ERT

Expert Paper

Single Market for Energy

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Introduction

European markets for gas and electricity were successfully established in the last 20 years and have generated clear benefits for European consumers and industries. However, these markets have come under pressure since the end of the summer in 2021, which was exacerbated by the current geopolitical context, in particular the war in Ukraine.

Given the economic consequences of the sharp increase in gas and electricity prices, questions on the security of supply and energy market design are at the top of the political agenda. Currently, political sentiment is slanted towards a comprehensive overhaul of the marginal pricing system. ERT believes there is a case for targeted improvements to the market functioning, but not a complete transformation in the short-run.

Strengthening the Single Market for energy is crucial to successfully address both short-term and long-term challenges in the energy transition (e.g. security of supply, affordability, and decarbonisation). The current fragmentation and country-by-country approach on support schemes (for biofuels or hydrogen for example) or in response to rising energy prices threaten the overall EU cohesiveness and the implementation of the EU Green Deal.

The response to the current energy prices crisis must be taken at the European level to maintain the cohesiveness of the Single Market. In that sense, the ERT welcomes the approach taken by the Commission to carefully address any power market design reform with a preliminary impact assessment study. Since the corresponding legislative process will inevitably take time, ERT also supports the need for rapid emergency response, such as the recent Council Regulation to address high energy prices, provide liquidity to the market and protect consumers and industries by targeted support measures.

1. The Single Market for electricity

Challenges

- The energy markets currently expose consumers and energy-intensive industries to highly volatile and high prices, affecting European competitiveness.

- Furthermore, the energy-only market set-up does not sufficiently encourage the massive amount of new investment necessary for delivering new decarbonised production capacities and security of supply. Both aspects would require more long-term price signals for investors through additional instruments (e.g. capacity markets, two-way Contracts for Difference, auctions of renewable energy sources).

- However, European electricity markets are currently still achieving both an optimised dispatch to consumers and the efficient mobilisation, at any moment, of the most economical production asset, thanks to the effectiveness of the short-term price signals based on the marginal costs of production in each Member State. The European integrated spot market has proved resilient in the context of the current shortage and the increased variability of electricity supply. The variability of supply will continue to rise in the future due to the growing penetration of renewables.

- The wholesale electricity market clearing price currently reflects the marginal natural gas cost, which is driving the prices upwards.

Recommendations for the mid- to long-term

a) **Promote long-term contracts and transnational renewables PPAs.**

   i. Today, Power Purchase Agreements (PPAs) account only for a marginal share of European electricity markets (less than 5%). Their development should provide both security of supply and price stability to the producer and the end user. The development of PPAs would alleviate part of the weaknesses of the current market design.

   ii. As the European Commission (EC) seems restrictive vis-à-vis the development of long-term contracts, it could be necessary to review the case law on long-term contracts. In addition, one should also incentivise transnational PPAs (e.g., by pushing the Transmission System Operators, TSOs, to grant cross-border transmission rights beyond one year).[1]

   iii. Possible incentives in renewable state aid mechanisms to also offer PPAs should be investigated further, but without reducing the appetite for renewable investments.

   iv. The existing timeframes of PPAs leads to high risk-premiums. A market for PPAs with shorter duration (e.g. 3 years) should also be under consideration.

b) **Support the deployment of capacity mechanisms and the possibility of linking them between neighbouring countries.** The energy market currently works well to deliver short-term price signals, but it must be supplemented by capacity remuneration mechanisms to deliver long-term signals, facilitating investments in existing and new capacities (generation, demand response, storage) and ensuring the security of electricity supply at the level required by the adequacy criteria. These mechanisms should better include the participation of cross-border capacities in national mechanisms, following the provisions[2] set by the Clean Energy Package.

c) **Develop flexibility means in Europe.** The rising penetration of renewables, combined with the reduction of dispatchable capacities, will require the development of various types of flexibility means to ensure the proper functioning of the electricity system, such as decarbonated thermal production, storage, and demand-side response management. A large part of the requirements set out in the Electricity Market Design, which are essential for demand-side flexibility, are still far from being fully implemented by the

1 ERT flagship publication on "Renewing the Dynamic of European Integration: Single Market Stories by Business Leaders" (December 2021): see the story "Pinning down promise" by the Chair of ENGIE, page 110-113 (https://ert.eu/wp-content/uploads/2021/12/ERT-Single-Market-Stories_WEB-low-res.pdf)

2 The provisions are contained in Art.26 of the Electricity Regulation (https://eur-lex.europa.eu/eli/reg/2019/943/oj) and the methodologies mentioned therein.

Member States.[3] Demand-side flexibility, based on market approach, could be a precious available resource, that can be activated quickly and usually does not require major CAPEX investments. In 2016, the European Commission assessed that access to all flexibility options would directly translate into a reduction of wholesale electricity supply costs by around €50 billion in 2030.[4]

d) **Develop interconnections.** The lack of interconnections, together with differences in the mix of the Member States, is reflected in a wide price spread between countries. These interconnections need to be strengthened. Today, the construction of interconnections between two countries requires the agreement of both TSOs, which is hampering their development. The EC should therefore ensure better coordination between TSOs and plan these interconnections in TYNDP (Ten-Year Network Development Plans).

e) **Increase market liquidity.** Today, the well-functioning of the electricity and gas market is affected by the increased level of margining requirements, translating into extremely high cash liquidity pressure for market participants. This situation triggers more and more participants to exit the regulated markets for over-the-counter (OTC) transactions, reducing liquidity and increasing the risk of a systemic default. One solution (proposed by the European Federation of Energy Traders, EFET) could be to establish an emergency funding mechanism in case of extreme market situations, whereby any high credit rated public entity, such as the European Central Bank (ECB), would temporarily provide the necessary guarantees or other liquidity facilities to the clearing member. Other solutions entail accepting non-cash collaterals or limiting margining calls. However, we are strongly cautious about emerging ideas such as to include the energy sector under banking regulation rules, which are disproportionate to the actual risks and would dry liquidity from the energy markets, eventually increasing prices.

3 Report of Smart Energy Europe on the implementation of the electricity market design, March 2022 (https://smarten.eu/wp-content/uploads/2022/03/The_implementation_of_the_Electricity_Market_Design_2022_DIGITAL.pdf)

4 European Commission, Impact Assessment accompanying the EU Electricity Market Design

2. The Single Market for gas and renewable gases (Biogas, Hydrogen)

Challenges

- **The circulation of gas flows within Europe is far from optimal:** the European gas transport network was initially designed for east-west and north-south flows. The current tensions have revealed bottlenecks for west-east and south-north flows. Certain Central European countries, which are traditionally heavily dependent on Russian supplies, remain distant from the LNG flows arriving in the west.

- **There is a need for further harmonisation of gas standards throughout Europe to facilitate cross-border flows.** For example, odorization is done on the French transport network, while in other countries, it either does not take place or happens downstream the distribution network, which prevents interconnection.

- **The market for renewable gases (Biogas, Hydrogen - H_2) remains fragmented,** as well as the support schemes in each Member State.

- **Access to the existing gas grid alone will not be sufficient** to enable the EU to reach the envisaged targets for renewable gases. Mechanisms that support production rather than tariff discounts (representing also a cross-subsidy) are needed to scale up the market.

Recommendations for the mid- to long-term

a) **Encourage the acceleration of permitting & financing of new necessary infrastructures for the security of gas supply:** with due consideration to avoid stranded assets in the future, specific infrastructure (interconnections, regasification - FSRU) is urgently necessary for the European security of supply and liquidity of the market. Particular attention should be given to cross-border collaboration and optimised usage of existing interconnectors.

b) Push for **the establishment of a genuine European Guarantee of Origin/Proof of Sustainability market for renewable gases (biogas, H_2),**[5] which allows for the physical delivery of gases to be separated from its production and enables renewable gas flows across various European regions, helping to develop further investment in the biogas and hydrogen markets and addressing Europe's current energy supply challenges. In this context, the requirements for green gas of non-biological origin should be kept flexible enough to enable the creation and satisfaction of demand as well as cost-efficient production and transport.

c) **Work with the European Platform for international gas purchases to ensure a diversification of European import sources (LNG, H_2)** and secure long-term supply with more long-term contracts, while avoiding the creation of new dependencies.

5 ERT flagship publication on "Renewing the Dynamic of European Integration: Single Market Stories by Business Leaders" (December 2021): see the story "From the get – G.O." by the CEO of TotalEnergies, page 130-133 (https://ert.eu/wp-content/uploads/2021/12/ERT-Single-Market-Stories_WEB-low-res.pdf)

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This Expert Paper has been prepared by the Energy Transition & Climate Change Working Group

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