Consultation Paper
of the European Commission
on generation adequacy, capacity mechanisms
and the internal market in electricity (11/15/2012)

ENERGIA CONCORRENTE

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1. Foreword

Energia Concorrente is a trade association which gathers some of the major Italian operators in the electricity market.

Its associates, Axpo, Repower, Sorgenia, Tirreno Power and GDF Suez hold about 11.000 MW of generation capacity, mostly new CCGT power plants, and produce annually about 30 TWh of electricity, supplying more than 2 millions of clients and employing about 2.000 people.

The aims of the Association are the promotion of competition in the electricity and gas markets and the defence of the interests of its Associates before the national and international Institutions within the complex proceedings for the definition of sectorial rules.

In particular, Energia Concorrente intends to collaborate with public and private authorities and associations for the solution of the issues regarding the sectorial rules, to promote studies and technical publications in the energy field, to inform its Associates about the evolutions of the markets and to represent the same Associates in the negotiations of national and international understandings.

With this paper, Energia Concorrente intends to formulate some comments regarding the *Consultation Paper of the European Commission on*

generation adequacy, capacity mechanisms and the internal market in electricity.

In particular, the following considerations will focus on two issues: the capacity payment system in Italy and the construction and operation of batteries for electricity storage.

2. The capacity payment in Italy

The capacity payment has been introduced in Italy by Legislative Decree n. 379/2003, which provided for the Italian Authority for electricity and gas (**Authority**) to define the criteria and conditions pursuant to which the Transmission System Operator (**TSO**) should propose a draft of regulation. Art. 1 of the Decree states that the proposal should ensure "*the achievement and the maintenance of the production capacity, in order to grant the coverage of the national demand with the necessary reserve margins*". Paragraph n. 2, furthermore, specifies that such remuneration should be based "*on competitive, transparent, non discriminatory and non distortive mechanisms, oriented to minimize the charges for consumers*". In addition, it is expressly provided that the system shall be applicable both to new and existing capacity, ensuring their efficient operation and maintenance.

Pending the definition of the final regime, the Authority in 2004 has initially adopted a transient system, still in force (the c.d. capacity payment regulated by decision 48/04), based on the awarding of an administered fee to those operators which make their capacity available.

At the same time, the Authority started a long consultation after which it adopted the Decision ARG/elt 98/11 (the **Decision**), which identifies the criteria and principles for the future capacity market mechanism.

Before proposing some substantial comments on the choices made by the Authority, we deem worthwhile to briefly sum up the key points of the discipline. The aim of these provisions is to ensure the offer of adequate capacity by the producers or, in other words, to guarantee the availability of a quantity of energy sufficient and adequate to satisfy the entire expected needs, and the necessary reserve margins.

In order to achieve that, the Decision provides for the TSO to define a "standard contract for the acquisition of capacity", which shall bound the counterpart to make available production capacity for a period not lower than three years and with development plan for at least four years (art. 6.2).

The producers, which intend to subscribe such contract, are selected through competitive procedures (art. 10), with the introduction of a real capacity market. More specifically, the tender procedure system is based on a lowest bid auction, where the offers represent the fee for which the tenderers agree to bound a certain level of their production capacity in a certain area defined by the TSO.

The lowest bidder, for the duration of the contract, is bound to offer its capacity on the Day Ahead Market (**MGP**), and then to make available the residual (unsold on MGP) capacity on the Market for Dispatching Services (**MSD**[1]) (art. 7.1.a).

[1] The Day Ahead Market (MGP) and the Dispatching Service Market (MSD) have been introduced after the liberalization of the electricity sector for the exchange of different goods and services: in fact, on MGP volumes of energy, which are necessary to cover the daily demand, are negotiated between purchasers (i.e. large industrial customers) and sellers (normally a generator), while on MSD the generator offer to Terna the sources which are necessary for the balance and the safety of the grid. Consequently, the two markets are different for typologies of sources negotiated (energy and services), for the prices (which reflects the different costs sustained for producing the different sources), for the different procedures for the price fixing mechanism (price of the marginal unit on MGP, pay as bid on MSD). The separation in two distinct markets for the trade of energy and services is typical of all the liberalized electric markets.

At the same time, due to the contract, the producer is obliged to give back to the TSO the difference - if positive – between the reference price and the strike price provided by the contract, multiplied for the capacity sold in the energy and service markets in compliance with the obligation mentioned before (cfr. art. 7.1.b).

It must be noted that the strike price (art. 9) is defined as the standard variable production cost of a specific technology selected by Terna, while the reference price (art. 10) is the price fixed on MGP (for the capacity sold in that market) or MSD (for the capacity sold for the "other services" in that market).

Energia Concorrente is convinced that the development of markets, opened to competition and able to give efficient price indications, represents the better way to reach the optimum in sources' allotment. Consequently, Energia Concorrente shares the Italian Legislator's choice of introducing a market-based mechanism to sustain production capacity. However, the capacity market can be a valid system to procure long term indexes to the sector only if the following measures – concerning in particular the abolition of the return of MSD revenues to the TSO and the transparency of the system – will be adopted.

A mechanism for supporting production capacity appears to be absolutely necessary because the turbulent increase of renewable sources is causing relevant effects on the national electricity markets, determining the erosion of the spaces for competition and the decrease of the security and adequacy of the electric system. In fact, the incentive mechanisms for such sources (the most remunerative in Europe) had the effect of reducing the shares of the competitive markets with a significant disadvantage for the operators which invested in traditional sources. These plants operate today in a context where the space left to the free market is reduced to about half of what it used to be; the other 50%, in fact, is covered by sources which obtain public aids.

Furthermore, the plentiful growth of non-programmable capacity causes serious risks for the safety of the system and imposes to keep in operation the existing traditional capacity which is able to give to the system the necessary flexibility. Therefore, if, on one side, the national Legislator has decided to support the renewable sources with an highly rewarding incentives' system, today there is the clear opportunity to grant a support also to those operators holding production capacities which are essential for a safe management of an electricity market so hardly affected by the indiscriminate development of the non-programmable sources.

However, the framework outlined by the Authority, which the TSO is going to enforce, shows a level of criticality able to jeopardize the fulfilment of the objectives pursued by the national law, when it was introduced. Taking into account what mentioned above about the technicalities of the mechanism, Energia Concorrente regards as totally unreasonable the provision concerning the return to the TSO of every revenue gained on MSD when the market price exceeds the contract price. The current Italian system provides the definition of a unique price limit both for MGP and MSD on the basis that the contractual obligation of the operator is unique and jointly concerns both markets, but this view is totally mistaken because the obligation under the contract only consists in the supply of capacity and not - surely - in the supply of services on MSD: the participation to this market, which is made compulsory by the system, implies costs which are sensibly different from those of the mere supply of a *commodity* (electricity) on MGP; therefore, it should not be subjected to the same price limit set out for MGP.

The MSD is characterized by a lack of segmentation. Consequently, the price limitation imposed by the new capacity market introduced by the Authority has the effect of capping a wide range of dispatching services, many of which have a particular added value related to the specific technological skill necessary to produce them (power and frequency regulation, various

typologies of tertiary reserve, etc.). The price limit imposed to such performances from the new regulation is clearly in contrast with their value/cost, as it is targeted to the variable costs of a kind of plants which may be considered adequate for the energy market but not for the services market.

Conclusively Energia Concorrente, in light of the critical issues mentioned above, deems that the system proposed by the Authority risks to fail the objective stated by the national Legislator, *i.e.* the pursuit of the safety and adequacy of the electric sector. In fact, the discipline outlined by the Decision significantly discourages the operators to implement the investments necessary to ensure the reliability of the system. On the contrary, its application can discriminate, particularly, the operators which invested the most in the technological development of their power plants, in order to provide more efficient services on MSD. Consequently, such undertakings will have no incentive whatsoever to invest more resources in the costly technologies necessary to maintain and improve the dispatching services.

As in the mechanism defined by the Authority the demand is centralized and identified by the TSO, it is fundamental to provide for adequate transparency in the process for the definition of the expected demand and for a third party certification of such demand. It is clear, in fact, that the TSO has objectives (such as the development of the network) potentially in contrast with the development and maintenance of the capacity.

With specific respect to the present Consultation Paper, Energia Concorrente points out the following:

- taking into account the severe limitation to the free market caused by the incentives granted to renewables sources (supported by State aids), it is necessary to provide mechanisms aimed at protecting the installed capacity, which doesn't receive incentives and has adequate flexibility. In fact, this kind of capacity cannot easily find on the market sufficient

resources to keep itself efficient, which could potentially cause massive disinvestments and jeopardize the European electric system. In light of that, the mechanisms should be calibrated on the demand in a sufficiently broad perspective, considering also the quantity of flexible sources necessary to the system in the long term;

- even if the remuneration criteria should not be considered as aids, but as tools for the correct appreciation of a performance (availability of capacity), it is necessary that such measures grant a fair remuneration of the performances offered, taking into account the actual needs of programmable sources by the electric markets;
- the participation of the demand should be evaluated in comparison with similar performances to be supplied and after the renounce to other existing remuneration system for the interruptible service;
- considering the right emphasis of the Commission regarding the opportunity to design the mechanism not on a specific technology in order to avoid discriminatory effects, it must be underlined that the Italian system, as described above, is based just on the less costly technology (fixed costs of the open cycle technology). This approach advantages the operators which manage such kind of plants (in particular, the incumbent) because they can more easily cover their costs through the mechanism;
- it is important that the system does not limit the prices on the MSD, which could have distorting effects. In fact, if a capacity payment mechanism can be associated with the imposition of a maximum price cap on the MGP, it is incorrect and distortive if such a limit is extended to the market for services (MSD) where, to be sold and purchased, are costly services for the supply of which huge investments must be performed.

We also underline that, in Italy, some capacity payment mechanisms based on tariffs defined by authorities and limited to particular categories of plants are still in force.

We make reference, in particular, to some obsolete oil fuelled plants owned by the incumbent for which a fee is granted for the security of the gas market in case of emergency. We deem that such a fee is able to divert the competitive dynamics: in the electricity market, it reinforces the position of the incumbent and in the gas market it frustrates the necessary investments aimed at granting the security of the system. Such a capacity payment mechanism could further reinforce these distortions.

We hope that the recommendations of the Commission will be oriented to guarantee the compatibility of the capacity payment mechanisms with the transparency and non discriminatory principles, the implementation phase will follow a preliminary verification regarding the effective adequacy of the measures to achieve the targets for the market development proposed and these kinds of provision will be enforced also in the gas market in order to grant the safety of the system.

3. The realization and management of electric storage batteries

Energia Concorrente deems that the use of the strategic sources, and, in particular, of batteries for energy storage and hydro-pumping plants, can be useful to grant the maximum efficiency of the network. However, it is essential that these systems be disciplined in a fair and non-discriminatory way.

In particular, it seems indispensable that the construction and the management of these plants be committed to private operators through

competitive, transparent and non discriminatory procedures, and in any case precluded to the TSO.

In fact, should the TSO be authorized to realize and manage such storage systems, as the Italian law currently provides (see art. 36 of d.lgs. 1 giugno 2011, n. 93), some distortive effects could emerge. In particular:

(i) Independency and third party role of the TSO could be definitely compromised due to the conflict of interests between the same TSO and the private electricity producers.

In opposition to the traditional network infrastructures, which are static pieces of equipment, these plants can be managed by the TSO actively and "dynamically" on the market, by storing, balancing and possibly releasing energy at the right times: this way, the TSO is able to operate them, effectively, as they were proper power generating plants.

In such case, the system operator would play – simultaneously – the double role of purchaser and seller, competing *de facto* with the other players in the wholesale market, in patent conflict of interests; this, apart from deeply manipulating the market conditions, could favor unfair and discriminatory practices against the system's users: for example, the TSO would be able to grant its own storage plants easier access to the network and-or to the dispatching of the electricity produced/stored, as well as being in the position to invest (or divest) in the development of the network in those areas where it is functional to its storage stations, damaging the competitors in the market for services.

It is evident that such a solution would imply a patent violation of the principle, clearly set by art. 9 and 12 lett. f) of directive 2009/72/CE, requiring the separation of the TSO from the interests of other market operators.

This issue has often been raised by the italian Authority for Electricity and Gas (lastly, in its Public Letter 461/2012/I/COM), the position of which seems coherent with what is happening in the other Member States (as underlined in a recent publication by the Ref-E institute).

In Germany, for example, storage systems are realized by the private operators and remunerated by the TSO through administered fees for the stored energy, besides being exempted from some network charges.

Similarly, in France, storage systems are accounted as generation units and their realization by market operators is directly supported by the State.

(ii) *The TSO would be discouraged to perform the necessary investments in order to fulfil the obligations of developing and improving the national grid, stated in artt. 13 par. 4 and 22 of directive 2009/72/CE and art. 16 of directive 2009/28/CE.*

The possibility to use the stored energy in order to solve (but only temporarily!) potential balancing problems on the grid can determine a less urgent need, in the system operator's perspective, to perform the development of the network necessary to grant the effective dispatch of the energy generated by private producers. Such investments, on the contrary, would represent the sole permanent and definitive solution to the congestion issues which affect the electric grid (particularly in Italy).

The same Directive 2009/72/CE outlined this risk, underlining that "*without effective separation of networks from activities of generation and supply (effective unbundling), there is an inherent risk of discrimination not only in the operation of the network but also in the incentives for vertically integrated undertakings to invest adequately in their networks*" (9° whereas, emphasis added).

(iii) *The TSO could breach the European provisions which require to manage the national grid – in particular the dispatching services – at market conditions (we make reference to artt. 12, lett. a) and 15 par. 6 of directive 2009/72/CE).*

It is widely clear that the only possible way to manage the storage systems in compliance with the "market conditions" principle would be to entrust them, through public tenders, to private operators.

The choice to allow the TSO to built and operate the storages under a substantially administered regime, on the contrary, has the effect of totally excluding the market from the management of such tools and to drastically limit the needs for the TSO to resort to the market in order to perform the dispatching services; consequently, this choice would be in patent contrast with the mentioned artt. 12, lett. a) and 15 par. 6.

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