

## ***Response to the European Commission Green Paper on Energy Policy***

***September 2006***

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### **Introduction**

We have noted that the Public Hearing to discuss reactions to the Green Paper and the possible content of an EU Strategic Energy Policy will be organised under two main headings:

1. EU energy mix and achieving the objectives of sustainability, competitiveness and security of supply - Discussion of the advantages and drawbacks of different sources of energy with the objective of ensuring that the EU energy mix best achieves the objectives of sustainability, competitiveness and security of supply.
2. A competitive and secure European Internal Energy Market for the benefit of EU citizens and industry - Discussion of the ways and means to improve the transparency and the predictability of the internal energy market and the investments needed to ensure the continuous provision of energy at affordable prices.

We harbor major doubts as to whether the currently evident intentions of some individual Member States, to promote what they regard as national security or national competitiveness, even national environmental objectives, are compatible with the successful pursuit of true EU single markets in electricity and gas. We have organised our comments below according to some of the main titles of the Green Paper itself. We highlight *in italics* the topics, which require particular care when it comes to *the compatibility of national policies or measures with the completion of the internal market.*

## **Completion of the internal electricity and gas markets must remain the first priority**

We absolutely agree that this is now, and must remain, the very first priority area for EU energy policy. We also largely endorse the opening statement of section 2.1 of the Green Paper:

“Sustainable, competitive and secure energy will not be achieved without open and competitive energy markets, based on competition between companies looking to become European-wide competitors, rather than dominant national players. Open markets, not protectionism, will strengthen Europe and allow it to tackle its problems. A truly competitive single European electricity and gas market would bring down prices, improve security of supply, and boost competitiveness. It would also help the environment, as companies react to competition by closing energy inefficient plants.”

It will be important in the discussion at the Hearing on 22 September and in subsequent elaboration of any EU Strategic Energy Policy, to *distinguish* between what constitutes *true competition between companies* at the European level and what some stakeholders regard as the ingredients of “*competitiveness*” for the whole of European industry. It is also notable that the stated Commission goal that competitiveness should “bring down prices” is in itself a non sequitur, since it is greater competition within the EU, which may lead to fairer or more cost-reflective pricing, whereas a lowering of prices might play a role in the development of greater competitiveness, measured over any particular period of time, in world terms.

The challenge regarding the promotion of competition has been taken up partly in the DG Competition sector enquiry, and we look forward to seeing its results. That challenge is also implicit in every merger review in the energy sector and in the country structural reform reviews currently being conducted by DG TREN. We regard the stringent application and enforcement of existing EU rules as to third party network access, unbundling, non-discrimination against cross-border trade and transparency about infrastructure availability as axiomatic for further progress. [By way of encouragement, we note that even a “national champion” is a potential new entrant or a disadvantaged competitor in a foreign territory].

### **Competition and “competitiveness” are both desirable, but not the same**

Competition in the European energy market is important for EU industry, but should not be confused with the global competitiveness of the EU. Both are desirable but policies to facilitate the development of greater competition are crucial and must not be sacrificed on the altar of national economic protection, dressed up as a competitiveness agenda.

We caution against paying too much attention to special pleading for some industries, which may be finding it difficult to sustain their business models in certain locations in Europe in the face of current wholesale energy prices. The preservation of jobs in particular enterprises, which have become uncompetitive in global terms and/or unsustainable in terms of EU

environmental objectives, is not necessarily good for the competitiveness of Europe as a whole. This is particularly true if the preservation is undertaken by national government assistance. It becomes pernicious when the defense of jobs and industries nationally is used as justification for market-distorting energy subsidies to individual consumers or caps on the energy prices charged to whole classes of consumer. *At its very worst this policy strand leads to intervention in the wholesale energy markets to “control” pricing by generators and importers or to isolate the national energy sector from the effects of market forces felt across borders. Such intervention is already evident in current administrative initiatives or legislative decrees of several EU Member State governments.* To the extent the national intervention is in conflict with anti-trust or state aids or free trade rules, or with liberalisation directives and regulations, *it must be dealt with severely and consistently, using all appropriate instruments and institutions of EU policy and law.*

### **We may yet need further reforms to promote liberalisation**

The Green Paper introduces the ideas of a European Grid Code, a European Regulator and a European Center for Energy Networks. We are encouraged by the will shown by several regulators and by the Commission to pursue better enforcement of existing rules through the electricity Mini-Forums and through the regional gas initiatives. EFET is fully engaged in pushing for more consistent observation by Transmission System Operators (TSOs), and more imaginative implementation by regulators and ministries, of the clearly formulated provisions of the EU cross-border electricity regulation and the EU gas transmission regulation. The challenge is for TSOs to operate their networks as if there were unified operators, optimising their services across the EU grids. Sharing sufficient information with neighboring TSOs, ensuring consistent operational approaches and providing harmonised services to network users are all elements of this. The result should be that the network users receive as efficient a service as if all the grids were operated (even if not owned) by one entity.

If this push should not yield concrete results, in terms of the eradication of widespread discrimination against new entrant exporters and importers, and in terms of a consequent improvement in the degree of wholesale tier competition across national boundaries throughout the main grids of continental Europe, then there will be strong justification in calling for new Europe-wide reform of energy regulation and grid operations. In particular we believe the Commission and ERGEG should already start evaluating the case for a regulatory authority to deal with all cross-border access issues inside the EU and at its external boundaries; such a body must not duplicate national roles, so primary legislation would be needed to adjust the competence of national authorities accordingly.

We also suspect that fresh measures to strengthen unbundling of transmission from production, import and supply businesses will prove necessary. (See section on Unbundling below)

Additionally, it seems that the Commission needs extra powers to outlaw commodity price limits, which have been imposed or are planned by some Member States, especially in the electricity sector. While regulation of the transmission tariffs charged by monopoly grid operators is desirable, we are concerned that government interference in power pricing seriously impacts liquidity and damages confidence in the emerging internal electricity market. Three large Member States currently intervene to cap prices charged by generators at the wholesale level, for example, while another is even legislating to allow customers, who had already exercised their choice to switch suppliers, to revert to an artificially low regulated retail tariff.

### **Operational and commercial reform of cross border transmission capacity allocation must precede "priority" new interconnection plans**

TSOs should play a crucial role in ensuring that competition can take place between, not just within, national and/or regional markets. Without TSOs offering *fully firm* capacity at *truly maximum* levels, competition will develop much more slowly. Market participants, facing an import risk that they are unable to manage, may not be willing to enter new geographical markets.

While some connections between national grids are permanently or frequently declared "congested", a lack of physical lines or pipes at the border itself is rarely proven to be the primary real cause for the inaccessibility of cross-border capacity to new entrants. Many TSOs, the way they are currently structured and regulated, take little interest in facilitating wholesale market development. This is a real mischief, which Member State ministries and regulators must address.

TSOs must maximise the availability of transmission capacity across national borders, make the capacity rights offered firm, and publish adequate information

The role TSOs play will have to change compared with current practice in three particular ways:

1. Both power and gas TSOs must ensure the firmness of transmission capacity rights granted. This is absolutely vital for the market to function well, by providing a way for wholesale trading counter-parties to hedge their long-term price exposure in line with their respective delivery/purchase obligations. Firmness implies that currently common *force majeure* clauses in electricity transmission capacity auction rules must be tightened considerably. It should then become possible for wholesale market participants to hedge transmission risks over variable long time frames, beyond the one year long capacity products that are available at present;

2. Power TSOs must comply with their regulatory obligation to maximise the cross border capacity they allocate to the market. The TSOs' current practice of publishing fixed, bilateral NTC figures rather tends towards minimisation, in fact. It may be appropriate, for example, for regulators to allow them to profit from achieving increases in capacity offered. Otherwise their congestion management income will not be used as efficiently as it could be, ultimately leading to less capacity being made available to the market and less competition. Robust incentive-based regulation is thus vital for achieving capacity maximisation. Very specifically for electricity, regulators must introduce incentives for TSOs to reassess the attribution of bottlenecks to national borders, compared with the costs of attributing congestion points within their grids on the one hand, and re-dispatching generation plant inside a national system, or even counter-trading between national markets, on the other.
3. For the gas grids there remain serious problems of insufficient information availability and, as in power, inconsistencies between the internal and cross-border nomination regimes for some countries. Whilst incentives to maximise cross-border capacities offered to the market may also be needed for gas, the first step is for the TSOs to publish the actual (aggregate) flows and the unused capacities at all relevant points (a term defined in the Gas Transmission Regulation 1775/2005). Incentives can then be considered, after regulators have approved TSO proposed values for baseline capacities.

Once these three reforms of TSO practices start to be seriously tackled, then there will be scope for a further stimulus to cross-border market liquidity: The introduction of secondary markets in transmission capacity rights.

#### A secondary market in transmission capacity rights is feasible and efficient

One of the elements in our suggested incentive scheme is that TSOs should be allowed to buy back in the market any part of the capacity rights they turn out to have oversold in advance, or indeed to buy back (in the manner of what is currently called curtailment) also whenever this is necessary for them to manage unexpected operational circumstances such as physical outages or unplanned loop surges. (Of course that does not exclude the alternative methods of co-ordinated re-dispatch of generating plant and cross-border counter-trading.) However, if a liquid secondary market in transmission capacity rights does not exist, TSOs will not be poised to take the role of "re-purchasers".

This is not the only reason why secondary markets are necessary. Wholesale market players have evolving traded electricity portfolios to manage. Sometimes they buy capacity rights on a yearly basis, which they do not need during certain seasons. At other times they only need the capacity rights they buy daily or monthly during peak hours; thus they may like to sell on their rights in a deep and liquid market during certain off-peak periods. Meanwhile other players, with contrasting portfolios of power sales and purchases, may

find themselves naturally on the buying side in some of those same seasons or off-peak periods, in their own efforts to optimise those portfolios.

EFET is aware that the EU Congestion Management Guidelines only currently envisage explicitly a “use it or sell it” principle somewhere near to the D-1 gate closure, allowing transmission capacity holders to sell on (or back) their unused (i.e. not nominated) capacity rights at the daily auction spot price. This feature is supported by EFET, although it is actually only a kind of last resort market for not used capacity. A secondary market allowing the sale and purchase of capacity rights at any moment in time, functioning in a complementary fashion to the regular advance (yearly/ monthly) primary allocations, is the missing link, which wholesale market players need to optimise their portfolio in capacity rights, according to their commodity portfolio on both sides of a particular border. And to aid that optimisation further, they need also the possibility - as mentioned above - to sell or buy in such a secondary market whatever quantity and duration of rights (as “strips”) will fit their portfolio need from time to time.

EFET believes that work should be done in parallel on both objectives, i.e.

- Improve the primary capacity markets (firmness and maximisation of capacity)
- Develop secondary capacity markets.

Both developments are linked, because the participation of TSOs on the secondary market will add opportunities to support the first objective.

### **Investment in generating capacity will take place if price signals are allowed to evolve in a real market context**

In a liberalised and competitive power and gas markets, contractual “products” are traded bilaterally, over-the-counter or on exchanges. The result is that the prices for buying and selling the contracts are readily observable to all market participants. This allows them to make informed decisions on when and how to source their requirements. Vertically integrated players, independent generators, independent retailers and “pure” traders both compete and co-operate to buy and sell in the market. As the number of such players and the frequency of their transactions increase, forward markets become increasingly liquid, such that they can buy or sell significant volumes without a material impact on market prices. In turn, the spread between buy and sell prices (i.e. the “premium” paid by market participants for managing their wholesale market risks) narrows.

Market oriented buy-sell spreads result in improved short and long-term efficiencies in the linking of supply with demand:



- Efficient production, operation and consumption  
Production is sourced at best conditions e.g. at long or short term least cost level. With a readily observable price for each time period, generators can choose either to generate themselves or to buy contracted deliveries from the market (effectively from other, cheaper generators). Producers of gas can decide where to export and when to sell domestically; importers of gas either as LNG or by pipeline can decide from where to import and when. Large consumers with tariffs linked to wholesale prices may choose not to consume at particular times of the day or year to avoid relatively high prices. Gas participants can also decide whether or not to put gas in to or take it out of storage depending on the current and future market prices. The overall result is an economically efficient pattern of generation, production, importation and consumption, and should correspondingly lead to efficient investment decisions.
- Efficient risk management  
Forward markets allow market participants to buy and sell electricity and gas over many different periods and to fine-tune their portfolios as their expected requirements change. Traders facilitate this process by adding liquidity and reducing the costs of buying and selling energy. Reliable forward markets must also be expected to underpin investment in generation capacity, gas production, LNG & pipeline import facilities and storage.

It follows from the above analysis that, *in a liberalised energy sector, freed from the rigidities of central planning and from capricious bureaucratic or politically partisan intervention, market signals should be capable of producing the right decisions about investment, in terms of fuel choice, location and capacity adequacy.* Naturally the danger remains that political concerns, about national security, short-term consumer price increases and sustainability (*or indeed protectionist and populist political instincts under cover of such declared concerns*), will in fact interfere with the process of the market receiving and acting upon reliable wholesale price signals.

National and regional preferences, or indeed prejudices, risk interfering with market signals already in four key respects:

- Through the re-imposition of regulated, cost-based, and/or capped energy prices, as a way to circumvent free market access.

We are aware that the Commission has already commenced infringement proceedings against several Member States, in an attempt to halt such government interference, particularly in the functioning of the power market.

(See also section on the need for new legislative measures above)

- Modes of support for renewable power generation are often incompatible with transparent and optimum operation of the wholesale power market

Any energy sector enterprise operating inside the EU should at least be entitled to an explanation of what current and future energy-related environmental policy is designed to achieve. Or the question may even be: Is the policy actually founded on an environmental objective, or does it just appear to be? In the case of some Member State energy taxes and renewable power policy instruments, for example, it is by no means certain that the primary objective of the executive or the legislature has been environmental protection. Money raising or fiscal substitution may have been the real motivation behind an energy tax. Similarly renewable support legislation can become caught up in arguments about protection of a domestic industry, security of energy supply or diversity of fuel types.

EFET is convinced that the most economically efficient way to reach sustainable levels of renewable energy supply and production across Europe is through the introduction of market mechanisms. Provided these are properly applied, according to policy preferences per technology or source, they will not only support investors' interests, but also encourage technological innovation. That in turn will lead to market prices more aligned with short run and long run cost factors, as well as improved choices for consumers.

EFET therefore advocates the European-wide tradability of certificates related to renewable energy production and supply. Currently there are several obstacles, which are working against the creation of such a market, however. Not least of the obstacles is the recent apparent endorsement by the Commission itself of some Member States' continuing promotion of distorting feed-in tariff methodologies.

Where environmental objectives in energy policy are clouded in the manner described above, the overlay of other policies with a more certain or singular environmental purpose may highlight or exacerbate market distortions. There is then also the risk of overlaps, abuses or arguments about implementing instruments. This is classically the case now with GHG emissions limits, allowances and trading mechanisms, especially as we come to the debate about national allocation plans for the period 2008-12.



- “Special” supply contracts, linked to particular generating plants needing heavy capital investment, may not help overall market progress

Some Member State governments, concerned about security and diversity, are contemplating bundled long term supply contracts, offered on a potentially discriminatory basis, to underpin state planned, and possibly state sponsored, investment in capital intensive production technology. An important role for competition authorities, in relation to future long-term agreements for large generators supplying large consumers, is to avoid potential abuse of dominant position. They, and possibly sector regulators, could help ensure the commodity and transmission parts of such contracts are fully unbundled. If congestion were sometimes correctly attributed by the national TSO inside the affected Member State, rather than always at borders, either generator or consumer would then have to take on contractual risk of a constraint between input and delivery point. The permissible duration, and permissible percentage capacity utilisation on any relevant overburdened HV line, of the transmission element should be looked at separately from the anti-trust and State aid aspects of the commodity supply element. Probably the key criterion, apart from price, for the anti-trust evaluation of any particular contract structure on the commodity supply side will be the degree of exclusivity involved (e.g. does it amount to a full requirements off-take promise, at least base-load, for the relevant consumers and does it preclude the generator supplying other customers?)

- The EU as a whole will lose from fragmented national government efforts to “corner gas supplies” on offer from third country exporters

Other national governments seem pre-disposed not only to keep in place potentially distorting national renewable power subsidy schemes but also to invoke foreign policy, in an attempt to offset the risk of undue dependence on more carbon intensive forms of generation. A few have already succumbed to the temptation to misuse security and diversity of supply arguments, to justify favouring national, rather than EU-wide, exclusive, long-term treaties (or treaty-type mutual “undertakings”) with third country gas exporters, or their state sponsors. Unilateral initiatives of this sort tend to undermine both objective, commercial evaluation of transportation investment projects and the potential success of EU diplomatic efforts to help secure improved access to those third countries’ own energy markets. (See also our section on external relations below)

## **Unbundling, especially of gas system operators, is still inadequate in many countries**

### Effective unbundling entails honest compliance

There must be clear and true separation of businesses conducting high voltage and high-pressure network transmission operation from any affiliated or related energy businesses. The truth of this separation must be evident when viewed in terms of legal structure, financial governance, management reporting and physical location of staff and offices. A commercial function, such as production, trading or supply, which remains within the same group corporate structure, may of course need to use the transmission network of its corporately affiliated TSO. If it does so, it must never be treated any differently from a third party user. Such integrated groups must of course accept other obligations to ensure behavioural compliance with the gas and electricity directives. Compliance reports are an essential part of this process for such companies, but very few compliance reports have yet been published.

### Regulators need to focus on the basic role of the TSO and help them achieve best practice

In considering *how* to separate the TSO from the other businesses, it is essential to bear in mind the TSO's fundamental *raison d'être*: The unbundled transmission operation business must be principally responsible for the safe and efficient operation, maintenance and development of its network, so as to meet all reasonable demands of current and future network users. Although another purpose of the TSO's existence may be internally to provide a stream of dividend income to its parent energy company, this purpose should *never be allowed to interfere with the discharge of its principal responsibility in a non-discriminatory, objective and transparent manner*.

We suggest that if a TSO is to be legally and functionally unbundled, without ownership control changing at the same time, there are two key questions that should be asked upon the consideration by its own management, and/or the management of the owning company, of each and every operating decision, investment decision and functional change:

- Could the decision or change lead to possible discrimination against third party users of its network?
- Could the decision or change retard the development of a competitive market (whether within the national territory or on a cross-border basis)?

If the answer in any case to either of these questions is "probably so" then best practice would be to seek a different way of operating, investing or functioning, so as more positively to promote non-discrimination, objectivity and transparency in the delivery of transmission services.

*We believe energy regulators should be taking concerted, co-ordinated action to stamp out those operating modes of TSOs, which do not meet such a test of best practice.  
If they cannot, or are reluctant to do so, further legislation on unbundling may be justified.*

## **Security of supply will be reinforced by a well functioning internal market**

### **Competition among a multiplicity of market participants strengthens, not weakens, security**

In the context of the liberalisation of both gas and electricity sectors, energy security of supply can be guaranteed ultimately only by having sufficient energy production capacity available and sufficient transportation capacity to bring the energy to consumers. This can be achieved most efficiently through the proper functioning of markets. Policymakers and regulators must, at this still delicate stage of liberalisation, give priority to the development of robust wholesale markets, with possibilities for forward, day-ahead and intra-day trading, complimented by cash-settled balancing mechanisms. Legal obligations falling on particular actors to ensure system or supply security should be imposed only with discretion. Security and reliability measures or standards may be essential to define best TSO operating practice, but, in the absence of emergencies which interrupt either production or distribution, must not detract from the due play of market forces. And they should not distract government authorities from the continuing regulatory supervision of system operators (TSOs), for the purpose of safeguarding third party access to networks on objective and non-discriminatory terms.

Neither the Autumn 2003 network failures and ensuing blackouts in Europe and North America, nor the minor interruption to gas imports in parts of central Europe in early 2006, had much to do with long-term energy security. But a major lesson to be learnt from those events is that TSOs must develop more trust and communication among themselves e.g. concerning network load and anticipated flows. TSOs need to learn to co-operate, to help each other in their security roles, while not jeopardising network access, especially at cross-border interconnection points. Many TSOs must yet develop procedures also to provide transparent information about capacity availability and utilisation to market participants.

We recall the wise words set out towards the start of the Commission's own "INTERPRETING NOTE of COMMISSION SERVICES on the ELECTRICITY and NATURAL GAS INTERNAL MARKET DIRECTIVES 2003/54 and 2003/55 (MEASURES TO SECURE ELECTRICITY SUPPLY Version 1.1, 25.09.03)":

"The Electricity Directive gives the European Union and the Member States enough instruments to ensure that security of electricity supply at reasonable prices can be achieved.

The main focus of this paper is to describe which options are open to Member States, if exceptional circumstances warrant intervention in the market. This paper also gives suggestions as to which of these options would be the least distorting of competition and the internal market. This is important in the light of the fact that any measures taken are justified by their public service character and would therefore have to be able to pass the test applicable to public service obligations.”

As already mentioned under our heading, warning that competition is not the same as “competitiveness” above, there has in fact been a tendency on the part of several Member States since 2003 to forget that *they should be relying on the functioning of the newly liberalised markets in power and gas as the primary means of ensuring security of supply.* (The stringent test of justification of measures in terms of fulfillment of a public service obligation appears to be stretched already to cover rather eventualities or risks, which are presently unlikely to occur. Examples include risks of closure of national coalmines, failures of nuclear technology or safety procedures and even apparently the threat of the exposure of energy intensive industries employing significant numbers of citizens to higher prices)

### **Price signals can also ensure there is enough reserve generating capacity**

The market must be allowed to work first to provide sufficient generation capacity, and only if there is evidence that generation reserve margins are falling below agreed levels, should any intervention be considered. Well-designed forward, spot and balancing markets at the wholesale level best ensure efficient use of assets and the maintenance of a balance between supply and demand. If the liquidity and transparency of those markets are impaired or their functioning subject to other distortions, special schemes can be considered in the short term to discourage demand or encourage production capacity reserve.

As a pre-condition for the implementation of any new generation capacity obligations (or indeed of any calls for tender under existing legislation), national governments should satisfy themselves that:

- Freedom exists in practice to invest in generation
- Day-ahead and intra-day wholesale markets operate optimally in terms of potential liquidity and transparency
- Balancing markets are properly functioning
- Market distorting generation capacity withdrawal is discouraged
- Demand response is encouraged by appropriate incentives

It is important to avoid the creation of inflexible, broadly targeted capacity payment arrangements. Experience in England and Wales, Spain and the United States suggests they constitute a blunt instrument, which can cause market distortions. On the basis that regulators would allow them to recover the relevant costs incurred, we propose TSOs could instead purchase options

from certain producers at market related prices. Exercise of the options would oblige those producers to run standby plant in defined circumstances.

### **Open access to networks across national boundaries is fully compatible with electricity security and reliability**

The Directive on electricity security of supply places great emphasis on the development of transmission infrastructure. However, in many important geographical electricity markets of the European Union the most effective way to improve security on a trans-national basis, while not jeopardising third party access and competition, will be to optimise the utilisation of existing cross border transmission capacity. This already happens very effectively in Scandinavia under the aegis of NordPool.

On much of the continental high voltage grid, organised as a synchronous zone by UCTE, the level of physical interconnection is already well developed. Most especially in the area stretching north of the Pyrenees and north and east of the Alps (including Switzerland and the Balkans), the grid is actually highly meshed. And yet continental interconnection capacity is not always fully used (even if there is a price differential between countries)], or its use is dominated by a small number of incumbent companies either side of relevant national borders. Thus the challenge in that huge area, accounting on its own for more than half of overall European electricity demand and some two thirds of production capacity, is not so much to invest in new transmission lines, as to make sure that market actors really are able to obtain access to established cross border connection capacity when transacting in the European wholesale power market.

Compliance with important elements of EU Regulation 1228/2003, which sets the parameters for the management of congestion and the allocation of cross-border transmission capacity, is still very patchy, although it came into force in July last year. Enforcement of it by regulators, with the backing of the Member State governments and the Commission, must be a priority. Any security guidelines adopted in comitology under that Regulation must not be at odds with proper enforcement of its central measures.

### **The mantra of gas security of supply still confuses the debate about proper implementation of gas sector liberalisation**

As with electricity, the gas market must be allowed to work first, to provide sufficient gas, and the TSO must be obliged to construct sufficient transportation capacity to deliver the gas to market. It is important to underline the distinction here between the obligations on the TSO to make sufficient investments so that there is the (spare) capacity available to transport gas from an alternative source in the event of a disruption, and the purely market-based incentives on suppliers to find the most economic sources of gas for their customers. There is little point in having gas available

for an emergency if there is not sufficient investment downstream by the TSO to enable that gas to be delivered from the alternative source or from storage in the event of a major disruption.

Furthermore the risks on TSO investment are asymmetrical: If there is over-investment in transmission capacity then some proportion of the TSO's costs (which are themselves only a proportion of the final gas cost) will need to be recovered from the market, but if the TSO under-invests then some gas simply cannot be delivered to consumers and there is a supply failure. Given the increasing importance of gas as a fuel for power generation this scenario has serious consequences across the whole energy market. The EU Gas Security of Supply Directive sets out requirements on Member States to ensure that there is clarity in the security of supply roles of market participants and transparency in the security of supply criteria that they must satisfy. As yet there appears to have been little compliance with these requirements, and the Commission should take action to ensure that this is remedied without delay.

Well-designed forward, spot and balancing markets at the wholesale level best ensure efficient investment and use of pipeline, LNG, gas storage and indeed gas production assets as well as the maintenance of a balance between gas supply and gas demand. Unfortunately the gas price in many parts of Europe is not formed through a traded market involving many participants and in which the gas price responds to gas supply and gas demand. Supply security will continue to be at risk, or the maintenance of secure supplies will continue to be inefficient until market forces are allowed to develop in these areas of Europe.

Political intervention may well be required to establish transitional arrangements to create the conditions to enable a traded wholesale gas market to develop. Several countries have, for example, implemented some form of gas release programme to make gas supplies available to new entrants and to improve the chances of gas trading hubs developing. The Commission's own analysis shows that there is still severe market concentration in the EU Gas Market. The 2005 Benchmarking report shows that nowhere is there low concentration and only in the UK in the HHI less than 1800, indicating moderate concentration. Even in the markets with reasonably advanced liberalisation, like The Netherlands, Italy and Spain, the market is assessed to be highly concentrated. It seems clear that further gas (and capacity) release programmes, perhaps on a larger scale, or alternatively partial divestment or assignment of supply portfolios to alternative suppliers will be needed to stimulate competition in those parts of Europe where market concentration is worst.

The issue of gas stocks is often raised in relation to security of supply. Again, EFET believes that, whilst the public policy objectives should be set by Governments, the market should be left to determine the best way to fulfil

these objectives. Non-discriminatory third party access to storage is essential if suppliers are to satisfy security of supply standards.

Designating a certain proportion of gas storage capacity as a gas stock solely for emergency use should be a last resort solution, which would be implemented only after all market-based options have been examined and exhausted. Any new proposed gas stock approach to security of supply would need to clearly define exactly what the purpose of the gas stock would be, ensure that the quantities, the rules for their use and how it is paid for is completely transparent and that the whole arrangement is accepted by market participants including the consumers who no doubt would bear the final costs.

### **Well functioning power, gas and emissions wholesale markets can help support greater sustainability and diversity of the energy mix**

#### **Consistent, carefully targeted policies and market-based mechanisms are pre-requisites for achieving sustainability**

##### Renewable electricity

We are sure that the most economically efficient way to reach sustainable levels of renewable energy supply and production across Europe is through the introduction of market mechanisms. These are already being implemented in some countries today. Provided these market systems are properly applied, they will not only support investors' interests, but also encourage technological innovation. That in turn will lead to lower market prices and improved choices for consumers.

EFET therefore advocates the European-wide tradability of certificates related to renewable energy production and supply. Currently there are several obstacles, which work against the creation of such a market:

- ◆ Low market volume: For promoting renewable energies, most countries have chosen feed-in tariffs at fixed prices rather than certificate systems.
- ◆ Incompatible certificate systems: Some countries do have certificate systems to promote renewables, but these vary from country to country.
- ◆ No mutual recognition: With the exception of the scheme in Italy, certificates may be used only for obligations and incentives in the issuing country.
- ◆ Certificate redemption still linked to the physical electricity supply: Only a trade in certificates that is separate from physical trading in electricity will develop the requisite flexibility and volume.



These market barriers can only be eliminated by brave political decision-making on a harmonised European basis. As a first step it is important that Member States should be encouraged to abandon or phase-out feed-in tariff systems, in favour of more market-based approaches. EFET notes that a standardised and internationally usable system of certificates is already available in the form of RECS.

The RES-E Directive sets an obligation to Member States to establish a transparent system aiming to guarantee the origin of renewable electricity and to avoid double-selling. This system is called Guarantee of Origin (GoO). A cost-efficient way to realise future targets may be to create a GoO system that enables trading of the environmental benefit. It could lead to “GoO certificates” becoming tradable.

A robust and well-supervised EU Emissions Trading Scheme (EU ETS) is the best way to tackle GHG emission reductions

The extreme sensitivity of the emerging EU GHG emissions market to the release of actual, verified emissions data for the first year of operation was demonstrated in May this year. Market prices for EU allowances dropped approximately 60% and there were consequential effects on intimately linked commodity prices such as power and also on the share prices of companies in these markets. Obviously emissions data must be published at some time, but EFET members are concerned that confidence in the EU ETS may be compromised at this early stage of its development by inappropriate data, timing and method of release. All Member States need to recognise that many categories of information related to the EU ETS are potentially price sensitive. Particularly the handling of data about National Allocation Plans and governments’ consultations for allocation schemes in Phase 2 and beyond, and arrangements for the publication of data about emissions projections for any period covered by the scheme, are worthy of further examination. EFET therefore has encouraged the European Commission to issue a Guidance document addressing the key requirements for publishing important emissions trading market information.

In the meantime, the allocation process for the period 2008-2012 is lagging behind schedule. Only four Member States had notified NAPs to the European Commission as of 12 July, while the deadline was 30 June. Delays in the NAP submissions will lead to delays in the entire process of public comments, EC scrutiny, amendment and implementation. This may lead to a delay in the issuing of allowances and countries may even miss the 28 February 2008 final issuance deadline.

*EFET calls for prompt and full publication of all the allocation plans.*

Some scarcity of allowances is required to create a well functioning, effective, liquid emissions market. Therefore, Member States must refrain from

structural over-allocation to particular categories of installation or particular industrial sectors within their allocation plans. *EFET suggests that the European Commission should continue to monitor the submitted allocation plans with the utmost care, in order to ensure the EU ETS remains effective, leads to real reductions in emissions and is capable in the period up to 2008 and beyond of truly underpinning imperative market confidence.*

Power prices in European markets have risen partly as a natural consequence of the internalising of new CO<sub>2</sub> emission costs, including the incorporation of the opportunity cost of GHG abatements in generators' offers to the wholesale electricity markets. One possible solution to the competitiveness issue is to extend the EU ETS-type model to as many other countries and sectors as possible, as soon as possible. (As long as extensions are not undertaken, those countries and sectors, lacking economic incentives to minimise their environmental impact, may well continue increasing their relative GHG emissions to the atmosphere.) EFET favours such an extension, since we firmly believe in harmonised, market-oriented solutions across *all territories* where a policy goal is to be applied.

There have been several extensive studies of the Kyoto reduction mechanisms. One of their common key conclusions is that linking of credits to emissions trading markets could significantly reduce costs for participants and increase the environmental effectiveness of emissions trading markets. This would lead to lower worldwide abatement costs, which in turn could help protect European industry against the effects of rising emission allowance prices. In addition, it could be a crucial argument for involving other countries currently not participating in the scheme.

To ensure the maximum environmental effect, while not putting the competitiveness of European industry at stake, it would be preferable to establish a single over-arching scheme from the outset rather than to rely on the organic growth of an international scheme by well-motivated companies, economies or regions (e.g. Canada, Japan and the EU). Moreover, focusing the development of an international scheme on a sub-set of nations runs the risk of:

- ◆ Undermining the effectiveness of the scheme in limiting global emissions, as emissions continue to rise in non-participating countries.
- ◆ Jeopardising the current positive perception of emissions reduction in participant countries, leading to pressure to leave the scheme and/or never to enter it in the first place.
- ◆ Diversion of energy intensive production facility investment to non-participating countries, thereby potentially increasing transport-related emissions related to movement of raw materials and/or finished products and potentially diverting resources to less efficient technologies and processes, which

- ◆ are only “economic” when the cost of carbon dioxide emissions can be ignored
- ◆ Inefficient allocation of abatement measures, as low-cost reduction options in non-participating countries are overlooked.

**EU institutions must not become distracted by debates about the desirable degree of diversity of supply, nor by plans to achieve it.**

Diversity is recognised as a key to maintaining or enhancing Europe’s energy security. Diversity of supply sources, supply routes and suppliers should all increase as the markets open more to competition. This is not only because better access to interconnections within the EU makes the internal market larger and more accessible to a range of physical and commercial options, but also because new entrants tend to seek (or be forced) to find electricity and fuel supplies from different sources from those that are in the hands of the incumbent. Whilst the market will try to make the best economic choice, there appears also to be a natural tendency for market to diversify.

The purpose of any policy requiring diversity also needs to be thought through carefully to ensure that the diversification actually mitigates risk at an optimal cost. This type of analysis is again very difficult to carry out and is best left to the market. Well-functioning wholesale markets for energy will help to provide the price signals that are needed to help make these decisions.

Overall the further integration of the internal energy market will improve efficiency both for normal operations and in achieving supply diversity. Completion of the internal markets in electricity and gas should therefore remain the top priority of EU energy policy.

**External relations regarding energy security and reciprocal liberalisation need to be co-ordinated by the European Commission**

Developing and improving good external relations should continue to be an integral part of EU energy policy. There is a need for all EU institutions and Member States consistently to strive for market and structural reforms in third countries, as well as internally. Whilst there will always be a need for bilateral treaties between Member States and third countries for certain limited purposes in the energy field (e.g. to govern the sharing of liabilities involved in the construction of pipes or cables), individual Member States must be careful not to undermine EU international energy policies and the internal energy market, by developing ill-conceived bilateral arrangements of a supposedly more “strategic” nature. Examples would be State-to-State “security undertakings” or “minimum level supply promises”. Even if such arrangements are presented by a national government as fallback measures for extra security, in the event of the market failing to cope with a supply disruption, the European Commission will need to be diligent to ensure that



any such initiatives are not actually barriers to trade in the rest of the EU, are not anti-competitive and do not involve State Aid.