

NordREG Position Paper on the European Commission's Consultation and Prospective Changes to the Electricity Market Design

We would like to thank the European Commission for the opportunity to present our views as part of this consultation. We would also like to commend the Commission's efforts in addressing the current energy crisis. The energy crisis has manifested into challenges for Europe which threatens the economic and social welfare of the European countries and the EU. There are high prices, which negatively affects consumers and the overall economy, as well as raises concerns for security of supply.

NordREG is a cooperative initiative between Nordic energy regulators. NordREG's work is linked to the integration of the Nordic electricity market and the efficient handling and implementation of EU-regulation in the Nordic Region. NordREG also undertakes other common initiatives to improve the functioning of the Nordic electricity market. This common Nordic position paper is meant to provide inputs as to how to ensure the best possible outcome of the forthcoming reform of the European electricity market design.

The paper describes five fundamental principles that, in NordREG's view, should guide the work on how to address the issues of the electricity market and how to reshape the current market design. Each individual principle should be considered equally important.

Short Term Markets are Functioning Well

The war in Ukraine, the global pandemic and general uncertainty in the markets has increased the volatility as well as the price level of electricity, which admittedly has created a lot of issues for the electricity consumers in the form of high electricity bills. NordREG finds that the challenging situation in the markets and the high prices are in fact a result of the rapid changes in the supply of electricity as well as the fuels used for electricity production, while the market model itself has actually been functioning as intended.

The European Union's electricity market regulation underlines that the prevalent supply and demand conditions should be reflected in the market price without distortions. Now, as the energy import from Russia has rapidly decreased, the supply of energy has changed significantly, which has led to higher market prices for electricity. If this supply/demand mechanism was to be distorted, or the prices were not allowed to increase as a result of a change in supply, we would lose the incentive for demand

response as well as for making investments for production or new technological solutions. NordREG therefore deems that the short term markets are functioning, and fears that extensive reforms may be of little effect or even counterproductive. NordREG would also like to emphasize that the directive on common rules for the internal market for electricity ((EU) 2019/944) is yet to be fully implemented. Thus, we consider it too early to have a conclusive evaluation of the functioning of the market design. NordREG believes that the Directive should be fully implemented before considering significant changes to the markets.

The current pan-European electricity market has generated substantial benefits over time. NordREG believes that it is important to identify the aspects of the current model that have created the benefits, and to make sure that these aspects are not lost in the upcoming reform process. If changes are to be made, it is important to firstly identify any market failures before suggesting initiatives to changing the market design. High market prices are not a market failure by themselves. NordREG recognizes the fact that there are other reasons than market design issues that may hamper a rapid growth in energy supply. One example is permitting processes that ensure societal interests but need to be balanced against the interest of lower electricity prices and also be effectively implemented. One good example of instruments addressing potential market failures is EU ETS which leads to least cost decarbonization and is supported by well-functioning markets.

Avoid Market Distortion and Fragmentation

To be able to maintain well-functioning short-term markets, it is necessary to safeguard them from any distortive effects and excessive market fragmentation. In this regard, NordREG emphasizes that open and transparent cross-border competition should be kept as main principle for the market operation, and see risks in promoting PPAs, obligatory two-way CfDs or mandatory hedging policies.

For instance, the introduction of CfDs as described in the consultation document could lead to support schemes diverging nationally, and rivalry between member states concerning who is able to provide the most alluring level of support. This is likely to diminish the benefits that could be obtained by fully free market competition. In addition, it would be very hard to assess the correct level of remuneration, which again might lead to excessive use of public funds and the associated opportunity costs. CfDs also create market distortions by incentivising generation, even when prices are zero or negative, since producers are guaranteed a minimum revenue, independent of market demand.

Any hedging (PPA, forward, LTTR, CfD) which is based on physical transfer of a certain volume of electricity instead of purely financial products, will also have distortionary effects on the markets by drawing liquidity away from the short-term markets and thereby weaken the price signals..

NordREG supports proposed changes to Europe's forward markets

NordREG finds that functional forward markets are pivotal in addressing the current challenges in the markets. We therefore believe that transforming Europe's forward markets should lie at the core of any future market design reform. However, NordREG believes that the market participants should have freedom to decide on hedging, based on their individual risk preferences and strategies. We do not deem it feasible nor efficient for an external party to assess the preferences and risk positions of market participants.

NordREG finds thus that hedging is important, but that it should be done only by choice of the individual market parties themselves, and not as something that should be specifically legislated. Instead, focus should be put on how to improve the hedging opportunities, liquidity of the markets or other solutions such as virtual trading hubs. As an example of this, the Nordic forward markets based on a virtual hub price and price-area differentials have been the functional foundation for hedging since the 1990s. While not perfect, the market-based virtual hub has provided efficient hedging for many consumers, and especially industrial consumers all across the Nordics.

A reform should be based on Impact Assessments

The electricity markets are a complicated system with high interdependence between various segments that together constitute our current market design. By removing or adding functions to this complex system, one risks prompting unexpected chain reactions with unknown consequences. Furthermore, we also note that certain solutions and concepts seem not to be clearly defined and thus may be interpreted in different ways by stakeholders (e.g. whether one means physical or financial PPAs or different types of CfDs).

NordREG advice caution in revising the market model without having a common understanding of how the proposed solutions and concepts are defined and without knowing what the consequences of these proposed solutions may be. For this reason, NordREG believes that performing thorough impact assessments is a necessary and essential step before making any kind of changes to the existing model. Otherwise we face the risk of implementing contradictory and costly measures. As part of these assessments, one should also map out the different models / policy options

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and based on these findings developing concise definitions for the chosen measures.

Consequently, NordREG also sees challenges with the Commission's proposed timeline for presenting a legal proposal, as it does not seem to leave sufficient room for having the above-mentioned impact assessments performed.

Competitive retail markets provide real benefits to end users

All of the views and suggestions of NordREG as described above have the overarching target of improving the situation of the end user of electricity.

In order to capture the benefits, the retail markets need to be competitive with low switching barriers for end users.

A competitive retail markets will give the consumers the benefits of the market changes in terms of risk management as well as low prices. Competition fosters innovation that in the end benefits the consumer. At the same time, it enables demand response from the consumers willing to be flexible, by giving the right price signals and incentives to reduce consumption when the system and/or markets are under pressure.

The removal or attenuation of the price signals for the end-users will thus hamper the development of demand response and may make it more difficult to increase the number of flexibility providers in short-term markets. NordREG also considers that some of the proposed measures designed to protect the customers will be costly for the suppliers of electricity. These costs would likely be passed down directly to the customers themselves, which would question the solutions' ability to solve the issue of high electricity costs.

When it comes to protecting vulnerable consumers, NordREG believes these consumers should be protected outside the markets, not through the markets.

NordREG are happy to provide clarifications and more in-depth explanations to the points above.

Kind regards,
NordREG Board

