# REVIEW OF THE TREATMENT OF NEW RESOURCES IN THE CAPACITY MARKET

## Section – 1: Introduction

1. In advance of responses to our capacity market (**"CM"**) consultation we have set ourselves to review the treatment of new capacity resources[1] – prospective generation, refurbishment and unproven Customer Demand Response (CDR) - under our current design proposals. The objective is to test the consistency of our consultation position and to simplify design proposals where possible.

2. The review will identify areas of concern, and where required, design options that result in: (1) a genuine improvement with respect to our current position; (2) align the treatment among capacity market resources where possible – new and potentially existing resource; and (3) reduce unnecessary design complexity.

3. Our stakeholder engagement – via our most recent stakeholder workshops and previous Expert Group feedback - and own internal analysis have already identified some common relevant areas of concern which allows for early planning the work of this review ahead of receiving consultation responses.

4. This paper sets out those identified areas of concern and seeks views from this group to determine the set of potential viable options, if any, to be considered in advance of consultation responses to address the identified concerns with the design. Final feedback from consultation responses will then be incorporated at a later stage of this review.

## Section – 2: Recommendation

5. To **seek views** on scope of holistic review of our current policy position on the treatment of new resources that should compromise **ALL** the options presented in this paper.

## Section – 3: Identified issues with the current design

6. While the current individual treatment of new resources is supported with a robust economic rationale, from a holistic perspective the overall package is significantly complex. Notwithstanding the fact that the resulting level of complexity could be a necessary condition to achieve our policy objectives, significant layers of complexity increase the risk of unintended consequences. This translates into a significant risk that our current treatment of new resources - and indeed between new and existing ones - to become potentially discriminatory either because incentives are not aligned and/or are of different order of magnitude. This can result in CM resources operating at different level playing fields.

[1] See Annex 1, 2 and 3 for a reminder of the consultation position on the treatment of new resources.

7. Table 1 provides a visual depiction of this potential risk for incentives applying at the pre-delivery year stage:

Table 1: Current pre-delivery year treatment of new resources

| | Pre-delivery year treatment for new resources | | | | | | |
|---|---|---|---|---|---|---|---|
| | Credit cover | SFC milestones | Termination agreement | Cash-flow penalties | Reductions agreement length | Deliver before delivery year | Monitoring, reporting & remedial action |
| Prospective Generation | Collateral for termination fee (TF1) at SFC milestone | 50% incurred expenditure | If SFC milestone is not met. | Termination fee collateral lost if SFC is not met. | | | Yes |
| Refurbishment | | 50% incurred expenditure | | | 1 year for not meeting SFC milestone | 2 years before actual delivery year | Yes |
| Unproven CDR | Bid bond for CDR | | | | | | |

8. From Table 1 above it becomes apparent that:

   - Consequences from failing similar milestones differ among resources. For example, for prospective generation, failure to meet the Significant Financial Commitment (SFC) milestone results in a termination event and in a 100% loss of posted collateral. However, refurbish plant sees its agreement length reduced.

   - Failure to bring forward promised unproven CDR capacity is penalized with a 100% loss of the bid bond. However, failure to demonstrate commitment (at the SFC milestone) to bring forward prospective generation results in loss of collateral and the termination of the capacity agreement.

   - Refurbished plant is required to deliver before the delivery year. Currently, there are not similar provisions for prospective generation and new DSR.

   - CDR does not have any monitoring and reporting obligations.

9. Table 2 provides a visual depiction of the incentives applying at the post-delivery year stage:

Table 2: Current delivery and post-delivery year treatment of new and existing resource

| | Delivery and Post-delivery year treatment of new resources and existing resource | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | Adjust capacity payments | Reduc. contract length | Restrict. auction bidding | Restrict. 2nd trading | Long Stop dates | Termination agreement | Cash-flow penalty | Monitoring/ Reporting & Remedial action |
| Prospective generation | Scaled down to the true level of ION certified capacity delivered. | | | Less than 100% ION capacity imply a restriction to 2nd trade for delivery year 2 and 3. | 18 months for 90%> ION capacity > 50% And a further 6 month to bring remainder or otherwise de-rated to level operational at that point | If ION capacity is less than 50% at the 18 month post-delivery longstop date. | *Delivered capacity subject to scaled VoLL<br>*If termination event, then non-collateralized TF2 termination fee is applied | Yes |
| Refurbishment | Adjusted to reflect pre-refurb level if 2 years post-auction delivery milestone not met. | A further 1 year reduction if 2 years post-auction delivery milestone not met. | Restricted to bid for 1 year contracts for two years. | | | | Scaled VoLL for pre-refurb capacity levels | Yes |
| Unproven DSR | Unproven CDR See payments scaled down to reflect | | | | | | Scaled VoLL | |

10. From Table 2 above it becomes apparent that:

- Refurbishment has no generous relief periods – longstop dates and minimum completion requirements - as per prospective generation. While refurbishment sees a reduction in contract length if it does not meet the two years post-auction delivery milestone, prospective generation delivering more than 50% of ION-certified capacity at the longstop date is not further penalized.

- While refurbishment does not see its capacity agreement terminated for failing to meet the two years post-auction delivery milestone and sees bidding restrictions for future auctions, prospective generation failing to meet the 18 month longstop date sees its capacity agreement terminated but the termination fee payable at the termination point is not collateralised. Further, no bidding restrictions for future auctions apply.

- If a stress event where to occur, existing generation is liable for a penalty of z*VoLL-CO for the capacity that fails to deliver in the delivery year. However, prospective generation sees no penalties for the capacity that they fail to bring forward, although both types of resources are contributing roughly equally to the stress event happening.

11. In addition to the above observations, stakeholders have already raised the following points:

    - Termination fees (TF1 and TF2) are set too high.
    - Setting the SFC milestone is subject to gaming risks around declaring low planned expenditures to meet the milestone.
    - The SFC milestone termination event is too much of a cliff-hedge approach with no relief periods. Relief periods such as the one applied to prospective generation are much more welcomed.
    - Bid bonds for unproven CDR might have been set too high.

**Section – 4: Options to address issues**

12. The review of the treatment of the new resource could be based on the assessment of the following proposed "additive" options for the consideration of the Expert Group:

*Option 1: Review the calibration of parameter values*

13. Under this option the review would seek to revisit the calibration of the main parameters values determining the treatment of new resources or some very minor changes to the current design. This could include revisiting:

    - Termination fee levels for prospective generation.
    - The timings and expenditure thresholds applying at the SFC commitment milestone for prospective generation and refurbishment.
    - Revisit the timings of the longstop date and completion requirements for prospective generation.
    - Revisiting the calibration of credit cover arrangements for unproven CDR.

14. Under this option no further reductions of complexity and/or alignment of treatment among CM resources will be considered.

*Option 2: Seek to align the treatment between new resources only and reduce complexity where possible*

15. This option would go beyond option 1. In addition, the scope of the work would be to explore alternative options to align and reduce the complexity of the treatment between prospective generation and refurbishment generation resource. A priori, major

opportunities for this exercise seem to emerge between these resources. For example, this option could potentially consider:

- Either prospective generation seeing a one year contract reduction if failing to meet the SFC commitment milestone, or refurbishment having to post collateral and losing it if the SFC milestone is not achieved.

- Introducing relief periods for refurbishment to mimic the treatment of prospective resource.

- Eliminate the requirement on refurbish resource to deliver before the actual delivery year.

- Where new resource sees its agreement terminated impose restrictions on future auction bidding.

*Option 3: Seek to align the treatment of new resource with that of existing where it is supported by an economic rationale*

16. Initial internal analysis on this option shows that it necessarily compromises a significant change to the current design. An extreme version of this option would be to piggy back on existing CM and energy market incentives and align the penalty treatment with that of existing plant. This could include:

    - Creating, at the point of delivery, a distinction between the level of the capacity obligation (upon which performance is measured) and the level of capacity payments that will be scaled down to the true capacity delivered. This creates strong incentives to deliver on time as parties can potentially be penalized at z*VoLL-CO if a stress event were to occur, yet potentially receive no capacity payments (if not operational).

    - Dispense with the SFC milestone and implied termination events and collateral requirements recognizing that market incentives and CM penalties are sufficiently strong incentive to deliver on time.

    - Dispense with the post-delivery longstop date and minimum completion requirements recognizing that a 4 year delivery lag already incorporates a substantial period to accommodate delays. However, parties will be encouraged to reduce the gap between the level of their capacity obligation and true delivered capacity.

17. Note that this option significantly reduces design complexity and allows for a greater alignment of incentives between resources. However, there are issues for: (1) the investability of the scheme; (2) increased delivery uncertainty because fewer controls are in place; (3) incentives might not bite because penalties are not secured and (4)

implementing a new design. Notwithstanding these risks, risk mitigating measures might be available, probably, at the expense of increasing the complexity of the option.

**Section – 5: Next steps**

18. We are planning to:

- Seek views from the Expert Group on the scope of the work (13/12/13).
- Incorporate feedback from consultation responses (close 24/12/2013).
- Come back to the Expert Group with final proposals in January 2014.

**Annex 1: Consultation position on the treatment of prospective generation**

- It is important to ensure plants under construction holding capacity agreements have strong incentives to build on time (since if they are late or fail to commission altogether consumers will face potential higher capacity prices and additional security of supply risks, and other participants will (unfairly) bear a higher risk of facing penalties).

- To ensure they will be ready for the delivery year, new plants will be required to demonstrate that they have incurred at least 50% of the project expenditure scheduled to have been made, as per their construction plan, within a year of being awarded the capacity agreement.

- Failure to provide sufficient evidence will result in the termination of the capacity agreement and the application of a termination fee which it is proposed will be based on 0.5 * net-CONE * capacity obligation. This termination fee will be funded from collateral which must be posted as part of new plants' pre-qualification.

- The Government proposes to require collateral sufficient to cover 100% of a plant's potential exposure to termination fees. For example, this will equate to one off collateral of c. £7.5m for a new plant with a 520 MW capacity obligation. The Government is considering whether the collateral requirement should be applied in respect of the 2014 capacity auction or from a later date.

- Types of acceptable collateral include:
  - An approved Letter of Credit or equivalent bank guarantee from a bank with a long term debt rating of not less than A3 by Moody's or A- by Standard & Poor's;
  - Cash deposit/prepayment (payment made before the delivery of the service);
  - Advance payment (payment made after the delivery of a service but before contract settlement);
  - An approved ESCROW account;
  - A performance bond (provided by an insurance company, not a bank);
  - Bi-lateral insurance; and
  - Independent security.

- Plants will have their collateral returned in full if they are unsuccessful in the capacity auction, or when they successfully pass the 12 month milestone.

- Capacity payments will be suspended for new plants until they become operational (though their agreement term will begin at the beginning of the delivery year). Such plants would not be liable for performance penalties until they had started to receive capacity payments.

- Any new capacity failing to have at least 50% of the amount specified in its capacity agreement operational by 18 months after the start of its first delivery year will have its capacity obligation terminated, and be liable for a termination fee. The proposed formulation is ( 0.5 * net-CONE * capacity obligation + £10/kW) * the unit's capacity obligation. The additional £10/kW represents the economic damage emerging from increased security of supply risks resulting from their delay. Such capacity would be eligible to participate in subsequent auctions as a price taker. The Government expects plants with 50-90% of their capacity operational by this stage would have an additional six months to commission the outstanding amount, and if they are not completed by that date, their de-rated capacity will be adjusted accordingly.

**Annex 2: Consultation position on the treatment of refurbished plant**

- To ensure work has been completed by the start of the relevant delivery year, the Government proposes requiring a capacity provider with a capacity agreement for units awarded a three-year agreement to demonstrate that they have incurred at least 50% of the capital expenditure scheduled for at that point, as per their refurbishment plan, within a year of being awarded the capacity agreement.

- Any unit failing to demonstrate this would have its capacity agreement term reduced to one year.

- Parties with three-year agreements would also be required to demonstrate that their work was complete within 24 months of being awarded their capacity agreement so that additional capacity can be procured in the year ahead auction if necessary to correct any shortfall. Parties failing to demonstrate completion of their refurbishment work by this milestone would have their capacity agreement term reduced to one year. In addition, parties that fail to complete their refurbishment within 24 months will have their de-rated capacity for the delivery year adjusted to its pre-refurbishment level, and will be restricted to bidding for annual capacity agreements for the following two years.

**Annex 3: Consultation position on the treatment of unproven Customer Demand Response (CDR)**

No credit cover will be required from existing DSR under pre-qualification route (a). Where DSR providers are pre-qualifying under route (b) they will be required to provide credit cover (a bid bond) to ensure there is an incentive to give accurate and realistic information and to test their intention to deliver. This will be in the form of a bid bond set at £4,420 per MW. This value aims to strike a balance between ensuring providers have a robust incentive to make realistic predictions while not presenting a significant barrier to entry. The Government is considering whether the credit requirement will be applied in respect of the 2014 capacity auction or from a later date.

National Grid will inform the settlement body that a prospective customer response CMU (see Section 4.8 for a description of the different types of CMU) has applied for pre-qualification and the settlement body (or the settlement agent) will calculate the bid bond required and request it from the DSR provider. The bid bond must then be paid to the settlement body at least a week before the auction. The settlement body will inform National Grid that the bid bond has been received thereby allowing that prospective CMU to pre-qualify.

The forms that DSR bid bonds can take will match the credit arrangements set out in the Connection and Use of System Code (CUSC) in Section 2, 'Connection', and Section 3, 'Use of System':

- a qualifying guarantee; and/or
- a letter of credit (available for an initial period of not less than 6 months); and/or
- cash for credit to the Escrow account; and/or
- a bilateral insurance policy; and/or
- an insurance performance bond; and/or
- an independent security arrangement.

The bid bond will be held by the settlement body until one of the following triggers occur:

(a) the auction takes place and the provider does not win an agreement or does not participate in the auction;

(b) the provider wins an agreement in the auction and subsequently proves capacity by passing a test (see below); or

(c) the provider wins an agreement and fails to pass a test within the allowed time.

Under (a) or (b) National Grid will inform the settlement body and the bond will be returned to the provider. Under (c) the bond is forfeit and surrendered to the Exchequer.

CMUs that entered the auction with unproven resources and are subsequently only able to provide part of the capacity for which they were awarded an agreement in the auction will have their obligation scaled down to the level of capacity they can provide. However it is proposed that they will lose their full bid bond if they fail to deliver. This is intended to act as a strong incentive to deliver.