

European Commission Consultation Paper on generation adequacy, capacity mechanisms and the internal market in electricity

A EURELECTRIC response paper



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EURELECTRIC response to European Commission Consultation Paper on generation adequacy, capacity mechanisms and the internal market in electricity

TF Market Design for RES Integration

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EURELECTRIC Response to European Commission Consultation Paper on generation adequacy, capacity mechanisms and the internal market in electricity

General comments

EURELECTRIC welcomes the EC consultation on CRM and generation adequacy as a timely opportunity to bring high up on the agenda the generation adequacy challenges the European electricity system is facing to date and that is likely to exacerbate further in the coming years.

EURELECTRIC fully supports the 2020 policy objectives and the decarbonisation of the electricity sector by 2050 but stresses the need to underpin a smooth transition towards a low-carbon economy on a strict coherence of national and EC policies. In order to strengthen investors' confidence needed to ensure generation adequacy, the EU should take on a holistic approach post 2020 by integrating its policies on CO₂ reduction, RES and energy efficiency into one coherent structure. The EU ETS should be the key driver to bring the EU power sector towards carbon-neutrality whilst support schemes to mature RES technologies should be progressively phased out. The EU should adopt as soon as possible economy-wide ambitious CO₂ targets for 2030 and beyond, up to 2050. Furthermore, Member States should avoid taking discretionary measures and destabilise the investment climate by introducing retroactive changes.

EURELECTRIC recognises that the promotion of renewables has brought benefits in terms of reducing carbon emissions, lowering dependency on fossil fuels and developing new technologies. However, the integration of RES is also producing distortive effects on the functioning of wholesale markets, in particular with respect to the price formation and the operation of back-up plants. This not only brings new challenges to the market design and the implementation of the third energy package but also negatively affects the framework for existing generation units and new investments. Investment decisions in RES are made primarily on the basis of the level of support rather than market price signals.

EURELECTRIC supports the stepwise development of European generation adequacy standards. The ENTSO-E generation adequacy methodology will have to be improved, in particular with regard to taking into account economic parameters of the existing and future generation assets, as well as the level and reliability of interconnection between various Member States.

Removing the various remaining distortions such as end-users regulated prices, stepping up efforts in integrating electricity markets, bringing RES into the market and developing demand response are key areas to be addressed by policy makers in order to improve generation adequacy. However, we observe that in many cases the implementation of these measures is going very slow and many member states rather continue increasing interventions in the market based on national decisions. In those markets where, in particular, generation adequacy is endangered, capacity remuneration mechanisms should be considered to ensure that enough back-up capacity is made available to the market through a coordinated regional approach amongst Member States. The primary objective of CRM should be to ensure sufficient capacity to meet peak demand. Other objectives, like promoting flexibility, reducing CO₂ etc. should not be included in the assessment as there are other policy instruments for these objectives. In order to maximize the mobilization of investments in flexible resources, the functioning of the day-ahead, intraday and balancing markets, as well as reserve management should be further improved.

If introduced, CRM should be market-based, technology neutral, ensure equal treatment of existing/new units, generation/storage/demand, be open to all market participants, take into account interconnectors and be established as a stable framework, allowing for a self-regulation that will lead to very low capacity prices when there is overcapacity and sufficient earnings in the energy market.

Developing a blueprint for a EU-wide capacity mechanism is premature. The EC should develop a set of coherent EU level compatibility criteria for the use of CRM at national level, including a request for a member state planning to implement such a measure to justify the need for such a measure.

Detailed comments

1. Do you consider that the current market prices prevent investments in needed generation capacity?

Electricity generation investment decisions are not based on current market conditions, but on the expected evolution of a number of value drivers over the lifetime horizon of the investment (20 years and more), such as:

- Expected fundamentals in the market (supply/demand balance, power/fuel/CO2 prices, etc);
- Expected evolution of regulation (charges, taxes, levies, etc.) and of policies and support schemes (RES, Energy Efficiency and CO2 targets, etc.);
- Expected evolution of environmental policies at EU level, such as emissions limits (Directives: LCP, IED, and future developments)
- Expected evolution of the operating hours of new assets in competition with other existing and new expected assets,;
- Expected impact of new technological evolutions (like smart meters on demand side, etc...).
- Expected evolution of the Emission Trading Scheme

Therefore current market prices are not the only relevant signal to trigger investments in generation capacity. In our view, the current lack of clarity about the key post 2020 policy goals and tools strongly hampers investment decisions.

In order to strengthen investors' confidence in the future of the energy sector, the EU should stick to the 20/20/20 objectives and take on a holistic approach post 2020 by integrating its different policies on CO2 reduction, RES and energy efficiency into one coherent structure. The EU Emissions Trading Scheme should be the key driver to bring the EU power sector towards carbon-neutrality, therefore the EU should adopt as soon as possible economy-wide ambitious greenhouse gas reduction targets for 2030 and beyond, up to 2050¹

¹ EURELECTRIC report "Powering Investments: Challenges for the liberalised electricity sector" December 2012)

2. Do you consider that support (e.g. direct financial support, priority dispatch or special network fees) for specific energy sources (renewables, coal, nuclear) undermines investments needed to ensure generation adequacy? If yes, how and to what extent?

Yes, but the impact depends much on how support is designed. The introduction of support schemes -to any type of generation technology- distorts price formation in any market and leads to a situation where investment decisions are based primarily on the level of support, rather than on market price signals.

The rationale behind this is that subsidies blur price signals, going against market fundamentals and economic efficiency often resulting in expensive and complex solutions, which at the end of the day are to be paid by public funds or by final consumers, creating public debt problems or high electricity bills increases. In addition, if investments are triggered by support schemes it is questionable whether such investments will indeed be the ones needed to maintain generation adequacy in the system.

Whilst EURELECTRIC acknowledges the positive role renewable technologies play in fulfilling the 2020 RES targets the distortive effect of most RES support schemes, like Feed-in-Tariffs is increasing.

As a result, market functioning is disturbed and viability of conventional generation is threatened through reduction of the operating hours, which might endanger the security of supply of the system. Additionally, this could hinder decisions of new investments in generation, as well as maintenance of existing generation fleet.

Three actions should be performed to limit the distortive effects of existing support schemes and move towards better practices in RES support: ²

- Over-compensation should be avoided as history has shown that it can lead to “stop and go” or bubble types of investments which fundamentally harm the investment climate (as it was the case for solar PV and CSP in Spain and for PV in the Czech Republic for example).
- RES generation like any other generation technologies should be incentivised to sell their own production in the market, take balance responsibility for meeting scheduling, nomination and balancing requirements on their portfolio and be subject to equivalent obligations regarding grid connection. These good practices are already a reality in many European Member States, in particular for onshore wind. It is time, however, to implement these rules in all Member States for all renewable technologies.

² EURELECTRIC response to the EC Communication “Renewable Energy: a major player in the European energy Market”, June 2012

- another effective way to reduce the distortive effect of RES support schemes such as feed-in-tariffs on the market is to move towards support schemes (e.g. contracts for differences, green certificates or variable premia), which expose producers to market dynamics and encourages the operation of power plants when energy is actually needed. A market reflective operation of RES installations leads to lower overall costs of the electricity system and allows to avoid negative prices.

We therefore call for an evolution, not a revolution in this matter and urge the Commission to take prompt and decisive action on this, so that progress can be made well before 2020.

3. Do you consider that work on the establishment of cross-border day ahead, intra- day and balancing markets will contribute to ensuring security of supply? Within what timeframe do you see this happening?

Yes. The establishment of cross-border day-ahead, intraday and balancing markets, as well as development of a coordinated process for capacity calculation will indeed contribute to ensuring security of supply, while still not solving all issues related to generation adequacy. The development of a common grid model and increased cooperation of TSOs and DSOs, including better coordination of congestion management (cross-border re-dispatch/countertrading) will play an important role in increasing cross-border capacity available for the market and ensuring more optimal regional and cross-border flows in the system. In this context, it is important to stress that in order to reap full benefits of more efficient cross-border capacity allocation, TSOs must avoid reducing interconnector capacities between markets in case of system stress situations (e.g. large RES in-feed due to strong wind conditions or high consumption). Finally, to promote security of supply it is crucial to do large scale investments into cross-border transmission capacity and new interconnectors and development of distribution grids and their smart application.

With progressing market integration, member states will have to review their national perspectives to assessing security of supply, which tend to overestimate security concerns, and move towards a more European approach, while still recognising the national political responsibility about security of supply.

The contribution of market integration to a higher level of security of supply is particularly large for markets with different characteristics. This is the case for the integration of the Nordic market, which is a hydro dominated system, with the Central-West European market, which is a thermal capacity constrained system. The contribution of market integration to a higher levels of security of supply is, however, limited for synchronous areas with limited interconnection (particularly island systems), and can only be enhanced by increased interconnection levels.

The progress in introducing cross-border day-ahead, intraday and balancing markets is still too slow and not able to keep pace with the massive growth of RES generation. In its response to the Internal Energy Market Communication published by the European Commission in November 2012, EURELECTRIC calls for urgent action from the side of the Commission, ACER and other key stakeholders to speed up progress in the NWE integration during 2013.

4. What additional steps, if any, should be taken at European level to ensure that internal market rules fully contribute to ensuring generation adequacy and security of supply?

Ensuring coherence in the internal market design, promoting convergence of market-based RES support schemes, their compatibility with the market and better use of cooperation mechanisms, as well as deletion of regulated prices are clear examples of key tasks to be undertaken at European level by the EC. This will contribute to removing distortions, which at the present significantly affect generation adequacy and security of supply.

European electricity utilities are fully exposed to a lack of consistent methodology in pursuing the three energy policy objectives of security of supply, sustainability and competitiveness. This lack of coherence in EU energy policy itself needs to be addressed. In particular, there is a conflict between the market-driven approach to energy liberalisation and to EU ETS and the various sectorial targets in renewables, energy efficiency etc. being imposed at European level.

Policies and regulation should take into account the time horizons of the electricity sector. Visibility on long-term trends and regulation, and policy consistency are crucial if generation adequacy and security of supply are to be guaranteed in the long run. In this context, we call on the Commission to publish a benchmark of discretionary measures taken by authorities (introduction of distortions in market mechanisms; discretionary taxation; retroactive changes to support schemes), which are heavily impacting the sector. Such random regulatory interventions must be avoided if we want to restore a decent and attractive investment climate in the electricity sector.

More concretely, the European Commission should aim to

- Remove market distortions, avoid counteracting policy measures and defend the market-based mechanism of carbon price as the key instrument to reduce CO2 emissions.
- Develop a reliable and clear roadmap with concrete deadlines for phasing out supports as most technologies are gradually reaching maturity
- Fully implement the 3rd energy package
- Put an end to distortive regulated end consumer prices, as well as price caps on wholesale markets

- Ensure a level playing field in the internal market by requesting Member States to stop penalizing the energy industry (burdensome tax initiatives, administrative requirements, etc.)
- Facilitate the necessary expansion of interconnector capacity
- Encourage demand response
- Improve the functioning of wholesale gas markets, in particular in order to avoid that. Hurdles in gas markets result in sub-optimal dispatch of gas fired power plants.
- Improve the liquidity of forward markets by avoiding making hedging more expensive through burdensome financial regulation for non-financial companies..

Ensure proper remuneration of generators in case of re-dispatch for congestion management.

5. What additional steps could Member States take to support the effectiveness of the internal market in delivering generation adequacy?

As mentioned in the answer to the question 4, Member States should stop various discretionary measures that are conflicting with the overall EU energy policies and endanger reaching the EU energy policy objectives. This is particularly crucial in the area of generation adequacy.

Firstly, among member states and even parts of member states, there appears to be a trend of setting “energy independence/autonomy” objectives, in the belief that even parts of member states should become energy autonomous, attaching little value to the role of interconnection and the internal market in security of supply issues. While still recognizing the national political responsibility for blackouts, investing in grid expansion, when socio-economically justified, should be seen as one of the tools to hedge at lowest cost regional security of supply using complementary generation adequacy situations in Europe.

Secondly, to support the effectiveness of the internal markets, Member States have a key role in removing distortions introduced in national regulations and reduce the degree of intervention in their energy sector. For example, in a liberalized market, generators should have freedom of dispatch and be allowed to close/mothball plants solely based on economic principles.

Thirdly, market intervention through ad-hoc taxes further interferes with the development of the internal energy market and hampers investments in power plants. Harmonization of taxation of electricity is to a certain extent provided for in the Directive 2003/96/EC (restructuring the Community framework for the taxation of energy products and electricity); Member States can however freely fix the level of taxation as long as the minima determined in the Directive are respected, and can also introduce specific tax measures, what in some cases has happened recently (new energy taxation Law in Spain implemented in 2013) , different national taxes on nuclear and on fossil fuels used for power generation). EURELECTRIC has investigated recent tax developments and found that numerous member states have established new or increased existing taxes which lead to competition distortion, hamper market integration, reduce the profitability of electricity generation assets and, as a consequence, have a negative impact on investments³.

6. How should public authorities reflect the preferences of consumers in relation to security of supply? How can they reflect preferences for lower standards on the part of some consumers?

Our belief is that security and availability of supply are among the most important requirements for the majority of customers.

At present, public authorities themselves determine the degree of security of electricity supply by setting various reliability planning standards, including Loss of Load Expectation (LoLE), which reflects the expected number of hours per year for which available generating capacity is insufficient to serve peak demand (load).

National Regulatory Authorities could carry out customer research to assess customers' preferences on quality and availability of supply and their willingness to pay to maintain or improve the existing standards. As it is not practical for imposed standards to vary, preferences for different standards across customers can only be accommodated via market solutions. At the moment there is little practical means for customers to demonstrate their choice in the trade-off between security of supply and price except for the highest consuming business customers. Approaches need to be pragmatic and recognise that different customers have different needs, preferences and potential to be more flexible or to accept different security of supply standards. Customers should have the option to offer their flexibility and benefit from the market value. Customers' preferences are only actually known once they buy a product or service. Therefore an appropriate market framework needs to be in place to enable commercial companies to develop and offer innovative products and tariffs whilst proper regulatory incentives should be adopted to allow the timely development of smart grid.

For household and small businesses, demand flexibility can provide a balancing service via a load aggregator; there needs to be a review of the criteria applied by TSOs to allow for use of aggregated demand response as a balancing service.

³ EURELECTRIC report "Powering Investments: Challenges for the liberalised electricity sector" December 2012)

Finally consumers and/or retail can also hedge their price risk (risk of price spikes because of scarcity) by concluding forward contracts (including reserve contracts and option contracts). This should be further promoted, as this will also result in remuneration of generators for having flexible capacity available. At the same time, it should be recognised that it will take time for demand flexibility to develop and to contribute to supply security and that necessary steps must be taken in order to do so. Even if in some markets, like Nordic, demand has shown elasticity during peak hours, the potential is far from being fully developed. In general, public authorities will always have to play a certain role in encouraging demand flexibility and in defining the capacity needed to ensure a predetermined degree of security of supply.

7. Do you consider that there is a need for review of how generation adequacy assessments are carried out in the internal market? In particular, is there a need for more in depth generation adequacy reviews at:

Generation adequacy must be measured against the level of system reliability in countries where it is decided upon legally or by regulators. As such, a first action could be to make such reliability requirements transparent and to develop benchmarks of these system reliability or adequacy requirements. Monitoring/assessment of reliability/adequacy should in our view be carried out on a regional scale (whenever the level on interconnection facilitates it).

However, the current European regulatory framework, mainly based on national schemes and some coordination at European level, results in a situation where Member States are concerned predominantly about ensuring national generation adequacy. Whilst they have a legitimate interest in doing so -given the political impact of power shortages - the impact on other Member States also needs to be considered.

Overall, EURELECTRIC supports that generation adequacy takes into account contribution of cross border connections. This requires a firm commitment between involved countries by sharing interconnection resources, avoiding reductions of interconnection capacities in case of scarcity, and so respecting trade agreements. Through the coupling of day-ahead, intraday and balancing markets this contribution is becoming more efficient and should thus be fully acknowledged in the national assessments.

Generation adequacy assessments should take into account the possible capacity closures also due to economic reasons and not only based on technical lifetime.

The contribution from demand response resources should be also more clearly included, together with other sources that can contribute to security of supply. With increasing demand response, the required generation capacity level will be a result of economic optimisation by the market actors between the supply and demand-side resources.

a. National Level

Based on electrical infrastructures, there are no systematic reasons to differ between national and regional levels, as cross border capacity needs to be taken into account. However, considering the diversity of situations of Member States' regulatory framework, political orientations, and considering that the current transmission system is based on historical national approaches, this scale remains pertinent to assess generation adequacy, while taking into account the contribution of interconnections by reducing or increasing each Member State capacity needs.

Detailed national reviews are already made regularly in numerous countries and should be published yearly, after thorough and transparent public consultation.

b. Regional Level

Based on electrical infrastructure, there are no systematic reasons to differ between national and regional levels, as cross border capacity needs to be accounted for.

Regions where there are specific concerns about generation adequacy (either due to specific network constraints, or crucial synergies with neighbouring countries) increasingly assess their generation adequacy specifically, and find local agreements or coordination process to ensure that generation adequacy is guaranteed.

c. European Level

As the market becomes more integrated, European generation adequacy assessments will take on greater importance and will have to consider the electrical infrastructure and system differences at European level.

8. Looking forward, is the generation adequacy outlook produced by ENTSO-E sufficiently detailed? In particular,

a. Is there a need for a regional or European assessment of the availability of flexible capacity?

Yes, TSOs should develop a regional assessment about available flexibility in the system, including generation/storage) and demand response. The level of flexibility available through the interconnections and within Member States should be properly taken into account through a regional analysis. The limitations to the dynamic use of interconnectors that are embedded in market-coupling algorithm (like Nordic-TSO imposed ramping limits on DC cables) should be assessed and analysed at a regional level rather than a national one.

Generation investment decisions, including the ones into flexible capacity (storage, demand response) will be taken by market operators, and all concerned assets should be owned and operated on a market basis by commercial parties (regulated grid operators should not own or operate generation/storage assets).

b. Are there other areas where this generation adequacy assessment should be made more detailed?

One of the drawbacks of the ENTSO-E generation adequacy outlook is related to the fact that it is based on the technical lifetime of generation assets and does not include the economic parameters of the existing and future generation. This might result in an over-optimistic assessment of generation adequacy, especially if much-increased renewable output results in low load factors for back-up generation assets, which might hence be prematurely decommissioned for economic reasons.

Furthermore, it is important to provide more complete data and better transparency of the ENTSO-E methodology used for the generation adequacy assessment. In the ENTSO-E TYNDP 2012, the general methodology justifiably includes variable RES into the 'non-usable capacity'. However, the fact that all TSOs are not using the established methodology in a consistent way requires better coordination of the work from the side of ENTSO-E.

In addition, we welcome more consistent application of probabilistic methodologies to assess the impact of RES, but want to stress that for the proper use of these techniques the accurate modelling of the variable sources, which is indeed not easy to do, is of paramount importance.

9. Do you consider the Electricity Security of Supply Directive to be adequate? If it should be revised, on which points?

Yes, the Directive is adequate. The Directive 2005/89/EC sets forth the general principles that Member States have to follow to ensure an adequate level of security of supply without creating excessive burden on final customers. Notwithstanding those principles, Member States still enjoy a certain amount of leeway to achieve the results dictated by the Directive. As a result, in the absence of specific regulations at European level, aiming to define common criteria to assess security of supply, Member States have adopted different approaches.

In general terms, EURELECTRIC considers the Electricity Security of the Supply Directive to be adequate even if we acknowledge a lack of coordination between member states at European level, which is to be improved in the future.

The development of Network Codes (like Operational Security, Capacity allocation and Congestion management with its chapter on capacity calculation) will help to ensure a more harmonised approach to operating the European system and will thus contribute to greater supply security.

10. Would you support the introduction of mandatory risk assessments or generation adequacy plans at national and regional level similar to those required under the Gas Security of Supply Regulation?

No. One to one equivalency is neither feasible, nor appropriate since other factors intervene in security of supply in electricity that adds a different complexity than in the case of gas. Important differences exist in terms of security of gas and electricity supplies. Security of electricity supply is rooted in a short-term dimension, i.e. keeping the lights on by avoiding that imbalances in demand and supply create disturbances and a cascading effect on the grids that leads to black-outs. In gas, on the other hand, much of the focus has been on the EU's dependency on a small number of external suppliers and on long-distance transportation of the energy.

EURELECTRIC believes that risk assessment is a good tool to monitor the level of security of supply, but at the same time recognizes that the existing non-binding TYNDP performed by ENTSO-E, already embeds the concept of security of supply (Regulation 714/2009). As a first step, it would be preferable to enhance the transparency of the TYNDP in terms of regional planning (see also EURELECTRIC response to ENTSO-E Ten-Year Network Development Plan 2012 Package) and to perform an additional focus on the ability of the system to integrate variable resources. The drafting process of Network Codes, in particular Operational Security and (Cross-border) Balancing will give additional instruments to organise a more harmonised approach and actually bring elements that are similar to those in the Gas Security of Supply Regulation.

11. Should generation adequacy standards be harmonised across the EU? What should be that standard or how could it be developed taking into account potentially diverging preference regarding security of supply?

Yes. Europe should move towards harmonised generation adequacy standards as network infrastructure and the European market becomes more integrated. In a pan-European market, it is not possible to assume that capacity located in one country only contributes to that country's security of supply. Moreover, a harmonised approach is necessary to avoid the risk of distorting cross-border trade.

At the same time, security of power supply is of key importance to member states and while a specific regulation at European level remains absent, the only regulation in this respect, i.e. Directive 2005/89/EC empowers each Member State to tackle its own security of supply. Moreover, the structures of the power system (like generation mix, presence of hydro reservoirs, level of connections etc.) vary widely among the different member states. Therefore it seems quite difficult to really obtain such harmonisation in the short term.

A pragmatic way forward would be that the European Commission outlines harmonized general principles that member states should comply with and that member states start cooperating at regional level to gradually move towards European adequacy standards, taking also into account cross-border network capacities. Having the same generation adequacy standards, however, is not enough to ensure the same level of investments across Member States. Other conditions already mentioned in previous answers should be fulfilled, in particular when it comes to creating a level-playing field between Member States and among all generation technologies.

12. Do you consider that capacity mechanisms should be introduced only if and when steps to improve market functioning are clearly insufficient?

To enhance electricity markets' ability to deliver generation adequacy, governments and regulators must first of all allow energy-only markets to function properly. To this end, distortions, which hinder the balance of demand and supply, must be removed. Such distortions include regulated end-user prices, restrictions on plant operations, price caps, and other regulatory or administrative measures, which unnecessarily hinder wholesale market outcomes.

At the same time, integration of wholesale markets and strengthening of transmission and distribution capacities (both domestic and cross-border) must remain a top priority for EU and national policymakers.

In view of enhancing and speeding up the integration of renewables into the EU system, RES generation, like any other generation technology, must progressively enter into the market on a level playing field with all other generators. In particular they should be incentivised to sell their own production into the market as well as to meet scheduling, nomination and balancing requirements as other generators do. In addition, there should be progress towards converging market-based support mechanisms across Europe.

Enabling market-based industrial demand to participate in wholesale market spot price formation will be fundamental for a well-functioning electricity market. This could reduce peak capacity demand and the need for flexible “back-up” plants, but estimates vary about how far this potential will be exploited. Enabling demand response must therefore be one of the core elements of current energy policies.

All abovementioned improvements will undoubtedly be necessary in all EU markets to minimise the system costs of ensuring generation adequacy. They should, therefore be pursued by policymakers in parallel with the increased penetration of RES generation. However, we observe that in many cases the implementation of these measures is going very slow and many member states continue rather increasing interventions in the market based on national decisions

Due to the fact that the starting point and the implementation of the abovementioned measures is largely different across Member States, in some EU markets it appears unlikely that all market improvements will indeed be implemented in due time.

In those markets, and in particular, in the situation when generation adequacy is endangered), policymakers should consider introducing or maintaining a capacity remuneration mechanism – ideally at a regional level or at least in coordination with neighbouring markets. In any case, consistency with the process of EU market integration should be ensured. Taking into account the imports capacity through cross border interconnections to evaluate the residual capacity needs of each system should ensure this consistency⁴.

13. Under what circumstances would you consider market functioning to be insufficient:

a. To ensure that new *flexible* resources are delivered?

The ability of the market to ensure that the necessary flexible resources are delivered is endangered by various national interventions, which are penalising the energy industry. Only in case authorities do not intervene in the market and accept price signals such as price spikes and price volatility, energy and balancing market will be able to deliver the necessary price signals for flexibility.

Flexibility should be remunerated by energy and balancing markets and/or systems services (including Demand Response), which should all be improved to ensure that all the flexibility is “produced” at the lowest cost, and that the flexibility cost is borne by those players who are causing imbalances.

⁴ EURELECTRIC report “RES integration and market design: are capacity remuneration mechanisms needed to ensure generation adequacy?”, May 2011

There are developments (pilot projects) in some member states in which TSOs and/or DSOs develop and operate storage. Such developments should be strongly rejected as the market is and should remain responsible for storage. Otherwise the regulatory uncertainty for the market would increase and the risk for inefficient investments in storage/flexibility would increase.

b. To ensure *sufficient* capacity is available to meet demand on the system at times of highest system stress?

Markets will only function properly if regulation allows revealing appropriate price signals. The ability of the market to ensure sufficient capacity is available to meet demand of the system can be endangered by various national interventions, which are detrimentally impacting the ability of the market to reveal the appropriate price signals. Such distortions include regulated end-user prices, restrictions on plant operations, price caps and other regulatory or administrative measures, which unnecessarily hinder wholesale market outcomes. In addition, various energy taxes, injection tariffs, etc. also imply competition distortion and large differences in market attractiveness for energy investors across Member States.

There is also a large uncertainty about how RES, CO2 and Energy Efficiency policies will evolve after 2020. Sudden, discretionary and unsustainable market interventions have already destabilised investors' confidence and postponed investment in new and existing reliable power generating capacity. Therefore, as a first fundamental step, energy markets must be allowed to function properly by removing distortions, which hinder the demand and supply balance.

At the same time, integration of wholesale energy markets must remain a top priority. Also, RES generators must progressively enter into the market on a level playing field with all other generators. This means that they should be balance responsible, and support schemes should expose them to market prices (via variable premiums, green certificates, etc.). Finally, enabling market-based industrial demand to participate in wholesale market spot price formation, intra-day markets and balancing markets is fundamental for a well-functioning electricity market, although difficult to achieve.

Due to the fact that the starting point and the speed of implementation of the abovementioned measures is largely different across Member States, in some EU markets the abovementioned measures might not be implemented in due time to ensure generation adequacy. In those markets, and in particular, in the situation when generation adequacy is endangered, capacity remuneration mechanisms, could be considered as a complementary and necessary tool to ensure that enough capacity is made available to the market.

14. In relation to strategic reserves:

- a. Do you consider that the introduction of a strategic reserve can support the transition from a fossil fuel based electricity system or during a nuclear phase out?**

The concept of a strategic reserve has a number of positive features as a transitory measure to ensure the system can cope with peak demand. It can be easily implemented and easily abolished. The strategic reserve has a limited disturbing effect on the energy market as long as it is used in exceptional, clearly defined situations only.

However, strategic reserves do not represent an appropriate tool to incentivise investments in new generation. Depending on detailed design, the strategic reserve would rather be suitable to keep in operation existing plants, delay decommissioning of non-profitable units that are however necessary to ensure security of supply and incentivise demand response.

Furthermore, strategic reserves do not appear to be an effective instrument for a transition from a “fossil fuel” to a “low carbon” system where the transition passes via a massive introduction of variable renewables. Strategic reserves consist mainly of “out of the money” plants. Therefore these plants should not be dispatched on a “regular” basis, but only when security of supply is endangered.

A stable regulatory framework, long-term envisaged energy policy and e.g. a strong EU ETS are significantly more effective tools to achieve the climate objectives. At the same time, strategic reserves could prove to be necessary to serve as insurance in disruptive periods with high uncertainties.

- b. What risks, if any, to effective competition and the functioning of the internal market do you consider being associated with the introduction of strategic reserves?**

As long as the strategic reserve is controlled by the TSO, used as a last resort measure and never interfere with the price formation it would not deteriorate competition. To avoid interference with long term investment signals it must not in any way decrease wholesale prices. It should only be used to as a last resort to in real time help supply meet demand. To ensure that normal market dynamics are allowed to work, any strategic reserve should preferably be dispatched at Value Of Lost Load (VOLL) or alternatively at the technical max price used at spot market exchanges. This technical max price must be considerably higher (e.g. at the 3000 €/MWh level in CWE, and not at the 180€/MWh level as applied in Iberia) than normal scarcity prices so to ensure that no competitive offers are crowded out.

15. In relation to capacity markets and/or payments:

- a. **Which models of capacity market and /or payments do you consider to be most and least distortionary and most compatible with the effective competition and the functioning of the internal market, and why?**

Capacity mechanisms should only be introduced in order to ensure operation of existing units and investments in generation/storage capacity needed to meet peak demand or in demand that will provide sufficient back-up for variable generation, They should therefore be based on the combination of their efficiency at achieving the target they were set-up for and their compatibility with efficient competition and functioning of the internal market. Other objectives like reduction of CO2 emissions, promotion of flexibility or weakening of incumbents' dominant positions should not be taken into account when designing and introducing CRM.

The capacity mechanisms should be **technologically neutral** and **market-based** in order to avoid any discrimination between technologies or participants and in order to reveal the scarcity value of capacity. Any mechanism that discriminates between different technologies, different type of companies, existing or new built and between generation, demand response or storage would be distortive to the energy market. The CRM should ensure that all capacities (be it generation/storage or demand) contributing to security of supply that delivers the same service (i.e. availability) receive the same remuneration.

The mechanisms should be **forward looking**. They should rely on an analysis of future system needs performed by TSOs in order to ensure that enough capacity is kept in operation and built on time to ensure security of supply while avoiding at the same time inducing overcapacities. These analyses should ideally be performed **in a coordinated way at national, regional and European level** in order to reveal the level of need in every country while taking into consideration the existing and anticipated interactions between markets. They should **not impact the way capacity is offered on the energy markets**, including the existing and anticipated cross-border transmission capacity.

The mechanisms should be **transparent** in their design and application in order to minimize the regulatory risk for investors.

- b. **Which models of capacity market and /or payments do you consider to be most compatible with ensuring flexibility in a low carbon electricity system?**

Flexibility should be incentivised by the energy and balancing markets and/or through ancillary services, and not by capacity markets. This is important to achieve competitive capacity markets where all capacities contributing to security of supply receive remuneration proportionate to their contribution.

c. Are there any models of capacity mechanism the introduction of which would be irreversible, or reversible only with great difficulty?

It is not the existence of the mechanism in itself that should be reversible, but rather its impact on the market. If the mechanisms are market-based, the scarcity value will automatically drop to low values when there is overcapacity and sufficient earnings in the energy market. Market-based mechanism might therefore remain active without producing an impact (minor overall costs) on the market, and therefore being ready when needs appear again. Any retroactive change must be avoided. A strategic reserve could be designed as reversible.

16. Which models of capacity mechanisms do you consider to have the least impact on costs for final consumers?

Market-based approaches with as few parameters as possible, and leaving as much room for the market as possible, will create lower costs compared to models with numerous targets and administratively set parameters. In assessing the total costs and benefits for end- consumers, not only the very short-term but also the long-term effects should be taken into account.

It is also important to realise that for final customers, not the “cost of CRM” is important, but the total system cost, including the energy cost and the CRM cost. A capacity mechanism (generally speaking) will reduce the energy cost.

Selective approaches might be less expensive in the very short-term, but more expensive in the long run. Supporting new build generation units only would lead to the result that existing units are pushed out of the market and hence prematurely closed down, which will lead to a larger demand for new units and hence higher overall costs to consumers. The CRM costs for end-consumer will strongly depend on the determined level of required capacity, including the determined reserve margin and interconnection capacity. In this context, it is important to stress that Member States should determine the reserve margin and hence the level of capacity required in the system, which should not restrict the technology.

When setting the “level of required capacity”, it is necessary to use models that integrate capacity from “abroad”, as an integrated approach will reduce the amounts of capacity needed, and avoid overcapacity in the whole system.

17. To what extent do you consider capacity mechanisms could build on balancing market regimes to encourage flexibility in all its forms?

Not at all. Capacity mechanisms should aim at ensuring that enough capacity is in place and available. Using capacity mechanisms to encourage flexibility would imply some type of technology discrimination that in EURELECTRIC's opinion should not exist. Mixing the objectives of generation adequacy and generation flexibility may result in discriminatory, complex and less transparent mechanisms, which increase consumer costs.

Balancing markets are encouraging and remunerating flexibility together with energy markets, providing natural demand for technological characteristics like ramp-up rates. CRM address fundamentally different system needs than balancing markets. CRM, unlike balancing markets, are designed to incentivize sufficient generation/storage assets, as well as demand response to back up the intermittency of RES. CRM, unlike balancing markets, are also more suited to promote technology non-discriminatory competitiveness in procuring the services which are required to maintain adequate security margins, including from technologies such as Storage and Demand Side Response.

18. Should the Commission set out to provide the blueprint for an EU-wide capacity mechanism?

No, developing the blueprint for a EU-wide capacity mechanism is premature.

First of all, there is currently no specific regulation that tackles security of supply at European level. Security of supply under the Directive 2005/89/EC falls on the different National jurisdiction. Therefore Member States are entitled to set up their own national capacity remuneration mechanisms.

Furthermore, a single EU-wide capacity mechanism might not be feasible, as differences among regions, as far as specificities of their electricity systems (e.g. penetration of RES, conventional mix, level and type of interconnection, level of reserve margins, market design etc.) are concerned, make it currently difficult to use "one-size-fits-all" solutions.

Finally, the starting point is different across Europe. In some countries CRMs already exist or the introduction of the CRM is on the way, while other countries do not at all envisage this concept.

The implementation of the Target Model and new Network Codes, including reliability criteria and relevant operational procedures, are key elements to be put in place before a roadmap for an EU-wide capacity mechanism could be implemented. Any other market distortions (impacting investment decisions, like taxes, injection tariffs etc) should also be addressed properly.

What is more important is that ACER and the European Commission (in cooperation with all relevant EU and national stakeholders) develop a set of coherent EU level compatibility criteria for the use of capacity remuneration mechanism at national level, including a request for a member state planning to implement such a measure to justify the need for such a measure.

Practically speaking, these guidelines could be adopted to promote the development of coordinated methods to assess the cross-border contributions to the security of supply of each zone and common European sets of scenarios for variable generation and random events. This should guarantee the well-functioning of regional markets and compatibility under the framework of the Internal Electricity Market.

In addition, developments in national markets should be closely monitored to prevent CRM, as well as other security-driven mechanisms, distorting the internal energy market and its competitive dynamics. Therefore guidelines should be agreed upon at EU level (or published by the EC) in order both to identify and quantify the created distortions coming from a lack of CRM harmonization, as well as to facilitate MS cooperation in these issues and to prevent the emergence of nationalistic industrial policies. The key requirements as discussed under question 20 are a very good starting point for this process.

19. Do you consider that the European Commission should develop detailed criteria to assess the compatibility of capacity mechanisms with the internal energy market?

Yes, the European Commission has to ensure compatibility between the regulatory framework and the internal energy market and put all necessary measures and tools to remedy possible incompatibilities or design mistakes. In this sense it would be advisable that the Commission focuses not solely on a forthcoming regulation, but also on the current situation. Regulatory mistakes that have led to an excessive share of electricity production decoupled from market prices at the expense of large costs to final consumers need to be tackled with the utmost sense of urgency

If an impact assessment indicates that capacity remuneration mechanisms are necessary, they must be designed in accordance with market principles. Therefore, EURELECTRIC believes that the European Commission should develop a set of EU level compatibility criteria for the use of capacity remuneration mechanism at national level, including a request for a member state planning to implement such a measure to justify the need for such a measure.

Moreover, attention will have to be paid to implementation modalities of national CRM to ensure their adequacy.

In this context, it is also important to stress that before developing detailed criteria to assess the compatibility of CRMs with the IEM, the EC should focus on analysing market design distortions, regulatory interventions and long-term uncertainties / perceived risks, which in many Member States have triggered the need for CRM to counteract their impact on market efficiency. The EC should assess the compatibility of these distortions and interventions in each Member State with the IEM and propose measures to remove them.

20. Do you consider the detailed criteria set out above to be appropriate?

EURELECTRIC supports many of the criteria developed by the European Commission. However, several others that consider implementation of capacity mechanism to be temporary and limited in time, should be adjusted. If introduced, a sustainable mechanism would ensure that if there is no risk on capacity adequacy, the cost of the mechanism will be negligible. For example, this implies that, if more interconnections are built towards a neighbouring country with over-capacity, if energy efficiency measures effectively succeed in lowering demand, the capacity mechanism should signal a lower need for capacity in the system, by means of a self-regulated instrument that will lead to very low capacity prices when there is overcapacity and sufficient earnings in the energy market.

1. The necessity for a capacity mechanisms should be clearly established in the context of:

- a) The potential of the identified needs being met in the normal operation of the internal energy market, in particular:*
 - i) Increased interconnection and in particular the completion of identified projects of Common interest.

Yes. However, increased interconnection capacity between bidding zones doesn't not remove the need for a certain amount of generation at local level for internal congestions and to ensure dynamic system stability and variable RES backup.

Besides, development of interconnections has to be combined with increased transmission and distribution capacity within each bidding zone to prevent any new or increasing internal congestion problems.

We also need to be aware that the pace of development of RES and grids is completely different, which could lead to local system integrity issues arising. Local generation capacity might be needed for grid stability or until congestions are removed and interconnection capacities allow imports from another Member State.

The anticipated deep evolution of the electric system with its move towards more decentralization and RES generation capacity connected mainly to the distribution grid requires that DSOs play a more active role in ensuring reliability and continuity of supply by notably facilitating the market in providing flexibility to their grids and developing additional system services.

- ii) Steps to encourage effective competition by addressing the position of dominant undertakings.

Effective competition and market integrity should be ensured by existing regulation and legislation including REMIT. In a European integrated market the position of any player in a local market will be less relevant.

- b) Alternative, less distortionary measures, which could be taken, for example steps to improve energy efficiency or reduce electricity demand.*

Demand response is important for generation adequacy and should be put on equal footing with generation and storage. Energy efficiency and reduction of electricity demand are not “alternatives” for a capacity mechanism, but they are important drivers for a sustainable power system. Unlike demand response measures do energy efficiency measures not necessarily reduce peak demand or improve the match between demand and supply at any time. A lower electricity demand would not change the fundamental situation for generation adequacy. Short term it might lead to closure of some more existing generation units and no need for new investments in conventional generation, storage and demand response solutions. Therefore, investors need a clear view on energy efficiency and demand reduction policies in order to be able to take the right investment decisions. It should be noted that increasing energy efficiency can lead to higher electricity demand, for example by introducing heat pumps or electric cars. It could as well be questioned if some of the current energy efficiency measures can be considered to be less distortionary.

- c) Removing barriers to the effective participation of demand in the electricity market.*

Yes. Participation of demand is fundamental for an electricity market to function properly. It is important to keep in mind that too low set price cap levels in some markets or regulated tariffs are hampering effective demand side participation. To enable end consumers participation in the electricity market, prices need to be fully liberalized. Demand should participate in CRM on equal (not better) footing with other technologies.

2. The effectiveness of the capacity mechanism addressing the identified market failure should be demonstrated and that it is additional to what would have occurred under normal market rules.

Yes. However, a comparison of a possible new situation (with CRM) with a theoretical situation (without CRM) will be difficult as once additional generation capacity investments are achieved, energy prices will by definition be affected. Furthermore, in the meantime many other fundamental parameters will also be evolving (fuel prices, economic situation etc).

3. The duration of the application of the capacity mechanism should be clearly limited and clearly specified,

This might be difficult to implement, but the same effect could be achieved by having the capacity price determined in a competitive market-based way, which gives a self-regulated instrument that will lead to very low capacity prices when there is overcapacity and sufficient earnings in the energy market. The mechanism might therefore remain active without producing any effect on the market having minor overall costs, and could be reused again when a need for capacity reappears.

It is important that no retroactive changes are made to the introduced CRMs.

- a) *The impact on the market of the introduction of capacity mechanisms should not make it difficult to reverse that decision in the future.*

A market-based capacity mechanism will lead to an automatic adjustment of the capacity price (scarcity value dropping to low values) whenever there is overcapacity.

- b) *The necessity of retaining reinstating a capacity mechanism should be subject to review.*

Yes, but care should be taken to avoid increasing regulatory risk, which is likely to damage investor confidence and drive up costs.

The more self-regulated elements a mechanism offers, the less regulatory interventions are necessary. Therefore it should be clear for investors under what circumstances and in what way the mechanism might be reviewed.

4. Any capacity mechanism should be open to electricity undertakings operating in other Member States, to the extent they are able to make the electricity available in markets to which the capacity mechanism is established.

Yes. This could theoretically be achieved by having a common capacity mechanism for several bidding zones. If the capacity mechanism were organised as a market, there could be auctions per bidding zone according to the same principles as market coupling. In case there are no congestions, the auction will result in a common capacity price (and a minimum of needed capacity for the whole of the area). In case of congestions, price of capacity will be higher in bidding zones with more scarcity in the same way as during the day-ahead market coupling.

Cross-border capacity selling would be more difficult in case there are different capacity mechanisms (e.g. capacity payment model versus a capacity ticket model) in different bidding zones or no capacity mechanism at all in some bidding zones.

However, as far as there are no long-term access right to interconnections, a pragmatic and efficient approach is to consider capacity offers at Member State level and to take into account the contribution of interconnections by reducing or increasing each Member State capacity needs.

5. Any capacity mechanism should not act as a barrier to cross border trade or competition in the internal market by:

- a) *Artificially altering trade flows or the location of production, in particular by:*
 - i) Restricting the ability of electricity undertakings in the Member State to sell their electricity to customers elsewhere in the internal market, (i.e. capacity physically located in a Member State should not be reserved for that Member State).

Yes it is important that impacts on cross-border competition are minimised. A capacity mechanism should not directly interfere with energy markets functioning. Development of cross-border Day-Ahead, Intraday and balancing markets will ensure efficient cross-border trading. However, different capacity mechanisms, in particular when the objectives (e.g. the amount of needed capacity) are set differently, will distort cross-border competition, in the same way that existing national regulations are disturbing the level playing field, leading to reduced market efficiency.

- ii) Distorting the commercial behaviour of generators in the day ahead and intraday markets.

Yes it is important that day-ahead and intra-day markets are not disturbed. Capacity mechanisms should be complementary and should not interfere with energy markets functioning.

CRM is only remunerating “availability”, not “the effective generation”. For that purpose, specific rules to verify the availability are needed in order to pay for the reliability, not for “imaginary” capacity. But these rules should not lead to “must run” situations of the plants to prove availability, in particular if the plant is “out of money” because exactly such a rule would indeed affect the merit order and thus the energy prices in the market.

- iii) Distorting investment signals in the internal market leading to inefficient locational choices.

Yes. One of the key features of a CRM is to allow keeping existing generation units in operation and attract needed investments in a certain market. In order to minimise inefficient locational investment choices, it is important to coordinate the CRM with neighbouring markets, taking into account cross-border capacities, by setting appropriate “needed” reserve margins, etc.

- iv) Distorting investment signals in the internal market leading to the displacement of new investment from one Member State to another.

Yes. See also iii)

b) Distorting dynamic incentives/crowding out;

- i) The incentive on consumers or generators to respond to high prices at periods of scarce capacity should not be diminished.

Yes, demand response to price signals should be an integral part of the design. This means that there should be no regulated end user prices. The mirrored reaction should hold true in periods of very low electricity prices

- ii) The mechanism should not undermine incentives on the electricity market to deploy new techniques for demand reduction or electricity storage and generation.

Yes. Please note that EURELECTRIC would prefer to use the term “demand response or participation” rather than “demand reduction” in order to reflect better the reality (i.e.: demand is responding to price signals like generators).

c) Creating market power or exclusionary practices;

Equal treatment of all market participants, consumers, retailers, existing and new generators (including storage operators) irrespectively of technology has to be ensured.

- i) The mechanism should not strengthen or maintain the market power of incumbent firms.

The mechanism of CRM shall be designed independently of market power. Competitions issues shall be addressed by other regulatory frameworks. The EU target being a European integrated market, the position of a player in a local market is not relevant. Moreover, if implemented, a capacity market should be on a level playing field for all actors and not entail competitive distortions. EURELECTRIC considers that with one instrument only one target should be achieved. By putting too many different targets into one instrument the instrument becomes complex and less efficient.

Effective competition and market integrity should be ensured by existing regulation and legislation including REMIT. In a European integrated market the position of any player in a local market will be less relevant.

- ii) The mechanism should not act to maintain inefficient market structures or undertakings, acting to deter new entry.

Yes. If implemented, a capacity market should be on a level playing field for all actors and not entail competitive distortions.

6. To be non-discriminatory a capacity mechanisms should

a) Be allocated after an open competitive bidding process.

Yes, the capacity price should be determined in a competitive way (e.g. auction, traded certificates).

b) Allow demand response and energy efficiency solutions to bid into capacity markets on an equal basis to generation.

As stated under question 20, 1, b) energy efficiency is not an “alternative” for a capacity mechanism, but it is an important drivers for a sustainable energy system. The European Commission should make a careful distinction between “energy efficiency” and “demand response”. Energy efficiency leads to a “permanent” elimination of energy need, while demand response is a “short term” reaction. Capacity mechanisms should not be the instrument to achieve energy efficiency. Indeed the energy (bill) savings should be the main driver for this goal, taking into account also the other instruments suggested in the Energy Efficiency Directive.

There should be no discrimination between comparable capacities (one product = one price principle). A capacity mechanism must respect free market rules in an environment based on a level playing field for all actors, but to obtain this level playing field, availability criteria for generators, demand response and storage should reflect market needs. Some market participants might offer secure generation for long periods and other market participants might offer short term demand reduction. This has to be reflected in the CRM based on the capacity needs in the market.

7. Not be confined to any particular generation technology, i.e. being tech. Neutral (insofar as the mechanism is directed towards security of supply concerns – this may not apply if other objectives are also being pursued).

Yes, there should be no discrimination between technologies, subject there is a level playing field in the service they offer (one product = one price). CRM should certainly not apply to only new capacity as that will in the short run only result in overcapacity and in the long run will have no positive effect since existing generation will have to close down.

EURELECTRIC considers that with one instrument only one target should be achieved. By putting too many different targets into one instrument the instrument becomes complex and less efficient. Carbon emissions should be incentivized by emission trading and flexibility should be ensured by energy, reserve/balancing and system services markets. Existing units should not be discriminated and there should as well be no discrimination between different market participants.

8. Capacity mechanism should be at least cost:

- a) The direct costs imposed on suppliers or others electricity undertakings must be kept to the minimum necessary.*

Yes. A capacity mechanism must aim for the most cost effective solution for the whole power system, taking into account both the CRM cost and the energy cost. However, the cost of a capacity mechanism depends on how the parameters (reserve margin, possible strike price) have been set. Therefore those parameters will have to be defined on a regional/European level (see point 4 on cross-border capacity coupling), or at least be taken into account in the evaluation of the needs the possible import capacity provided by cross border interconnections. Please see also our response to question 16.

We also want to reiterate that for the customers, the “total cost” (i.e. CRM cost + energy cost) is important, having “more or less” capacity in a system (due to the settings in the CRM) leads to respectively “higher or lower” CRM costs, but accordingly to “lower or higher” energy costs for the customers.

b) Persons providing capacity under the obligation must not be overcompensated.

Yes. A well implemented capacity mechanism, respecting free market rules in an environment based on a level playing field for all actors and solely pursuing security of supply, will not lead to overcompensation but will lead to – efficient – market prices both for the CRM as for the energy. It is therefore important to involve electricity consumers, as well in order to have sufficient competition in these markets. When both CRM and energy prices are market based, it should give all stakeholders, generators, customers and also regulators sufficient confidence in price setting and create more trust for investors to invest.

c) Any selection process in the mechanism should be conducted in a transparent, open and non-discriminatory way which is market based.

Yes.

d) The duration of any compensation to generators under the mechanism should be clearly justified.

Yes. A well implemented capacity mechanism must offer sufficient predictability and stability to all actors, investors and customers (they should be associated with a predefined time horizon to offer sufficient predictability and stability to all actors, investors and customers.. Please see our response to question 20, 3 a).

9. Costs associated with capacity mechanisms should be allocated to the beneficiaries of secure energy supply with different classes of consumers being treated in a non-discriminatory way.

Yes. However, customers could also participate in the secure energy supply via demand response. Therefore a well-designed capacity mechanism should avoid “overcompensation” for generators as well as “double discount” for customers.

20 a. Should any criteria be added to this list?

No, the list of criteria seems to be complete.

20 b. Which, if any, criteria should be given most weight?

It is most important that any capacity mechanism is properly rewarding capacity, that no other policy objectives are pursued with this mechanism and that it is market-based, open to all market participants and not discriminating between new and existing units, different technologies or between generation, storage and demand response. Otherwise costs to consumers will be higher than necessary.



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