

**Price formation and capacity withholding
in light of Regulation (EU) 2019/943 and Regulation (EU) 1227/2011**
EFET position paper



31/01/2020

In accordance with Article 3 of Regulation (EU) 2019/943 (the ‘Electricity Regulation’), Member States, national regulatory authorities (NRAs), transmission system operators (TSOs), distribution system operators (DSOs), market operators and delegated operators must ensure that electricity market rules encourage free formation of prices and avoid actions which prevent the formation of prices on the basis of demand and supply.

The European Federation of Energy Traders (EFET)¹ wholeheartedly welcomes this new provision of the recast Electricity Regulation. Indeed, **only undistorted prices give an accurate signal for bidding decisions, dispatch and demand response on the one hand, and can serve as a sound basis for investment and divestment decisions on the other hand.**

With an increasing share of intermittent power generation in the European energy mix, precise price signals are needed more than ever to ensure the reactivity of market participants’ bidding and dispatch decisions to rapidly changing demand and supply conditions. This massive penetration of intermittent generation will need to be accompanied by the development of extra peaking generation units, storage solutions, demand-side management, and other types of flexible assets and services. It may also bring opportunities to invest in power to x production assets. Accurate price signals will allow market participants to identify the nature and timing of such investments alongside more traditional investment in generation and transmission capacity.

In parallel with the recent entry into force of the recast Electricity Regulation, ACER published on 15 October 2019 updates to the fourth edition of its Guidance on the application of Regulation (EU) 1227/2011 (REMIT). The main update of the Guidance concerns capacity withholding, with details on when and how such a practice can constitute manipulative behaviour on the market. We therefore take this opportunity to

¹ The European Federation of Energy Traders (EFET) promotes and facilitates European energy trading in open, transparent, sustainable and liquid wholesale markets, unhindered by national borders or other undue obstacles. We currently represent more than 100 energy trading companies, active in over 28 European countries. For more information, visit our website at www.efet.org.

recall basic principles with regard to the free formation of prices in EU electricity markets and suggest some clarifications where appropriate.

In particular, **we recommend clarifying further the wording of footnotes 16 and 23. The current text seems to indicate that opportunity costs should be considered alongside short-run marginal costs when assessing an asset owner's or operator's marginal costs. This should be stated more explicitly and should not be limited to "energy-limited generation assets" or "capacity-limited generation assets," but should be open to any generation asset.** Footnote 19 should also be expanded to include both an energy-only market and a combination of a capacity and energy market, as the Guidance should apply consistently to both of these types of market mechanisms.

We call upon Member States, NRAs and ACER, as well as all relevant actors listed in Article 3 of the recast Electricity Regulation, to uphold the principles enshrined in the Regulation, while ensuring the sound application of REMIT provisions.

1. Free formation of prices

Pricing in electricity markets follows the basic economic principle that prices are formed by supply and demand, i.e. that buyers and sellers decide when to buy or sell, at what price, for which volumes and for what period. As a result, **prices should be allowed to fluctuate freely and reflect the true value of scarcity during times of system stress and high demand for power; similarly, prices should reflect the value of surplus in times of low demand for power.** The volatility of electricity prices, when not induced by flaws in the market design, is a sign that the market reacts properly and fast to demand and supply signals. When flaws in market design are demonstrated, removing these distortions to the free formation of prices should be a priority for Member States, NRAs, TSOs, DSOs and nominated electricity market operators (NEMOs).

Like other market activities, the formation of prices, of course, should be monitored by NRAs to ensure the appropriate enforcement of REMIT and the Market Abuse Regulation (MAR). EFET has been a primary supporter of both regulations and has always called for transparent and lawful conduct of trading activities in the electricity market. We call for improved understanding of anti-trust provisions and market abuse prohibitions to ensure they do not indirectly prevent scarcity or surplus pricing from materialising as a result of overly self-restrictive behaviour of market participants.

2. Signals for supply-demand matching

Prices in the electricity market should reflect the value of energy in real time – or expectations thereof in the intraday, day-ahead and forward timeframes – in a transparent manner. Increasing the efficiency of the market will improve price signals in wholesale markets during episodes of scarcity or surplus. This will ensure that all types of capacity (generation, demand and storage) can be used properly and valued based on a level-playing field.

2.1 Imbalance price

As a matter of principle, the pricing of electricity must always reflect the physical balance of the electricity system. Market participants are responsible for balancing their sales and purchases of electricity and shall bear the financial consequences of any imbalance, which is eventually settled with the system operator at the imbalance price.

In order to give market participants every incentive to balance their portfolio, it is crucial that the imbalance price, in line with the Electricity Regulation, reflects the real-time value of electricity, taking into account the physical reality of the assets connected to the grid. The closer to delivery (real-time), the more volatile prices may be and the more likely it is for price spikes to arise, as they legitimately reflect any imbalances in the electricity system.² In the extreme case of actual physical scarcity (where the TSO has to decrease the load to maintain the supply-demand balance), the imbalance price must reflect the value of lost load (VoLL).³ This means that in such cases the imbalance price should be set at an estimate of that VoLL.

The imbalance price risk is managed by market participants in all timeframes of the electricity market, starting with the long-term forward markets, up to week-ahead, day-ahead and intraday markets, all the way to the balancing timeframe. Price formation in these markets is ultimately based on expected imbalance prices. Market participants arbitrage between the different timeframes, which helps reach the correct price formation and thus, fosters optimal dispatch and investment decisions by market participants.

In this sense, the imbalance price should not be regarded as a penalty to force market parties to stick to their schedules. Rather, the imbalance price should reflect the value of electricity in real time, which, as such, provides the correct economic signal to avoid imbalances or help the system.

The imbalance price must deliver economically efficient incentives for balance responsible parties to adjust their positions in all market timeframes, until as close to real time as possible.

2.2 Price spikes across all market timeframes

The Electricity Regulation requires market rules to encourage the development of more flexible generation, sustainable low carbon generation, and more flexible demand, to which we would also add storage.⁴ These components of the future electricity market are essential to tackling the challenge of ensuring system stability and continuity of supply as intermittent electricity production from renewable energy sources increases in volume. The development of flexible assets and services will be

² This has also been confirmed by the German regulators BKartA and BNetzA in their latest guideline concerning price spikes and their appropriateness, published in March 2019. See here:

https://www.bundesnetzagentur.de/SharedDocs/Pressemitteilungen/DE/2019/20190927_Leitfaden.html.

³ VOLL means, in accordance with the Electricity Regulation, an estimation in Euro/MWh of the maximum electricity price that customers are willing to pay to avoid an outage.

⁴ See Article 3(c) of the Electricity Regulation.

achieved at the lowest socio-economic cost when competing on a level-playing field without undue distortion.

Expectations of price spikes will form a major incentive for market participants to invest in new technologies, especially flexible capacity, electricity storage and demand-side response. The possibility of price spikes is critical to cover investment and fixed costs in all such flexible assets and services that tend to have infrequent operation times and thus, support a high risk on the recovery of their fixed costs.

Only when market participants see that there can be a reliable recovery of the cost incurred for building and operating a new asset can investment happen.

Regulators should do away with barriers that hinder the development of these technologies and should allow price spikes, as well as normal price trends and price troughs, to convey the respective signals. NRAs, instead, have often chosen to intervene against just price spikes – for instance, by approving ill-structured imbalance prices, maintaining tight bidding or clearing price caps and floors in various market timeframes, or allowing the use of unjustified constraints by TSOs in cross-border transmission capacity calculation. In addition to removing necessary price signals, such measures undermine market participants' trust in the market design, which, in turn, hinders the further development of new technologies.

To insure against physical short-term scarcity, the system operator will call on a number of options, including the use of operating reserves (like FCR and FRR) and load shedding as a measure of last resort. None of these important activities should ever result in suppressing the imbalance price signal.

A scarcity situation does not mean that the market will not perform its duties. Standard market rules should guarantee the functioning of the energy markets and the contribution of all relevant capacities to security of supply and system security. In fact, a scarcity situation should not be suppressed as long as capacities are available, regardless of the cost of activation. NRAs should ensure that TSOs refrain, as far as possible, from suspending markets, curtailing interconnection or taking any other out-of-market measure. If TSOs have to take such actions and if such actions are likely to impact the market price, NRAs must take measures to avoid or correct the impact of these TSO actions on the electricity price.

3. Price spikes in light of REMIT

As noted by ACER at the 3rd Energy Market Integrity and Transparency (EMIT) Forum in September 2019,⁵ it is correct that price spikes are necessary for the owner or operator of an asset with operating costs below the market price to obtain an infra-marginal rent, which can be used towards covering fixed costs. This remains an important feature both to guarantee the operability of existing assets and to attract

⁵ <https://www.acer.europa.eu/Events/ACER-Energy-Market-Integrity-and-Transparency-Forum-2019/Documents/Price%20spikes%20in%20wholesale%20power%20markets%20-%20The%20perspective%20from%20REMIT.pdf>

investments in new assets and services – generation, storage, demand response, other innovative energy services.⁶

We also support ACER in their view expressed at this Forum that *“price spikes are a normal feature of electricity markets, reflecting the tightness of demand and supply.”* The updated Guidance further clarifies that *“REMIT does not prohibit prices to be high, provided that they reflect a fair and competitive interplay between supply and demand.”*

Besides others, we also support the following principles laid out by the German regulators BNetzA and Bundeskartellamt in their joint guidance note on price spikes:

- Price spikes based on free, competitive price formation (the interplay of supply and demand) are permissible.
- There exists no general obligation under REMIT to offer power plants at certain prices to certain market segments, hence:
 - optimising a portfolio of assets across timeframes should be seen as a legitimate commercial strategy.
 - not bidding in the forward or day-ahead markets in expectation of higher returns in the intraday or balancing markets cannot be seen automatically as capacity withholding.
 - speculation about higher prices in day-ahead and/ or intra-day markets does not constitute market manipulation.

We agree that on a case-by-case basis analysis may be required to establish whether price spikes are the consequence of abusive market behaviour, or whether they are the consequence of the natural functioning of the market and the legitimate behaviour of the market participant(s) in question.

Overall, the commercial offering of an asset should be assessed against all relevant commercial, economic, technical and/ or regulatory justifications.

4. Capacity withholding: rational bidding behaviour vs. manipulation

For the correct implementation of the Electricity Regulation and REMIT, it is important that both regulators and market participants have the same clear understanding of the distinction between rational bidding behaviour and market manipulation. This is vital for the formation of prices, not only to avoid the distortion of prices as a result of manipulation, but also to ensure that market participants do not overly restrict their bidding behaviour for fear that regulators would sanction their rational and lawful activities on the market.

Offering capacity up to the willingness of buyers to pay is rational economic behaviour. In any case, only bidding done with the objective to influence a price or price references for another product, or in combination with providing misleading information, should be regarded as a violation of REMIT. Once again, the case-by

⁶ See presentation on price spikes in wholesale power markets by ACER, delivered at the EMIT Forum on 5 September 2019.

case analysis of the situation, as recommended by the ACER Guidance, will help regulators discern whether or not the behaviour of a market participant aims to manipulate the market, and hence, constitutes a violation of REMIT.⁷

When assessing whether a market participant withheld capacity in an illegal manner, a regulator may wish to ascertain whether the marginal cost of the relevant capacity is below market prices. The assessment, as correctly stated in footnote 16 of the ACER Guidance, should include, in particular, opportunity costs on both the demand and the supply side, and outage risks. Indeed, when deciding whether to offer the output from any given unit within its operated or contracted portfolio in the forward or day-ahead market, market participants face opportunity costs, as prices in markets closer to real-time (i.e. intraday or balancing markets) may increase. Such opportunity costs will be considered when offering the electricity output from capacity in any timeframe, meaning that market participants will make an economic assessment of the temporal optimisation of their portfolio across the different trading timeframes.

The clarity of the ACER Guidance on this point must be improved and applied consistently across the document: footnotes 16 and 23 seem to indicate that opportunity costs should be considered alongside short-run marginal costs to assess an asset owner's or operator's marginal cost. The wording of the footnotes, however, should be made more explicit in this regard and should not be limited to "energy-limited generation assets" or "capacity-limited generation assets," but be open to any generation asset. Furthermore, the Guidance should apply consistently both in the context of an energy-only market and a combination of an energy and a capacity market. Therefore, we would recommend expanding footnote 19 to include these two types of market arrangements.

In summary, market participants should remain free to determine the price at which they offer the electricity output and the volume of such electricity which they offer from any type of asset, as long as they do not do so by distorting competition or manipulating the market. Thus market participants should remain free to offer or abstain from offering their capacity in a specific timeframe, provided that this decision is based on a sound commercial, technical and/ or economic assessment and without the intention to manipulate the market. An excessively restrictive market design – or application thereof – would cause market participants to take an overly conservative approach in their bidding, in order to avoid risks of penalties and reviews. This would harm the ability of the market to let price spikes materialise and to properly respond to this signal. As a result, necessary investments in flexible capacity and innovative energy services may not happen, as associated development and investment cost may never be recovered.

⁷ Irrational bidding behaviour of a market participants artificially inflating (or dampening) prices to uncompetitive high (or low) levels, in addition, could be considered predatory pricing under competition law, even if not prohibited under REMIT.