term objective of the Commission and is one that has been supported in varying degrees by Member States. A number of different studies carried out both within the Commission and independently have questioned the manner in which energy is delivered to the final consumer and the result of the opaque pricing structures. Most have concluded that there is considerable scope for providing the consumer with better information and more competitive supply options. The 3rd energy package set out to improve the measures already in place and highlighted that a fully integrated trans-EU electricity supply structure and a related market in electricity have still to be achieved.
3. These issues are developed well in the Commission's stock taking document "Towards a New Energy Strategy for Europe 2011-2020". IFIEC will respond to this document separately, but points to the importance in terms of the Market Design concept of the statement "The overall goal of European energy policy remains to ensure safe, secure, sustainable and affordable energy for all, businesses and consumers alike". IFIEC strongly supports this statement, but action is needed to bring it into effect. At present, the degree to which the market is functioning and to which consumers are provided with competitively priced options varies across Member States.
4. Unlike other products, storing electricity is not an option and some investments options are limited or inexistent (nuclear and hydro), so effective market platforms are important. It also means that any market in electricity might not easily be aligned with the principles of any common commodity market. The key is that the electricity market should deliver solutions to different customer choices for different range of delivery periods, assurance that the supply is secured and that the pricing is fair, competitive and adapted to each consumer's needs.
5. A further concern of IFIEC members is the increasing amount of imposed cost arising from policies not directly linked to energy alone. To remain internationally competitive there has to be recognition that adding external costs onto EU companies which their international competitors do not face, seriously affects ability to compete in global markets. There is no benefit in creating an effective electricity market if companies remain uncompetitive due to obligatory imposed costs.
6. IFIEC believes 4 main points should be reviewed or introduced:
 - **Trading Platforms and associated Pricing Mechanisms.**
 - **Market Integration.**
 - **Structural Measures.**
 - **Transitory Steps.**

Pricing Mechanisms

7. The most important changes to pricing in recent years has been due to:
 - the basis for pricing moving to exchange platforms;
 - volatile "markets" for coal, oil and natural gas;
 - the additional costs due to EU environmental and social policies;
 - the difficulties, or even inability, to have access to globally competitive contract with periods that correspond to industrial investment timeframes.

8. IFIEC continues to believe that a market based system is the correct approach, but market platforms were introduced without sufficient transparency and strong regulatory surveillance. This often allowed (dominant) players to set exchange prices without sufficient regulatory control.
9. IFIEC members rely on the efficiency and liquidity of market platforms and tools for their portfolio risk management. Such platforms or tools are however still not available today to deliver reliable power supplies ranging from day ahead (market exchange) to medium (market exchange and bilateral contracts) and long term (mostly bilateral contracts longer than 4 years). To make sure these function properly, a balancing market is needed, as well as an Intraday arrangement. How these operate will be fundamental to reliable delivery based on competitive offers.
10. The producer needs assurance that the electricity generated has a customer in the coming hours and days. That assurance is also needed when considering investment, when the economics of financing capital plant over a probable +25 year long term of investment return are crucial. Efficient production for both suppliers and consumers then means supplies being secured through both short term and long term contract arrangements. For energy intensive industrials, long term bilateral contracts play a crucial role for satisfying their (base load) consumption, but short and medium term operations (day-ahead and forward) are then important in covering their remaining needs.
11. IFIEC accepts the concept of an EU energy market, but stresses that different customer groups have different needs in that market and that the very specific characteristics of electricity as a commodity (it can virtually not be stored), require specific market rules. In the same way that Governments need assurance of security of supply to maintain public services and institutions continuously throughout the year, IFIEC's members' efficiency depends on similarly maintaining competitive supply for the continuous processes they employ over the same long term. Unlike domestic and commercial demand which varies considerably between day and night and across weekends and holidays, continuous processes provide a base load certainty for generators over 24 hour terms.
12. With industry facing ever increasing international competition pressure, access to competitive long term contracting is essential. These arrangements can only operate effectively when purchasing from major suppliers, as only they can provide the volumes and flexibility required. IFIEC can accept objections to such long term contracts whenever they would aim at market foreclosure, but insist on the need for industry to have access to them under normal market conditions in view of a stable and competitive long term power supply.
13. IFIEC's members believe they should have full contractual freedom and thus be able to agree long term bi-lateral contracts to ensure their own security of supply for a high proportion of any year, should they wish. Any "topping up" can then be made by purchasing in the short term market. IFIEC believes that the policy should be to identify simple terms under which long term contracts can operate fairly. They are all part of an effectively operating market and should be available to all purchasing groups whose industrial activity matches such supply models and where such a contract would benefit their efficiency, costs and investment decisions.
14. As some industrial producers have increased their competitiveness by offering shorter order/delivery turnaround than ever before, the energy demand has also changed on a daily basis. Some industrial customers increasingly meet this by day ahead purchasing of a part of the demand. This has made the day ahead market central to short term price setting. Even so, regulation of this platform needs to improve in terms of purchase assurance to ensure that the price signals are fair, competitive and reliable. This means the rules covering price setting come under an EU standard agreed by the energy regulator. These would cover such as:
 - generating plants that become unavailable to be declared within a stated long term that ensures the information is available before the platform price is affected;
 - generating capacity that is withheld must be justified and declared as soon as the (complete or partial) shut down decision is made;
 - offers should be based on marginal cost;
 - excess production should be delivered to the market ex-ante;
 - special attention being given by regulators to the bidding behaviour of remaining dominant players. This is so that regulators can confirm that they are not abusing their positions through such as marginality of bids and reducing/withdrawing capacity.

15. While the day-ahead is central for short term price setting, “Intraday” markets have an important role in balancing the electricity system. This market should otherwise be seen only be as “corrective” and related to unexpected events occurring after day ahead clearing. For this market to be accepted as meeting this criterion, regulators need to define a clear set of conditions in order to eliminate the risk of influencing pricing in the day ahead and forward markets. Such criteria should include, amongst others, the allocation of all remaining available transmission capacity (including on the borders) to the day ahead market (no specific reservation for intraday) and the exclusion of bilateral OTC cross-border agreements.
16. A balancing market is desirable, but it relies on effective and liquid day ahead and Intraday markets. IFIEC regards these as being the priority, with the balancing market following when these are operating effectively.
17. The total cost of EU policies, such as renewable energy and the EU Emissions Trading Scheme (EU ETS), are also significant and long term. In the case of EU ETS, this continues to represent an important burden for industrial customers while delivering unjustified windfall profits for generators due to the free allowances being charged to consumers. Whilst IFIEC supports the carbon reduction and energy technology diversity principles, policies need to recognise potentially damaging results. This will be an important part of retaining and even encouraging the growth of major industrial business in Europe.

Market Integration

18. IFIEC believes that an integrated EU market is necessary for both effective competition and security of supply and should give consumers a competitive advantage in terms of price and security of supply. This will not be achieved in the short term and regional arrangements will be needed in the interim. It is important to ensure that these are installed in such a way as to be transferred simply to the wider structure when the time is right. Even so, removing all potential congestion points is unrealistic, so the emphasis should be on a prioritisation programme of change, with regulation procedures to oversee how all these points are managed.
19. The initial action should be to ensure that the full capacity at potentially congested points is used at all times. Holding back available transmission capacity, especially at the interconnectors, prevents effective competition and can have as a result to deter new entrants. It follows from this that cross border trade should be under strict regulatory oversight.
20. The important factor is to remove system constraints such as cross border bottlenecks. In many instances it is these that have produced competition arguments, rather than actual supply shortages and have led to consumers being penalised when trying to optimise costs and efficiencies. IFIEC therefore insists on the need for infrastructure upgrades, as a means to create integrated and liquid power markets, without neglecting the main objective of bringing competitive and affordable solutions to the end customer. In order to facilitate those investments, TSOs must be given the necessary financial capacity in a stable investment climate and should be incentivized to coordinate and harmonize their investments programs.
21. The large utilities dwarf the size of TSOs and customers, are able to transfer capital easily across Europe and dedicate large amounts of resources to optimising complex regulatory and commercial positions. Whilst national and inter-country constraints can be overcome by large pan-European generators-suppliers, the experience of large industrial companies with pan-European sites is that they do not have the same cross border purchasing options, being obliged to accept more local contracting. There may even be an opportunity for large utilities to segment their customer bases and arbitrage regulatory and pricing differentials. There will be roles for both large and smaller supply side players in a future, competitive European electricity market, but there must be effective regulation over how they operate their varying market power.
22. IFIEC Europe is convinced that the specific characteristics of electricity as a commodity (e.g. linked to grids, virtually not storable, important economies of scale and scope in generation) and the economic situation in the current (generally local or national) power markets, with very often still strong incumbent players, require special attention of policy makers and regulators.. Unless existing smaller

and independent players as well as new entrants are given a fair chance to enter this market, the benefits that consumers were meant to gain from market liberalization will not be realized. The situation today is that most industrial consumers find themselves worse off than in the former regulated markets.

23. The EU policy is for increasing quantities of renewable energy. Since the means of generating this is heavily slanted towards wind and solar based technology, there will be increasing unpredictability in supplies entering the EU transmission system, even with better forecasting. To keep the system balanced against the unpredictability risks, the power will need to be transported, potentially to any point in Europe. This poses a major challenge for policy makers as apart from the efficiency losses, it means constructing an EU electricity distribution system based on maximum potential inputs. For most times this will largely be unnecessary and consumers cannot be asked to finance such an overdeveloped infrastructure.

Structural Measures

24. Turning the electricity supply industry into a market based sector offers considerable challenges and IFIEC supports fully the commitment being given by the Commission and ERGEG/ACER to achieving this. It will need:
- an independent regulation system based on competence not only in the operation of the sector technically, but in the financial measure to incentivise change for the benefit of all consumers;
 - increased harmonization of European energy policy, targeting global competitiveness with no restriction on fuel mix nationally;
 - priorities being established, as aspects such as transparency, capacity utilisation, marginal cost pricing, maintenance programming and inter-company power exchanges can be managed by regulation much more quickly than infrastructure challenges needing major investment;
 - a clear framework to promote new investments in capacity and infrastructure. Whilst the energy demands of IFIEC members means they will probably be looking to the larger suppliers (i.e. those likely to be the present dominant national players), the market must give equivalent opportunities for smaller players to invest.
25. IFIEC recognises the challenges that investment poses and believes that regulation needs to identify and to incentivise investments.
26. Some are believed to be thinking that generation capacity investment should be financed through a form of capacity market. This appears to take all the risk from the supplier without the investor having any rights to either the asset or the power produced. Clearly, this is not to be confused with a bi-lateral project, which IFIEC believes could be one route for larger users. IFIEC is not in favour of a separate capacity market, as this appears to create opportunities to charge the highest cost for capacity AND power (through marginal cost).

Transitory steps

27. New infrastructure will take years to implement, so the question of steps that can be taken in the short term must arise. IFIEC is concerned that this should not result in an even more fragmented situation than at present. Any steps taken nationally should be to an agreed framework of priorities and subject to scrutiny to ensure they will be able to be brought simply under the pan-European framework when appropriate. DG Energy needs to give early and clear direction to ERGEG/ACER as to priorities and arrangements by which such transitory steps are introduced.
28. IFIEC also believes that much can be gained in the shorter term by putting the initial focus on better transparency requirements, ensuring pricing mechanisms are structured to benefit consumers and by maintaining close supervision over operating practices. IFIEC is available to continue discussion of these points as the global competitiveness of its members is directly affected and needs resolving at European level as a matter of urgency.

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