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Contribution to DG Competition consultation on capacity mechanisms

1. Introduction

EUGINE is the centre of knowledge for engine power plant technology and electricity market design. Its members are the leading European manufacturers of engine power plants and their key components. They are manufacturing in Europe highly-flexible power plants based on internal combustion engines which are able to start-up within one minute and to reach full output within five minutes. As a consequence, they are extremely interested in the current debate on security of supply and very much welcome the opportunity given to stakeholders to submit comments on this interim report on capacity mechanisms.

The fact that 28 capacity mechanisms were found in the 11 countries selected by DG Competition shows to what extent the internal market threatens to be distorted and undermined by purely national considerations. EUGINE regards this sector inquiry as a key exercise to take stock of the current situation and then fix the problems in connection with the market design initiative scheduled by DG Energy for end of 2016.

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2. Intermittency as the biggest challenge for Europe' security of electricity supply

The share of variable renewables (wind & solar) in the EU energy mix has been constantly growing for years and is expected to continue rising in the decades to come. This represents both the biggest change in Europe's energy system and the biggest challenge for its security of supply.

As a consequence, the EU and its Member States should focus on securing enough highly flexible resources in a technology neutral way and based on a transparent and harmonised adequacy assessment. This will avoid the misuse of the system to create simply additional income for relatively old-fashioned baseload capacities that do not match the needs of the system and the politically defined targets, providing the security of supply at minimum financial and environmental cost as requested by Europe's citizens and businesses.

3. Flexibility solutions

EUGINE would like to stress that various flexibility solutions already exist: interconnections, electricity storage, demand-side response and, above all, flexible generation, especially highly-flexible gas-fired engine power plants which are able to start-up, ramp up and ramp down very quickly. As the European Union intends to be technology-neutral, there is absolutely no reason to give any specific preference or funding to one or the other of these various flexibility solutions. EUGINE requests a pure market-based approach where market participants freely decide which type and amount of flexibility is needed.

4. Capacity mechanisms

4.1. Principle

In a capacity mechanism, the primary investment signal for new plants is the level and availability of the capacity payment on offer (either through a central procurement mechanism or through a decentralised capacity market). Capacity developers are incentivised to deliver generation technologies that are likely to be awarded a capacity contract, which may not have the flexibility characteristics requested by the market. With a capacity mechanism in place, a pre-determined capacity "margin" is procured on a regular basis and investment cycles are

thus absent from reading changes in the energy market price. Moreover, capacity mechanisms are often a highly-administrative, complex and costly option. Finally, capacity mechanisms established at a national level tend to focus only on the national capacity available and by this restrict cross-border trade in electricity and hinder the whole internal energy market.

4.2. Case studies

As the interim report shows, many Member States have established various types of capacity mechanisms or are intending to do so. The Spanish, French, German and British examples, shows numerous problems and risks related with these moves.

The Spanish system has proven to be one of the most costly and less technology neutral system: retail prices have been quickly and strongly increasing due to the system of capacity payments in place. In France, there are very strong concerns that the new scheme reinforces the dominant position of the incumbent player. Moreover, although the gas-fired engine power plant technology could provide new, highly-flexible and sustainable capacity to the French Brittany region where a separate tender is organised by the French authorities, this tender for the construction of a new gas-fired power plant in Brittany is focused on the Combined Cycle Gas Turbine (CCGT) technology which goes against the technology neutrality principle. The same problem can be seen in Germany where the strategic reserve is not composed of the type of capacity able to react quickly to provide security of supply (highly-flexible resources) but of less flexible resources (coal power plants). Finally, it is a pity that the specific case of the United Kingdom was not taken into account for this sector inquiry: the capacity mechanism set-up in the UK shows almost no contracts for new flexible generation. At the first (2014) and second (2015) auctions, only respectively 5% and 4% of the resources contracted went to new generation which is naturally insufficient to help the UK face the intermittency challenge.

Based on this experience, market-wide capacity mechanisms, be they centralised (UK example) or decentralised (French example) seem not to be an appropriate answer to security of supply concerns. Instead of focusing funding on new, flexible and sustainable power plants for peak loads and hence reducing costs, they are distributing money to numerous power plants (especially already existing ones) which will not be able to provide quick additional electric capacity when needed. They threaten to give additional funding to numerous power plants which would be running anyway.

4.3. Conclusion

EUGINE fully agrees with the European Commission concerning the numerous risks related to capacity mechanisms, including that such schemes “reward new investments only in certain types of generation”.

On the other side, EUGINE disagrees with the idea that “central buyer mechanisms and decentral obligation mechanisms are the options that appear to be more appropriate to address a long-term, general problem of generation adequacy.” Such schemes tend to “institutionalise” market distortions for the long run. Once established, it will be extremely difficult to replace them by a real market-based approach.

For EUGINE, if the EU wants to secure properly functioning electricity markets with clear price signals, electricity markets should be protected from distortive effects of poorly designed national capacity remuneration mechanisms locking Europe into old and polluting power plants. The EU should rather adopt common standards for adequacy assessment and restrictive criteria for capacity remuneration mechanisms to avoid that diverging national mechanisms question the whole EU energy policy.

The only acceptable solution among capacity mechanisms might be ‘strategic reserves’, for specific emergency cases and a limited time (short term). As long as it is ensured that such capacities are kept outside the regular market, strategic reserves might be the less distortive option and a useful solution in case of sensible fears of market failure. As such strategic reserves are intended to be used as a measure of last resort, also the strategic reserve capacity needs to be flexible enough to react in a fast manner when required (in opposition to the German model of coal power plants being kept aside in a strategic reserve).

If existing capacity mechanisms are kept in the system or new capacity mechanisms are set-up in the future, the European Union should adopt a set of minimum requirements minimising their potential negative impact on the internal energy market: any capacity mechanism should be market-based, be open for cross-border participation, solve proven problems related to the security of supply, value flexibility solutions and be a temporary scheme.

5. Market design

Finally, EUGINE would like to stress the importance of the upcoming legislative initiative on the electricity market design to fix the current problems. To achieve a successful European energy transition at minimum cost, EUGINE recommends to enhance the Energy Only Market thanks to the following solutions:

- Turning the Energy Union communication into European actions
 - Addressing the resource adequacy issue at EU level (i.e. common standards for cross-border adequacy assessment) to make unilateral interventions unnecessary (capacity mechanisms)
 - Accelerating the Integration of the Internal Electricity Market (market coupling, network codes, policy harmonisation)
 - Strengthening investment signals (2030, ETS reform)
- Using market forces to develop flexibility at minimum cost
 - Investments should be driven by price signals (without caps), not by distorting interventions locking-in non-flexible and polluting technologies
 - Technology neutrality is needed to guarantee a level-playing field and a competition leading to reduced costs for society
 - Value for flexibility should be created to provide clear signals for investments in cost-efficient flexibility solutions
- Empowering market players to foster self-balancing and ensure security of supply
 - Sharing responsibility: All market participants should have the same balancing responsibility
 - Cost-reflectivity: the imbalance charge paid by the participants creating imbalances should reflect the full costs (availability & utilisation fees)
 - Marginal pricing: “pay-as-cleared” pricing methodology for balancing energy would incentivise self-balancing and thus flexibility solutions
 - Shorter time frames are needed for a more dynamic, competitive and liquid procurement of reserves by TSOs and market participants

Further information on EUGINE policy recommendations can be found in the background paper "[Designing electricity markets for a successful energy transition](#)" as well as in the EUGINE [contribution to the public consultation on the electricity market design](#) organised last year by DG Energy.