CONTRIBUTION TO THE EU ENERGY STRATEGIC REVIEW

URGENT MEASURES ARE REQUIRED TO IMPROVE THE FUNCTIONING OF ELECTRICITY AND GAS MARKETS

The Alliance of Energy-Intensive Industries proposes a set of solutions

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Summary

- Conditions are needed to allow internationally competitive electricity and gas prices.
- The electricity and gas markets are not functioning.
- Better regulation must be enacted and measures are urgently needed.

Position

The Alliance of Energy Intensive Industries is a strong supporter of the new energy strategy for Europe set out in the Green Paper “A European Strategy for Sustainable, Competitive and Secure Energy”. Our position focuses predominantly on the objective of the Green Paper to improve the internal energy market and to obtain a secure and competitive energy supply for industry. In this respect it is absolutely crucial that the Strategic Review recognizes that one of the most important objectives of the internal energy market is to promote the competitiveness of EU industry, thereby contributing to growth and employment. Securing energy supply at competitive prices is therefore crucial. This is of particular importance to the energy intensive industries.

If the EU wants to secure the strategic supply of essential basic and intermediate materials to its secondary industry and the subsequent value added chain, it should build a framework allowing the market to provide security of supply and competitive energy prices for energy intensive users.

Electricity and gas prices must be competitive internationally

The key consideration in the achievement of this objective will be to obtain internationally competitive market-driven prices in relation to the unique profile of the energy intensive industries:

- The industry has a constant, high, predictable and very stable consumption profile of electricity and gas, during both peak and off-peak periods, with options for interruptibility, compensation of reactive energy, high pressure/voltage connexions, etc. Although this stable demand enables the producers to limit costs and risks, these benefits are not taken account of in the energy prices paid by the energy intensive industries. This situation is especially adverse when industry is required to purchase electricity from trading platforms, designed to provide day-ahead balancing prices, as is the case currently when long term contracts expire.

- In addition, energy represents a very high proportion of overall production costs. Any price increases will therefore have a very high impact on margins, thereby strongly influencing the viability of energy intensive industries.

- Our products are traded as commodities with prices set globally on a competitive basis.

- Regional cost disadvantages cannot be passed through to the price, but simply reduce the commercial viability of operations.
Given this unique profile, the energy intensive industry needs truly competitive electricity and gas markets delivering prices with long-term predictability and stability.

The electricity market is not functioning

As identified by DG Competition's Energy Inquiry, there are currently no properly functioning electricity markets in the EU. Indeed, over the recent years, electricity prices have risen significantly above pre-liberalization levels, and they are still increasing. On mainland Europe, gas and oil are only minor fuels for power generation and increased gas/oil costs can be no justification for steep electricity price increases. The main reason is that power markets within the Member States are highly concentrated, volatile, short-term and illiquid, and prices are being imposed by the power generators in a distorted manner. Generators have linked their sole reference price to the cost of operating the marginal (highest cost) generator required to meet electricity demand in the system.

A major cause of the current power price increases is the pass through of CO$_2$ certificates, as generators are using their dominant position in the power market to take advantage of the EU Emission Trading System (EU ETS). For example, the pass through of CO$_2$ allowance prices in the power price in Germany is 60-80%, leading to huge distributional impacts and no environmental benefits. The EU should insist that EU ETS be modified to solve this excessive pass through and to deliver the required environmental goals.

In this non-functioning market, it is no longer possible for electricity customers to engage in true negotiations, nor to conclude long-term contracts as in other regions in the world, while in addition the price paid for electricity by European energy intensive industries is now much higher than in other regions in the world. As a consequence, the international competitive position of European industry has deteriorated sharply.

This deterioration is difficult to accept, especially as the EU has a relatively favourable primary energy mix and a sound generation cost structure, chiefly composed of hydropower, nuclear power and coal, which should be able to deliver internationally competitive base load power prices. Hence, the EU must promote a new energy policy for competitive and sustainable base load generation. In this light, the European Commission should further push for a well-balanced energy-mix and reward the advantages of nuclear power for base load electricity, energy supply and CO$_2$ emission reductions. In this respect, the EU Commission should invite Member States to reconsider their phasing out of nuclear power production.

The gas markets face high prices and a lack of transparency

Gas, and especially the Liquified Natural Gas (LNG) markets will soon become even larger. This will have more influence on the electricity prices of the future, even without a direct relationship in many countries. Gas markets are linked to long term Take or Pay (T or P) contracts for gas suppliers, but translated into an oil price connected spot market price for consumers. There are only a few players and frequently no choice of supplier in specific regions. One-sided changes in price calculation methods of suppliers have enormous effects on the market price. The high concentration of the logistic infrastructure managed by only a few operators has generated a tight situation for the consumers in a distorted manner. It is necessary to correct this illiquid market situation and to create options beyond today's link between the gas and the oil price. For parts of the energy intensive industries, the gas market price increases hit twice: directly and then indirectly through the electricity price.

Solutions are urgently needed

In energy intensive industries, investment horizons are long, and therefore long-term energy price security at a level that allows operations to be viable is a key requirement. However, industry cannot wait for any new market regulations to take effect. Many long-term contracts are coming to an end and, if no action is taken, they can only be replaced by the current short-term contracts and prices.
Because of this uncertainty in the energy markets, the EU has become a high-risk area for new industrial investments for energy-intensive industries, while existing operators have begun to shut down production, leading to further EU de-industrialisation. Major energy intensive user companies are planning or already conducting their expansion outside the EU essentially in order to benefit from long-term secure energy supply and affordable energy prices which will allow them to remain competitive on a general basis.

While there seems to be little action on gas markets, currently a few Member States, now also encouraged by the Commission’s High–Level Group, have recognised that the market failure puts at risk energy intensive industrial consumers in Europe. They have started the organisation of measures to introduce specific market mechanisms. However, this has not led to a proven European solution and there remains little current action on the gas markets.

The Alliance would ask that the actions resulting from the Green Paper support such innovative market based initiatives to meet the diverse needs of European energy intensive industrial consumers. However, more broadly, EU and national authorities should encourage and define the measures whereby EU-based energy intensive industries can survive and secure their competitiveness as soon as possible. This requires transitional measures to be put in place until such time as there is a properly functioning, fair and competitive electricity and gas market. The Alliance strongly recommends including this sense of urgency and the need for very quick solutions in the follow-up to the Green Paper.

**Better regulation enacted : measures urgently needed**

The Green Paper emphasises that industrial competitiveness requires a well-designed, stable and predictable regulatory framework, respectful of market mechanisms. This is still far from a reality in the EU, but is crucial for the required long-term stable investment climate. For this to happen, a number of measures have to be taken urgently at EU level:

- The DG Competition Energy Inquiry will correct distortive behaviour if identified and the Commission should continue to closely monitor trade practices. More measures are needed, however. The swift and forceful removal of all barriers to free competition in the electricity and gas markets should be the priority.

- The implementation of the current Directives alone will not be sufficient to solve the current market problems. The European Commission should promote a 3rd legislative package without delay, including all crucial recommendations for better market functioning, e.g. ownership unbundling of the grid-operators from integrated companies for electricity and gas markets.

- The existing price setting mechanism is a structural fault of the liberalisation process and should be transformed into a system in which an interaction of supply and demand fundamentals will again be possible, as in established functioning commodity markets. The price levels at the exchanges do not reflect market prices, as just a small percentage of consumption is traded by exchanges.

  This means that
  - short-term (e.g. balancing) prices should no longer be allowed to inexcusably function as a reference for longer-term contracts,
  - energy-intensive industries must be truly able to negotiate again, particularly in respect of long-term wholesale supply contracts, based on “arms-length” negotiations between producers and buyers - the European Commission should make it clear that it accepts such long-term contracts in the light of competition legislation,
  - the current exchanges will have to be modified in order to produce true long-term price curves, while having visible supply-demand fundamentals in the prices formed.

- More inter-connectors and infrastructure are needed, but particularly also better management of flows and connectors, and more interconnection outside the EU.
Even more importantly, ownership unbundling of production and grid on the one hand, and the unbundling of traders from producers on the other hand, are both essential elements to start creating market competition and openings to new entrants, and should form a basic element of the approach of the European Commission. In this respect, it is also important for existing production capacity to be freed, and more investments to be made. Lastly, strong independent regulators should have the authority to guarantee the functioning of the market and to provide large industrial consumers with a real choice of supplier in the future.

- New entrants are needed for base-load generation, and to make their creation possible a set of strong supporting measures should be proposed, including concerning their plant authorization.

- The ETS Review should urgently address the indirect impact of the scheme on electricity prices and competitiveness. When investigating various allocation mechanisms, attention should be paid to the substantial pass through of opportunity costs by the power producers, disproportionately impacting energy-intensive industry, and seriously eroding the international competitiveness of energy intensive industries.

- Because of the dominant positions on gas markets, much more transparency is needed in the chain of prices and costs from the origin of gas to the European borders and the subsequent translation into European price levels.

On top of the problem of non-functioning electricity and gas markets comes a range of additional costly burdens, particularly energy taxes, and promotion of renewable energy. Such double burdens should be avoided.

The development of economically viable renewable energy schemes is very important for the development of a healthy EU energy mix and the required environmental benefits. The Alliance requests that this policy be developed in such a way as to create a real “win-win” situation for all stakeholders and the environment. This policy should not disturb the existing biomass markets.

However, the current incentive schemes for Renewable Energy Sources, particularly wind energy, are distorting the power market and are adding unnecessarily substantial costs for base-load consumers. In addition, they are placing pressure on grid costs and, due to huge fluctuations, are putting grid security at risk. Renewables should be supported when the source is cost-efficient in practice compared to other CO₂ reduction measures. In addition, only types of renewable energy should be supported that can be commercially useable after a transition period. In this context, base load customers, who have a stabilising function for both the electricity grid and markets, should not be forced to pay for the (balancing) costs of peak-load renewables.

### Key actions needed

- Enforce competition and add measures to attract competitive new entrants for base load generation.
- Ensure a price forming mechanism that provides transparency and reflection of supply demand in an open market.
- Ensure full ownership unbundling of the networks from the producers.
- Ensure there are sufficient energy connections between the Member States.
- Provide a framework that allows Member States to develop transitional measures in line with State aid legislation.
- Develop and maintain appropriate fuel mix policies, including reviewing the nuclear option, to secure supply for the long term and tackle climate change.
- In parallel, use the ETS review to address the substantial pass through of opportunity costs by electricity producers, which further deteriorates the competitiveness of industrial users – instead give priority to allocation methods that promote good practice and ensure that Europe’s most CO₂ efficient plants are fairly rewarded.