Capacity Market Consultation Workshop
4 November 2013

Summary of key issues raised by stakeholders

Following the publication of the EMR consultation on implementation proposals on 10 October 2013[1], DECC held a full day workshop on the 4 November 2013 to allow interested stakeholders to explore the contents of the consultation document relating to the Capacity Market, and to discuss detailed policy proposals with DECC officials.

The workshop included presentations on specific aspects of the Capacity Market design (Amount to Auction; Eligibility and Qualification; Auction format; Delivery; Payment; Trading and Governance), followed by feedback sessions where stakeholders had the opportunity to ask questions and give their early views on the consultation.

The following note records the views expressed by participants during the workshop. A list of the organisations represented at the workshop is attached in the Annex.

Presentation 1: Amount of Capacity to Contract

<u>Delivery year:</u>

- The proposed delivery year is not aligned with other initiatives (CfD, etc.).
- The proposed delivery year does not match up with National Grid delivery starting on 31st October. This makes it difficult to set tariffs.
- The proposed delivery year links with seasonal demands and seasonal electricity contracts.

<u>Uncertainty about actual delivery:</u>

- The theoretical volume of capacity contracted may not match the capacity needed in a stress event.
- Risk analysis is needed on DSR contribution: how do we know the amount of capacity DSR will provide and what happens if DSR does not deliver? How will DSR input affect other participants? Who will do the assessment: National Grid based on historical data, or through supplier-customers interaction?
- The price for new entrants bid should inform the Net Cost of New Entry (CONE) value set, but will new entrants deliver in four years' time?
- If demand forecasts are higher than actual demand, there is a risk of over-procuring capacity. In this case, longer-term contracts would be more inefficient and costly for consumers as they lock in overcapacity for longer periods.

[1] https://www.gov.uk/government/consultations/proposals-for-implementation-of-electricity-market-reform

Value of NET CONE:

- The value of Net CONE proposed is too low, particularly because of assumed scarcity rents. A preferable option is to use the CONE only, with no link to scarcity rents, instead of having an administrative price.
- The process to determine Net CONE is reasonable, but the amount is too low meaning that the auction cap (which is a function of net CONE) is too low.

Price cap for new entrants:

- The price cap for new entrants is not justified, as there is limited information to make decisions on bids and the price cap may be too low. The auction price cap of £75kW is more realistic, but it is unclear how it was determined.

Indexing:

- Why is indexing linked to CPI rather than to RPI or PPI which would better reflect producer costs?

Transparency and uncertainty risk:

- It is important that the process to determine the amount of capacity to contract is as transparent as possible. Otherwise, there is risk of contracting for too much capacity.
- How do you know how much capacity to contract when there is uncertainty about the length of contracts – 10/25 years?
- National Grid's Future Energy Scenarios felt to be a transparent process and allows industry to feed into the process.

Presentation 2: Eligibility and Pre-Qualification

Pre-qualification logistics:

- Clarity is needed as to precisely what information a participant is required to submit, what will be done with all the pre-qualification material, and what is the appeal process.
- Participants acknowledged that because of the tight timetable in 2014, there will be no chance to have feedback on submitted qualification packs, but welcome this possibility going forward.

De-rating:

- The de-rating process is two deviations less than the standard. Why can it not be two deviations greater so that you are overcompensated?
- How will de-rating work in practice? Will it be transparent?
- Participation of DSR and CHP will make it difficult to get numbers right.
- It would be beneficial for the methodology to be available in draft before final numbers are published.
- It was discussed whether de-rating process should be determined by the operator or centrally. Central administration might be inaccurate and basing de-rating on historical performance reduces future investment signal in reliability.

Portfolio Structure:

- It is not clear what the impact will be for owners.
- Portfolios proposals were felt to be complicated. It was suggested they could be made optional, rather than mandatory.

Other issues:

- The threshold of £125kW per year/£250kW per year for refurbishment and new build to qualify for longer agreements will encourage people to target those numbers and could provide perverse incentives.
- Requiring refurbishment projects to be completed so far in advance of delivery risks increasing investment costs.
- Why is the de minimis 2MW? It could be greater or less.

Presentation 3: Auction – frequency and format

Auction clearance:

- What happens if the auction does not clear? Will the cap be increased or the reliability standard revised? This represents a huge risk.

Agreement length:

- 25 years is too long and 10 years is too short, something in between would be better. 15 years is an option.
- How do you discriminate between 10/25year contracts if both are allowed?

Refurbished plants:

- There is need to have a clearer definition of refurbished plants, particularly to ensure capacity in the medium term.
- Existing plants do not seem to have sufficient incentives.

Costs of Capacity Market:

- Concern was expressed about a possible mismatch between estimates set out in the Impact Assessment and actual clearing prices in auctions which could be significantly higher than in DECC modelling. There needs to be clarity that the mechanism will not be annulled if costs are higher than modelled.

Termination fees:

- Termination fees were felt to be too high, which could undermine the "bankability" of the Capacity Market. A step termination structure for fees was suggested as a better alternative. Termination fee at time of auction provides a disadvantage for those that already have secure funding.

Auction monitor:

- The proposed auction monitor has too much power for a body appointed by National Grid unilaterally. It would be better if it were appointed on a collaborative basis by DECC, National Grid and Capacity Market participants.
- Ethical conduct certificates are unnecessary and do not add value.

- DECC needs to be clearer about green technologies and the intermittent energy supply they produce.

Frequency:
- It was felt that having auctions 3-4 years ahead of delivery is the right format, but it was suggested there should there be more auctions in between T-4 and T-1.
- The frequency will impact on the range and number of participants. T-4 puts a lot of risk on T-1: what if we cannot find that additional capacity?
- The participation of CHP and DSR at the four year ahead auction increases the risk of uncertainty in the amount of electricity required, and therefore could result in insufficient supply. Some CHP and DSR would be better at one year ahead auctions.

Presentation 4: Delivery

Penalties:
- Performance incentives are needed rather than penalties.
- Penalties may increase in the future and it would be good to have them defined in the rules and regulations or calculated with a simple formula to counter this risk.
- Over-delivery payments need to be linked to penalties.
- It was suggested that penalties should be relaxed in the period before the secondary trading market is established.
- There was a concern about planned maintenance being a major issue: should there be a provision for this to be mandatory during low demand?

Penalty Cap:
- Need to ensure that penalty caps and payments are set at the right level. Penalty caps would deter secondary trading and hinder larger organisations. It would be preferable to eliminate them.
- There should be a balance between low cap and high rate of payments, or vice versa high cap and low rate of payments.

Stress event:
- It was felt that the system of warnings and decisions to define and notify a system stress event was complex. Is 4 hours ahead the right time for a warning to be issued? National Grid should have a mechanistic approach to when a stress event starts and stops – rather than discretion.
- DSR – some are subject to VOLL and others are not, needs to be clearer. To favour DSR, the stress event would need to be signalled both when it starts and when it ends.

Force Majeure:
- Will gas be accountable?
- There is also need to ensure we balance penalties with consumer value.

Interconnection:
- Will there be incentives for non-GB participants?

- Supplier side and peak demand – more complex, harder to price than market share.
- Different level of players e.g. TRIADs – those not on 30mins metering are disadvantaged.

Presentation 5: Payment

<u>Monthly payment flows:</u>

- It would be better to wait to year-end to invoice penalties/over-delivery payments to have a longer period to equalise them.
- If overpayment and penalties were not the same, there is no incentive for generators.
- Clarity is needed on penalties on a portfolio basis. Lack of revenue neutrality may result in insufficient revenue.
- Several participants didn't like a payment model using forecast demand over peaks. Different alternatives were proposed, including a forecast over the whole year or using actual demand instead of forecast.
- If a forecast over peak is used then National Grid should provide a forecast of TRIAD.
- Problem with the penalty calculation because of the 'soft cap'.

<u>Investability:</u>

- Financial trading will be hampered by differences in over-delivery payments.
- There are various investability issues: penalty rate, price cap, terms of contracts, security of contracts.
- What happens to collateral if plant build is delayed by another party?

Presentation 6: Trading and Governance

<u>Financial trading:</u>

- It is very unlikely for financial trading of obligations to happen because of limited pool of generators participating in the market that would be available for physical trading.
- In the first 2-3 years, a market of insurance products might develop instead.

<u>Physical trading:</u>

- Physical trading will not happen. Why would plants that did not participate in auctions want to trade?

<u>Asymmetry problem:</u>

- The price of hedging is unknown if you don't know your income from over delivery.

Governance issues:

- The cash-out reform will impact on everyone who participates in 30 min intervals.
- No contractual counter body on force majeure.
- Can Ofgem change rules and if so, how? There needs to be a transparent, consistent and clear change control process set out by Ofgem for changes to rules.
- Concern was expressed that Judicial Review did not provide sufficient recourse to dispute changes made by Ofgem.
- There needs to be knowledge-sharing between the participants as to projects/ideas taken to Ofgem which were then rejected. This would prevent different participants from doing similar proposals. An industry panel was suggested.

Annex

List of stakeholder organisations represented at Capacity Market Consultation Workshop on 4 November 2013

Carlton Power
Centrica Energy
CHPA
Drax
Ecotricity
EDF Energy
Eggborough Ltd
Electricity Storage Network
Energy Pool
Energy UK
EnerNoc
EON
ESB
Flexitricity Limited
GE
Haven Power Limited
Infinis
InterGen (UK) Ltd
Kiwi Powered
Local Waste Solutions
Mainstream Renewable Power
National Grid
Neas Energy Ltd.
Ofgem
Open energi
PwC
RBS
REA
RWE Npower
RWE Supply & Trading
Scottish Power
SSE
Statoil
UK Power Reserve
Vitol
Waters Wye Associates
Welsh Power Group Limited
Which