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*The regulation of (renewable) electricity markets in developed and  
developing countries*  
**Lecturer:** Dr. David Jacobs

**Term Paper**  
**The Need For Capacity  
Mechanisms And Their Limits  
At Solving Issues Of  
'Energy-Only'–Markets**

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# 1 Introduction

As many developed countries around the world have been liberalizing their wholesale electricity markets to different degrees during the last three decades<sup>1</sup>, their governments, regulators and customers had to make the experience that not all the hoped-for benefits of these steps did materialize<sup>2</sup>. Economic theory had predicted that competitive markets should lead to cheaper electricity as prices would eventually converge towards marginal production costs. The market mechanism was thought to provide the necessary price signals to give generators enough incentive to invest in new capacity so that supply and demand could be matched in the future<sup>3</sup>.

Alas, market designers didn't pay enough attention to intrinsic imperfections of electricity markets leading to insufficient investments in generation capacity. Inelasticities on the supply as well as the demand side and the difficulty to store larger amounts of electricity for later use result in high price volatility on the wholesale market<sup>4</sup>. Together with regulators' unwillingness to allow spot prices to climb too high fearing that firms exercise market power, new investments became unattractive to power companies thus leading to what became called the 'missing-money problem'<sup>5</sup>.

This issue particularly concerns so-called peak power plants<sup>6</sup> whose short-

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<sup>1</sup>Chile and UK were the first countries to abolish generation monopolies and opening up their markets to private companies introducing supply-side competition. Several US states and EU countries followed in the 1990s and 2000s

<sup>2</sup>see IEA (2002, 2003)

<sup>3</sup>Finon & Pignon (2006), p.3

<sup>4</sup>ibid (2006), p.9

<sup>5</sup>The 'missing-money problem' refers to the issue that so-called peak power plants which are in use only for a small part of the year (during peak demand periods) need high prices to cover their considerable fixed costs. If there are price caps in place, these prices will not come about which in turn results in under-investment in capacity.

<sup>6</sup>Böckers, Giesing, Haucap, Heimeshoff & Rösch (2012a), p.4

term response times to sudden increases in demand make them indispensable for the system operator to ensure system reliability avoiding involuntary rationing by shedding load.

Aggravating the situation is the increasing share of intermittent renewable sources especially in the German electricity market. Spot prices experience a downward pressure as renewables feature marginal production costs near zero and their bids on the wholesale market have to be taken according to German legislation<sup>7</sup>. This development makes it even more difficult for peak power plants to recoup investment costs. As a result from the year 2020 on, several authors predict a lack of peak capacity in Germany<sup>8</sup>.

Capacity adequacy, defined as supply security in the long-run, can arguably be considered a public good, being non-rival but also non-excludable<sup>9</sup>. System failure caused by insufficient generation imposes heavy losses on all market participants be they consumers or suppliers of electric power. Having the characteristics of a public good, private actors will not provide system reliability unless incentivized or forced to. Government intervention could be a solution to this problem of capacity shortages.

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<sup>7</sup>Diermann, Carsten, von Hammerstein, Christian, Hermann, Hauke Matthes, Felix Chr. & Schlemmermeier, Ben (2012), p.36

<sup>8</sup>ibid (2012), p.25 also Grave, Lindenberger & Paulus (2012)

<sup>9</sup>Finon & Pignon (2006), p.3

## 2 Structure & Research Question

This paper looks into the issue whether capacity instruments<sup>1</sup> can solve the aforementioned 'missing-money problem' in the long-term. This has to remain largely a theoretical discussion as the results and unintended effects of market liberalization<sup>2</sup> have become fully visible only during the past decade in most markets<sup>3</sup> and capacity mechanisms are a fairly new approach to the problem. Empirical data are rather thin and Germany which is to provide some exemplary illustrations for the questions at hand does not have any capacity market to date. On the other hand repeated interruptions in the wake of California's electricity market reforms in the 1990s<sup>4</sup> show that concern about how to guarantee future generation adequacy is not merely a theoretical thought experiment.

Germany's generation parc, for example, has not run through a complete investment cycle since market deregulation<sup>5</sup> in the late 1990s and neither did

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<sup>1</sup>This paper will employ the terms *capacity instrument*, *capacity mechanism* and *capacity market* interchangeably. Being linguistically accurate the expression *capacity market* should refer to the entire market system, whereas *capacity instruments* are the individual tools interacting with each other via *capacity mechanisms* to constitute the *capacity market*. For reasons of readability I will use the three terms analogously.

<sup>2</sup>The term liberalization refers here to reforms to national electricity markets that attempted to introduce competition. Measures taken included vertical unbundling by which incumbent energy firms had to separate different business activities along the value chain (generation, transmission, distribution to end-consumers), granting access to monopoly network infrastructure to third parties and the creation of independent regulators. Liberalization often went along with full or partial privatisation of state-owned electricity assets. Market liberalization has been implemented to varying degrees in different countries, and this paper will take the developments on Germany's electricity market as an illustration. Nonetheless the conclusion drawn should be applicable to a certain extent to any deregulated electricity market

<sup>3</sup>see IEA (2002)

<sup>4</sup>see Jurewitz (2002) as well as Woo (2001)

<sup>5</sup>The terms *deregulation* and *liberalization* will be used synonymously here, although dereg-

other markets even if liberalization started earlier in some cases. So empirically no final judgment can be made whether 'energy-only'-markets<sup>6</sup> provide sufficient incentives to build new plants or not. Some authors even express doubts over the existence of a 'missing-money problem'<sup>7</sup>. After an overview of some of the specific characteristics of electricity and electricity markets the paper will describe the 'missing-money problem' and why liberalized 'energy-only'-markets may not be able to guarantee sufficient investment in capacity for ensuring adequate supply.

In the third part I will present the challenges to the established 'merit-order' from the massive increase in renewable electricity generation and how this aggravates the 'missing-money problem'. This paper does not have the scope to expore advantages and disadvantages of different capacity schemes, but will rather highlight general shortcomings of this solution. For a thorough discussion on the effectiveness of specific designs see Battle & Pérez-Arriaga (2008), Diermann et al. (2012) and Siegmeier (2012).

My paper argues that capacity mechanisms will fail to address the deficiencies of 'energy-only'-markets if regulators inhibit the free functioning of market mechanisms via upholding caps on spot prices. Secondly I attempt to show that the objective of expanding renewables' market share will make it more difficult to ensure supply adequacy while at the same time reaping the potential welfare gains of a deregulated market.

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ulation, the removal of sector specific regulation, can be considered a subset of a more complex liberalization effort (see Sioshansi 2006a)

<sup>6</sup>On an '*energy-only-market*' solely electrical power is traded, generation and transmission capacity are not part of the transactions

<sup>7</sup>see Hogan (2005)

## 3 The Need For Capacity Mechanisms

### 3.1 Electricity As A Good Unlike Others

Electric power is unlike other goods or commodities in that it is expensive to store for later use. Given the current technology level only pump storage plants allow this on a large scale, geographic conditions permitting, which limits the feasibility of the approach to mountainous areas. Electricity markets thus require continuous and above all instantaneous balancing between supply and demand<sup>1</sup>, as there is only a very limited amount of stored power available to make up for generation shortfalls.

Failure to balance supply and demand at any given time will put the system's stability at risk. This can result in disruptions for the entire electricity network due to involuntary load shedding as customers are forcibly cut off from power supplies by the system operator. As only in rare instances it is technically possible to suspend deliveries to specific end-consumers their willingness to pay higher prices to continue the service or else forego supply cannot be acknowledged by the market.

In addition, most households have fixed-price contracts with utilities making them unresponsive to price spikes caused by supply scarcity<sup>2</sup>. This renders the demand side very inelastic in the short- as well as the long-run<sup>3</sup>. The 'traditional' function of market mechanisms to restore the equilibrium between demand and supply by price swings as classic economics would have it cannot be provided by the current market design.

On the supply side we also find short-term inelasticities since lead-times

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<sup>1</sup>Creti & Fabra (2007), p.259/260

<sup>2</sup>Hughes & Parece (2002), p.32

<sup>3</sup>Marty (2007), p.274

for the construction of new power plants are considerable, ranging from between 2-3 years for gas-fired installations to 10 years or more for nuclear reactors<sup>4</sup>. The lump-sum nature of investments in generation capacity with hefty upfront costs for new infrastructure also leads to slow decision-making processes by power companies. By implication the system operator has to estimate future demand for specific time frames and then make sure that sufficient capacity will be available during that period.

If capacity supply is inflexible and highly used at a certain point in time, even small changes in available capacity or demand can result in huge price swings<sup>5</sup>. This inherent price volatility in the electricity sector is unwelcome to generation companies since it complicates estimating future revenues from new capacity very tricky thus making these investments less likely to be undertaken.

While scarcity of supply makes the available generation capacity very valuable when wholesale prices are high, it renders it utterly valueless in case the whole system collapses and no electricity can be sold anymore<sup>6</sup>. The mere possibility of extreme cases where the system breaks down under too much load or when the system operator resorts to involuntary load shedding to prevent this happening, gives capacity adequacy the character of a public good. No customer can be excluded from the benefits of a functioning electricity system since it is nearly always impossible to cut off individual consumers. By implication providing the good 'supply security' is not a profitable business in itself and will thus not be furnished by an 'energy-only'-market.

Joskow and Tirole deem regulatory action all the more warranted as a single power plant not supplying the contracted for amount of electricity could potentially cause system failure. This would impose a severe negative externality on all market participants<sup>7</sup> since they would all be affected immediately.

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<sup>4</sup>Flinkerbusch & Scheffer (2013), p.15

<sup>5</sup>Hughes & Parece (2002), p.32

<sup>6</sup>Joskow & Tirole (2007), p.63

<sup>7</sup>ibid (2007), p.78



## 3.2 Electric Power Markets And Their Specific Nature

To serve peak loads almost at any time there needs to be idle reserve capacity available, which does not earn any income when not supplying electricity to the system<sup>8</sup>. Therefore, peak power plants have to make high returns when called upon in order to recover not only marginal costs but also their long-term fixed costs which only high spot prices on the wholesale market could ensure. Operators that provide peak capacity will not bid their marginal costs as in that case the assets would not be profitable<sup>9</sup> without additional capacity payments to fund their investment expenses.

At the same time most electricity markets feature caps for wholesale prices imposed by regulators. Market supervisors fear that high prices are less a signal of scarce supply but rather the result of strategic behaviour by energy firms using their market power. By withholding some of their capacity, artificial scarcity can be induced which would in turn lead to higher prices if the price mechanism was totally flexible and free.

As policy makers and regulators impose upper price limits on electricity, the chances of peak power plants becoming sufficiently profitable to give incentives for new investment<sup>10</sup> are significantly reduced. Thus peak power plants, although essential to ensure adequate generation capacity during periods of high demand, pose substantial investment risks for private actors<sup>11</sup>. Adding to that problematic situation, construction of new conventional power plants is rarely feasible in incremental small-scale steps. Lump-sum investments imply higher risks and by easing undersupply via extra capacity may paradoxically undercut their initial economic rationale<sup>12</sup>. *As long as generators cannot be certain to recover their fixed-costs, the prime objective of market liberalization, to drive down prices to marginal costs in the long-term will not be realized.*

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<sup>8</sup>Hughes & Parece (2002), p.33

<sup>9</sup>Ni, Wen & Wu (2004), p.366

<sup>10</sup>Keller & Wild (2004): “Investment only makes sense (i.e. is profitable) when the discounted value of revenues from sales of new [...] capacity exceeds investment and operation costs”, p.244

<sup>11</sup>Finon & Pignon (2006), p.4

<sup>12</sup>Keller & Wild (2004), p.244

## 4 The Effects Of Renewable Energy Sources

The existing system of selecting supply offers according to the merit-order<sup>1</sup> gets disrupted as renewable energy sources (photovoltaics, wind & tidal power) increase their market share. These technologies combine high fixed-costs (in relation to the specific generation potential for an individual plant) with the advantage of very low marginal costs since their input factors are provided free by nature.

Bidding with very low offers renewable energy pushes all other generation capacity rightwards in the merit-order. Thus the previously most expensive conventional plants (regarding marginal costs) are not contracted for by the system operator anymore, leaving this capacity unused and thus unprofitable. In general, spot prices, reflecting only marginal prices, are pushed lower during non-peak times. All participating plants are affected by this structural shift in the wholesale price level. Final unique wholesales price are insufficient for expensive power plants to recover their fixed costs via the difference between their marginal costs and spot prices. Conventional capacity thus earn lower returns, making it more difficult to pay off investment expenses. Some plants will be rendered entirely unprofitable since they get called upon too rarely for their revenues to cover fixed costs<sup>2</sup>.

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<sup>1</sup> *Merit-Order*: Sorting of power plant types according to their marginal generation costs in increasing order

<sup>2</sup> Böckers, Giesing, Haucap, Heimeshoff & Rösch (2012b) p.10

## 5 Shortcomings Of Capacity Instruments

As this paper mentioned in its introductory part, we do not have extensive empirical data so far to make a thorough assessment of how successful capacity markets really are in practice. In most countries capacity instruments have not been in place for long enough to judge their performance over the entire period of an investment cycle in the electricity sector (20-30 years)<sup>1</sup>. The original 'energy-only'-market structures and the solutions politicians in different countries have found to tackle the 'missing-money problem' are so diverse that a *most-similar* or *most-dissimilar* empirical research design would be very difficult and probably unreliable to apply.

Therefore I will limit the following discussion on capacity markets to a theoretical level, which should yield informative insights nonetheless. Even with the implementation of a certain capacity mechanism additional objectives policy makers may want the national electricity market to achieve cannot easily be squared with the aim to ensure future electricity supply. Low prices for industry to maintain international competitiveness and for households out of consideration for social policy purposes will barely provide the price signals we have seen are necessary to make investment in new capacity attractive.

Several important aspects of supply adequacy will be left aside due to the limits of scope of this term paper. The effects of an increasingly integrated European electricity markets are to remain unexplored as will be the issue of insufficient transmission infrastructure, an essential facet of overall supply security as well.

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<sup>1</sup>see Diermann, Carsten, von Hammerstein, Christian, Hermann, Hauke Matthes, Felix Chr. & Schlemmermeier, Ben (2012)

## 5.1 An Effective Solution To Market Design Defects?

### 5.1.1 Problems of their own

First of all it should be mentioned that capacity instruments bring along their own issues which merit attention when making a judgment about their effectiveness in fixing the defects of existing market designs. Since planning and construction of new power plants is a lengthy process, calls for bids in an auction or contracts in an administrative system should be launched far ahead of actually drawing upon the additional reserves. Long-term supply arrangements would also reduce investment risks for generators, which were identified as one of the causes for the 'missing-money' problem. At the same time this shifts risks like over-investment back to end-consumers<sup>2</sup> and would also reduce competition among generators to offer the most cost-effective solution to a lack of capacity<sup>3</sup>.

### 5.1.2 Incentive Structures — Plus ça change?

Current market designs are marred by a lack of price signals due to price caps, be they grounded in regulatory or political motives. Policy makers and regulators may desire low electricity prices so as remains competitive in a globalized world in this respect. Or they may have concerns about the affordability of electricity for certain parts of society and shield them and business from the violent price swings a free market is prone to induce. These curbs deny market mechanisms the ability to offer sufficient incentives for private companies to invest in new power plants as they are unlikely to recover their total costs. In order for capacity instruments to provide these exact inducements they would at first have to come up with a different way to determine the appropriate level of generation capacity<sup>4</sup> if supply and demand cannot be balanced through flexible prices. A single authority, be it the system operator or market regulator, would have to decide upon the quantity of reserve power to contract for or oblige distribution companies to do so.

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<sup>2</sup>Hogan (2005), p.5

<sup>3</sup>Böckers, Giesing, Haucap, Heimeshoff & Rösch (2012a) p.81

<sup>4</sup>Hogan (2005), p.5

Having arrived at an estimate about future load demands a price for capacity needs to be established either by the contracting authority itself or via a separate market where demand and supply for extra generation potential settle on a specific price. The option of one institution deciding upon quantity and/or price of reserve capacity raises the basic question, whether a centralized decision process is able to accomplish this task in the first place. The same information asymmetries persist as in an 'energy-only'-market, and it is hard to imagine the responsible authority to correctly anticipate future demand and plant availability all the time. In addition such a system open opportunities for agency-capture by special interest, plain politicisation or simply misjudgments about market conditions with potentially serious consequences for the entire electricity market<sup>5</sup>.

How is a capacity market to discover the quantity of capacity necessary for system stability? Price-based designs, see Battle & Pérez-Arriaga (2008), Diermann, Carsten, von Hammerstein, Christian, Hermann, Hauke Matthes, Felix Chr. & Schlemmermeier, Ben (2012) and Siegmeier (2012) for details, also try to harness demand- and supply-side valuations for finding a cost-effective solution to the 'missing-money' problem. However with regulatory price caps still in place, capacity instruments will, like traditional 'energy-only'-markets, fail to ensure enough generation power is available at any time. Constraints on market prices applied to capacity mechanisms will also impede price signals to induce new investments like they do in today's market designs.

To determine capacity requirements by administrative means and then to directly contract private actors to meet them is a different approach to tackling capacity shortages. But this would mean moving back closer towards the old model of command & control policy via publicly owned generation companies. Then again, one of the initial aims of liberalization undertakings was to have the market decide which projects to finance thus transferring investment risks to the private sector. This objective would be undermined by a capacity design that relied only on bureaucratic assessment.

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<sup>5</sup>Flinkerbusch & Scheffer (2013), p.24

## 6 Conclusion

Implementing a capacity mechanism expresses a mistrust of 'energy-only'-markets' ability to provide a satisfactory solution to the 'missing-money' problem. This paper has attempted to show why current market designs fail to deliver adequate levels of electricity supplies during peak loads, although some authors take a different view.

Hogan<sup>1</sup> for example argues that an 'energy-only'-market does not necessarily have to rely on spot-pricing alone and that long-term supply contracts between generators and distribution companies can be envisaged. Böckers et al. for their part judge the argument that high electricity prices are politically unacceptable a false one because short-sighted<sup>2</sup>. Not the wholesale price is relevant they argue, but the total costs consisting of capacity payments via surcharges or taxes added to end-consumer prices. In the end these compound costs would equal peak prices in a free market environment. Their reasoning however omits the political-economy aspect of electricity market regulation. Since introducing complete cost transparency to the retail level would look like price spikes to customers, which are also voters, such a step will be less than appealing to politicians. A detailed study of electricity markets' political-economy merits further research but cannot be provided here.

The cornerstone of a capacity mechanism is the ability of its designer or 'master' to correctly assess current and future capacity requirements. If capacity instruments are not allowed to use prices to arrive at this estimation, they will fail to provide sufficient generation power like 'energy-only'-designs. As market incentives through price adjustments are ruled out for political consideration the flaws of the existing market structure will not be overcome.

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<sup>1</sup>Hogan (2005), p.8

<sup>2</sup>Böckers, Giesing, Haucap, Heimeshoff & Rösch (2012a) p.81

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