

Terna's consultation on the first phase of implementation of the Italian capacity mechanism



EFET response – 24 November 2016

Introduction

The European Federation of Energy Traders (EFET¹) thanks Terna for the opportunity to provide an input to its consultation on the planned capacity mechanism in Italy.

EFET remains convinced that a well-functioning pan-European market remains central to macroeconomic efficiency and is a key component to ensuring security of supply. An undistorted, well-functioning and competitive market also provides the energy price signals that will trigger efficient dispatch and investment decisions by all market participants, which will in turn reduce costs for end-consumers.

In our view, the decision to establish a new capacity mechanism or maintain an existing one should be based on a pan-European capacity adequacy assessment taking account of all capacities (generation, DSR and storage, including the contribution from neighbouring countries). Moreover, capacity mechanisms, where implemented, should be carefully designed in order not to interfere with the free formation of price signals in the energy markets. With this respect, EFET recommends the Italian Institutions to closely follow the design principles for capacity mechanisms that the EU Commission will lay out as part of its 'Winter Package' before the end of the year: this particularly regards the conditions under which capacity mechanisms can be introduced in a market-compatible manner and the rules for the participation of capacity located in another Member State and for interconnection usage.

Last, we believe the implementation of a capacity mechanism should not deter Terna from continuing to improve market functioning in Italy. Greater attention should be paid to the development and improvement of intraday markets by moving gate closure to H-1, implementing 0-24 continuous trading and facilitating cross-border exchanges to ensure the maximum use of interconnection capacity. The development of continuous intraday trading across borders and the improvement of harmonised and linked national balancing markets are necessary steps to improve security of supply in Italy as well as in conjunction with its European neighbours.

¹ The European Federation of Energy Traders (EFET) promotes and facilitates European energy trading in open, transparent and liquid wholesale markets, unhindered by national borders or other undue obstacles. EFET currently represents more than 100 energy trading companies, active in over 27 European countries. For more information: www.efet.org

Specific comments

Market participants need more clarity

Although the scheme contains market-based mechanisms such as auctions and secondary trading sessions, it may expose market participants to significant regulatory risks. All administratively determined outcomes need to be well understood and transparent to avoid damaging the integrity of price formation.

In particular, the timing of the procedure is too generic and not entirely clear. We seek clarification on how long the first implementation phase will last. Also, it is not clear if a unique 'Mother' auction will be organised during this phase or if several auctions are instead foreseen.

As a general matter, EFET requests clarification on the involvement of the dispatching users (UdD) in the capacity mechanism, should they manage third party assets: we understand that Terna will sign a contract with the owner of a production unit, but it is unclear which framework or contract will govern the relationship between the owner and the UdD or the relationship between Terna and the UdD.

We also note that Terna foresees to publish the demand curve and most technical parameters only 30 or 60 days in advance of the auctions. This is not acceptable as it exposes market participants to excessive uncertainty and risk, impacting price formation on wholesale forward markets and the hedging strategies of producers and importers. The need for predictability is especially important in the initial phase of implementation when no reliable price signal for reliability options is established and the 'Mother' auction is organised closer to delivery than the standard Y-4.

Overall, market participants need a clearer vision of the timing and specificities of the mechanism. For the sake of clarity, we suggest that Terna organises open meetings with market participants (such as users' forums) to facilitate the discussion and to answer their questions.

A proper lead time is needed

EFET objects the provision contained in par 4.1 of the consultation, upon which the delivery of the product could start the same year as the auction, entailing therefore a very limited lead time. On the contrary, we believe that Terna should provide market participants sufficient lead time and that the delivery should start at least one year after the auction takes place (i.e. auction in 2017; delivery 2018). This is necessary to reduce negative effects on forward markets and on already negotiated contracts to the minimum, and to allow proper planning of the participation to the scheme.

Strike should be set at VOLL

One critical element in the design of the capacity scheme, which may have an impact on the free formation of prices in the energy market, is the level at which the strike price is set. In general, it is essential that the strike price level is set well above any normal and tight market conditions and

therefore above the costs of the most expensive generating unit in the market. This price should in fact be set at a level which would be reached only in case of severe scarcity.

Given that – as we understand it – the load will also be entitled to participate to the MSD and to the capacity scheme, EFET believes it is necessary to calibrate the strike price level on the demand side response rather than on the peak unit generating costs. Therefore, we suggest that the strike price is set at the value of lost load (VOLL or ‘VENF’ – 3.000 EUR/MWh).

Ensuring a level playing field is vital

EFET believes that ensuring a level playing field in the capacity mechanism is vital for competition.

We believe that all no capacity should be allowed to receive double subsidies from the capacity scheme and other subsidy schemes, such as RES-E feed-in tariffs. Incentivized units should put on the same foot and hence no directly or indirectly incentivized subsidised units should be allowed mandated to relinquish other subsidy schemes to take part to the mechanism.

We approve the introduction of a derating factor for the demand side, as compared to programmable generation sources, consumption units would only be able to offer downward services on the MSD. We would welcome clarity on whether the derating factor will be extended to RES units offering asymmetric services on the balancing market.

Last, we object to the definition of mothballing units (‘unita’ in conservazione), as we believe that every market participant should be free to mothball its units for a much shorter period (i.e. three months). We recall again the need for a proper and long enough auction lead time.

Flexibility requirements and technical parameters

In general terms, EFET believes that more investments in flexibility should result from price signals arising from competitive, well-functioning electricity markets with cross-border access in all timeframes. However, if in the short term the Italian Institutions desire to reward the flexibility of power plants, demand and storage through a capacity mechanism, this should be temporary and should be designed as to reward their ability to ramp-up and down-react to system needs with efficiency. EFET believes the flexibility requirements that have been introduced by Terna do not have any meaningful economic sense in their current form, and fail to recognise the flexible potential of generation, demand response and storage. In fact, their introduction would not imply any significant effect besides a priority in the (rare) case of perfect parity in the capacity auction and would not valorise the contribution of flexible capacities.

Regarding the technical parameters for cogeneration plants, the consultation document does not include any detailed rule on how to calculate the capacity left after the heating production and that might be offered as CDP in the capacity mechanism. Therefore, EFET requires Terna to clarify if market participants will have to make this calculation by themselves or whether Terna will give specific instructions to follow.

In addition, EFET takes the opportunity to underline possible criticalities due to the misalignment of the timings of the gas transport tariffs and the relative capacity allocation mechanism, which

might create distortions in the capacity mechanism bidding strategies. Moreover, the quarterly update of the additional components of the general charges might also cause uncertainties for market participants.

Definition of relevant areas should be clarified

The provision according to which the “Areas of delivery” will be published by Terna only 60 days before the auction date is questionable. For the sake of predictability, we recommend the TSO to publish with much greater notice the areas where the product will be delivered. This is necessary to minimise the impact on traded forward markets. We recommend Areas are determined following an open consultation with market participants and announced at least six months before the ‘Mother’ auction.

Moreover, it should be clarified why the delivery points on the secondary market will not be the delivery Areas but the energy market “Zones” defined by AEEGSI del 111/06.

For the sake of simplicity, EFET believes that capacity market “Areas” should coincide with energy market “Zones” except in cases of significant and demonstrated grid congestions.

Once “Areas” are defined by Terna, we recommend they are modified only in exceptional circumstances due to major grid developments and/or significant evolutions in the location of generation/consumption units. All changes should be subject to an open consultation with market participants.

Demand side and renewables should be entitled to participate in the scheme from the beginning

EFET supports technology neutrality in the design of a capacity mechanism, which implies that the market design must allow a competitive participation of all the technologies on a level-playing field. EFET believes that both demand side and renewable energy generation should be entitled to participate in the capacity scheme from the very beginning. Terna’s consultation document assumes that consumption and RES units will be allowed to participate to the MSD: while we are aware of AEEGSI’s intentions to open the balancing and ancillary services market to these types of units, we seek full clarification on whether this will become a reality and according to which timeline.

Import definition in the demand side curve

In the construction of the demand curve, the contribution of imports has been considered with a value in line with the contribution registered in the previous three years. First of all, we suggest that the resource adequacy assessment be performed by every Member State in coordination (at least) with neighbouring countries. Second, by considering the contribution of imports for the previous three years only, there is a risk that the assessment does not provide a trustworthy

picture: we believe that Terna should also assess the likelihood of occurrence of extreme events – in Italy and in neighbouring countries – which might affect the patterns of production/consumption and ultimately reverse the statistical import/export flows.

Nonetheless, EFET supports the principle of locational neutrality in the design of a capacity mechanism, which implies that the market design must allow for a competitive participation of capacity based in foreign countries. The active participation of foreign units to national mechanism, with both premium and obligations, should be granted as soon as viable in the permanent capacity mechanism.