The Consumer Voice in Europe

# European Commission's Interim Report of the Sector Inquiry on Capacity Mechanisms

## BEUC response to public consultation

**Contact: Monika Štajnarová – energy@beuc.eu**

**BUREAU EUROPÉEN DES UNIONS DE CONSOMMATEURS AISBL | DER EUROPÄISCHE VERBRAUCHERVERBAND**
Rue d'Arlon 80, B-1040 Brussels • Tel. +32 (0)2 743 15 90 • www.twitter.com/beuc • consumers@beuc.eu • www.beuc.eu
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## Why it matters to consumers

Energy is an essential service. Consumers need access to reliable, secure and sustainable energy supply at an affordable price. Energy bills have become one of the main financial concerns for many households and they should not pay for it more than is necessary. Several Member States put in place or are planning to introduce so-called capacity mechanisms which aim to improve security of supply. If not well-designed, these national mechanisms can artificially push consumers' electricity bills up, for a long period of time.

## Summary


Capacity mechanisms bring along a number of challenges and there is a high risk that the mechanisms will not be adequately designed due to their complexity. These mechanisms bear the risk of creating unfair competitive advantages leading to inefficient market outcomes and additional costs for consumers.

**BEUC demands:**

- Security of supply should be ensured at the lowest costs for consumers.
- Reasons to introduce capacity mechanisms should be properly scrutinised.
- Costs of capacity mechanisms and their impact on consumers' bills should be carefully assessed. Impact on consumers' bills should form also an important part of the European Commission's sector inquiry.
- The assessment of the necessity of introducing capacity mechanisms must be coordinated among Member States. A pan-European methodology for adequacy assessment should be established and assessments should be coordinated at the regional level.
- If deemed necessary, capacity mechanisms should be non-discriminatory and should include not only generation capacities but all kinds of flexibility mechanisms such as interconnection capacities, demand-side response, storage and energy efficiency. Capacity mechanisms should only be a temporary measure of last resort and accompanied by a clear exit strategy.
- In the upcoming Market Design Initiative, the European Commission should provide a guidance to Member States to design possible capacity mechanisms in the least intrusive way possible while the long term objective should be to limit new mechanisms and unwind the existing ones.

## 1. General remarks

BEUC welcomes the European Commission's sector inquiry into national capacity mechanisms launched in April 2015 as well as the opportunity to comment on the Commission's Interim report. The Commission's investigation will provide important input to legislative proposals on a new energy market design that should tackle the 21st century challenges and facilitate the decarbonisation of our energy system.

Energy services are essential for consumers who need to have access to energy supply which is reliable, secure, sustainable, at an affordable price. Energy bills are one of the main financial concerns for many households and consumers should not be obliged to pay higher price than is necessary. The overall objective should therefore be the security of energy supply at the lowest costs for consumers while minimising negative impact on the environment.

A number of Member States already put in place capacity mechanisms which can undermine building a well-functioning internal energy market. Although capacity mechanisms could eventually rise the level of security of supply, this may not justify the additional costs associated with the introduction of such a new subsidy scheme. Currently low wholesale prices suggest that new capacity is not needed and increasing generation adequacy via capacity mechanisms at the national level remains questionable.

At the same time, capacity requirements are based on forecasts made several years ahead and the future need can be overestimated. Deviation between the forecast and the real electricity demand risks having a negative impact on the price formation. On top of that, capacity mechanisms are usually long-term tools and as observed in some countries, the introduction of one capacity mechanism can lead to chain of these mechanisms.

Capacity mechanisms lead to increasing costs for consumers as they are, in one way or another, paid through consumer bills.[1] However, the impact on consumers' bills is largely missing in the European Commission's Interim Report and BEUC calls on the Commission to include this analysis when finalising its inquiry.

When evaluating the design of particular capacity mechanisms, different non-generation alternatives that can contribute to adequacy should be considered such as demand-side response and energy efficiency as well as the role of interconnections. At the same time, the need for capacity mechanisms should be coordinated at the EU level and based on an accurate regional resource adequacy assessment. These mechanisms should only be a measure of last resort and only for a temporary period.

The upcoming EU legislation needs to adapt the regulatory and policy framework so that market rules are designed around consumers' interests. This is of outmost importance as energy markets are changing and transforming into a new paradigm where the outdated market model is replaced by a rather decentralised one with more bottom-up energy supply and increasing share of renewables. More flexibility is needed on the side of Distribution System Operators because variable renewable generation will mainly have to be integrated locally on low voltage grids. Properly designed energy markets should make capacity mechanisms redundant.

[1] For instance for winter 2015-2016 in Belgium, CREG quantifies the cost of the reserve to 58.6 million euros, plus additional costs if the reserve is actually activated.

## 2. Specific comments on Commission's tentative conclusions

### 2.1. Generation adequacy assessment and reliability standards need to be harmonised and better coordinated

In the process of completing the internal energy market, it is increasingly difficult to decide about generation adequacy on a merely national basis. The Commission's Interim report also points out that Member States' methodologies to assess adequacy are often not comparable and not all Member States define reliability standards, ie. a benchmark for measuring whether generation adequacy has been achieved. Even if there are reliability standards, these are not always based on sound economic assessment. Consequently, national policies do not enable creation of the stability necessary for coordination and optimization of the investments that the European energy market needs. Harmonised procedures for assessing system adequacy are therefore needed.

In the view of upcoming Market Design Initiative expected by the end of 2016, BEUC therefore calls on the European Commission to provide a guidance to Member States to design possible capacity mechanisms in the least intrusive way possible. It would be desirable to establish a pan-European methodology for adequacy assessment. The assessment should then be coordinated at the regional level. In fact, a few countries already go beyond national adequacy assessment and started a regional assessment.[2]

In addition, the focus should be on cost-efficient infrastructure and interconnectors across borders and making sure their functioning is not hindered by national considerations. Member States should conduct an ex-ante cost benefit analysis including the impact on consumers' bills. International experience shows that capacity mechanisms can cost up to 10% - 20% of wholesale electricity (i.e. energy only) prices.[3] This will inevitably push consumers' bills up. Therefore, it is essential that the reasons to introduce capacity mechanisms are properly scrutinised and costs of capacity mechanisms and their impact on consumers' bills are carefully assessed together with less costly and less distortive measures.

### 2.2. Design of capacity mechanisms needs to be improved

The evidence as well as the Commission's Interim Report show that capacity mechanisms are highly complex. This brings along high risk that the mechanism will not be adequately designed. It may create unfair competitive advantages leading to inefficient market outcomes and additional costs for consumers. In a period when existing power plants cannot run profitably and are being shut down, subsidising installations may create yet another subsidy dependent market.

Moreover, in its' Communication 'Making the Internal energy market work'[4], the European Commission clearly stated that *if capacity mechanisms do not treat demand reduction fairly, they can lock in generation-based solutions rather than energy efficiency or demand response solutions*. Considering these solutions first is in our view a key prerequisite for building a more efficient energy system. As also highlighted by ACER,[5] capacity mechanisms can have a negative impact on competition as they may *"distort cross-border trading or even act as a barrier to trade if they are designed without taking*

[2] Pentalateral Generation Adequacy Assessment, http://www.benelux.int/files/6314/2607/1566/Penta_Report_Common_Statement_Ministries_2015.pdf
[3] SWD(2013) 438 final
[4] COM/2012/0663 final
[5] Capacity mechanisms and the EU internal electricity market. The regulators' view: ACER's report on capacity mechanisms. Alberto Pototschnig and Martin Godfried

*into account their cross-border impact or are implemented at national level without any coordination with neighbouring jurisdictions."*

It has been to the detriment of market harmonisation efforts that several models have emerged, resulting in a patchwork of different capacity mechanisms around Europe. The preliminary results of the Commission's inquiry also show that capacity mechanisms can result in over-compensation leading to consumers overpaying for electricity. Designing capacity mechanisms which favour some operators or certain technologies will have a distortive effect on competition and can discourage investments into other solutions. Therefore, there is a need for guidance on whether and how these mechanisms can work together.

If capacity mechanisms are deemed necessary, the mechanism should be introduced as a last resort solution and only for a temporary period. Member States/ regions should ensure these mechanisms are non-discriminatory, focus on solving specific problem and consider different ways of achieving generation adequacy, ie. interconnections, demand-side response, storage and energy efficiency. The data[6] about the capacity auction conducted for the PJM[7] wholesale market suggests a total consumer savings of $1.2 billion due to demand-side participation for a single annual auction. While these markets are more mature and have some specific characteristics, they indicate the possible potential for demand-side response. At the same time, energy efficiency can be the best energy 'source' investment improving affordability of energy, driving down the need for additional and costly infrastructure and tackling climate change. "Energy Efficiency First" principle should therefore be embedded in all decision-making related to energy.

The upcoming Market Design Initiative should also set the rules for capacity mechanisms so that these are accompanied by a roadmap including appropriate measures to remedy market failures as well as by a clear exit strategy with the deadline for the phase out and related monitoring requirements.

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[6] Beyond Capacity Markets - Delivering Capability Resources to Europe's Decarbonised Power System, M. Gottstein, Principal, Regulatory Assistance Project, and S. A. Skillings, Director, Trilemma UK, 2012

[7] PJM (Pennsylvania-New Jersey-Maryland Interconnection) is the regional transmission organisation that coordinates the movement of wholesale electricity in all or parts of 13 US states and the District of Columbia.

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