

## **REVIEWING THE PROPOSALS FOR SECONDARY TRADING IN THE CAPACITY MARKET DESIGN**

### **Section 1: Objective of the Review**

1. DECC is looking to review the incentives for secondary trading in the existing Capacity Market proposals provide the necessary and sufficient conditions to ensure secondary trading will happen organically and in time so that investors can count on it in the bidding strategies for 2014.
2. This paper sets out how the review will achieve its objectives.

### **Section 2: Qualitative Analysis**

3. The review will consider the major issues around secondary trading so it is able to conclude whether existing proposals are fit for purpose:
  - i. What do we need secondary trading for? Is it systemically important?
  - ii. What is the financial instrument that we expect parties to be able to trade in the secondary market to manage their delivery risk?
  - iii. What are the incentives in the current proposals for hedging to occur? What are the barriers?
  - iv. Are there changes to the policy design that would enhance the incentives for a hedging market to develop?
  - v. Is the provision that liability caps be applied at a portfolio level a necessary condition for stimulating a liquid hedging market or can it be eliminated for sake of reducing the complexity of the mechanism?
4. DECC has maintained that secondary trading is an important tool for investors to be able to manage the risks associated with holding a capacity obligation. The ability to physically trade is helpful for DSR aggregators and for new build so that they can find replacement capacity if they are unable to deliver. Moreover, the ability to hedge a position through financial trading is helpful to protect parties not running outside of peak. However DECC notes that the presence of an annual cap on liabilities as well as the four hour warning period before load-following penalties are applied in a stress event should both significantly reduce the need for parties to hedge their position.
5. Engagement with stakeholders to date has already flagged a number of potential barriers to secondary trading that should be considered further as part of the review:
  - i. Uncertainty around the size of the load following obligation: Parties face uncertainty ex ante around the size of their load following obligation as it changes according to low carbon output.
  - ii. Uncertainty around the incentive size: Parties face uncertainty around the size of the penalty or overdelivery payment due to the cap on

liabilities, the link to cashout, and due to the requirement that overdelivery payments be scaled according to penalties.

- iii. Financial directives: The introduction of new regulation on the trading of financial products (such as MiFID and EMIR) could introduce barriers to the development of a hedging market.
6. If there are grounds for concluding that the conditions for a hedging market developing organically are not met, the review will then need to consider:
- i. Whether relaxing the current restrictions on physical trading of obligations provide an appropriate alternative means of allowing parties to manage their delivery risk – noting that as currently designed, the mechanism imposes so many restrictions on secondary trading that it is only of help to market participant in specific and exceptional circumstances.
  - ii. Whether it is appropriate for liabilities to be lowered to an extent that the immediate development of a hedging market is not systemically important for parties to finance new investment at reasonable cost. It may therefore be worth considering whether the liability cap should be reduced to levels equivalent in offtake agreements, and whether allowance for maintenance windows should be given in the contract. In this scenario however it would be important to consider how the mechanism could transition back to a more theoretically efficient market design as a secondary market develops.

### **Section 3: Quantitative Analysis**

7. We will look to undertake quantitative analysis to assess the materiality of the barriers to trading – such as the likelihood that overdelivery payments would be scaled down below penalty rates under credible stress tests.

### **Section 3: Stakeholder engagement**

8. The review will involve speaking to a wide range of stakeholders over November and December. In the first place, the Expert Group and Energy UK should be encouraged to develop a consensus position on how they think secondary trading can be made to work. DECC will seek to have additional stakeholder engagement with:
- i. Independent generators: To help identify the barriers to trade that could be problematic with the existing proposals.
  - ii. Utilities: An objective for the review will be to see if companies with significant portfolios can be encouraged to give commitments that they will organise a market. However it is not practical for Government to

intervene directly in the market – for instance by setting up an exchange or by mandating that parties must trade on it.

- iii. Insurance companies and other intermediaries: To form a view of the legal and commercial barriers to setting up a financial options market.
9. The review will need to be completed by January so that there is time to develop any substantive policy amendments in time for publication of final secondary legislation in the spring.

#### **Section 4: Questions for the Expert Group**

10. The Expert Group is invited to provide comments on:

- i. Are the objectives and work plan for the review appropriate?
- ii. What are the essential roles for secondary trading and is secondary trading systemically important to the Capacity Market design?
- iii. Are existing provisions for secondary trading sufficient to enable DECC and investors to have sufficient confidence that a secondary market will develop in a timely manner? If not, what are the barriers and what policy solutions would enable sufficient secondary trading to develop?
- iv. If it is unlikely that investors will have sufficient confidence in secondary trading in the first auction, what transitional measures could limit investment risk until a secondary market develops?

11. Stakeholders are particularly encouraged to collaborate to develop an industry consensus position on how secondary trading can best be facilitated.