

# European Commission's Communication 'Making the internal energy market work'

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A EURELECTRIC response paper



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# EURELECTRIC response to the European Commission's Communication 'Making the internal energy market work'

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## **EURELECTRIC response to the European Commission's Communication 'Making the internal energy market work'**

### **General comments**

EURELECTRIC welcomes the general findings and the proposed actions of the European Commission's (EC) Communication on the Internal Energy Market (IEM), but sees an urgent need to go further to bring the completion of the IEM back on track. Integrated electricity markets together with the use of market-based instruments can provide a cost-efficient contribution to decarbonisation. Rather than being considered a secondary priority, market integration should therefore be speeded up to facilitate the transition towards a low carbon economy.

Greater attention should also be paid to alleviating the multiple overlapping and conflicting energy priorities/targets, uncoordinated national RES support schemes, national CO<sub>2</sub> taxes, regulated end-user prices and other measures and restrictions which are the root cause for the current energy policy failures. Current developments in several member states seem to be moving away from the objective of an integrated electricity market: attempts to achieve energy self-sufficiency, state intervention on wholesale and retail end-user prices, discretionary taxation or national approaches to carbon pricing are preventing the internal market from developing. As a result, the role of the market is diminishing and the behaviour of market participants is increasingly driven by regulatory measures or interventions.

Our assessment is that the EU internal energy market is now genuinely at a turning point. Either the EU rapidly changes course and strongly pushes member states to align the various national policies and targets which overlap with or even contradict European policies. Or we will very soon witness a deterioration of the IEM and risk that the European Council's commitment to achieve the IEM by 2014 will not be realised.

Whilst EURELECTRIC fully subscribes to the analysis made by the EC in its Communication, we believe that the series of actions listed in the paper is insufficient to prompt a firm move towards liquid, well-functioning electricity markets that are able to accommodate large volumes of intermittent generation.

EURELECTRIC hence urges the Commission to give the completion of the internal market a high priority when preparing the agenda of the European Council meeting on energy scheduled for May 2013.

## Specific comments

### ***A more decisive approach by the EC is needed to speed up the implementation of the Internal Energy Market and reduce market distortions***

#### Enforcement of the 3rd Energy Package

A well-functioning single European energy market is one of the key prerequisites to accomplishing a cost-effective transition to a low-carbon economy by 2050.

But to this end, member states must implement existing EU energy market legislation correctly and much more rapidly and remove market distortions such as regulated prices and price caps. To date, retail prices for electricity and gas are determined by the market in only nine Member States, meaning that the majority of European consumers do not have the possibility of benefiting from competitive market prices, driven by the market liberalisation and market coupling.

In this context, EURELECTRIC welcomes the strong emphasis in the Communication against regulated prices and supports the proposed enforcement actions, including forcing member states to introduce phase-out timetables for regulated prices as part of the structural reforms and launching infringement procedures against those member states who have so far failed to fully implement the existing legislation.

EURELECTRIC also welcomes the recognition of the fact that regulated tariffs remain one of the major hurdles for suppliers in providing innovative and smart solutions to engage customers more in the energy markets and stimulating demand response. In addition, electricity prices are strongly impacted by various taxes and levies on generation, introduced by member states in an uncoordinated way, thus further limiting the fair competition in the internal market and the possibility for customers to reap benefits of liberalisation and competitive wholesale market.

A quicker implementation of the target models for day-ahead market coupling, intra-day, balancing and forward markets is needed to fulfil the ambition of an integrated European market by 2014 and to increase the possibility to integrate renewable energy into the market. In order to progress towards the 2014 target, political commitment, seamless cooperation and concrete implementation of the pilot projects on the ground remain a crucial success factor. Furthermore, experience with the network codes has proven that rather than fostering a European approach to market integration, they have been limited to a large extent to cement the existing status quo based on the lowest common denominator. EURELECTRIC calls for the network codes to be more ambitious in harmonising the rules and to better reflect market-based principles.

### Regional Market Integration

In contrast to the latest Florence Forum conclusions in December 2012, EURELECTRIC is surprised not to find any detailed reference in the Communication to the on-going NWE (North Western European) project, ACER work on the cross-regional roadmaps and AESAG process. EURELECTRIC is strongly concerned about the delays in implementing both Day-Ahead and Intraday projects in the NWE region and urges the Commission and ACER to step up their leadership in the process. At the same time, swift implementation should not impede the robustness of the process, meaning that proper testing and back-up solutions should be ensured.

More genuine involvement of market stakeholders should be sought in the process of developing integrated day-ahead, intra-day and balancing markets. EURELECTRIC is concerned that the current delay in developing a pilot integrated region in the Northern Western Europe together with the incomplete implementation of the Third Energy Package will further exacerbate the challenges posed by the penetration of large volumes of variable generation.

### Need for reducing discretionary national tax measures

Market intervention through diverging national taxes and levies further interferes with the development of the internal energy market and hampers generation investments. Retail consumers should be made aware that the energy component of their bill is usually below 50% of the total bill, while the remainder is made up mainly by taxes and charges (including for the purpose of financing RES support) and grid fees.

Some Member States do not only tax electricity at the point of consumption, but have also introduced taxation on fuels (gas, coal, nuclear fuels, etc.) or hydro stations used for electricity production which leads to double burden and has distortive effects on the market integration, dispatch of power plants and on investment decisions.

## ***RES integration: electricity market design and investment climate must be addressed as a matter of urgency***

EURELECTRIC recognises that the promotion of renewables has brought benefits in terms of reducing carbon emissions, lowering dependency on fossil fuels and developing new technologies. However, the integration of RES is also producing significant distortive effects on the functioning of wholesale electricity markets, in particular with respect to price formation and the operation of conventional power plants, resulting in substantially lower load factor and margins for these plants. This not only brings new challenges to the market design and the implementation of the third energy package, but also negatively affects the framework for existing generation units and new investments”.<sup>1</sup> Investment decisions in RES, however, are made primarily on the basis of the level of support and not the market price.

### Make the energy-only market work

EURELECTRIC fully subscribes to the analysis made by the EC in the Communication and believes that governments and regulators should allow energy-only markets to function properly. In doing so, distortions such as regulated tariffs, price caps that hinder the demand and supply balance should be removed. Furthermore the integration of wholesale markets together with the proper advancement of the grid infrastructure should remain a top priority.

### Make RES fit to the market

Whilst EURELECTRIC acknowledges the positive role renewable technologies play in fulfilling the 2020 RES targets, we also observe that the distortive effects of most RES support schemes, like feed-in tariffs, is increasing.

Three actions should be performed to limit the distortive effects of existing support schemes and move towards more appropriate practices in RES support:

- Over-compensation should be avoided both because of it being unnecessarily expensive and also, as history has shown, because it can lead to ‘stop and go’ or investment bubbles which fundamentally harm the investment climate;
- RES generation like any other generation technologies should be incentivised to sell their energy in the market, take balance responsibility for meeting scheduling, nomination and balancing requirements on their portfolio and be subject to equivalent obligations regarding grid connections. These good practices are already a reality in many European Member States, in particular for on-shore wind. It is time, however, to implement these rules in all Member States for all renewable technologies.

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<sup>1</sup> EURELECTRIC report “Powering Investments: Challenges for the Liberalised Electricity Sector”, December 2012

- Another effective way to reduce the distortive effects of RES support schemes (e.g. feed-in-tariffs) on the market is to move towards support schemes which expose producers to market dynamics and encourages the operation of power plants when energy is actually needed (e.g. contracts for difference, green certificates or variable premia). More flexible and market reflective operation of RES installations can lower the overall cost of the electricity system and avoid negative prices.

EURELECTRIC supports the Communication's call for better optimization of the state support for energy sources and convergence of national RES support schemes to reduce the total cost and its distortive effects on market integration, while still ensuring that the 2020 RES targets are met. EURELECTRIC believes that this should be an absolute priority and calls on the EC to tackle this issue with the necessary sense of urgency. In this context, the implementation of cooperation mechanisms should also be promoted. To this end, EURELECTRIC urges EC to take action and define a clear roadmap in the forthcoming EC Guidelines on RES support schemes. After 2020, support schemes for mature RES technologies should be phased out. R&DD support for RES immature technologies should remain.

#### Ensure generation adequacy

As already explained by EURELECTRIC in its report<sup>2</sup>, the need to generate a large share of electricity from RES reduces the number of operating hours and profitability of conventional power generation technologies, including medium load and back-up generation. However, the latter are necessary to cope with RES intermittency and unpredictability. In some EU markets, their lower levels of profitability are significant, raising concerns about maintaining existing conventional plants in operation and future investment decisions economically unfeasible, and thus endangering generation adequacy.

On the topic of capacity remuneration mechanisms, EURELECTRIC expressed its support<sup>3</sup> to the Commission's strong concerns about the lack of a European approach to generation adequacy and potentially counterproductive/distortive effect of national CRM initiatives currently underway. Therefore we welcome that the Commission is currently preparing CRM guidelines with the objective to bring more coherence in the on-going initiatives, including developing common criteria to define the need for CRM in the EU.

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<sup>2</sup> EURELECTRIC report "RES integration and market design: are capacity remuneration mechanisms needed to ensure generation adequacy?", May 2011

<sup>3</sup> EURELECTRIC response to European Commission Consultation Paper on generation adequacy, capacity mechanisms and the internal market in electricity, March 2013



On this topic, EURELECTRIC calls for making electricity markets well-functioning and fully integrated, but believes that in those markets where measures related to removing market distortions, stepping up efforts in integrating electricity markets, developing demand response and integrating RES into the market are not implemented timely, and where generation adequacy is hence endangered, CRM should be considered.

CRM should be market-based, technology neutral, ensure equal treatment of all market participants, take into account interconnectors and be established as a stable framework, allowing for a self-regulation that will lead to very low capacity prices when there is sufficient capacity and sufficient earnings in the energy market.

The main objective of CRM should be to remunerate capacity, while flexibility should be remunerated in the energy and balancing markets. Developing a blueprint for an EU-wide capacity mechanism is premature. The Commission should develop a set of coherent EU level compatibility criteria for the use of CRM, including a request for member states planning to implement CRM to justify the need for such a measure and to implement it in a coordinated way at regional level in order to avoid market distortions.

### ***Building flexibility must rely on market-based instruments***

Increasing volumes of intermittent renewables will require adapting the entire energy system and making it more flexible. Managing increased variability calls for flexible and back-up generation capacity, integrated wholesale markets, storage, smart grids and demand-side participation, as well as the appropriate infrastructure at transmission and distribution level. Policymakers must therefore adopt a holistic system approach. Achieving a well-functioning integrated energy market by 2014 is crucial to deliver this flexibility by providing a proper value for electricity generation, demand and storage. In this way market integration will also contribute to addressing current generation adequacy concerns in some member states.

Therefore EURELECTRIC welcomes the Communication's strong desire to enhance flexibility through the integration of wholesale markets and network reinforcement/expansion. EURELECTRIC believes that ancillary services and balancing markets (and not CRM, which should, if introduced, reward availability) are the market instruments to remunerate flexibility, which is increasingly needed in the future electricity system.

The ability of the market to ensure that flexible resources are delivered at least cost is currently endangered by diverging and disproportionate grid charges in some MS (e.g. double grid charges for pumped hydro storage) and various political interventions on national level aiming at reducing price spikes and price volatility, which constitute the necessary price signals for flexibility.

### ***Ensuring a market-consistent customer focus***

We support moves towards increased transparency to promote consumer engagement in the energy market. We believe that robust competition is the primary means to safeguard the interests of all energy consumers and incentivise efficient and responsible behaviour by market participants. That said, we very much recognise that any market reform should take special account of its impact on consumers at risk and we welcome the Commission's intention to support Member States in defining the concepts and drivers of consumers' vulnerability. According to the Third energy package, Member states, when defining the concept of vulnerable customers may refer to energy poverty. It does not say however that the two concepts are interchangeable and we are concerned by the growing tendency to mix them up. Being vulnerable (e.g. disabled, senior citizen) does not automatically mean a person suffers from fuel poverty and the solutions needed are different. In most cases where customers have energy debts they are likely to have other debts and their circumstances may require a more holistic approach in order to provide effective support. This is why we do not support sector-specific social legislation and believe it should be for social policy to ensure that essential services are met and to help consumers tackle the root causes of total debt, including energy debt. In any case, if specific measures were to be introduced, they should be compatible with the functioning of competitive retail markets and not entail competition distortion or disproportionate administrative costs.

### ***Gas markets must become more flexible***

Increasing shares of variable renewable generation will also have consequences for gas transmission systems and wholesale markets, which the Commission recognises. We welcome the fact that implementation of two of the fundamental building blocks of the Third energy package, namely TSO unbundling and the introduction of entry/exit systems, have significantly improved the competitive market outlook in a number of Member States. However, the Commission should remain vigilant in ensuring these obligations are enforced and implemented in a consistent manner across the EU. The on-going study on behalf of the Commission by DNV KEMA on the practicalities of how Member States have implemented and interpreted the concept of an entry/exit regime is welcome in this respect.

We also welcome the progress that has been made in developing the Framework Guidelines and Network Codes envisaged under the Third Energy Package. We encourage the Commission to continue to play an active part in facilitating their timely development and implementation. In particular, the EU Network Code on Gas Balancing will be vital in ensuring that the operational and supply flexibility that exists within, and between, wholesale gas markets is optimised efficiently and that within day liquidity accelerates. This will be important if, as expected, gas fired power stations are called upon to generate even more flexibly and unpredictably than they are currently doing in many EU Member States.

The EC and ACER should also ensure a more harmonised transmission grid tariff structure to avoid competition distortion between gas-fired power plants in different Member States. Whilst the gas and electricity target models have been developed largely in isolation, it is encouraging to see that another DNV KEMA study on behalf of the Commission recently concluded there is no need for far-reaching changes to the respective target models and that the measures necessary to ensure efficient interaction between gas and electricity balancing can be implemented within the scope of the evolving regulatory framework.

Transparency about an individual market participant's imbalance position within day, and about that of the system as a whole, is an essential pre-requisite for market based balancing and for integrity and efficiency in price formation. The Commission should therefore continue to press regulators and TSOs to properly enforce the transparency requirements contained in the Regulation so that all stakeholders are kept fully aware of the flows and forecasts driving gas demand and supply fundamentals, both nationally and across the IEM as a whole

### ***Network development should be encouraged as a foundation for a strong IEM***

EURELECTRIC supports the Commission's call to advance the expansion and modernisation of the networks. Lengthy permit granting procedures represent one of the major barriers for necessary network development, including interconnections that are key for a working internal energy market. Their acceleration should be facilitated as a matter of priority. It would also incentivise more private investors to engage in energy infrastructure development.

The EC should recognise the fact that investments in distribution networks will represent the major part of overall network investments and that their share of overall network investments will rise. Distribution system operators (DSOs) are currently facing multiple new challenges, notably due to the ever-increasing share of distributed generation to be integrated into the grid and the decreasing residual consumption that is taken off from the grid. The share of necessary distribution investments is estimated to grow from about two thirds up to 2020 to almost three quarters of total transmission and distribution investments by 2035 and to four fifths by 2050.<sup>4</sup> Agreeing an adequate regulatory framework which allows for cost-effective investments in distribution networks and proper risk allocation is a key issue.

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<sup>4</sup> IEA Energy outlook (€520 billion by 2035) and European Energy Roadmap 2050.

### ***Tomorrow's smart energy system raises questions about the future role of DSOs and suppliers***

The Commission has expressed its view that an efficient deployment of smart grids will have to exploit the synergies between ICT and the energy sector at infrastructure and service level, and urges both sectors to cooperate in a pro-competitive way, thus opening the field for new entrants. The Commission also stressed that the regulated activities of DSOs should be limited to tasks which are best performed by a natural monopoly, and that new services made possible by new technologies must be developed and offered by market parties in competitive markets.

EURELECTRIC strongly believes that DSOs, with their key responsibilities of developing and managing their networks while maintaining the system security and quality of service<sup>5</sup> will play an important role within the smart grid deployment. As system operators, DSOs must be operational information facilitators for final customers connected to their networks towards TSOs as this data is necessary for secure and reliable network operation. This puts them in the best position to be neutral market facilitators planning and managing the new opportunities and risks related to the grid, in cooperation with all other market participants.

In a 'smart energy system' characterised by smart grids and load flexibility, DSOs will also provide suppliers with timely, transparent and non-discriminatory information and their own customers' data allowing them to offer innovative products based on customer preferences. Moreover, suppliers and new emerging commercial parties (ESCO, aggregators) will further develop their role as energy services providers. They will increasingly offer energy efficiency services, by using smart devices, allowing consumers to reduce their overall consumption and lower their energy bill by adapting their consumption pattern to market price signals. Suppliers will use load flexibility for load management and balancing purposes and will offer this flexibility to system operators for grid congestion management. Finally, new system services should be created at the distribution level that would contribute to optimal operation of the distribution network, while maintaining the overall system reliability. They could either be procured by DSOs as ancillary services from DER or be defined in grid codes.

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<sup>5</sup> DSOs are subject to technical performance requirements for quality of service including continuity of supply and power quality laid out in national law, standards and grid codes.

### ***Smart grids: National action plans and standardisation***

The Communication recognises that with the growing need for flexibility and energy efficiency and to accommodate distributed generation and demand-side participation, coordinated action will be needed to deploy smart grids at European, regional and local levels. The objective is to develop transparent and simple rules and standards for demand response and data management.

EURELECTRIC underlines that smart grids are not an end in themselves. Moreover, a one-size-fits-all approach will not deliver, since the right 'level of smartness' depends on the state of the national grid, the network layout and configuration, the level of demand and penetration of distributed generation and other distributed energy resources (such as electric vehicles and storage). Therefore, we welcome the development of specific national action plans as proposed by the Communication, rather than a single EU level plan, that reflects an evolutionary approach, as already stated in our response to the EC Communication on smart grids<sup>6</sup>. The plans should be developed in discussion between relevant stakeholders and the National Regulatory Authorities. Their modalities including the 'swiftness of deployment' should reflect the needs of and be aligned with the existing EU targets.

All available alternatives to the traditional increase of grid hosting capacity (network reinforcement) should be considered. The most cost-effective solution or combination of solutions for a given network should be selected. In some situations, distributed generation (including ancillary services), demand response, storage or ICT-based network technologies may contribute to reduction of local network reinforcement needs. A mixture of "smart" solutions and "business as usual" techniques is likely to be used in most networks. A level playing field should be ensured without a priori prioritizing one solution over the other.

Member States' approach to smart metering roll-out should reflect such an assessment. Smart meters are an important part of smart grid. They should be rolled-out where economically viable, thus bringing value to both the end-customers and to the electric system as a whole. In most Member States, this task would fall on DSOs<sup>7</sup>. The positive cost-benefit analysis for smart meters has been confirmed in a number of member states. In those markets where this is not the case, other solutions to trigger/facilitate demand response may prove to be more cost-effective, including smart devices (e.g. smart energy boxes) that are developed by suppliers and aggregators, and that allow consumers to adjust their consumption to price signals. Smart meter roll-out should thus not to be imposed from the European level and stay subject to the CBA as currently required by the Third Package.

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<sup>6</sup> See EURELECTRIC Response to European Commission's Communication on "Smart Grids: from Innovation to Deployment", June 2011. And EURELECTRIC 10 Steps to smart grids – EURELECTRIC DSOs' Ten-Year Roadmap for Smart Grid Deployment in the EU, 2011.

<sup>7</sup> In the UK, the supplier-hub model has led to Smart meters being rolled out by suppliers rather than DSO's.

EURELECTRIC acknowledges the Commission's support of the swift development of a first set of smart grids standards by the end of 2012 and the anticipated iteration of the Mandate to further refine the methodology and start to look into interoperability and conformance testing. Nevertheless, we notice that the standardisation activities are increasingly being pressurised by political goals thus demanding a lot of resources by the industry to perform this important work in a coherent and timely manner. Due care should be given to the alignment between the standardisation processes and regulatory initiatives, e.g. EU Network Codes and standards should be 'open' enough in order not to preclude future market models or 'lock-in' technical solutions that are not optimal from the network operation perspective. We also believe that market driven standardisation should continue to play an important role.

## Conclusions

Based on the above, EURELECTRIC reiterates its call upon the European Commission to act decisively in the following areas:

- Foster better coherence between the EU and national energy policies and promote the central role of the market in achieving the EU's energy policy objectives
- Speed up the implementation of current EU energy market legislation and enforcement of the 3<sup>rd</sup> Energy Package and the Energy Infrastructure package
- Increase political pressure to make progress in regional market integration and accelerate the development of the NWE region day-ahead and intraday projects as a crucial stepping stone towards creating a European energy market
- Take actions against regulated end-user tariffs which hamper the development of a well-functioning market, necessary investments and the exploitation of the potential of demand response
- Step up efforts in limiting discretionary national taxation initiatives and other regulatory interventions in the market
- Take swift actions to integrate RES into the market whilst moving towards more market-based RES support schemes and progressively phasing out support schemes for mature RES technologies
- Develop a regional approach to generation adequacy and CRM, whilst ensuring compatibility with the internal energy market
- Create favourable conditions for remunerating flexibility in the market through competition between all forms of technologies
- Define a clear market model for smart grids and demand side participation that clarifies the roles and responsibilities as well as the interactions between suppliers and DSOs



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