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## **EFET response to the AEEGSI consultation n. 234/2014 on Capacity Remuneration Mechanisms targeting flexibility services**

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The European Federation of Energy Traders (EFET<sup>1</sup>) welcomes the opportunity to provide its views on the constitution of a new segment of the Italian capacity market: we understand the new segment will be dedicated to the negotiation of capacity suitable to provide the flexibility services needed to cover Terna's estimated long-term needs and will integrate the capacity market scheme already verified by the Authority with the deliberation 375/2013/R/eel. Within the response to this consultation we would like to state EFET position on capacity markets and answer to the specific questions addressed by the AEEGSI.

### **1. Background**

Over the last two years, EFET has closely followed the ongoing discussions around capacity mechanisms in various Member States. We produced a position paper in 2011 setting out our general views, while in 2013 our discussion paper<sup>2</sup> assessed some of the design features of capacity mechanisms if such interventions are implemented. These documents discussed some of the drawbacks associated with this type of intervention. It also set out some fundamental improvements, as follows, that regulators and governments need to make to electricity market design, regardless of whether they are considering capacity mechanisms:

- Integrate renewable energy into the power market design (wholesale market and network infrastructures)

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<sup>1</sup> The European Federation of Energy Traders (EFET) promotes and facilitates European energy trading in open, transparent, sustainable and liquid wholesale markets, unhindered by national borders or other undue obstacles. We currently represent more than 100 energy trading companies, active in over 27 European countries. For more information, visit our website at [www.efet.org](http://www.efet.org).

<sup>2</sup> *EFET Discussion Paper on Capacity Remuneration Mechanisms*, February 2013, available at: [http://www.efet.org/Cms\\_Data/Contents/EFET/Folders/Documents/EnergyMarkets/ElectPosPapers/~contents/Z5Z2WKTWJ8DB8F3A/EFET-discussion-paper-Capacity-Remuneration-Mechanisms\\_February-2013.pdf](http://www.efet.org/Cms_Data/Contents/EFET/Folders/Documents/EnergyMarkets/ElectPosPapers/~contents/Z5Z2WKTWJ8DB8F3A/EFET-discussion-paper-Capacity-Remuneration-Mechanisms_February-2013.pdf)

- Develop and improve intraday markets by moving gate closure to H-1 and facilitating cross border exchanges to make the maximum use of interconnector capacity
- Develop and improve balancing mechanisms, also on a cross border basis
- Allow free price formation in wholesale markets and remove explicit and implicit caps/floors
- Extend real-time metering to enable demand response
- Remove unnecessary operational requirements and restrictions on generation companies.
- Improve the functioning of the gas market, avoiding run-or-pay obligations and ensuring that power plants have flexible access to transmission networks and wholesale gas markets.
- Ensure a stable and consistent energy policy framework for de-carbonisation based on ETS.
- Foster the cooperation between TSO on a Pan-European level and also to tackle the long term capacity adequacy needs at least on a regional level.

These recommendations to improve the energy (MWh) market will already strongly promote an ongoing match between supply and demand and encourage the efficient use of all assets (generation and demand-response). Flexibility and reliability are essential to back up the increasing share of intermittent generation. The position paper concluded that better functioning markets could mitigate or remove the need for policy makers to consider capacity mechanisms.

## **2. Energy-Only market design**

EFET believes that distortions caused by over-regulation should be avoided in order not to disturb the formation of price signals. We believe that policy-makers and national regulators should focus on the improvement of market conditions, rather than addressing adequacy concerns by implementing ad hoc administrative measures.

We consider that an energy-only market design (complemented by markets for contracting regional reserve capacity) would be able to assure a match between supply and demand. The signals given by wholesale energy prices can and should constitute the primary means of incentivising investment into new capacity.

EFET would like to stress the importance of the provision for balancing reserves to be exchanged on a cross-border basis. In a market where intraday cross-border trading is working properly with the mean of a single platform, where nominations are possible until h-1 and where a residual balancing market is run by the system operator, there would be less need for capacity remuneration mechanisms. Well-functioning and competitive intraday cross-border markets and integrated balancing markets should also provide appropriate signals for investment in production units providing flexibility services.

Focusing on purely national considerations will hinder the development of an integrated European electricity market and will undermine a key benefit of the internal market, i.e. the use of generation capacity efficiently across the EU irrespective of national border. Energy

close to real-time would be exchanged through borders and foreign market operators would have the possibility to contribute to reserves or electricity peaks needed by a national TSO. We also believe that market participants need to have appropriate incentives to balance their positions at gate closure and a harmonised approach to balancing based on a single marginal imbalance price needs to be implemented. A supplementary market for contracting reserve capacity would complement the energy only market design in order to enable system operators to deal with real time incidents.

### **3. Motivations for capacity mechanisms**

EFET believes that the market should ideally perform certain core functions:

- formation of prices so that supply and demand balance
- allocation of fixed and variable costs
- organisation of risk management activity, forward trading and the maintenance of spare capacity and storage possibilities
- provision of incentives for efficient investment decisions

Policy makers should, therefore, always think carefully before intervening in these areas, as there is a clear risk of undermining some of these basic objectives of competitive markets. At the same time, misleading energy policies and some specific market failures in the electricity sector may justify a public intervention. These can be categorised as follows:

- the need for instantaneous balance in electricity systems and the public good nature of grid stability and generation adequacy,
- the lack of sufficient demand side participation in the market on an hour-by-hour basis, meaning that price signals are obscured
- the excessive risk\uncertainty for investors and the lack of sufficient forward price signals
- the politically motivated interventions leading to implementation of price caps in either wholesale markets, or for end users.

Shortcomings in market design could possibly lead energy-only markets to yield insufficient revenue for generators to cover the fixed costs of peaking plant. Given that companies' generation portfolios are likely to adjust to major changes caused by the impact of renewable generation, this raises the possibility that the power outcome will not be optimal in a socio-economic sense or will not fulfil particular political objectives. Under these circumstances, there could be some rationale for limited intervention.

#### **4. EFET criteria for capacity measures**

Capacity remuneration mechanisms, if implemented, should be carefully designed in order not to disturb the formation of price signals in the energy markets. The EFET criteria for evaluation are that capacity mechanisms should ideally:

- demonstrably enhance adequacy and reliability
- avoid distortion or dilution of price signals from energy (MWh) markets
- be transitory in nature, with a natural dynamic and process towards phase-out of their price signals as generation adequacy improves
- focus on time periods far enough ahead to limit overlap and interference with forward and future markets in electricity
- facilitate an active demand side and promote wide consumer engagement through willingness to pay for reliability and/or price stability
- be non-discriminatory, by explicitly taking into account the contribution of non-national generation through interconnection which may decrease local needs
- be non-discriminatory between new and existing facilities and between different technologies
- minimise centralised management processes and maximise the scope for independent decisions by market participants about their off-take and delivery obligations, so that market dynamics have a chance to function
- minimise risk of regulatory failure and of need for redesign (e.g. by avoiding overly complicated mechanisms)
- use market-based remuneration mechanisms (e.g. by means of auctions, tenders, or subscription obligations)
- be suitable for EU wide / harmonised application.

#### **5. General considerations over capacity mechanisms in Italy**

The Italian energy market is undergoing a significant transition: the day-ahead market coupling implementation at the Italian borders is foreseen by the end of 2014 and a market-based capacity mechanism is likely to be introduced by 2018.

EFET would like to remark how the integration of EU electricity markets through the market coupling process relies on coupled well-functioning day-ahead markets. Therefore, where capacity mechanisms affect this market, they are also likely to have an impact on the EU internal market. Badly designed capacity remuneration mechanisms could thus distort the outcome of the market coupling process and lessen the benefits brought by the regional integration.

A greater focus should be also posed on the development and improvement of intraday markets by moving gate closure to H-1 and facilitating cross border exchanges to make the maximum use of interconnector capacity. The development of continuous intraday trading across borders and the improvement of harmonised and linked national balancing markets are necessary steps to improve the Italian security of supply.

EFET also calls the Authority to concentrate on the measures necessary to sharpen wholesale price signals and on the actions necessary for the integration of renewable energy sources

into the market. AEEGSI itself recognises in the consultation that the reduced load factor of conventional plants is mainly caused by the massive expansion of renewable energy sources output. We recommend that the Regulator addresses the issue of priority dispatch of renewable production. If renewable producers are not incentivised to moderate their own output efficiently, then conventional generation may have to perform unnecessary costly start-stop operations.

## **6. Specific comments on the proposal consulted on by AEEGSI**

Despite our general position doesn't agree with widespread capacity mechanisms, we understand that a capacity market will be implemented in few years.

We would like to respond to this consultation about flexibility services remuneration mechanisms with some remarks that we hope will encourage the Regulator's discussion on these topics.

**Q1.** Among all the possible market mechanisms, EFET supports the use of options products to meet the requirements of generation adequacy. Ideally these would develop spontaneously from the market if the price signals were allowed to correctly reflect scarcity. We believe that a market player from abroad should have the possibility to participate through physical or financial options.

The scheme is largely market-based, though it contains elements of regulatory risk. All administratively determined outcomes need to be well understood and transparent to avoid damaging the integrity of price formation. We call for a greater transparency on the process with which the Italian TSO Terna will set the amount to be auctioned and will define the relevant scenarios necessary to evaluate the system adequacy. We acknowledge that some details have been already clarified in the discipline scheme issued by Terna and approved by the Regulator during last September: nonetheless we would like to ask for full clarification as the overall procedure is not wholly transparent and clear.

The details concerning the option structure and the relevant amount to be auctioned have not been given in this consultation. EFET would thus strongly welcome a specific consultation issued by Terna on these topics.

**Q2.** EFET supports the technology neutrality in the design of a capacity remuneration mechanism. We believe that no discrimination should be allowed between new and existing facilities and between different technologies. This implies that the market design must allow for a competitive participation of all the technologies. Given that all the resources taking part in the capacity market will take also part in the MSD market, these shall be charged with the same imbalance fees and shall be subjected to the same bid constraints.

All the resources have to compete on a level playing field, otherwise the market competition would be distorted.

**Q3.** EFET firmly believes that the establishment of a cross-border balancing market should be prioritised before implementing an additional market for flexibility.

Nonetheless, in the short term an interesting market based approach to target flexibility could be represented by forward contracts within MSD. Their effectiveness is strictly dependent on the amount to be auctioned: if the amount is too low, the price signals will be too weak and not able to address new investments in flexibility for CCGT plants. We wish for AEEGSI to take into account this situation while approving the mechanism.

**Q4.** EFET believes that the capacity market design should minimise the risk of regulatory failure and should not distort price signals. Therefore we do not support any explicit or implicit cap or floor to the annual premium of the option, which should reflect the market value of flexibility services rather than be subject to an administrative price-fixing.

**Q5.** We would like to ask for clarification on what AEEGSI means with “importo minimo” and to better explain the means of this provision. More investments in flexibility (CCGT upgrades or other technologies) should result from signals provided from competitive well-functioning reserve and balancing markets with cross-border access. However, if in the short term a capacity market for flexibility services is implemented, this should be temporary and should be designed as to reward the flexibility of power plants and their ability to ramp-up and down with efficiency. The capacity market design should allow for technology neutrality in order to be really market-based and to avoid the risk of arbitrary subsidies in favour of a specific category of production. It should also take into account the contribution of non-national generation through interconnection which may decrease local needs. We call for a level playing field for competition which encourages the foreign participation in the cross-border exchange of reserve and balancing services.