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Capacity Remuneration Mechanisms

Overview, Implementation in Selected European Jurisdictions and Implications for Switzerland

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**School of
Management and Law**

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Mechanisms**

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Executive Summary

In many European jurisdictions, capacity remuneration mechanisms are either in use or their implementation is being discussed. In light of falling prices on the wholesale markets for electricity, these mechanisms are meant to generate revenues over and above energy-only market revenues in order for power plants to be able to recover their fixed costs and ensure a reliable energy supply. In the first part of this paper, we present a framework for discussing the different types of capacity remuneration mechanisms currently in operation or under discussion. The terminology used is based on three ‘first-tier’ design choices related to the product being traded, the process of determining the amount to be contracted, and the responsibility for contracting the required amount. These design choices are the basis for the five main types of capacity mechanisms identified in this paper: ‘centralized capacity market’, ‘capacity obligations’, ‘decentralized capacity market’, ‘capacity subscription’, and ‘reliability options’. Admittedly, the boundaries between the various types are somewhat blurred. As will be shown, reliability options, in particular, can be applied in a way that resembles an energy-only market with a certain amount of mandatory contracting, or even a centralized capacity market, in cases where they are exclusively sold to a central authority. We also present important ‘second-tier’ design choices relating to, among others, auction and penalty design, contract duration, and lead time or locational considerations.

In a next step, we take a closer look at the implementation status of these mechanisms in France, Germany, and Italy, Switzerland’s main electricity import and export partners. Whereas capacity mechanisms are in place in France and Italy, in Germany the process intended to lead to an overhaul of the current market design is still ongoing. At present, the most likely outcome is an enhanced energy-only market design coupled with a strategic reserve. France has introduced capacity obligations, with the first auction of certificates scheduled for January 2016, while Italy has chosen reliability options and plans to hold the first auction at the end of 2015. For France, the main motivation for introducing a capacity mechanism is an energy scarcity during winter peaks and, therefore, the need to activate demand response. In Italy, the mechanism is focused on scarcity in the summer and is mainly designed to support gas-fired power stations threatened by closure.

While cross-border participation is already a reality in wholesale electricity markets, it is to date only rarely permitted for capacity mechanisms. Both France and Italy have stated their intent to allow for explicit cross-border participation; details have, however, not been released yet. In France, a public consultation process is currently underway. One of the few examples of explicit cross-border participation to date is the UK Capacity Market auctions, the first of which was held in December 2014. Another case is the network reserve program under the new act on the further development of the German electricity market (“Strommarktgesetz”), for which some degree of cross-border participation of Austrian, Italian, and Swiss generators of electricity is already taking place. However, due to limited experience with cross-border participation in general, many questions need to be answered. Two questions addressed in this paper concern the decisions on who is to participate (i.e., generators or interconnectors) and what the product to be traded is (i.e., availability or delivered energy). Whereas there seems to be a preference for availability to be traded to avoid distortions of the energy-only market, there are advantages and disadvantages to both the generator and the interconnector models of participation. The Transmission System Operators (TSOs) are likely to play an important role should cross-border participation become a reality and effective regional coordination will be necessary, as well as new rules governing, for example, cases of coincidental scarcity situations. At present, it is these and other questions that have to be solved before Swiss generators are able to participate in mechanisms in neighboring countries, but there may also be political barriers, as indicated by the

recent refusal of the EU to conclude a preliminary bilateral agreement with Switzerland concerning the electricity sector.

In addition to potential cross-border participation by Swiss generators, capacity markets in neighboring countries are also likely to impact on Swiss market participants due to their interaction with energy-only market outcomes. A potential decrease in the level and frequency of peak prices may create problems for the current business model of Swiss pumped-storage hydroelectricity. On the other hand, Swiss electricity consumers may benefit from lower prices on the wholesale electricity market. Distributional conflicts may also arise, such as between consumers in countries with a capacity mechanism in place and those in neighboring countries without a mechanism but with cross-border participation. In the context of granting other countries cross-border participation in its mechanism, France is currently conducting research on these issues. Although efforts are being made at the EU-level to harmonize key design choices about mechanisms in general and cross-border participation, in particular, no such harmonization has emerged to date. As long as this is not the case, the discussion about how to coordinate and accommodate different designs and the issue of distributional effects will remain a point of discussion.

Part I: Overview and Implementation in Selected European Jurisdictions

1. INTRODUCTION

Resource adequacy in electricity markets refers to the market mechanisms that manage the capacity of installed energy generating technology and the ability of generators to meet anticipated demand. Markets, by design, manage resource adequacy using commercial incentives as opposed to regulatory control of the utility.

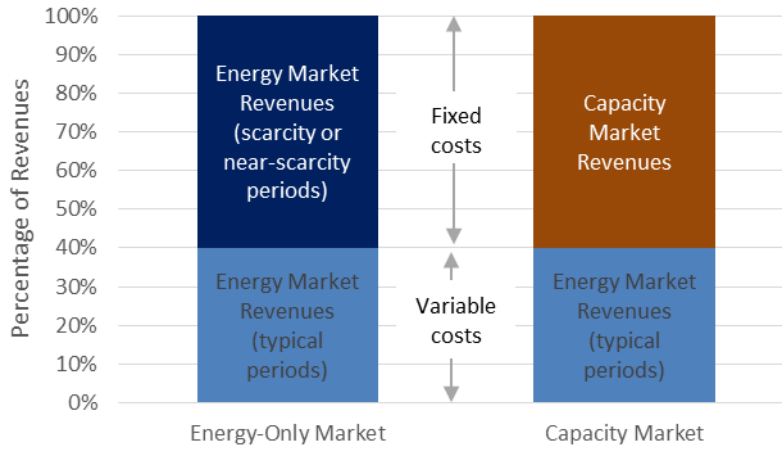
Some markets apply an energy-only model; in this framework, generators are paid for energy produced in a real-time spot market with the spot price typically based on the marginal cost of supply (which, strictly speaking, must also include the value to the demand side of the risk of insufficient capacity). Most of the time, the spot price is dominated by the variable cost of the marginal generator, which means that the recovery of fixed costs occurs during brief periods of scarcity, or near-scarcity. During such periods, the mean spot price may be significantly higher than the variable operating cost of any installed plant. Financial instruments are then used to manage the commercial risk due to market volatility and provide a more certain revenue stream to support the investment.

In energy-only market models, 'missing money' can arise when a spot market price cap is set too low to allow the recovery of fixed costs during scarcity periods. Unwillingness to accept sufficiently high spot prices has contributed to some markets adopting a more explicit capacity remuneration mechanism (CRM) to provide a safer investment environment. These mechanisms typically provide an additional revenue stream to generators (or demand-side resources) for the provision of available capacity over much longer timeframes, similar to those over which investment decisions are made (periods of several years). Conceptually, this allows generators to recover fixed costs via capacity market revenues (both incurred and recovered over a number of years) and allows spot market revenues to cover operating (variable) costs only, with matched decision-making timeframes of hours or minutes.

Figure 1 provides an illustrative example. A specific generator, operating in a particular way in a particular market, may incur 40% of its costs as variable costs (fuel, operations and maintenance, carbon costs, etc.), and 60% as fixed costs (fixed operations and maintenance, and capital repayments). In an energy-only market, generators might expect to recover more or less all their variable costs during typical periods, and would then contract with load serving entities (LSEs) (electricity retailers) to earn their fixed costs, with the level of those contracts being dictated by prices and anticipated occurrence of rare scarcity or near-scarcity periods, when prices reach much higher levels. If a capacity market is introduced, it will typically involve setting a much lower price cap in the energy-only market, such that energy market revenues only recover variable costs. Fixed costs would then be recovered via capacity market revenues.

In reality, the split between revenues from capacity and spot markets can be 'tuned' to any level desired, depending on the market design choices implemented, such as the level of the spot market price ceiling.

Figure 1 Illustrative example comparing the recovery of fixed and variable costs in energy-only and capacity market mechanisms.



Source: Own illustration

Note: Proportions are for illustrative purposes only.

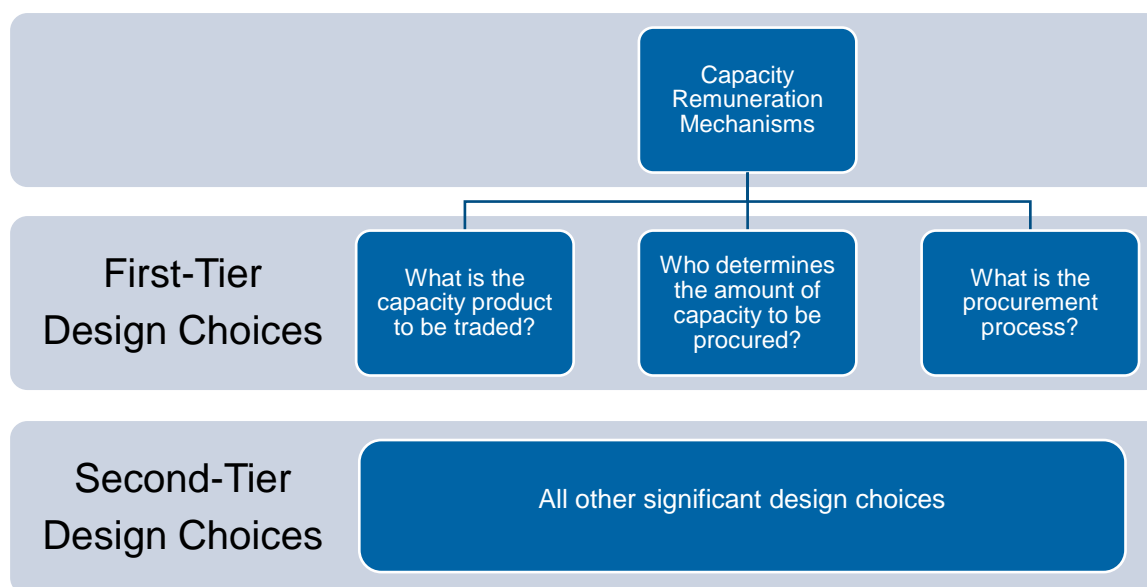
New Challenges for Resource Adequacy Mechanisms

Electricity markets around the world are currently facing new pressures that exacerbate challenges around market mechanisms for maintaining resource adequacy. Plateauing or reducing demand in many nations is combined with policies intended to drive investment in renewable and other clean technologies, many of which have variable availability (such as wind turbines and solar photovoltaics). Both of these factors are likely to create a more challenging investment environment, with less certainty regarding market revenues. For this reason, many markets are considering moving towards more explicit capacity remuneration mechanisms to increase investment certainty (including France, Germany, the U.K., Italy, and others). These developments make this an important time to provide clear frameworks for the design of capacity markets.

2. A FRAMEWORK FOR CHARACTERIZING CAPACITY REMUNERATION MECHANISMS

Three key design choices have been identified as being fundamental in defining the distinguishing features of the capacity market under consideration. The distinctions between most common types of capacity markets implemented around the world can be defined by characterizing these three design choices. In the following, these three design choices are therefore referred to as ‘first-tier’ design choices. Other design choices may also be significant in determining how the mechanism operates but are less important in dictating the differentiating terminology that is used to describe common models. These are designated as ‘second-tier’ design choices, respectively. This framework is illustrated in Figure 2 and described in more detail in the following sections.

Figure 2 Illustration of first- and second-tier design choices for the development of capacity remuneration mechanisms.



Source: Own illustration

2.1 First-Tier Design Choices

First-Tier Design Choice 1 – What is the capacity product to be traded?

Like for all created or ‘artificial’ markets, it is important to define the product that is to be traded. There are two broad choices: physical capacity or financial instruments (or both).

- **Option 1: Physical Capacity** – Most common types of capacity markets trade physical capacity via a ‘capacity credit’ or similar product, which is usually defined in megawatt (MW) of generating (or demand-side) capacity made available to the market in a particular year (or defined timeframe). There may be complex provisions that define the consequences if that capacity is ultimately not available in times when it is required, to ensure adequate incentives for capacity availability during rare scarcity periods.
- **Option 2: Financial Instruments** – A more recent innovation has been the option to instead trade a financial instrument such as ‘reliability options’. A reliability option is a call option similar to a capped contract traded in energy-only electricity markets. In a reliability option model, generators sell reliability options (usually, but not necessarily, to a central authority) and must then pay that central authority the difference between the spot price and the strike price whenever the spot price exceeds the strike price (Bidwell 2005). In markets with a high spot market price ceiling, failing to be available during scarcity periods results in a severe penalty. (When the spot price exceeds the strike price by a significant margin, any generator not operating will not earn spot market revenues to meet that contractual requirement.) Any capacity market that trades reliability options (rather than capacity credits) can be termed a reliability options mechanism.

Notably, a decentralized market (defined below) based on reliability options (rather than capacity credits) could be considered to be very similar to an energy-only market with some degree of mandatory contracting, creating a convergence between capacity market designs and energy-only market designs. Whether or not reliability options

can be termed financial instruments in practice also depends on who can sell these options. If only generators are allowed to do so, every reliability option is backed up by actual physical capacity.

First-Tier Design Choice 2 – Who determines the amount of capacity that will be required?

In an energy-only market, electricity retailers (or LSEs) directly determine the degree to which they wish to contract, based on the anticipated demand from their customers, the cost of procuring contracts to cover that demand, and the risk of spot market exposure (related to the potential for very high scarcity prices). In this model, then, the amount of capacity installed is determined by the market and will be critically dependent on the market price ceiling (usually set by a central authority).

In contrast, the implementation of a more explicit market for capacity requires that some authority should become responsible for determining how much capacity must be procured. There are three broad options:

- **Option 1: Central Authority** – In many capacity markets, a central authority directly determines the volume of capacity that is required (possibly based on a forecast of peak demand several years in advance).
- **Option 2: LSEs** – In other models, LSEs self-determine the amount of capacity to be procured based on their own forecasts of anticipated customer demand, and the risk associated with the penalties defined by a central authority if they fail to forecast accurately.
- **Option 3: Customers** – In some models, the customers themselves agree directly with providers the amount of capacity for which they want to contract.

First-Tier Design Choice 3 – What is the procurement process for that capacity?

All capacity markets must implement some approach for the procurement of capacity from the market. There are two broad options:

- **Option 1: Central Procurement** – A central authority directly procures capacity through a central process (such as an auction or tender).
- **Option 2: Bilateral Procurement** – LSEs or customers are responsible for procuring capacity, potentially through a bilateral trading process.

In any case, the cost of procuring capacity is typically levied on customers through retail tariffs.

2.2 Common Terminology Based on First-Tier Design Choices

The first-tier design choices lead to a number of common combinations, which are often described by the names outlined in Table 1. Terminology may vary between different markets, but these definitions are provided as a common foundation for discussion used throughout this paper.

Table 1 Common terminology for capacity mechanisms

| | Product Description | Who determines how much is procured? | Procurement process |
|--------------------------------------|----------------------------|---|-------------------------------|
| Centralized Capacity Market | Physical capacity | Central authority | Central procurement |
| Capacity Obligations | Physical capacity | Central authority | Bilateral process |
| Decentralized Capacity Market | Physical capacity | LSEs | Bilateral process |
| Capacity Subscription | Physical capacity | Customers | Bilateral process |
| Reliability Options | Financial instrument | Central authority (usually) | Central procurement (usually) |

These common groupings of first-tier design choices can be described as follows:

- **Centralized Capacity Market** – A central authority determines the amount of physical capacity required, and then directly procures that capacity from the market.
- **Capacity Obligations** – The central authority determines the amount of capacity required, and then passes the obligation for procuring that capacity on to LSEs (usually in proportion to their respective customer loads). LSEs then bilaterally procure capacity directly from providers.
- **Decentralized Capacity Market** – LSEs themselves determine how much capacity must be required, and then bilaterally procure that capacity.
- **Capacity Subscription** – Customers directly determine how much capacity they wish to contract for, and bilaterally enter into contracts with providers (Doorman 2005).
- **Reliability Options** – This could generally refer to any model based on financial instruments, although markets implementing this at present utilize central procurement, with a central authority determining the volume of capacity to be procured.

Depending on the way in which reliability options are designed, they can represent a variant of a Centralized Capacity Market, where generators sell one-way call options rather than capacity credits to the authority (European Commission 2013). While the payments for the underlying capacity may be similar, the penalty for non-availability is then represented by the difference between the spot market price and the strike price during times of scarcity or near-scarcity. Therefore, the boundaries between the two types are not always clear-cut. As we show below, reliability options can also be added to a centralized capacity market, providing a cost containment mechanism for electricity consumers and creating a second penalty for non-availability.

2.3 Other Types of Capacity Remuneration Mechanisms

There are a number of other types of capacity remuneration mechanisms implemented in various markets around the world. These are generally understood as follows:

- **Capacity Payments** – In a capacity payments mechanism, a central authority makes contractual agreements with new entrants to the market, negotiating to make additional capacity payments to that specific market participant at a particular level for an agreed period of time. Agreements can be individually negotiated, or may be based on simple rules (such as a published payment rate for a certain technology type entering the market at a particular time). The central authority may target a certain volume of capacity deemed to be necessary for achieving resource adequacy and adjust the price offered on that basis, or may simply offer a set price for additional capacity.
- **Strategic Reserve** – In a strategic reserve mechanism, a sub-set of energy generation is 'reserved' from the market and receives additional capacity payments from a central authority (these may be negotiated individually or at a set rate). This generator is typically a low-capacity factor plant that is withdrawn from the usual market operation and is only dispatched in rare circumstances when all other plants in the market have already been dispatched.
- **Focused Capacity Markets** – A focused capacity market could be any kind of capacity market that makes distinctions between different types of capacity in the level of capacity payments that are made. This may be related to the flexibility of a plant (with more flexible plants being eligible to participate in a different capacity auction, with typically higher prices) or other factors, such as emissions intensity (see also Section 3.2).

2.4 Second-Tier Design Choices

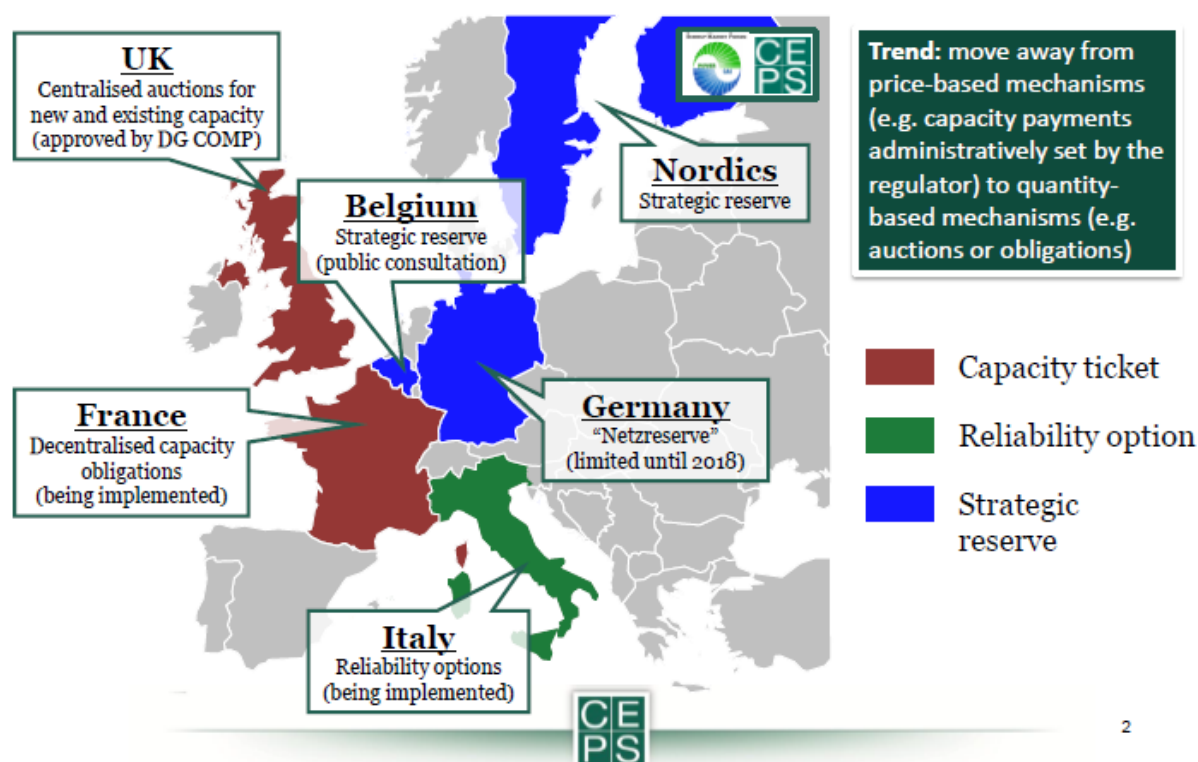
There are many second-tier design choices that are also important in dictating the operation of capacity remuneration mechanisms. These include:

- **Auction Design** – There are many design choices to make in the development of an auction process if one is to be included in the CRM design. Many involve features such as auction demand curves, which dictate the price to be paid for capacity, depending on the volume demanded by the market.
- **Contract Duration and Lead Time** – The duration and lead time for contracts is a critical feature of CRMs, since it relates closely to the investment timeframes for new capacity and influences the financing of new entrants.
- **Price Caps** – Price caps must usually be applied, both in the energy-only market and in the capacity market mechanism. These are important in determining the revenues earned by market participants.
- **Penalties for Non-Availability** – As discussed in Section 2.1, penalties for non-availability determine the incentives for generators (and demand-side participants) to be available during periods of scarcity and are therefore important in determining market outcomes.
- **Determination of Capacity Credits for Different Technology Types** – Different types of technologies may be eligible to create different amounts of capacity credits. For example, variable generators (such as wind and photovoltaics) are usually eligible to sell only a proportion of their rated capacity as capacity credits, given their variable availability.
- **Locational Requirements** – Transmission constraints may impose physical limitations on the ability of generators in some locations to supply load at other locations. It is important that these physical constraints are taken into account in the procurement of capacity.
- **Cross-Border Participation** – Countries that are closely integrated with their neighbors often have complex provisions for the participation of capacity in neighboring markets. Cross-border effects must be carefully considered and taken into account (see also Section 4).

3. CRMS IMPLEMENTED OR UNDER CONSIDERATION IN SELECTED EUROPEAN JURISDICTIONS

A large number of European countries has introduced, or is considering, the introduction of a capacity mechanism (Figure 3). The designs and approaches vary significantly between individual countries. In the following, we look more closely at the French and Italian capacity markets and at proposals for a mechanism in Germany, since these are the three most relevant countries in the discussion of implications for Switzerland (Part II below).

Figure 3 Capacity mechanisms, operational or under implementation in Europe



Source: Recent EU development on capacity markets, CEPS presentation by Fabio Genoese, http://www.ceps.eu/sites/default/files/EU_Recent_developments_1.pdf

3.1 The French Capacity Market

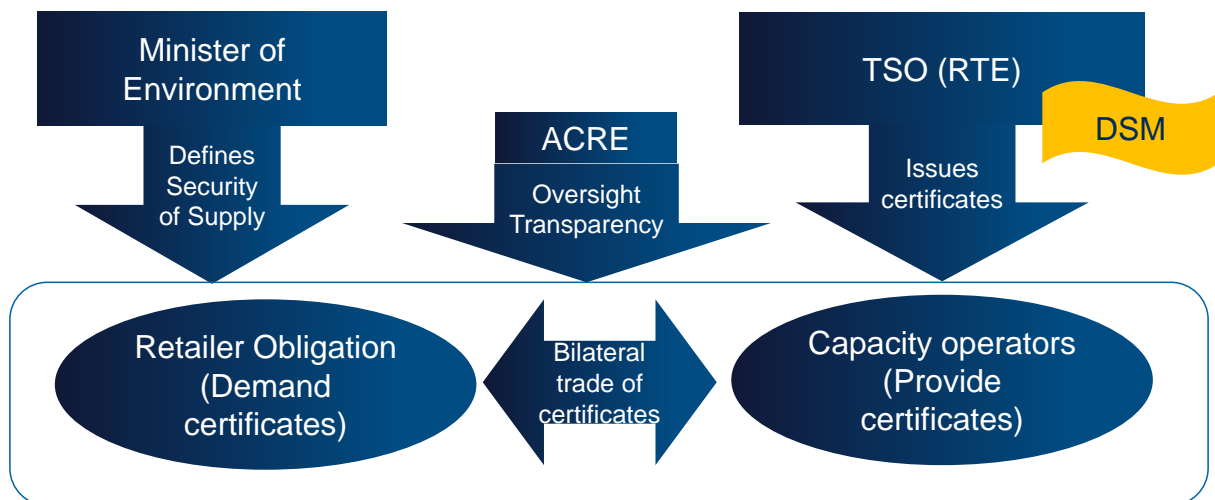
France has implemented its capacity mechanism in 2015, the first delivery year ranging from January 2017 to the end of December 2017, not including July and August 2017 excluded.¹ The first certificates of capacity were issued in April 2015, and EPEX plans to establish a regular auction to trade those certificates from January 2016 onwards. The stated aim of the French capacity market is the security of supply, especially in winter. There is a specific load scarcity situation in France in winter since many households use electrical heating. Demand response measures are, therefore, given a prominent role in the market design to help modify consumption behavior during peak periods (RTE 2014).

Under the French capacity mechanism, LSEs have an obligation to hedge their demand and buy capacity certificates equal to their customers' consumption during a standard winter cold spell, which reflects the risk of a short-fall. Eligible operators of generation and demand response capacity receive capacity certificates issued by the

¹ There is a shorter gap between the start of the mechanism and the first delivery year compared to the four years of lead time originally envisaged. This has been specifically addressed in the decree.

Réseau de transport d'électricité (RTE/TSO). The number of capacity certificates created corresponds to their contribution to reducing the shortfall risk, and thus their price will tend toward zero in situations of overcapacity. Certificates can be traded decentrally four years in advance of delivery, but also shorter timescales are possible in order to accommodate demand response more effectively. Certificates can be traded until the transfer deadline, which is set after the delivery year. Only when the transfer deadline is reached, the compliance is assessed and in the case of non-compliance, an imbalance settlement is required to be paid. The imbalance settlement depends on the actual situation: If security of supply was not at risk, this is close to the market price (market price * incentive coefficient), if security of supply was at risk, it is set at the annualized cost of a reference peak capacity, which is published four years before the delivery year by the Energy Regulatory Commission (CRE).

Figure 4 The structure of the French Capacity Market



Source: Own illustration based on RTE (2014)

Two institutions are charged with market oversight (see Figure 4). RTE is responsible for making adequacy forecasts with different time horizons and setting up a registry for demand management and capacities. The Regulatory Commission of Energy (CRE) publishes statistics on exchanges to enable estimates to be made of volumes traded or offered and prices asked. It is also in charge of setting the imbalance settlement prices. Given those characteristics, the French mechanism corresponds to capacity obligations, where the volume to be procured is set centrally and the procurement process takes place bilaterally (Table 2). Given its rather low involvement, the French government considers its capacity market to be in no conflict with EU state aid rules and therefore does not deem it necessary to have the mechanism approved by the European Commission.

Table 2 The French capacity market – Overview of first-tier design choices

| Status | How is the product defined? | Who determines the amount of product required? | What is the procurement process? | Who is responsible for procurement? | How are costs allocated? | Cross-border participation | Fundamental type |
|----------------------------|-----------------------------|--|--|-------------------------------------|---|--|----------------------|
| First auction January 2016 | Physical capacity (0.1 MW) | Central authority sets volume | Decentralized procurement; EPEX plans regular auctions | LSEs | The price of certificates should reflect shortfall risk; temperature-sensitive consumers (electric heating) to bear costs | Envisaged but in the first stage not explicit (i.e., implicit consideration of import capacities when determining volume required) | Capacity Obligations |

The French capacity mechanism employs different technologies to create certificates. Certificates are then corrected to take into account technical constraints (limited time of use will generate fewer certificates) and flexibility issues (e.g., number of certificates from inflexible capacities may be reduced). New and existing plants are treated as equal and in a technology-neutral manner, including demand side response. Demand side response can participate in two ways: Either implicitly, by reducing the obligation for the supplier, or explicitly, through the certification process.

Table 3 The French capacity market – overview of second-tier design choices

| Capacity treated equally | | | How is capacity payment determined? | Contract duration and lead time | Penalties for non-availability | Price caps |
|---|--|----------------------------------|-------------------------------------|--|--|---|
| New / existing | Technology | Imports | | | | |
| Existing and new plants are treated equally | Limited time of use and flexibility will generate fewer certificates | Only implicit in the first stage | Market, bilateral | One-year contract with two peak periods Four years of lead time but shorter for demand response | After a two-year balancing period, the 'imbalance settlement' is set according to situation (whether or not supply is at risk) | Indirectly, through regulated retail prices |

3.2 Considerations in Germany

Germany is currently debating whether its energy-only market will be sufficient to guarantee “security of supply, economic viability and environmental compatibility” (BMW 2014, p. 6) in the long term, or whether a capacity mechanism will be required. In its Green Paper, the Federal Ministry for Economic Affairs and Energy noted that even under the current energy-only market design, there is some implicit capacity remuneration through the system of balancing groups and imbalance settlements, which need to be paid if the actual production and consumption are at odds with a group’s schedule. In the context of network stability, Germany already has in place a mechanism to secure the capacity required. This network reserve was conceived against the backdrop of increasing energy generation (in particular wind) in Northern and Eastern Germany and demand centers in the South.

Network Reserve

In June 2013, the German government enacted legislation for a mechanism to procure capacity deemed relevant to ensure the stability of the network (the goal to date being network stability, not resource adequacy). (German Federal Government 2013). Under the new regulations, which are to remain in force until the end of 2017, the Federal Network Agency publishes the capacity to be held in the reserve on the basis of forecasts and analyses made by the network operators. During the first winter (2013-14) of its operation, the network reserve of 2,500 MW did not have to be used at all, mainly owing to very mild weather (BNetzA 2014).

In May 2014, the Federal Network Agency published its report detailing requirements until 2018 (BNetzA 2014). For the winter of 2014-15, a need of 3,091 MW was determined, rising each year to reach 7,000 MW in 2018. A share of these requirements has already been secured through a process by which the Agency can transfer ‘system-relevant’ power stations about to be closed into the reserve. While for the winter of 2014-15 nearly all of the necessary capacity is already secured, for 2017-18, only about 55 % are already contracted in this way. Before they can call on the reserve, the network operators have to first exhaust all other measures available to them to stabilize the network.

Operators can bid for the remaining capacities and then negotiate with the relevant TSO. Operators situated in Germany as well as within the European electricity market and in Switzerland can take part. For power stations situated in Germany, it is a requirement for power stations joining the network reserve to cease to participate in the energy market. Installations are reimbursed for any costs related to maintaining or getting the installation ready to be reserve capacity; this does not include costs related to the mothballing of the installation.

In order for generators from other EU countries or Switzerland to participate, it is a prerequisite that they are suitable, obtain permission from the relevant national authorities, and commit to being available when needed. Furthermore, their offer has to be as competitive as those from German installations. In fact, in the reserve for the winter of 2013-14, 1,000 MW were contracted from Austrian power stations and 200 MW from Italian ones (BNetzA and Bundeskartellamt 2014). Swiss power stations also participated in the bidding process in the past and obtained the relevant approval from the regulatory authority.

In special cases, such as if not enough existing power stations can be contracted or if the contraction of existing power stations is more costly, the network reserve can be used to build new installations. However, those generators are then also not allowed to take part in the energy-only market.

As the Green Paper states, the German network reserve would no longer be necessary if the grid was expanded to the relevant degree. On the other hand, power stations that are now part of the Germany’s network reserve could become part of a capacity reserve mechanism. If this reserve mechanism was regionally divided, it could still address the bottlenecks between Northern and Southern Germany, should those remain.

Strategic Reserve

The so-called 'strategic reserve' is mainly discussed as a mechanism to be implemented for the transition to either an optimized energy-only market design or the introduction of a capacity mechanism. As opposed to the network reserve, where the contracted generators are used to overcome bottlenecks, the power stations in a capacity reserve are dispatched if demand and supply do not balance. The power stations in the reserve are only deployed after all market transactions have been concluded, so as not to interfere with market forces. In order to guarantee this, the capacities would be bid into the market at the current ceiling price of 3,000 €/MWh.

In this framework, the amount of capacity required is defined by a central authority and procured and dispatched by the TSOs. Similarly to the network reserve, the power stations can then no longer participate in the electricity market. This measure is taken to ensure that the existence of a strategic reserve does not distort decisions on the energy-only market (BMU et al. 2013). While the network reserve is, to a large extent, a regulatory mechanism in which a number of system-relevant power stations are required to take part, the strategic reserve is procured based on tenders. In a bid to reach their 2020 emissions reduction goal, the Germans recently proposed, however, to transfer 2.7 GW of brown coal capacity directly into a potential strategic reserve. Similar to the network reserve, the cost of the mechanism is passed on to electricity consumers via network charges.

Network reserve and strategic reserve are therefore similar in many ways. Both can co-exist alongside each other or the requirements of the network reserve can be transferred to the strategic reserve, by, for example, focusing on capacity situated in Southern Germany where grid bottlenecks can be expected until the grid expansion is fully realized.

Proponents of the strategic reserve mechanism welcome its advantages, such as ease of implementation, the possibility to integrate it with a host of different electricity market designs, and its low cost. Its critics, on the other hand, note that the interactions between the reserve and the energy-only market may be underestimated, potentially leading to a situation where the prices needed for investments on the energy-only market are no longer achieved. Furthermore, the argument that limited regulatory intervention is required and that costs are low only holds if the strategic reserve remains small and does not influence market results on the energy-only market.

Centralized Capacity Market

Two types of centralized capacity markets are under consideration in Germany: i) a comprehensive capacity market ("Versorgungssicherheitsverträge"), where, in general, all capacity would be eligible to bid in the market (EWI 2012) and ii) a focused capacity market, where the market would be split into two different segments, one for new entrants with a certain flexibility and emissions standards and one for non-viable existing capacity (e.g., determined by the capacity utilization in a certain year) (Öko-Institut et al. 2012). In both cases, the central authority sets the volume of physical capacity to be put out to tender in each of the segments, which is then procured centrally through auctions (descending clock auctions). Costs are passed on to consumers in the form of a surcharge on the electricity price. These surcharges can be proportional to individual consumption or differentiated by the structure of consumption, by which consumption in peak times would pay more (EWI 2012). These first-tier design choices imply that both proposals fit under the common heading of 'centralized capacity markets'. Reliability options (restricted to the contracted capacity) are added as a cost containment measure for (rare occasions) of very high scarcity prices (Table 4).

Table 4 Germany: Comprehensive and focused capacity market – overview of first-tier design choices

| How is the product defined? | Who determines the amount of product required? | What is the procurement process? | Who is responsible for procurement? | How are costs allocated? | Cross-border participation | Fundamental type |
|-----------------------------|--|----------------------------------|-------------------------------------|--------------------------|----------------------------|--|
| Physical capacity | Central authority sets volume | Central procurement | Central authority | Capacity surcharge | Under certain conditions | Centralized capacity market with reliability options |

The two proposals differ most notably in terms of the types of generators can receive capacity payments. Whereas comprehensive capacity markets reward all types of (dispatchable) technologies and generators with a uniform capacity payment², focused capacity markets divide the market into two market segments: one for new facilities (achieving predefined flexibility and emissions requirements) and one for existing facilities that are threatened by closure.

However, although a common auction for all capacities is provided for in the comprehensive capacity market, it differentiates between existing and new plants through contract duration and bidding requirements. While new plants bid for 15 years of capacity payments, existing plants bid for only one year. Furthermore, existing plants are required to participate and have to bid with '0' in the capacity auction, i.e. they would supply capacity at any price.

Both proposals advocate the introduction of reliability options alongside the capacity auction as well as a penalty for non-availability of capacity. These options are expected to limit the price paid by the retailer on the energy-only market in scarcity situations, which the retailers are then expected to pass on to consumers. Furthermore, these options incentivize reliability, since the difference between the spot market price and the strike price has to be paid in any case, whether or not the generators are operating during the hour in question. It can, however, be expected that in a market with sufficient capacity the relevant strike prices (tentatively set at 300 €/MWh in one proposal, i.e., EWI 2012) will very rarely be reached.

² The proposal states that renewable generators may be able to participate, subject to certain conditions. However, it favors leaving renewables out of the market.

Table 5 Germany: Comprehensive and focused capacity market – overview of second-tier design choices

| | Capacity treated identically | | | How is capacity payment determined? | Contract duration and lead time | Penalties for non-availability | Price caps |
|--------------------------------------|---|---|--|--|--|---|---|
| | New / existing | Technology | Imports | | | | |
| Comprehensive capacity market | One auction for all capacity, but different contract durations and bidding requirements | Technology-neutral, including demand response | Advantages of European integration discussed, but no explicit mechanism presented | 1 auction (descending clock auction) | Lead time: five to seven years, plus interim auctions Duration: Existing: one year New: 15 years | Yes, but not specified further Plus reliability options | Existing generators have to bid at '0'; potential floor price Plus reliability options |
| Focused capacity market | Two market segments: 1) Existing plants threatened by closure – based on capacity utilization (plus controllable loads) 2) New plants subject to flexibility and emissions intensity prequalification | | Only those in single price zone, i.e., Luxembourg or Austria, and if not taking part in national mechanism | Two auctions for separate market segments (descending clock auction) | Lead time Currently: one year New: five years Duration: Existing: one (25%) or four (75%) years New: 15 years Controllable loads: Predefined intervals and frequency | Requirement: at least 90% availability at peak demand Plus reliability options | Restrict share of capacity that can be bid for by a single generator Plus monitoring Plus reliability options |

Decentralized Capacity Market

As a third option, the Green Paper discussed a decentralized capacity market mechanism for Germany (BDEW 2013; BET and enervis 2013), according to which LSEs³ are required to hold capacity credits to cover their demand in situations of scarcity, meaning during peak demand. These situations of scarcity are defined by the central authority that sets a price trigger (for the day-ahead market). If electricity prices exceed this trigger, retailers have to prove that they have contracted enough capacity to cover their demand. If this is not the case, they have to pay a penalty. Furthermore, the generators also have to pay a penalty if their capacity is not available in those situations of scarcity. Therefore, the level of the trigger price and the penalties for both retailers and generators play a crucial role in the outcome of this mechanism (Table 6).

³ In the proposals, the balancing group managers are the liable parties. In most cases, however, those are equivalent to the LSEs.

Table 6 Germany: Decentralized capacity market – first-tier design choices

| How is the product defined? | Who determines the amount of product required? | What is the procurement process? | Who is responsible for procurement? | How are costs allocated? | Cross-border participation | Fundamental type |
|-----------------------------|---|----------------------------------|-------------------------------------|----------------------------------|----------------------------|-------------------------------|
| Physical capacity | Central authority sets penalty level and trigger price; LSEs determine capacity needed in scarcity situations | Decentralized procurement | LSEs | To electricity consumers by LSEs | Under certain conditions | Decentralized capacity market |

This capacity mechanism treats existing and new plants equally and is technology-neutral. Demand response is incentivized in that an LSE can reduce the demand of its customers (at peak times) and can thus hold a smaller number of capacity certificates. These capacity certificates can be traded bilaterally or on an exchange. As a starting point, the BDEW (2013) suggested capacity credits for a duration of three months but noted that the adequate duration and lead time (i.e., forward sales of certificates) would subsequently be determined by the market. The proposal does not specify the level of an adequate penalty for both generators that cannot deliver the contracted electricity and LSEs that do not hold the required amount of certificates. It states, however, that a multiple of the average certificate price in a given period may be adequate. Capacity from other countries should be able to participate if the necessary physical transmission rights (PTR) are secured. Furthermore, the participation of a particular country should only be allowed if it does not participate in a potential national capacity market (Table 7).

This proposal is similar to some extent to the French capacity market design. However, compared to this proposal the French mechanism has additional parameters that are set by the authority and determine the amount of generation capacity to be purchased by the retailers.

Table 7 Germany: Decentralized capacity market – second-tier design choices

| Capacity treated identically | | | How is capacity payment determined? | Contract duration and lead time | Penalties for non-availability | Price caps |
|---|---|--|-------------------------------------|---|-----------------------------------|------------|
| New / existing | Technology | Imports | | | | |
| Existing and new plants treated equally | Technology-neutral, including demand response | Yes, if physical delivery (PTR) is ensured and if no participation in national CRM | Market, bilateral | Duration: starting point: three months, then determined by the market | Multiple of the certificate price | n.a. |

The Legislative Process

As the German Green Paper notes, the decision on which market design essentially depends on a range of fundamental assumptions and definitions, including assumptions on the behavior of market participants (including small consumers) or the definition of the adequate level of reliability. Following a public consultation on the Green Paper (open until March 2015) and discussions with the German federal states, neighboring countries and the EU, the Federal Ministry for Economic Affairs and Energy has presented a regulatory proposal in the form of a White Paper (BMWi 2015) which confirms the recent signals from the German government pointing to a preference for enhancing the energy-only market in combination with a strategic reserve in favor of implementing a fully-fledged capacity mechanism.⁴ In a further development, Germany now plans to transfer 2.7 GW of brown coal capacity into the strategic reserve as part of a plan to reach its 2020 emissions reductions goal through additional reductions in the electricity sector. However, the strategic reserve, and in particular its brown coal reserves, may be considered state aid by the EU and further hurdles may have to be faced as a result before they can be introduced.⁵

3.3 The Italian Capacity Market

The first auctions under the Italian capacity market are expected to take place at the end of 2015 (Petrian 2015). The aim of this capacity market is to ensure system adequacy at minimum cost for the electricity system as a whole in the medium and long term. Since there is currently enough capacity in the Italian market, the main issue is to ensure that not too much of it is retired. This applies, in particular, to gas-fired generators.

Table 8 The Italian capacity market – overview of first-tier design choices

| Status | How is the product defined? | Who determines the amount of product required? | What is the procurement process? | Who is responsible for procurement? | How are costs allocated? | Cross-border participation | Fundamental type |
|---|-----------------------------|--|----------------------------------|-------------------------------------|--------------------------|----------------------------|---------------------|
| First auction planned for the end of 2015 | Financial instrument | Central authority sets volume | Centralized procurement | TSO | Capacity surcharge | Envisaged | Reliability options |

As shown in Figure 4, there will be annual auctions which will be organized by Terna (the Italian TSO). Terna will define adequacy targets for different regions (capacity in MW, by year and area), which are identified according to transmission limits. Each target consists of an elastic yearly demand curve (for a maximum of four years into the future) which is a function of the volume, loss of load probability (LOLP) and the variable costs of marginal technologies. Sellers submit their portfolio offers for a period of three years. A descending clock auction is used to reveal the price to be paid for the obligation, which is a uniform price set at the intersection of demand and supply and which will reflect the standard variable costs of an efficient peak plant. Both new (planned and under construction) and existing resources can participate in the auction as long as they are dispatchable and not subject to any other incentive schemes or dismantling measures. The winning generators will receive a premium payment. However, they are obliged to submit offers in the day-ahead market, ancillary services, and balancing markets and will need to pay back the difference between the spot and the strike price to the TSO if they end up producing

⁴ <http://www.handelsblatt.com/politik/deutschland/sigmar-gabriel-nein-zu-kapazitaetspraemien-fuer-fossile-kraftwerke/11251096.html>.

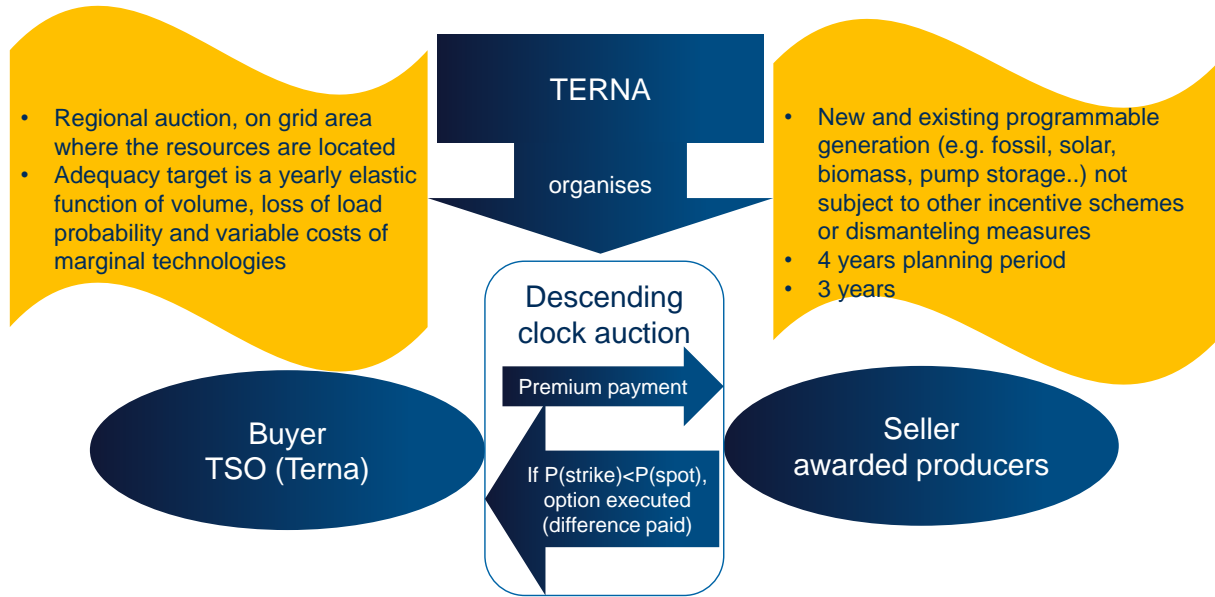
⁵ http://www.energie-und-management.de/?id=84&no_cache=1&terminID=110895.

electricity. This mechanism aims to reduce the risk for private investors by setting longer term price signals (AEEGSI 2014).

Table 9 The Italian capacity market – overview of second-tier design choices

| Capacity treated identically | | | How is capacity payment determined? | Contract duration and lead time | Penalties for non-availability | Price caps |
|---|---|-----------|-------------------------------------|---|--|-------------|
| New existing | Technology | Imports | | | | |
| Existing and new plants treated equally | Only dispatchable, not subject to other subsidies or dismantling measures | Envisaged | Descending clock auction | Lead time: four years Contract duration: three years | Difference between spot price and strike price in case of non-availability | Price floor |

Figure 5 Structure of the Italian capacity market



Source: Own illustration based on AEEGSI 2014

Part II: Implications for Switzerland

Although Switzerland is not planning to introduce a domestic capacity mechanism at present, the introduction of capacity mechanisms in neighboring countries, or the consideration of such schemes, has a number of implications for Swiss electricity producers, network operators, regulators, and electricity consumers. This is why affected stakeholders actively contribute to discussions about capacity market design in neighboring countries. Consider, for example, the joint submission of the BFE, EICOM, Swisselectric, Swissgrid, and VSE to the German Green Paper on future market design (BFE et al. 2015).

On the one hand, the interaction between capacity mechanisms and the energy-only market will impact on prices observed on the Swiss electricity market and have repercussions on the profits of electricity generators, costs faced by electricity consumers, and investment decisions. It will also create new circumstances to which regulators and market and network operators will have to respond. On the other hand, Swiss electricity producers may be able to participate directly in foreign capacity mechanisms. This cross-border participation has the potential to influence profit margins and investment decisions both at home and abroad. It will, however, necessitate a number of agreements and clarifications between regulators and market and network operators in Switzerland and abroad. In this section, we want to give an overview of the state of play with regard to cross-border participation. At the same time, we highlight the potential impact of interactions of introduced capacity mechanism with energy-only markets.

4. CROSS-BORDER PARTICIPATION

There are already several ways in which generation capacity can participate in markets in neighboring countries. Options include, in particular, day-ahead market auctions via market coupling (e.g., between France and Germany) or the auctioning of transmission rights (e.g., between Germany and Switzerland). Another example is the German network reserve ('Winterhilfe'; see also Section 3.2), where Austrian, Italian, and Swiss power stations have participated in the bidding process and have also been contracted (BNetzA and Bundeskartellamt 2014).

Basically, there are two ways in which capacities in other countries can be taken into account in the design of a national capacity market:

- **Implicit Participation:** Generation capacity situated in neighboring countries can (and should) be taken into account whenever the regulator (in the case of a centralized mechanism) or the liable parties (in the case of a decentralized mechanism) determine the amount of capacity that needs to be contracted to ensure system adequacy.
- **Explicit Participation:** Generators situated in countries that are connected electrically to a country introducing a capacity mechanism may also be able to participate directly in this mechanism. In fact, the European Commission asks the Member States to take into account “the participation of operators from other Member States where such participation is physically possible in particular in the regional context” (European Commission 6/28/2014, p.40), as a prerequisite for approving the mechanism.

In general, both implicit and explicit accounting for cross-border flows is necessary in order for national capacity mechanisms to lead to efficient outcomes. If, for example, the contribution of electricity imports to system adequacy in a country is underestimated, surplus capacities might be built in that country that would not have been necessary and thus make the system more expensive for consumers. Generation adequacy studies highlight the

importance of taking generation capacity in neighboring countries into account (PLEF 2015), which may significantly reduce the need for additional domestic capacity. A study commissioned by the German Federal Ministry for Economic Affairs, for example, finds that “[i]n the region covering Germany and the neighboring countries connected electrically and/or geographically, load and generation are balanced at any time with an extremely high probability of almost 100% up to the year 2025” (consentec and r2b 2015, p. 1). This indicates that, taking into account the demand and supply balance of the whole region up to this year, capacity mechanisms may not be necessary.

Similarly, explicit participation of foreign generators should ensure that the capacity mechanism supports capacities in a manner that does not distort the efficient operation of the energy-only market, including the mechanism by which electricity flows to countries with higher prices (ENTSO-E 2015). In the case of a well-designed market, explicit participation would probably be preferred on efficiency grounds (building capacity where it is cheapest), but this may then touch on distributional issues (cf. Meister 2015).

Before the introduction of capacity mechanisms, cross-border flows of electricity are either governed by (automatic) market coupling directing electricity flows to the country where prices are highest (until transmission capacities are reached) or follow an auction of transmission capacity. The different TSOs cooperate in monitoring those flows and if necessary take steps to ensure system adequacy at the European level (ENTSO-E 2015). The introduction of capacity mechanisms that would explicitly allow for cross-border participation would add another layer to the governance of these cross-border flows.

With regards to cross-border participation, two important design choices have to be made that determine the nature and extent of cross-border participation: (1) Who can participate and (2) what is the product being traded? We explore these and further issues in the next sections.

4.1 Participation

In general, two basic participation models exist when it comes to cross-border participation in capacity mechanisms: (1) the generator model and (2) the interconnector model. A third, mixed model (3) may represent a variant of the first one (Elforsk 2014). This choice of model determines how liabilities, responsibilities, profits, and risks are shared amongst market participants.

1. In a **generator model**, generators would participate directly in the capacity mechanism of the neighboring country. The model does, however, raise some important questions: Who is responsible for the prequalification, verification and certification of the cross-border capacity (the national or the foreign TSO)? How is availability checked (this also depends on the definition of the product that is traded across a border; see below)?
2. In an **interconnector model**, interconnectors participate as is, for example, the case in the 2015 capacity auctions for the British capacity market. The important question here is: Do the interconnectors offer interconnector capacity or are they also responsible for procuring the generation capacity? The receiving country would probably favor generation capacity.⁶ If the interconnector is also responsible for the generation capacity to be available, this will raise significant issues concerning the distribution of responsibility, liabilities, and profits. Questions arise with regard to whether or not a foreign TSO should participate in a market mechanism – and thus compete with domestic generators. This may not be compatible with the neutral oversight role a TSO usually plays and the financing structure of a TSO (natural monopoly).

⁶ In the case of electricity flowing from Norway to the UK, for example, interconnector capacity rather than available capacity is the limiting factor (cf. ENTSO-E 2015 which indicates that it should be the limiting factor for taking part in the capacity market).

3. In a ***mixed model***, the generators take part in the foreign capacity market directly, but only after the TSO has determined the amount of domestic capacity allowed to take part in the foreign mechanism. Furthermore, the TSO would have oversight of the process of delivery – and maybe other aspects, such as prequalification and certification. This mixed model may be interpreted as a generator model with extra requirements regarding the role of the TSO. In fact, a pure generator model without the direct involvement of the TSO is most likely not feasible at all.

EURELECTRIC, the association of the electricity industry in Europe favors the direct participation of generators (EURELECTRIC 2015). ENTSO-E (2015), on the other hand, stated that the most limiting (and therefore valuable) factor (either generation capacity or the interconnector) should participate, and that participation should further take into account the direct advantages of opening the market and disadvantages through increased cost, in other words, that transmission distances should be taken into account.

As Janssen and Kunze (2015) noted, it may not always be possible to determine the limiting capacity factor (i.e., interconnection or generation) upfront. In fact, the limiting factor may vary depending on the time of day/year or other variables. The authors have therefore developed two different variants of a mixed model that would cover both scarcity situations. In both cases, close cooperation between generators and interconnection owners is necessary: In their TSO-generator model, where generators would participate in the foreign CRM, they would also pay the interconnection owner for a guarantee that cross-border capacity will be available. In their TSO-TSO model on the other hand, the interconnectors would pay domestic generators for providing the necessary capacity. Both the guarantee for available interconnector and generating capacity may be procured in an auction.

Besides the direct choice of whether generators or interconnectors should participate, participation may also be limited due to the nature of the contracts being traded on a particular capacity market. While the European Commission demands capacity mechanisms to be technology-neutral (European Commission 6/28/2014), decisions with regard to, for example, lead times, the contract duration and definition of availability may preclude certain technologies. Small pumped hydro resources, for example, may only be able to generate energy for about 30 hours at a time and are therefore highly dependent on how contracts are specified in the specific mechanism. The design of capacity contracts in neighboring countries may, therefore, play an important role in the involvement of Swiss generators. The French design, for example, with its fairly short availability periods (see Section 3.1), is relatively favorable also for small pumped hydro producers.

4.2 Products

Another important issue determining the nature of cross-border participation in capacity mechanisms relates to the product being traded. The most important question in this context is whether the contract defines that actual delivery of electricity has to occur in periods of scarcity or whether generator, load, or interconnector are merely available in times of scarcity. As physical delivery may lead to situations where the capacity market outcomes interfere with the energy-only market and push active plants out of the merit order, the ***availability model*** is usually favored, as it is more compatible with the energy-only market and does not distort market outcomes (DNV GL 2014; EURELECTRIC 2015). It does, however, pose the question about how availability is measured. This becomes particularly challenging in the case of cross-border capacities.

One way to measure availability would be to ensure that contracted capacity bids into the intra-day or balancing market in times of scarcity. France, for example, has a requirement for generators to bid into the market. In the case of the availability model, the actual dispatch would then be determined by the energy-only market outcome. In the case of cross-border participation, the question arises whether the foreign capacity has to bid into the foreign spot market or foreign market for ancillary services – or whether it suffices to bid into the domestic market, as

market coupling or the auctioning of transmission capacity between the two markets would ensure that the flow is directed to where it is most efficient (cf. DNV GL 2014). If bidding into the domestic market suffices, the question arises who would check and communicate this to the relevant authority: the foreign or the domestic TSO.

Whereas a **delivery model** may be favored by the receiving regulator as it would provide more security, its actual implementation may be impossible in practice as it is not possible to reserve interconnector capacity for delivery a long time in advance, and this type of model is likely to interfere with the energy-only market and distort market outcomes and efficient cross-border flows.

4.3 Rules in Situations of Coincidental Scarcity

It is highly questionable whether a regulatory authority or TSO would allow contracted domestic capacity to honor its obligation under a capacity mechanism in times of coincidental scarcity situations. EURELECTRIC (2015) proposes to change the responsibilities of the TSOs in order to also account for these types of situations. Most likely, rules will have to be developed that specify exactly who pays the penalty in such situations. In fact, a harmonized penalty design may be required to deal with such situations. Strong regional coordination between regulators is, therefore, of high importance. This is confirmed by the fact that regional TSOs are actively discussing this topic (ENTSO-E 2015).

On the one hand, concerns over whether interconnected capacity will actually be available in times of scarcity may lead to the de-rating of foreign capacity (cf. de-rating of certain technologies in the French CRM design). On the other hand, as mentioned above, generation adequacy studies indicate that there is currently no indication of these situations occurring (consentec and r2b 2015; PLEF 2015). In particular, the introduction of capacity mechanisms would be expected to increase available capacity further and make coincidental scarcity situations less likely. Depending on the way the particular mechanism is designed, regulators can be expected to opt to include a security margin in their calculations of the capacity required, which would further increase the amount of capacity available. This also applies to potentially overly conservative de-rating of foreign capacity that could, in reality, make a larger contribution to the security of supply in the country in question (DG Competition 2015).

4.4 Roles for the TSO in Cross-Border Participation

On the one hand, TSOs play an important role in the operation of capacity mechanisms. They are usually responsible for prequalification, certification, and verification (cf. the French CRM design, Figure 4). On the other hand, they also play an important role in cross-border activities already taking place in the European electricity market. In the case of cross-border participation to capacity mechanisms, their role would, therefore, be further extended.

In particular, where a generator model is chosen (cf. Section 4.1), it is likely to be the TSO that will determine the amount of capacity available to take part in the capacity mechanism of another country. A natural limit could be available transmission capacity between the two countries. However, this is not necessarily evident, in particular if scarcity situations in the two countries occur at different points in time and in different seasons (Frontier Economics 2015). In cases where capacity is contracted many years in advance, the TSO would have to make a projection about the capacity that is likely to be available in the future. Moreover, the TSOs may be responsible for avoiding double participation in several capacity mechanisms of one generator (again this may depend on whether or not scarcity situations are likely to occur at the same time in different countries). It is likely that in the case of cross-border participation the domestic TSO would be responsible for the prequalification, certification and verification of domestic generators taking part in a foreign mechanism (Janssen and Kunze 2015).

Furthermore, an agreement would probably have to be signed between the domestic and foreign TSOs on measuring availability in scarcity situations. As mentioned above, the TSOs are also responsible for the coordination of

physical flow in scarcity situations to ensure system adequacy. A clear system of rules would have to be defined for coincidental scarcity situations to ensure regional system adequacy.

4.5 Relationship with the EU

The EU has recently rejected a preliminary bilateral agreement in the electricity sector with Switzerland.⁷ Discussions about this preliminary agreement were conducted against the background of the introduction of market coupling between Switzerland and France. In this case, the decision on market coupling had been linked to the existence of a bilateral agreement between Switzerland and the EU.

The course of action of the EU, in this case, indicates that bilateral agreements regarding the participation in capacity mechanisms between Switzerland and an EU Member State may also be influenced by the existence or not of a bilateral agreement between Switzerland and the EU. Since the EU is becoming increasingly involved in checking and approving (proposed) capacity mechanisms of individual Member States – such as in the context of state aid– this is even more likely. Also, consider, for example, the German trial tenders for large-scale PV, which are envisaged to be opened to foreign investors but would then have to be situated in a country that has a cooperation agreement with Germany (Bundesregierung 2/6/2015).

If there is indeed an EU-wide capacity mechanism in the future, it is highly likely that a bilateral agreement in the electricity sector between Switzerland and the EU would be a precondition for the participation of Swiss generators in such a mechanism. Other questions such as reciprocity (a Swiss capacity mechanism) would also come into play.

Regarding the relationship between plans of the European Commission and EU Member States, it becomes evident that the European Commission, along with other supra-national bodies (e.g., ENTSO-E, EURELECTRIC), favors the existence of a harmonized EU-wide CRM model (ENTSO-E 2015; EURELECTRIC 2015). This is opposed to the very diverse designs for CRMs currently chosen by the Member States. These diverse designs can be traced back to the different goals that countries follow with their capacity mechanisms (winter peak and DSM in France, summer peak and gas-fired capacity in Italy). For efficiency reasons, it would at least be desirable for key design elements to be harmonized in adjacent markets in order to enable a coupling of markets. However, there seems to be some tension between efficiency considerations and the very diverse goals of individual mechanisms enacted to date. Against this backdrop, the European Commission has recently opened an inquiry into whether or not the implemented and proposed mechanisms have the potential to distort the internal energy market (European Commission 2015). This also applies to the harmonization of rules concerning (explicit) cross-border participation, which are also discussed at the EU level (DG Competition 2015).

⁷ <http://www.srf.ch/news/schweiz/eu-gewaehrt-schweiz-keinen-strom-kompromiss>.

5. DISCUSSION AND OUTLOOK

As this paper demonstrates, many countries in Europe have implemented or are discussing the introduction of capacity mechanisms, including the main import and export partners of Switzerland, France, Germany, and Italy. The market designs chosen differ considerably depending on individual goals or market circumstances. Some details, such as the mechanism by which explicit cross-border participation could be possible, still have to be defined in the markets investigated in this paper. These developments in neighboring countries and potentially at EU level have implications for a host of different Swiss stakeholders, including generators, consumers, and regulators.

Besides the potential cross-border participation in the mechanisms in neighboring countries, the repercussions of the introduction of capacity mechanisms on the energy-only market will also determine the impact on Swiss market participants. The Swiss electricity price generally follows wholesale prices on the German and Italian as well as the French market. It can be expected that peak prices that occur in times of scarcity may be reduced or occur less frequently when capacity mechanisms are introduced, as additional capacity is kept online or built anew. The extent of this effect is a point of discussion and will largely depend on the amount of capacity contracted, either through a decentralized mechanism (France), a centralized scheme (Italy), or by way of a strategic reserve (the most likely case for Germany).

If peak prices are indeed reduced or occur less frequently, this poses a threat to the business model of Swiss pumped hydro. For Swiss consumers, on the other hand, the introduction of capacity markets in neighboring countries may mean lower electricity prices (depending on the extent to which those reach the individual consumer or different consumer groups). As a result, the costs and benefits associated with the introduction of capacity mechanisms in neighboring countries may be distributed unequally among different Swiss market participants. Further distributional effects exist between consumers situated in a country where a capacity mechanism is in place and consumers situated in a neighboring country where there is cross-border capacity participation. While consumers in the country that has the mechanism pay – to some extent – for capacity built across the border, the consumers in the neighboring country may benefit from lower prices on the energy-only market without contributing to the capacity cost. This example illustrates that the permission of cross-border participation may not be desirable for a country on distributional grounds (Meister 2015). This fact is also reflected in the current assessments by the French network operator (RTE 2015).

To date, there is no motivation to introduce a capacity mechanism in Switzerland due to its comfortable position with regard to available capacity (in summer, in particular) and connections to neighboring countries. However, it seems reasonable to ask the question whether the current energy-only market design will indeed be feasible in markets with very high shares of renewables, given their high fixed and low variable costs. Therefore, revenue streams in addition to the ones generated on the energy-only market are likely to become more important going forward. As noted above, these additional revenue streams may be provided by a range of different mechanisms ranging from a centralized capacity market to decentralized reliability options. Moreover, given that the business model of hydro generators in Switzerland has been suffering as a result of lower peak electricity prices, instruments providing payments for capacity may continue to stay on the political agenda. A final point to consider is to what extent reciprocity considerations may force Switzerland to introduce a capacity mechanism of their own in case they want to participate in those potentially more potent capacity mechanisms in neighboring countries in the future.

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LIST OF ACRONYMS

| | |
|------|---------------------------------|
| CRM | Capacity Remuneration Mechanism |
| LSE | Load Serving Entity |
| MP | Market Participant |
| SO | System Operator |
| VoLL | Value of Lost Load |

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