



**MARKET PARTIES PLATFORM**

*Linking Energy Markets*

## **Pricing the right products in a sustainable electricity market**

Discussion paper

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MPP-2014-00031





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### **Market pricing of capacity is inevitable**

In this paper the Market Parties Platform gives its view on the recent discussions on adequacy and capacity pricing. The MPP fully supports the transition to a sustainable energy industry through a low carbon strategy (CO<sub>2</sub> binding target) on a European level. We believe that the most efficient and customer oriented way to reach that goal is to use the market as means to do so. In current power markets many distortions exist which need to be eliminated. However, this process will take some time.

Therefore, it is questionable whether today's markets can develop the right pricing fast enough. Hence, additionally to the necessary development of current markets we therefore plea for the development of a system to reveal the market price of capacity on an international bases to ensure the required adequacy level.

In this paper we describe first the ideal situation in which the market itself would come to a correct pricing. In the second part of this paper we describe our concerns about the current international situation and the ability of the market in practice. We end with our recommendations and conditions for a capacity market.

### **Ideally a market will price the right products**

Markets have the ability to efficiently adapt to new circumstances. Looking at the development of the electricity market in Europe, it seems that it will evolve towards a market with lower predictability because of the effects of intermittent generation and the less predictable behaviour of participants. This situation will lead to highly volatile prices, often including moments when the price of electricity will reflect scarcity or drop to very low levels, zero or even falling below zero.

In theory, if all market participants are exposed to the entire range of market risks, the unpredictable situation described above will not necessarily be a problem. All market players will find different ways to hedge their risks. Consumers, e.g., could be exposed to real-time prices or have to pay a premium for receiving a fixed price. Generators with intermittent sources need to hedge their risk with contracts in order to give them the capacity and flexibility they need. Key in this situation is that parties have to meet all their market responsibilities to the full extent.

Contracts or products in the market should also cover the (investment) risks of parties that deliver capacity and flexibility. The design of the market should allow the recovery of all (but not more) costs of efficient and necessary capacity. Only if markets get the opportunity to solve these kinds of issues, it will lead to the correct pricing of the scarce goods, which is essential in any open, developed economy. In the electricity market capacity will become scarce in the future and therefore increases the risk of loss of load. Capacity and energy products must co-exist.

### **The reality of market development**

The ideal described above is not reality. In many countries interventions in the market lead to market risks that market parties cannot manage. Examples are:

- Regulation of wholesale and retail prices



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- Some RES support schemes
- Socialisation of market responsibilities, such as balancing responsibility
- Setting tariffs for system services instead of prices
- Obligations for generators to keep non profitable power plants in service
- Uncoordinated non market based capacity remuneration mechanisms
- National policies for security of supply
- Subsidisation of fuels

The market will not be able to adapt due to the current circumstances. To maintain the required level of security of supply the scarcity of capacity should be revealed in the market. Therefore capacity needs to be adequately rewarded as well. To ensure this a capacity market, preferably on a multilateral cross border basis, should be developed. This is urgent given a lead time of several years to develop and implement such an international market.

### **Recommendations and conditions for a capacity market**

The MPP believes that the market should be used for the transition to a sustainable electricity market with a healthy investment climate. For this we recommend:

1. Speed up the market integration process to ensure maximum competition. Priority should be given to the short term market (intra-day and balancing) in order to increase flexibility in the system including demand response.
2. Turn back and avoid interventions in the market
3. Coordinate energy policy at regional level
4. Prepare the design of a capacity market under the following conditions
  - Adequacy assessment should be done on at least a regional basis
  - The mechanism should be designed for the same region and cross border access should be assured
  - It should be non discriminatory with regard to location, technology, fuel, age, generation, demand response, etc.
  - Renewables should be integrated into the regular market, jointly with enhanced coordination of national support schemes
  - The price for capacity should reflect the economic scarcity. It is not a subsidy.
  - Any mechanism should be complementary to the energy market. Energy and capacity revenues should allow for the possibility to recover all (but not more) costs of efficient and necessary capacity.
  - As a service, the cost of enhanced security of supply should be borne by end consumers. Indeed, customers should have the possibility to choose their level of security of supply depending on the market pricing of capacity.

We urge the Pentilateral Energy Forum to put this on the agenda to solve this on a regional level. All the above recommendations are interlinked and should be seen as a complete package.



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## **Market Parties Platform**

The Market Parties Platform is a cooperation of energy industry associations in the Central West European electricity market (including the Benelux, France, Austrian and German market). Main goal of this cooperation is to actively promote the forming of an integrated CWE electricity market and efficient coupling with the surrounding regions. This will increase efficiency of the market and will therefore bring benefits to the electricity consumers in this region. The work is strongly linked with Eurelectric.