



Comments on the Interim Report of the Sector Inquiry on Capacity Mechanisms

Paris/Leipzig, 6 July 2016

On 29 April 2015 the Commission launched a sector inquiry into the financial support that EU member states grant to electricity producers and consumers to safeguard security of electricity supply (capacity mechanisms). EEX and EPEX SPOT provided a joint response on the accompanying consultation on 17 June 2015¹.

This document summarizes EEX and EPEX SPOT's comments on the interim report and the tentative conclusions of the sector inquiry published on 13 April 2016. In the report, the Commission draws several tentative conclusions on whether capacity mechanisms can ensure the security of electricity supply and on how capacity mechanisms impact the functioning of the EU internal energy market.

EEX and EPEX SPOT explicitly support the interim report's conclusion that wholesale electricity markets (the 'Energy Only Market') are able to provide the price signals necessary for investment, while defining clear criteria and requirements for capacity mechanisms where they are being implemented in order to minimize their impact on electricity markets. Going beyond this general conclusion, we would like to offer the following specific comments on the interim report:

I. Generation adequacy

- The continued integration of the internal energy market needs to be the basis for ensuring sufficient flexibility in the short term, as well as generation adequacy in the mid and long term. This means that any flexibility or generation adequacy measure must be designed and introduced taking into account the common goal of the completion of the integrated internal energy market.
- We agree that harmonized and more transparent ways of determining generation adequacy levels and reliability standards would contribute to make the need for different intervention levels more objective and improve cross-border comparability.
- Each European Union member state has to consider carefully whether capacity mechanisms are needed or not. We first and foremost recommend the swift finalization of the Internal Energy Market, as well as tapping the full potential of Energy Only Markets, including balancing markets and wholesale markets.
- In EU member states with mature energy markets, the Energy Only Market is the preferred solution to address the flexibility challenge, with continually further developed, well-functioning balancing markets as a part of it. Market-based reference price signals shall be the basis of decision-making for market participants.

¹ Please find the responses at <http://www.eex.com/download/en/7430> and [link to EPEX website](#)

- In EU member states where the further enhancement of the Energy Only Market proves inapplicable or insufficient to counter acute challenges to the security of supply, complementary capacity mechanisms need to support the completion of and be in line with a well-functioning Internal Energy Market. Such capacity mechanisms need to comply with the overall goal of an integrated European internal market for electricity i.e. be market-based, non-discriminatory towards technologies and foreign producers and coordinated across borders.
- Capacity mechanisms must be carefully designed with specific attention to transparent and open rules of participation and a capacity product that does not undermine the functioning of the electricity market. Participation of neighboring countries should be pursued but capacity markets should not lead to reservations of interconnection capacities that would be withdrawn from the energy market.
- We agree with the interim report's assessment that any capacity market should remunerate availability, rather than delivery of energy. Only this can reduce distortions on market coupling where such mechanisms are introduced.
- Any assessment of the introduction of capacity mechanisms must take into account and rule out the possibility of the development of additional mechanisms as to compensate other capacity sources, as the interim report points out. Besides Spain, the market in Great Britain is another example of this 'snowball effect' that the report refers to.

II. Further development of Energy Only Markets

- As stated in the interim report, the further development of Energy Only Markets and balancing markets should be pursued first before additional measures are taken. In so doing, in particular the concepts of liquidity and price signal, price peaks, new products on the market and the question of bidding zones should be discussed and taken into consideration.

Price signal

- Electricity prices should continue to provide a strong market price signal so that the right incentives are given to both producers and consumers and electricity is imported from the right place at the right time.
- Free price formation is the basis for the efficient functioning of Energy Only Markets. In particular, the setting of regulatory price caps must be avoided. Necessary technical price caps will be defined by marketplaces in a way that does not interfere with free price formation on markets.

- The interim report correctly recognizes the negative effects of long term capacity contracts put in place in some member states. Such contracts take away all the investment risk from investors instead of reducing risks when price peaks occur. In addition, they discriminate between old and new installations, and distort competition between domestic and international capacity, thereby distorting the level playing field that is essential to the markets' efficient functioning. Encouraging these contracts would be a clear step back for the development of the internal energy market.
- The market is already delivering a long-term price signal. Market participants can hedge themselves against price fluctuations in the spot market by participating in the derivatives market. These markets are increasingly liquid, offering a long-term price signal for market participants. In that context it is important to acknowledge that the question is not for how many years into the future the market is liquid and trading participants can hedge themselves but that the regulatory framework is stable and reliable. The criticism which is sometimes raised that electricity and gas markets lack liquidity in the long end (e.g. maturities in four, five years) has in so far no substance. Hence, there is no need for additional measures, such as the introduction of additional long-term contracts. The market is fulfilling its role.

Hedging products

- The importance of the derivatives markets with regard to the integration of renewables is constantly growing. The market is already delivering new financial products that are supporting the efficient functioning and further development of Energy Only Markets. For example, in September 2015, EEX and EPEX SPOT jointly introduced cap futures and enabled hedging against price peaks in the short-term intraday market. This financial product will ensure a better remuneration of flexible generation capacity. Other examples are 15 and 30 minute products, cross-border continuous intraday trading, and lead-time reductions across various markets.
- Additional hedging products, such as for weather risks, are currently implemented and short term future contracts (e.g. day and weekend contracts for peak-load in the French, Italian Dutch, Swiss and Nordic market areas) are launched which facilitate hedging risks stemming from marketing renewables.

Bidding zones

- Regarding the assessment of bidding zones, it is crucial that the on-going processes are well-aligned and coordinated. The sector inquiry should take into account more accurately results of existing European processes foreseen in the EU Regulation 2015/1222 on Capacity Allocation and Congestion Management. The interim report does not fully reflect

the variety of processes and relevant factors to be considered for a decision in its assessment.

- For further developing regional cooperation in grid financing, the possibility of a new independent regional institution should be evaluated². Its objectives could be promoting the optimal use of resources through operating pan-national markets, by regularly assessing resource adequacy on a regional level and applying a solid methodology that looks at demand, supply and infrastructure on equal terms.

Balancing markets

- The further development of balancing markets is essential. A level playing field for all sources of flexibility will promote the participation of demand side response and storage capacities. Moreover long-term contracts for balancing services will offer a long-term investment signal for flexibility providers.

III. Assessment of types of capacity mechanism

- We agree that the six different types of capacity mechanisms are not equally well suited to address capacity problems. The optimal choice will depend on the nature of the generation adequacy problem it is meant to address and on the structure of the member state's electricity market.
- We agree that out of the six types of capacity mechanisms, capacity payments risk either over-compensating (or under-compensating) capacity providers because they are not based on expectations on the supply/demand balance but rather an administrative decision that is often not dynamic in practice.
- We share the view of the Commission that the risk for overcompensation is lower with the four remaining types of capacity mechanisms, which address specific generation adequacy concerns. The choice of the most suitable model depends on the precise adequacy problem to be solved.
- Tenders for new capacity and strategic reserves may be appropriate to address a transitional capacity problem. A tender allows for new investment, while a strategic reserve is typically used to prevent existing plants from closing. Neither of these two models solves underlying market failures, but they can both bridge a capacity gap until market reforms are carried out to enable the electricity market to provide sufficient investment incentives, or until a more appropriate longer-term capacity mechanism is introduced. If the size of the strategic reserve becomes too large (slippery slope effect) there are strong risks of

² See „The market design initiative: Towards better governance of EU energy markets” at https://www.e3g.org/docs/Reforming_EU_energy_market_governance_for_new_market_realities.pdf

undermining the market functioning. These models should be accompanied by a credible plan how the market's functioning will be improved in the future.

- We agree that central buyer mechanisms and de-centralized obligation mechanisms could be appropriate options to address a longer-term adequacy problem. These two capacity mechanisms seem more efficient to attract new capacities and allow direct competition between generation, demand side measures and other capacity resources, thus creating stronger competition for the capacity remuneration and revealing the real economic value of capacity.

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