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Commentary

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The market design proposal: the journey has only begun

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On 30 November 2016, the European Commission issued the Clean Energy for All Europeans package, including a proposal for reforming the electricity market design. The reform will contribute to the transition of Europe's power sector towards a decarbonised future, which accommodates renewable energy sources (RES) whilst avoiding the negative consequences for the security of supply (due to RES intermittency) and for cross-border trade (due to the fragmentation of national support schemes). This commentary argues that the proposal includes several important innovations, yet most of the work lies ahead and requires significant political will.

No business as usual

The proposal's nature is articulated around four main tendencies:

A holistic approach. First, the choice of presenting it together with the revision of the EU legislation on renewables and energy efficiency, plus a proposal on the governance of the Energy Union, is an important political signal. It shows that the holistic approach of the Energy Union is taken seriously, and that the deep interaction of power markets with the EU's climate ambitions is recognised. At the same time, the package clarifies what such a Union is about: a process towards the decarbonisation and Europeanisation of the energy system, where governance matters more than government.

Energy-only market first. Second, to restore power markets – currently unable to provide effective market signals due to overcapacity – the package adopts a traditional liberal perspective, mandating the removal of regulated tariffs to ensure adequate price signals reflecting scarcity. According to this approach, unleashing undistorted market signals would enhance investments and reduce the need of out-of-the-market remuneration for both clean energy and conventional generation.

A reconciliation between internal market and climate. Third, a sensible and courageous approach is taken with regard to capacity remuneration mechanisms (CRMs). CRMs are national schemes subsidising the available power generation capacity when it is not used, to provide a back-up at times when intermittent RES generation is insufficient. On the internal market side, the package intends to prevent CRMs from further fragmenting the EU's electricity market by requiring the schemes to be open to demand side management and foreign capacity, and conditioning the CRM's approval to a cross-border adequacy assessment. On the climate side, it also acts on the quality of capacity remunerated by CRMs, through the introduction of an emission cap of 550 grams of CO_2/kWh, therefore targeting the construction of new coal units as well as existing ones as of 2026. This is a welcome change compared to the neutral approach adopted *vis-à-vis* the UK's capacity market in 2014.

Regional solutions. Fourth, the Commission seems to recognise that EU-wide solutions for electricity markets have exhausted their potential and that it is better to focus on regional initiatives. This is made evident by the choice of not proposing to transfer further power to common supervision and regulation, but rather to use the Agency for the Cooperation of Energy Regulators (ACER) to monitor the establishment of regional structures. However, the role and authority of these structures still needs to be clarified.

Political challenges ahead

As always, big challenges lie ahead on the road to implementation. To this extent, several factors need to be taken into consideration.

Getting scarcity pricing right. Scarcity pricing is expected to provide the right signals to investments, removing the distortions stemming from price regulation – still present in 17 out of 28 member states – and the need for CRMs. However, their signals do not come from a market in perfect competition. Monopolistic positions are still present in Europe, and price regulation is in many cases intended to prevent market abuses by dominant actors. Future action here should be twofold. First, a thorough application of competition rules will be necessary to make sure that dominant actors do not take advantage of deregulation. Second, hedging instruments aimed at guaranteeing that wholesale volatility does not translate into retail unpredictability must be developed and made simple and attractive enough for all consumers.

Tackling overcapacity. Scarcity prices can be useful, however overcapacity remains the cause of broken markets. Further reconciliation is expected between the internal market and the climate agenda, as overcapacity is also a problem for the latter. It prevents adequate remuneration for low carbon generation, providing rationale for fragmented subsidisation schemes. To cope effectively with overcapacity, it is essential to act on carbon pricing, both at the EU level through a sound Emission Trading Scheme (ETS) reform, and at the national level through emission performance standards or carbon price floors in the most efficient and coordinated way. A timid step in this direction is the above mentioned emissions cap for gaining access to CRMs, which however exposes the Commission to political criticism, as many could read this as an interference in national sovereignty on the energy mix.

Coping with the political economy of the transition. Political opposition is to be expected from the most coal-reliant countries. In particular, the proposal of an emission cap for gaining access to CRMs risks infuriating Poland's Eurosceptic government, who sees the extension of the Energy Union to a broader climate agenda as a national diplomatic failure for the country that first promoted the concept of an Energy Union back in 2014, focusing merely on fuel security. Concerns about job losses are present as coal mining jobs are labour intensive, local, non-mobile and low-to-medium skilled. To have an energy transition that works for all, the concerns of communities dependent on coal should be addressed, in order to prevent the EU action on decarbonisation from becoming the scapegoat of opportunistic political forces, promising to restore 'coal greatness' against the backdrop of unsustainable market fundamentals. Here, there is work ahead for the Council. In particular, an ideal grand bargain would include the following key elements: (i) Germany accepts to assist Central and Eastern European countries in the case of gas supply disruptions, according to the mandatory solidarity proposed in the February gas package, and that European energy security concerns are adequately considered when dealing with Russia; (ii) the EU addresses the concerns of coal provinces not only through the current Council's approval of state aid to facilitate the closure of uncompetitive coal mines, but also through facilitating the establishment of regional funds for structural change; (iii) in exchange, Poland and other Central and Eastern European countries adopt a more constructive approach to decarbonisation.

All in all, the Commission's proposal remains a work in progress. Further developments in technology, consumers' preferences, and policy might need to be accommodated in the future. For the time being, it is fundamental that the ambitions are not watered down during the political process. The global climate agenda has turned power market design into a highly political international issue, where not only smooth domestic market functioning is at stake, but also the whole credibility of the EU's climate policy. European leadership is now needed more than ever due to the uncertainties introduced by the election of Donald Trump on the multilateral climate agenda.

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