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London, 03.10.2011

To whom it may concern

Please find enclosed Statkraft's response to the Capacity mechanism consultation in the Electricity Market Reform White Paper

Statkraft is currently involved in a number of wind power projects in the UK, including a major offshore wind farm, Sheringham Shoal, that we are constructing together with Statoil. Statkraft is also a partner in the Forewind consortium which has the licence to develop offshore wind power projects on Dogger Bank. Forewind has a target of 9 GW installed capacity in the zone. We are committed to the UK market and hope to make significant further investments in new generating capacity.

Statkraft is also active in trading and origination in the electricity market. As a non-integrated electricity producer and wholesale trader, Statkraft is strongly dependent on well-functioning wholesale power and gas markets.

We appreciate the opportunity to provide our views on the proposal. In this response, Statkraft expresses its general concerns and opinions on this consultation. We have not answered the detailed questions on capacity mechanisms in the consultation document.

Please do get in touch if you have any questions.



Statkraft

Response to Consultation on possible models for a Capacity Mechanism

Introduction

As part of the Electricity Market Reform White Paper, DECC is consulting on different forms of capacity mechanisms that could be introduced in the GB power market.

In this response, Statkraft expresses its general concerns and opinions on this consultation. We have not answered the detailed questions on capacity mechanisms in the consultation document.

We do not believe that a capacity mechanism is required at this stage and we would urge caution about introducing a significant regulatory intervention in the market. We believe that energy-only markets have worked well in the different European electricity markets. We believe that greater interconnection and harmonization with European markets would be of significant benefit to UK security of supply. In particular, Norway's huge hydro storage capacity could provide a low cost option to balance increasing levels of intermittent generation in the UK. If Government does decide to implement a capacity mechanism, we believe it should choose a strategic reserve mechanism, as it is relatively simple and carries less risk of a negative market impact.

Statkraft in UK

Statkraft is Europe's leader in renewable energy and wants to further strengthen that position. It fully supports EU and UK targets towards a renewable energy supply and has a unique position to contribute towards solutions to the world's climate change and security of energy supply.

Statkraft is currently involved in 9 wind power projects in the UK. Statkraft is also active in trading and origination in the power market. With Statoil we are constructing a major new offshore wind farm, Sheringham Shoal, off the Norfolk coast. Statkraft is also a partner in the Forewind consortium which has the licence to develop offshore wind projects on Dogger Bank. Forewind has a target of 9 GW installed capacity in the zone.

We are committed to the UK market and hope to make significant further investments in new generation capacity. These investments will make a significant contribution to security of supply and decarbonisation, and would help to develop the electricity market and weaken the market dominance of the Big Six companies.

As a non-integrated electricity producer and wholesale trader, Statkraft is strongly dependent on well-functioning wholesale power and gas markets.

Position

No proven need to intervene and introduce capacity mechanisms

Before discussing the different capacity mechanisms, Statkraft emphasises that there does not seem to be a clear necessity or justification for the introduction of such a mechanism.

Energy only markets seem to have worked well in the different European markets, and generators have invested heavily in new capacity over the years since the introduction of liberalized power markets. Energy only markets are in our view the most suited to provide the right price signals for optimal dispatch of power plants, as well as to attract investments in the right mix of technologies including demand flexibility. Market design is however essential, including the balancing mechanism.

New regulatory interventions as a capacity market that adds to the complexity of the market will tend favour most the big established players that are best positioned to deal with the complex rules and fully work through all implications. This may hence not be helpful in making the market more attractive for new entrants and increase competition.

The Consultation Paper mentions that “capacity margins could fall below five per cent around the end of the decade”. However, shrinking capacity margins for longer time horizons is a normal phenomenon and is no proof of market failure.

Opinion: *We would urge caution before intervening in a well-functioning market. Capacity mechanisms might easily distort the market, might lead to over-investments or inefficient investments and can for example block a market driven development of demand side participation. Instead of proposing major redesign, it is important to remove the existing, smaller barriers for well-functioning energy market. The dual pricing system for settlements of imbalances is for example a hurdle for new entrants and should be replaced by a simple single pricing system. There should be attention to integration of the GB power market in the EU market through interconnectors and harmonised market rules.*

Going forward an increasing share of intermittent generation obviously will have a major impact on the power market. Zero or even negative marginal cost generation will dominate the scene in the future. Consequently, profitability of conventional power plants and incentives to demand response in energy only markets will require high prices (spikes) in hours with a tight supply demand balance. It needs to be monitored whether continuous reliance on such price signals is a sufficiently stable and enduring situation with increasing levels of renewable energies. A bi-annual monitoring period seems appropriate, possibly complemented by occasional studies on the need for and the benefit of market design changes such as capacity markets. Monitoring of adequacy of supply must take into account the wider regional and European situation as otherwise adequacy problems may be overestimated. Possible measures (like capacity mechanisms) should take import possibilities into account and should ideally be coordinated and harmonised with neighbouring countries, as far as is practically possible.

In addition, Statkraft wants to underline the importance of flexibility that can be provided by Norwegian hydro reservoirs. The existing Norwegian hydro storage capacity is huge (84.1 TWh). This means that there is significant existing capacity that can already be used for the GB market if new cables between Norway and GB would be realized. In addition, the Norwegian generation capacity as well as pumping

capacity can be further increased without realizing new reservoirs. It is apparent that existing Norwegian reservoirs in combination with more DC cables provide a low cost option to balance intermittent generation and avoid renewable energy being lost in periods of high wind and low load.

Opinion: *Market design changes might be needed in the far future. But for now, proper monitoring is important and flexibility options from outside the GB-market should also be considered.*

If capacity mechanisms are necessary, then the Strategic Reserve option is preferable

If however DECC is of the opinion that capacity mechanisms are necessary, now or in the near future, then Statkraft has a preference for a mechanism that is simple, transparent and has as little impact on markets as possible. For that reasons Statkraft prefers the Strategic Reserve option over market-wide mechanisms. Market-wide capacity mechanisms are more complicated and require more regulatory involvement, meaning an increased risk for undesirable side-effects. Strategic Reserve mechanisms are well understood and have been used in the Nordic markets. Also the Netherlands have developed a strategic reserve mechanism around 2004/2005 when capacity margins were getting tight.¹ But this mechanism was never actually used as adequacy of generation has been developing positively since.

In order to further reduce impact on market functioning, Statkraft is of the opinion that Strategic Reserves should not be dispatched based on market prices, but only as a measure of last resort to avoid load shedding. If it is based on market price, it should be very high price as not to significantly weaken incentives to keep flexible plants with high marginal cost online or to invest in such plants

Opinion: *A Strategic Reserve Model could be workable for the GB market. Strategic reserves should only be procured if triggered by proper monitoring. Strategic reserves should only be dispatched as measure of last resort.*

¹ See: http://www.brattle.com/_documents/UploadLibrary/Upload352.pdf