

Russian Capacity Market

A regulatory perspective on price cap and bid constraints

Russian Capacity Market (KOM) and Capacity Payment (DPM)

Russian regulators launched at the end of 2010 the new capacity market (KOM). Market results for capacity delivery in 2011 were significantly affected by the price-cap level applicable in 27 out of 29 capacity zones of all Russian market zones. The remuneration price level of the capacity market does not guarantee the full cost recovery of fixed costs. Low prices in the capacity market leads to concerns for investors which are anyhow keeping their commitments on new investments.

Capacity selection and regulatory bid constraints are applied to all power plants excluding nuclear, hydro and new capacity investments on power plants of the ex state-owned Gencos planned at the time of acquisition by the private investors ("mandatory investments"). Capacity coming from these power plants will have priority in capacity selection and mandatory investments will also be guaranteed by specific capacity payments, under long term contracts (so-called DPM).

For all capacity bids coming from any other existing power plant, price would be set on the market, but price-cap would apply to capacity bids in the specific zones (so called Free-Float zones of Russian electricity market)¹ where there is lack of competition. The Russian Federal Antitrust Authority (FAS) is in charge of assessing the level of competition within the Free-Float zones, defining yearly the list of zones where the capacity price-cap should be applied due to the lack of competition².

A specific governmental decree of last February set price-cap values for 2011 in the different Free-Float zones at a level more or less equal to the level of capacity tariff for the old power plants. In the first zone, Europe and Urals, 2011 price-cap is equal to 118,125 RUR/MW/month (about 2,900€/MW/month)³, which does not reflect the fair level of capacity remuneration proposed by the Market Council based on a benchmark performed by consultants⁴.

At the same time, all capacity bids are subject to check by FAS for the economical feasibility in compliance with the fair bid methodology, annually published by FAS.

The definitions of a new perimeter of Free-Float zones, price-cap level and related application for the upcoming KOM run is expected by FAS and the Government in June 2011 before the launch of the next KOM run (October 2011).

Last April the Government decided to postpone for 1 year the launch of the real long term capacity market with 4 years of capacity delivery. The new calendar for the next market runs foreseen an additional run of KOM with a yearly delivery for 2012 (market run expected in October 2011) and the start of long term capacity market with a KOM run for a 4-years capacity delivery (2013, 2014, 2015, 2016) expected before June 1st 2012.

¹ Currently the Russian electricity market is divided into 29 Free-Float zones, according to grid interconnections constraints, but the number of zones may vary from year to year. Clearing price does not consider the interconnection capacity among the Free-Float zones.

² For 2011 FAS has established that price cap would apply to 26 out of 29 Free-Float zones: 3 out of 4 Enel OGK-5 power plants are located in zones where capacity auction will be carried out with price cap application.

³ Valid for the 1st price zone (Europe and Urals) where all Enel OGK-5 facilities are located.

⁴ The Market Council proposed last year to set price cap at the fixed cost for a new entrant, assessed at 300,000 RUR/MW/month (about 7,500 €/MW/month), starting from 2014. According to the Association of Power Producers last year this value is 340,000 RUR/MW/month (about 8,500 €/MW/month).

Regulatory issues

From a theoretical point of view, the existence of price-cap should mitigate the abuse of market power but, at the same time, it could potentially generate market distortion and underinvestment in the market. Especially in market under developments with a strong need of capacity to ensure security of supply, stringent price-caps could jeopardize modernization and green field investments.

For this reason, price-cap should be applied only where and when strictly necessary and always as a temporary measure, until competition has not yet been achieved.

Where competition exist, antitrust control should be based on «ex post» rather than on «ex ante» procedure in order to avoid market distortions.

In mature and developed markets, in order to avoid excessive price spikes, the concept of "*bid cap*" has been introduced. The notion of bid cap is very different from the price-cap one. In fact, while price-cap is a tariff scheme, bid cap does not refer to generation costs but reflects the consumers willingness to pay in order to avoid curtailments.

European electricity markets are dominated by Energy-Only Markets model and the most common bid cap level is fixed at 3,000 €/MWh. In Energy Market with Forward Reserve Requirement with a significant weight of capacity remuneration like Russian market, the bid cap in energy and capacity market should be analysed eventually in a coordinated way. Final revenues for the generators (from both capacity and electricity markets) should always guarantee an appropriate return of investments, not endangered by bid cap.

In the US experience bid caps in the capacity markets are set as a multiple of the cost for a new entrant generator (so-called CONE). In the PJM and ISO-NE Markets (Energy Markets with Forward Reserve Requirements and Centralized Capacity model), bid caps are respectively 1.5 times and 1.4 times the CONE.

Currently in Russia discussion are ongoing about a general review and modernization of wholesale market model and regulatory framework with the final aim of the abolishment of capacity market and the introduction of an Energy-Only Market.

Conclusions

In capacity markets investors strongly need a long term view on regulatory framework and prices. To this end regulators should publish in advance rules for market functioning and methodologies to set market prices (e.g. conditions for the application of price / bid cap and its annual adjustment) and ensure a generally stable regulatory environment. In the case of Russia, FAS should clearly define new and transparent methodologies to assess the level of competition, set a new shape for Free-Float zones accordingly. Moreover stringent regulatory constraints shall be removed especially if a generator is not in a dominant position.

In general, bid caps are better than price caps. Market competition is the best way to push prices at cost levels and antitrust control should be based on «ex post» rather than on «ex ante» procedure in order to avoid market distortions.

Price-caps could be acceptable only in the market start up phase, where competition is low, and should be based on fixed costs of new entrants in the generation market, or a multiple of it.