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POSITION ON CAPACITY PAYMENTS

The problem of the “missing money”...

Economic theory demonstrates that competition in the electricity (or any other) market should lead to a situation where the marginal pricing mechanism provides the necessary cash flow for investing in the generation capacity required to ensure essential security of supply.

In practice, however, interactions between the market and regulation by authorities in order to realise other objectives may lead to a lack of incentives to invest in new power plants:

- Priority given to intermittent electricity generation from renewable sources, thereby reducing runtimes of traditional power plants and their ability to recover their fixed costs.
- High guaranteed incentives for renewables, allowing generators at certain moments to offer their production at zero (or even negative) price; as a consequence, average prices fall, even below the level corresponding to the cost-effectiveness of standard power plants.

Furthermore, there is a risk that traditional generation companies do not invest in Europe today, but delay their investment, anticipating the introduction of capacity mechanisms that guarantee them a higher revenue, thus bringing about such shortages! This is more and more used as an argument to support the introduction of different kinds of capacity mechanisms, such as capacity markets.

IFIEC Europe (IE) shares the concerns that public interventions, such as support for renewable energy, lead to electricity market distortions and a lack of investment in new and flexible capacities.

However, the fact that there is little investment in (flexible) capacity does not necessarily mean that capacity mechanisms are needed. On the contrary, this could be a signal that no new investment is needed yet. As a consequence capacity mechanisms must themselves be seen as market interventions only to be used as a last resort when it is clearly demonstrated that the market itself has failed.

Specific capacity mechanisms all have their shortcomings. For instance in case of classical “Call for Tender” procedures, such as imagined by the directive and which have the advantage to limit the financial support to the “missing money”, give the incentive for existing generators to wait for the next “Call for Tender” to receive the yearly capacity fee in addition to the market price.

IE is not convinced that generalized capacity payments are the best response to solve this problem. In fact, it must be avoided that, on the commodity market end users pay the (relatively high) marginal cost of the marginal generation unit (generally gas or coal), and on the capacity market the capacity cost of the marginal (i.e. most expensive) technology (e.g. new nuclear/hydro). Consumers are not willing nor able to pay for that!

Moreover, IE is not convinced that there really is “missing money”. Our impression is that the money is there, but it is just not flowing to those really interested in investing in additional generation capacity. Besides, most of the electricity sold to end users is not linked to the more volatile spot markets, but, through bilateral contract, to more stable forward prices. Finally, higher price volatility also leads to higher peak prices (as was clearly showed during last winter). IE

therefore invites generators to produce clear evidence of the “missing money” theorem before starting a discussion on the need for capacity mechanisms.

There are significant obstacles to investments in new generation capacity, such as slow and cumbersome permitting procedures, unclear and/or unstable energy policy, lack of competitively priced back-up or balancing capacity, ... So before introducing market mechanism, all options should be examined which could help investments to come. Some of these alternative solutions are examined below.

Alternative solutions proposed by IFIEC Europe:

As alternatives for capacity mechanisms, IE would like to propose the following solutions:

1. Limit support to renewables to the difference between the effective generation cost and the electricity price of the reference market. This will incentivise renewables producers to sell their electricity as efficiently as possible in the market. If producers of renewable energy are incentivised to integrate their electricity efficiently in the market, the price volatility and the need for extra back-up capacity will be reduced. Moreover, renewable should also be responsible for their own balancing costs.
2. Centrally decide of the back-up investments (by TSO for instance) to ensure the necessary base-load and semi-base supply, the investment cost being included in the RES support scheme amount. It will make sure that the high marginal cost of such tools will not impact the market price. Investments would be decided only once the cheapest demand management options have been exhausted (see 7. hereafter).
3. Improve the functioning and the efficiency of the gas market; competitive gas prices will increase the revenues of (flexible) gas powered electricity plants, making it more profitable to invest in these capacities. It is a necessary precondition for investment in gas-fired power plants.
4. Simplify permitting procedures and remove other policy obstacles to the construction of new power plants: reducing such obstacles to investment is a necessary precondition.
5. Extending the lifetime of existing (semi-)baseload capacity as long as it is technically and economically viable. .
6. Increase investments in interconnections especially between countries with high and low natural storage capacities. Such market integration will help coping with volatility through flexible power generation and flexible storage facilities.
7. Promote voluntary demand response participation. Industrial demand response may be cheaper and can be used in a shorter term than expanding gas capacities and storage facilities. To take advantage of such industrial flexibilities, appropriate financial incentives are needed.
8. Stimulate research and investments in energy storage systems to promote new technologies that are able to reduce volatility with the least possible costs.
9. Allow and support long term contracts between consumers and investors into power plants to offer investors a higher certainty on the revenue and pay back side of such investment and industrial consumers more competitive prices and visibility for the future.

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IFIEC Europe represents energy intensive industrial consumers where energy is a major component of operating costs and directly affects competitiveness.