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Is there a role for capacity mechanisms in Europe's power markets?

BusinessEurope reaction to the Commission's state aid sector inquiry into capacity mechanisms

Energy markets in Europe, as well as in other regions, are undergoing a profound and challenging transformation. This is due to number of drivers.

Generation capacity in the EU has increased due to the growth of renewable energy sources (with a decrease of conventional power plants) and simultaneously the electricity demand and wholesale price have decreased since 2011. This leads to a situation of overcapacity in Europe or at least in some parts of it. On average, there is currently a high security of supply, but many Member States are concerned about the future, especially because many power plants are closing. Given the complexity and multi-actors dimension of the on-going transformation of Europe's power markets, it is important to identify the problems and real issues at stake before taking action at EU or national level.

BusinessEurope favours the principle of the energy-only market - where generators are paid based on the volume of power they produce and where the market is providing the right signals for investment - as well as further integration and improvement of European energy markets. A European-wide electricity system with a market-based approach can reduce costs for consumers, industry and households. This implies limiting regulatory interventions, which can negatively affect the power markets. When market failures exist and affect wholesale prices, they should be addressed with targeted EU-level measures rather than a patchwork of initiatives.

The European Commission provided for its preliminary views on selected models of capacity mechanisms (CM) and with the final report by the end of 2016 it shall contribute to the forthcoming power market reform. The interim report and staff working document describe a growing number of Member States implementing or planning different forms of capacity mechanisms, with direct or indirect effects on the functioning of the power markets.

As outlined in our response to the October 2015 public consultation, capacity mechanisms, like any regulatory intervention, have risks associated and it is crucial that Member States and the European Commission work together to ensure other options are exhausted before capacity mechanisms are pursued. However, we have to recognise that capacity mechanisms now exist in some Member States. The European Commission and Member States should ensure that existing capacity mechanisms can work with the internal energy market.



I. Interim report: correct diagnostic, but capacity mechanisms are not always the solution

BusinessEurope has the following comments on the interim report and staff working document:

- **We welcome the European Commission's inquiry into capacity mechanisms** in place or planned in some Member states. It is especially important to assess how the different schemes interact with the internal energy market and competition rules and to what extent they address a possible problem effectively.
- **We share the diagnostic and market failures analysis.** The report rightly states that today's electricity markets are characterised by uncertainties as well as a number of market and regulatory failures, which affect wholesale market price signals. These include price caps, lack of a meaningful EU-level carbon price, uncoordinated and fragmented national renewable support schemes, unpredictable scarcity periods, lack of efficient short-term markets and lack of active participation of demand response operators. The European Commission should also recognise that regulatory uncertainties contribute to the present situation.
- **We agree that the transition to a low-carbon power market implies an increasing share towards this kind of generation, which is capital intensive, and is missing the right price signal in the market.** This can negatively affect efficient investment and divestment decisions.
- **We share the view that the domestic context is important, especially in relation to the generation adequacy, but a more consistent system adequacy analysis at regional level is imperative.** Taking into account solely national context or targets in place could stifle further integration and regional cooperation aiming at improving coherency. While considering local specificities, a balanced approach should aim at bringing more coordination at regional and/or European level. Overall, enhancing European market integration, incl. interconnections, will help ensure security of supply in a cost-efficient way for consumers.

It is therefore fundamental to develop national, regional and European adequacy assessment based on coordinated scenarios and methodologies (previously consulted with all stakeholders). System adequacy assessments must also analyse contribution of interconnections, foreign capacity, renewable energy sources, demand-side response and conventional generators to European, regional and national adequacy and security of supply.

- **We regret that, when assessing public interventions and capacity mechanisms, the European Commission only considers eleven Member States at this stage.** A wider approach throughout the whole of the EU would be worth considering, as there may be wider repercussions. We also observe that the Commission does not sufficiently address the issue of possible **cost implications** at this stage.



- **We think that the interim report does not make sufficiently clear the link between capacity mechanisms and a number of identified failures.** While addressing the right questions on the market situation (i.e. why the market does not provide the right incentives and signals), the European Commission does not address the fundamental question as to what capacity mechanisms should resolve. There may be some residual failures, which are difficult to remedy, and Member States need to address them and improve the functioning of their markets.

Overall, while capacity mechanisms in some Member States could be one of the possible instruments to provide for long-term investment signals and balance high share of variable renewable sources with adequate level of security of supply, it may not be the single and most cost-effective solution to the number of existing market failures. The European Commission should strongly promote other means to fix the market, with elements such as more dynamic pricing (incl. removal of price caps), further integration of the markets or enhanced implementation of existing rules. There is a clear need to avoid a patchwork of uncoordinated solutions, which may further negatively affect the markets and contribute to higher prices for consumers, depending on the chosen design. It is crucial that Member States and the European Commission work to ensure that other options are exhausted before capacity mechanisms are pursued.

II. Capacity mechanisms: need for a coherent approach, applying strict eligibility criteria

Whether capacity mechanisms could address market failures or shortcomings has no universal answer. This depends on the local context and other specific factors in different Member States. In any case, BusinessEurope calls for the application of strict eligibility criteria:

- **Transparent and open rules for participation** (along with sufficiently allocated time for bidders), aiming at the lowest possible cost; It must not undermine the functioning of the electricity market in the short- and long-term.
- **Applied only until it is ensured that an adequate provision of generation capacity can be made available on a durable basis.** Acknowledging that capacity mechanisms may play role in some cases within the energy transition, these should not be used extensively and should be applied only for limited time until it is possible to regain market balance and functionality. Also, specific local context may require specific measure.
- **Technology and fuel neutrality, non-discriminatory, open to cross-border, storage and demand-side participation and tied in a regional approach.** Also, when deciding on the right model and where applicable, the capacity price should rely on the market instead of regulatory pricing.



- Set with the **sole objective of security of supply**. Capacity mechanisms should not be seen as means to keep the status quo in the Member States, with specific energy mix, while more European approach with wide cooperation, integration of markets and interconnectors could eventually resolve the situation of security of supply and avoid capacity interventions. This could contribute to lock-in situation in some Member states. Also, they shouldn't be regarded as a substitute solution to existing market and regulatory failures (such as bid-caps, overcompensation, distortive RES schemes or market imbalance).
- The costs and possible impact of capacity mechanisms on consumers also need to be sufficiently analysed and duly taken into consideration prior to the decision on introduction of capacity mechanisms. While maintaining the security of supply, keeping the cost in check would guarantee to opt for the most cost-effective solution.

Conclusion

BusinessEurope is committed to the ongoing discussion on power market design and capacity mechanisms in order to make them a success, taking into account both generators and users' interests. The patchwork of capacity mechanisms currently implemented or under consideration by a number of Member states are generally seen as measures that could further compromise the internal energy market or can lead to fragmentation. An appropriate framework is therefore required for validating the need and features of any mechanism. The objectives are to maintain security of supply on one hand and to provide affordable electricity to all consumers in a cost-efficient way on the other.

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