Comments of the Portuguese Competition Authority to the Consultation Paper on generation adequacy, capacity mechanisms and the internal market in electricity

In the past two decades, environmental sustainability, generation adequacy and competition have been the major policy objectives concerning the European electricity sector, expressed in several European directives and regulations.

These objectives can be conflicting and its implementation has showed several coordination problems. Financial support to renewables technologies may distort competition and reduce the residual demand for conventional thermal technologies, which are still needed to meet generation adequacy goals. In a sense, state aids to some technologies can create entry barriers to others. In fact, some of the most $C0_2$ friendly technologies, like wind power, may not be most desirable technology in terms of generation adequacy, due its intermittent nature and its lack of guaranteed availability. On the other hand, the technologies that can deliver reliable supply and balancing services may face difficult profitability perspectives when their usage rate is decreasing due to the increase of low marginal cost subsidized technologies.

Although markets have been opened to competition and free entry is the rule, the state has not gave up its function of choosing the generation mix to support environmental and adequacy goals. In the EU, National Renewables Energy Action Plans, ask for member states to define specific targets in terms of which low carbon emissions technologies to develop. Renewables support schemes are widely implemented in several formats (feed-in-tariffs, feed-in-premiums, auctions, quota obligations, etc.). Most of the renewables support schemes are characterized by the lack of technological neutrality.

After the Preussenelektra judgment (C-379/98, 13/03/2001), where the European Court of Justice ruled out the existence of state aid in the sense of article 107.º of the Treaty on the Functioning of the European Union (TFEU) in case of renewables support schemes that are not financed through state resources, some countries have developed their support to renewables without an explicit control of EU state aid rules.

While renewable support schemes target environmental sustainability, capacity payments are aimed at generation adequacy. In both cases, they may take a form of a state aid, especially when their level is set by the state (even though it may not be a state aid in terms of TFEU's article 107.º) and not through market based mechanisms.

In the past, capacity payments were argued as a form of intervention aimed at solving a possible market failure, related with the concern that market prices could be insufficient to pay for generators' fixed costs, leading to possible underinvestment in generation capacity.

In the present, as it is argued in the Commission's Consultation paper on capacity payments[1], the possible lack of generation adequacy – especially in what concerns the availability of the generation technologies that can deliver balancing services – can be associated with the distortions created with the support to renewables technologies. In a sense, the need for capacity payments, if it takes the form of a state aid, can be seen as a way to compensate for the distortions that arise from other state measures.

The current regulatory framework combines features of the ancient central planning system, notably directed to renewables technologies, with an open market framework for the other type of investments. The lack of technological neutrality of State support and intervention and the different combination of features of each technology, means that once one technology starts to get support, eventually the others will ask for it too. Although the fundamentals of central planning have been abandoned, indirect State intervention through State Aids is still

[1] European Commission, Consultation Paper on generation adequacy, capacity mechanisms and the internal market in electricity, 11/15/2012

very likely and potentially contradictory with the principles of free entry and competition. In fact, the principle of free entry undertaken by risk taking agents is undermined when most of the investment in new generation capacity is channeled through State Aid support schemes aimed at supporting investors' costs and reducing their risk.

Arguing that capacity payments are aimed at correcting a market failure may not be correct when the possible market failure is a direct result from other domains of State intervention.

In policy terms, incentives to generation decarbonization should minimize distortions in competition. Instead of capacity payments, other forms of intervention should be considered. Better control of State Aid in renewables (at the EU level) and a better functioning of the European CO_2 emissions market are alternatives that should be further studied and implemented.

February 2013