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Ensuring secure and affordable energy supply without endangering decarbonisation goals: our reaction to the European Commission Communication on REPowerEU

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Introduction

Over the past 12 months, we have seen rising prices in electricity, gas and carbon markets in Europe. In response to this exceptional situation, the European Commission adopted a 'toolbox' to guide and align possible reactions from Member States.

We have welcomed most of the measures taken by Member States so far to alleviate the burden of price rises on end-consumers, such as direct financial support to vulnerable consumers or reduction of taxes and levies. We have, however, voiced our concern with a few of the measures adopted in certain Member States, in so far as they threatened the objective of affordability and funding of investment needed to meet European decarbonisation goals.

The war in Ukraine adds security of energy supply concerns to an already tense situation on energy markets. We welcome the new Communication of the European Commission as it addresses these concerns directly, alongside affordability of energy supply. This new Communication provides a clear direction of travel for the energy market and system in Europe, and additional guidance to Member States. Many of them will need to be further developed, but **we particularly welcome initiatives to**:

- Increase the pace of renewables buildout
- Continue to trust the EU Emissions Trading System (ETS) to provide a clear carbon abatement signal in power generation and heavy industry sectors
- Coordinate risk preparedness now, and plan for any further deterioration of the situation

However, the Communication also opens the door to policy developments that have us concerned. The current level of gas prices and threats to security of gas supply does not justify interventions – particularly in the electricity market – that threaten energy affordability and our decarbonisation goals in the medium to long term. Hence, **we advise extreme caution with regard to**:

- Wholesale price control measures, such as price caps and mandatory sales at fixed price
- Interventions in the collection and allocation of revenues from power generation affecting wholesale price formation, especially when not strictly limited in time and scope
- Changes to the fundamental principle of setting the day-ahead electricity price by reference to the marginal costs of dispatched plants, especially if uncoordinated across countries

We elaborate further our reflections and recommendations based on recent experience below.

The EU must develop a coordinated policy response across three time horizons

We think a response should distinguish between three time periods in which action is needed; being mindful of the repercussions and long-term impacts that a measure taken in one of these timeframes could have on the others.

- ***In the very short term***, we need a coordinated, pan-European response to managing gas security of supply, including via LNG and storage - indeed this response will need to extend beyond the EU27. We need also to provide help to ensure the most vulnerable consumers can continue to afford their energy and we will need to consider time-limited policies to support the energy sector in times of high prices and high levels of market volatility.
- ***In the short-to-medium term***, there is a need to ensure the security and diversity of energy supply, and coordination of risk preparedness at a pan-European level. This means continuing to coordinate gas security of supply measures, including developing market-based methods of ensuring sufficient gas is in storage, while still trusting the wholesale gas market to optimise demand and supply. It also means prioritising energy efficiency, ensuring demand response can make the maximum possible contribution and encouraging investment in alternative sources of gas supply, renewable energy and in flexible sources of energy.
- ***In the medium-to-long term***, we have to make sure we stay on track to meet our net-zero goals, by continuing to decarbonise not only the energy sector, but all other sectors. Achieving this requires very large volumes of investment. The attractive investment environment needed for this will rely on strong and liquid energy and carbon markets.

Our response to gas security of supply concerns must be coordinated and confront uncomfortable questions:

- **There is no option but work together to ensure gas security of supply**. That means coordinating emergency plans, completing the solidarity arrangements enabled by the Security of Supply Regulation and making sure risk-preparedness related measures are well aligned and coordinated. This also requires Member States to duly consider the impact their intervention may have on the cost and accessibility of gas in the neighbouring markets. Work on ensuring security of supply needs to involve all countries and all stakeholders.
- **This response needs to go beyond the Member States of the European Union**. Norwegian gas, LNG terminal capacity in the UK and contributions from global LNG markets will all be important. We need a transparent, international approach.
- **Further demand-side measures may be necessary if we get to a point where adequate supplies are not available at a price that consumers are willing to pay**. While we have seen that current prices provide strong incentives for demand reductions by industry and demand saving measures by consumers, individual Member States may identify sectors for whom the economic consequences of interruption may be less than others. Sectors that are most flexible may be encouraged to temporarily reduce demand in sequence to allow gas supplies to remain available for those who most need it. Price signals remain the most effective tools and should be used as far as possible.
- **Policies on gas storage should work with the market to ensure they can be delivered at least cost**. Where obligations are introduced to fill or retain gas in storage beyond levels that the market will naturally deliver, consideration should be given to the incentives used and how the costs will be recovered. Care should be taken to ensure that aggregate levels of storage increase rather than merely replace commercial with mandatory holdings.

Interventions to ensure storage filling should be based on market principles with stakeholders continuing to fulfil their established roles. This is likely to require a combination of incentives and obligations, as well as careful design to reflect the fact that some capacity has already been allocated.

- **As the European Commission Communication rightly notes, measures may be needed to support liquidity given the unprecedented market conditions currently being seen**. The current level and volatility in prices, and the potential for further changes, requires companies to post margins in order to trade via exchanges which are circa 8 times greater than they were a year ago. Providing targeted support for a limited period could reduce the risk of possible default.

- **Design of measures to attract LNG cargoes in a global market context will be key**. Market price signals have performed well in ensuring that LNG is directed to Europe when it is most needed. While we recognise the desire to coordinate cargoes, we underline the complexity such process would entail - we need to be careful not to distort the long-term functioning of this market. A no-regret measure would be greater transparency on the scheduling and availability of capacity at LNG terminals. Due attention needs to be given to the potential regulatory bottlenecks that could prevent moving gas from the terminals to different countries in Europe.

We must be careful short-term EU or national actions do not jeopardise our long-term goals

Over the past six months, EFET has strongly opposed measures whose long-term effects – rising costs for consumers, deterrents to decarbonisation and unstable climate for new low-carbon investments – outweigh the benefits of alleviating end-consumer bills in the short term. Examples of these have occurred in Spain, Romania and Italy[2]. Weakening the efficient use of our resources across borders, damaging investor confidence, and putting security of energy supply at risk cannot be the response to the severe situation we are experiencing. And actions to restrict the normal operation of the wholesale electricity market are not solving the underlying challenges faced in the gas market.

We consider that the European Commission plays a vital role in coordinating effective national interventions, so as to avert risks that measures backfire. Some such interventions do jeopardise consumer welfare or compromise the objectives of European energy policy. We advise extreme caution, if the EU or any Member States should be contemplating the following types of measure:

- **Wholesale electricity price control measures**: price control measures in the forward, day-ahead and intraday markets will distort long-term price signals – necessary to hedge risks especially in highly volatile periods – as well as short-term price signals – necessary to dispatch the most efficient resources. As they directly affect the financial viability of investments, they will have a strongly negative effect on the ability of the EU to attract the investments needed for the energy transition. They also have the perverse effect of detracting consumers to engage into energy efficiency efforts and demand response. Such measures include:
    - **Wholesale electricity price caps**
    - **Wholesale electricity transaction margin caps**
    - **Mandatory sales at fixed prices**

[2] See EFET reactions to recent measures taken in Spain, Italy and Romania in the context of the high energy prices.

- **Inframarginal power generation revenue clawbacks affecting wholesale price formation**: the design of such mechanisms as we have seen to date can perversely disincentivise the use of renewable and low-carbon electricity production, undermine the PPA market, and incentivise electricity production from carbon-heavier installations for those who can optimise a portfolio across different technologies. This would have a direct upward effect on greenhouse gas emissions and wholesale electricity prices. It will also strongly damage investor confidence and reduce the speed at which we diversify supplies. We advise against their implementation.
- **Alternatives to marginal pricing in electricity markets**: uncoordinated national decisions changing the way wholesale electricity prices are determined will prevent the pan-European day-ahead market coupling mechanism, which has been so successful and reliable during the last decade, from functioning. This will mean that market participants will not be able to properly and efficiently pool electricity production and optimise the use of transmission lines at a European scale. Market participants will also miss a reliable price signal for long-term hedging and investment, which is vital to smooth volatility and provide more stable prices for consumers.

There are ways in which we can make existing electricity markets function more efficiently - such as standardising the issuance of forward transmission rights, promoting PPAs, making available more cross border capacity, reducing gate closure times and accelerating the transition towards short imbalance settlement periods. We are confident that ACER's upcoming report will focus on these opportunities.

We need a European response to longer-term challenges of security of supply, affordability and decarbonisation

Europe should be proud of the European Climate Law, the Green Deal and related policy mechanisms, particularly the EU ETS. We can also be proud of our competitive, integrated gas and electricity markets, which have evolved to help deliver decarbonisation at least cost while ensuring security of supply. The current market conditions are the first direct test of the extent to which Europe is committed to this trajectory.

The European Commission is currently consulting on the Hydrogen and Gas Markets Decarbonisation Package, ETS reforms are proposed with strengthening and expansion being planned, and the rest of the Fit for 55 package is making its way through the legislative process. In parallel, ACER is investigating electricity markets and ESMA investigating carbon markets. These processes and regulatory investigations must be completed, and their results thoroughly taken into account before any energy market reform be considered.

It must be clear that meeting our European decarbonisation goal is non-negotiable. The European Green Deal is a pan-European project and decarbonisation at reasonable cost for consumers is only going to be achieved if we work together. The recent price escalation, taken together with the prospect of a supply crisis precipitated by the Russian invasion of Ukraine, present a unique opportunity to accelerate and incentivise the take-up of renewable and low carbon technologies and to further diversify sources of European energy supplies. We must enhance cooperation between Member States and Brussels – recognising that adverse consequences of unwarranted interventions in the operation of wholesale energy or carbon markets will never remain just national.

We urge the European Commission to keep on playing a central role in coordinating this process and charting a course which helps those who need it most, without undermining our ability to reach our climate goals at reasonable cost, while ensuring security of supply. EFET looks forward to contributing to this process as best we can.