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Dear Mr. Wieckowski,

**RE: Consultation on possible models for a Capacity Mechanism**

Gazprom Marketing and Trading Limited ("GM&T") welcomes the opportunity to take part in the consultation on the design of the proposed capacity mechanism for the GB electricity market. GM&T is a UK registered wholly-owned subsidiary of the Gazprom Group ("Gazprom") active in the marketing and trading of energy commodities worldwide including power, gas, oil, LNG and carbon allowances. In the UK GM&T is active in both the wholesale and the retail power markets and therefore maintains a natural interest in the proposed legislative reform.

Below please find our comments on the questions addressed in the consultation document.

- **Which Capacity Mechanism should the Government choose for the GB market and why?**

We understand that the overall objective of the Capacity Mechanism is to ensure future resource adequacy as existing generation capacity gradually reaches the end of its lifetime or retires due to environmental regulations. Given that the share of intermittent renewable energy sources, such as wind power, is only likely to increase rapidly over the following decade and the government's intention to promote the use of nuclear power through a system of guaranteed feed-in tariffs, new flexible gas-fired generation will be essential to accommodate the needs of an inflexible and highly intermittent future generation mix in the GB market. The model chosen for the design of the Capacity Mechanism should address the above issue of resource adequacy whilst insulating the existing electricity market from any undue distortion or perverse incentives. We also recognise that the chosen model should not be excessively complicated in nature so that it can be easily implemented in practice and allow for any unintended consequences to be anticipated and effectively mitigated.

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With the above considerations in mind we believe that the proposed models of Strategic Reserve and Reliability Market should be avoided and that – with certain preconditions - a market-wide mechanism in the form of a Capacity Market is the most suitable option to achieve the said objective within the context of the wider electricity market reform. Our rationale is as follows.

#### Strategic Reserve

The Strategic Reserve model, albeit seemingly the simplest of the three options, introduces a significant degree of administrative intervention in the market, which will hamper investment outside the scope of the capacity mechanism thereby leading to an ever –increasing need for reserve. The potential for this “slippery slope” effect has indeed been highlighted in the consultation document and certain mitigation measures have been proposed. Nevertheless, we remain mindful of the perverse incentives that the Strategic Reserve could create as the mere existence of an administratively set cap on market prices - which would be revisited periodically - would discourage private investment in flexible peaking plant. The economic viability of this type of plant depends on the level of scarcity rents received in times of system tightness when prices on the electricity market are very high. Removing the ability of the market to capture these scarcity rents will inevitably reduce the incentives for investment in such plant; more so if potential investors anticipate they would be better off holding off on their investment until a new tender for Strategic Reserve takes place, which could grant them stable guaranteed revenues to recover their capital and fixed O&M costs. In conclusion, we believe that the Strategic Reserve could actually amplify the problem it is trying to solve, i.e. underinvestment in flexible peaking plant, creating an overreliance on centrally procured capacity to address the issue of resource adequacy.

There are also a number of practical complications surrounding the methodological aspects of the Strategic Reserve model, which will be difficult to mitigate in practice. Firstly, the central determination of the required level of reliability necessitates a forward looking assessment of both peak demand and the level of investment that the market is likely to deliver. This increases the risk of getting the forecast wrong as a result of which the central entity might procure more or less capacity than actually needed. Secondly, the determination of the despatch price requires a prior assessment of the long run marginal cost (LRMC) for each generation technology. The latter is very sensitive to the underlying assumptions about fuel procurement costs, which have historically proven to be very volatile. Hence, there is a risk of underestimating the LRMC of existing/new generation and not setting the despatch price high enough to avoid distorting the economic merit order of power stations.

#### Reliability Market

In our opinion the Reliability Market model would be impractical in the context of the GB electricity market. We note that this model has been designed for and could work well in markets with a pool system in place and a clear day-ahead reference price. We are not convinced that this model could be



adopted to account for the specificities of the GB market - where the majority of electricity is traded in the forward market - without introducing additional layers of complexity which will undermine the effective operation of the market. The central determination of the reference market, for example, will largely dictate the bidding behaviour of generators not only in the reference market itself, but also on the forward markets prior to that. As is indeed acknowledged in the consultation document, in order to avoid excessive paybacks if the reference price exceeds the strike price of the option, generators would be reluctant to sell their electricity until the former is known. The Reliability Market model would hence discourage providers of capacity from trading earlier than the reference market and could seriously harm liquidity in the forward markets. We do not see how such a model could be enforceable in the context of the GB market without causing serious market distortion.

Furthermore, we are not convinced that the model of Reliability Market would offer sufficient economic signals to attract the necessary investment in flexible generation. On the one hand, the central determination of the strike price effectively caps the revenues generators can receive from the electricity market, thereby removing the ability of market participants to capture scarcity rents in times of system pressure. At the same time, although the option premium would provide a stable revenue stream we doubt that this in itself would be attractive enough for generators to accept to carry the risk of potentially unlimited liabilities due to the claw-back mechanism inherent in the call option. In conclusion, the Reliability Market model does not appear to us as a suitable option for the GB market.

#### Capacity Market

Contrary to the previous two options which have some evident drawbacks in our opinion, the model of the Capacity Market – if properly designed and implemented – could provide the necessary economic signals for investment without undermining the effective operation of the electricity market. Compared to the Strategic Reserve model and in terms of market distortion, although generators would seek to substitute uncertain revenues from energy sales for relatively stable returns from the sale of capacity, this should not alter the economic dispatch of generation facilities in the energy market nor prevent electricity prices from correctly rising to reflect resource scarcity. We consider this an important advantage of the Capacity Market as it maintains that prices on the market will be a proper and accurate reflection of the underlying fundamentals. In comparison with the Reliability Market model the Capacity Market does not harm liquidity in the electricity market as it is kept completely separate from it nor does it dictate the bidding behaviour of generators who can continue to choose the market they sell their production on. Most importantly it does not place a cap on the remuneration generators can receive from the electricity market. From an investor's point of view the Capacity Market does offer some revenue certainty to attract funding for new capacity and at the same time provides investors with full visibility over the maximum potential downside, i.e. the penalty for failing to keep the plant available



when needed. This is essential to maintain investors' confidence that they will not be exposed to potentially unlimited liabilities beyond their control.

Finally, from a methodological viewpoint it appears to us that the Capacity Market, albeit a new mechanism for market participants, is not unduly complicated to be implemented in practice and fits well with the characteristics of the GB market as it leaves unaffected the ability of generators to optimise their dispatch as they see fit, be it by contracting on the forward OTC market or by selling their electricity in the markets closer to real time.

Given our stated preference for the Capacity Market, the following section of our response focuses on the consultation questions, which are relevant to the specific design features of this model.

- **How and by whom should capacity in a GB market be bought and why?**

The proper design of the procurement function is of vital importance for the effective and efficient operation of the Capacity Market. The procurement function must encompass a proper price discovery mechanism and maintain transparency. For suppliers - who will bear the cost of the Capacity Market - the procurement mechanism must ensure equal and fair treatment of all market participants; independent or part of a vertically integrated group. As far as cost recovery is concerned it is important to develop a mechanism that does not expose suppliers to significant price risks and provides as much certainty and advance notice as possible on the additional costs that the mechanism will create for supply businesses.

Out of the three options proposed in the consultation document the one that fulfils the above mentioned criteria in our opinion is the central procurement function, whereby an independent institution procures the necessary capacity in an auction and subsequently distributes the costs to individual suppliers in proportion to their customer base for the delivery period. We note that the mechanism for the allocation of costs should take due account of the specificities pertaining to the retail market and be consistent with the current commercial practices of suppliers. In this respect, the additional levy per unit of electricity delivered should ideally be determined in advance for a number of delivery periods so that it can be factored into the price offers made to consumers.

We do not support the idea to impose an obligation on suppliers to procure the capacity themselves - either through an auction or through bilateral contracts with generators - as this would create significant uncertainty and additional transaction costs for retail businesses. Such mechanism would require suppliers to procure an initial volume of capacity in the primary market and subsequently readjust their position in the secondary market on a continuous basis so as to account for changes in their customer base up until the end of the delivery period. We deem this costly and impractical. Finally,



we believe that a Supplier Obligation could disadvantage independent and small suppliers vis-à-vis suppliers forming part of a vertically integrated group and is likely to create a non-transparent and illiquid system impeding new entry in the supply market and increasing the potential to exercise market power.

- **How long should the lead time for capacity procurement be? Should there be special arrangements for plants with long construction times?**

We recognise there is a trade-off between incentivising construction of new capacity, which necessitates long lead time between procurement and delivery of capacity, and reducing the risk of miscalculating the total capacity requirement (and hence the risk of over- or under-procurement), which seems far more achievable with a shorter lead time. Considering that the overall objective of the capacity mechanism is to attract investment in new flexible resource, which will be readily available to substitute for renewables when the latter cannot generate, it seems logical to have a lead time that corresponds to the construction time of the generation technology most suitable for this role, i.e. gas-fired CCGT. Hence, we recommend a lead time of four years. This should be sufficient to allow for new construction, while it is not unreasonably long to obstruct proper demand projections.

- **Should there be a secondary market for capacity? Should there be any restrictions on participants or products traded?**

Yes, we believe that a secondary market for capacity should exist although its usefulness will mainly depend on the criteria for determining when generators must be available. We do not see the need for restricting participation in the secondary market to certain players or disallowing certain products from being traded.

- **What could we do to mitigate interactions between a Capacity Market (especially if a Reliability Market) and Feed-in Tariff with Contract for Difference without diluting the effectiveness of either?**

The design of the Capacity Market must ensure that plants benefiting from other support schemes, such as the Feed-in Tariff with Contract for Difference (FIT CFD), receive no overpayment. We believe this is best addressed by prohibiting generation in receipt of financial support under the FIT CFD scheme from participating in the Capacity Market. One theoretical possibility that has been discussed in industry forums is to allow such plants to participate in the Capacity Market and subsequently deduct the premium they receive in the form of capacity payments from the overall remuneration they are granted under the FIT CFD system. Our view is that this should be avoided for the following reasons. Firstly, it would be counterintuitive to grant capacity payments to intermittent low-carbon generation

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technologies when the mere reason for introducing the capacity payments in the first place is to cope with the instability these technologies bring to the system. Secondly, the objective of the capacity mechanism is to reward the availability of fully dispatchable plant that can be relied upon whenever it is needed; a criterion that intermittent renewable sources do not meet. Thirdly, as far as dispatchable low-carbon technologies (such as nuclear and CCS) are concerned - although in principle they do meet the eligibility criteria - their participation in the capacity market would certainly dilute the effectiveness of the price discovery mechanism and should therefore be avoided. We note that the pricing decisions of such generators in the capacity market would be largely influenced by the level of guaranteed income they receive from the FIT CFD scheme.

- **What are the advantages and disadvantages of making a central, administrative determination of (i) the capacity that can be offered into the market by each generator; (ii) the criteria for being available; and (iii) the penalties for non-availability? In outline, how would you suggest making these determinations?**

The central determination of the above-mentioned parameters ensures that the level of reliability rewarded with capacity payments actually corresponds to an equivalent amount of physical capacity on the system, which in one of the main advantages of the Capacity Market over the Reliability Market. As mentioned previously we do not believe that generators in receipt of support from the FIT CFD system should be allowed to offer capacity into the Capacity Market. For the remaining generators, the volume of capacity contracts they are allowed to sell into the market should be set equal to the physical capacity they can reliably demonstrate that they will maintain available. In determining this, one should take due consideration of the characteristics of different generation technologies and potentially the past operational performance of individual facilities. Concerning the criteria for availability, one idea which could be explored is to require generators to remain available in the hours of the year when the loss of load probability exceeds what is deemed to be an acceptable level for security of supply; that is when the de-rated capacity margin is expected to drop below a pre-set security threshold. Penalties for non-availability should be set high enough to discourage misuse of the mechanism and to ensure that generators exhibit proper diligence to meet their contractual obligations to be available. We would think that a penalty set by a multiplier of the capacity payment received by the generator is preferable to a fixed penalty.

- **Do you have any comments on the functional arrangements proposed for managing a Capacity Market?**

At a conceptual level the functional arrangements envisaged for the design, implementation, delivery, operation and supervision of the GB capacity mechanism appear to be adequate. We do appreciate that

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the design of the institutional and delivery functions needs to be tailored to the characteristics and requirements of the chosen model. Once this is known, we would expect DECC to seek market participants' views on the detailed rules governing the operation of these functions.

- **Do you think that a trigger should be set for the introduction of a Capacity Market? If so, how do you think the trigger should be established, and how should it be activated?**

Given the government's stated position in favour of a capacity mechanism, our view is that the Capacity Market should be introduced as soon as practically possible to avoid creating uncertainty among potential investors. The long lead times involved in preparing the primary legislation, detailed rules and procedures and in setting up the necessary institutional and delivery functions together with the required lead time of at least four years between the auctioning of the capacity and its commissioning date seem to suggest anyway that the first capacity payments will be made at around the close of this decade, precisely when the de-rated reserve margin in the GB system is forecasted to drop below the desired security threshold of 10%.

I hope you find these comments useful. If you have any queries please do not hesitate to contact me on [REDACTED] or at [REDACTED].

Yours sincerely,

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Regulation Manager (Power)  
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Unsigned as sent by e-mail.

