

London, 4 October 2011

Mr Matt Wiecowski
Department of Energy and Climate Change
3 Whitehall Place
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decc.capacity.mechanism@decc.gsi.gov.uk

Dear Matt,

Statoil response to consultation on possible models for a Capacity Mechanism

Statoil (UK) Ltd welcomes the opportunity to respond to the DECC Consultation on possible models for a Capacity Mechanism, in the broader context of the Electricity Market Reform (EMR).

As the largest importer of natural gas to the UK, Statoil takes a direct interest in the UK electricity market. Our interest is further reinforced by our recent investments in the Sheringham Shoal offshore wind farm, as well as our role as a development partner for the Dogger Bank offshore wind zone. In addition, Statoil has an ambition to become a CO₂ storage provider for third parties. This has been highlighted by our participation in three UK projects that recently applied for EU support.

We understand that a capacity mechanism is required as a product of the other mechanisms being introduced by the Electricity Market Reform. The potential for a significant increase in wind generation and the addition of new nuclear plant will mean that support generation will be required to keep the lights on, but that this generation will not be required all the time. Plant is less likely economic at low load factors and may struggle to be financed.

The proposal for the creation of a capacity mechanism raises one overarching concern: that the capacity mechanism proposed is intended to provide the construction of new generation capacity to secure an adequate capacity margin, but it does not take into account the other elements that concur to the generation of flexible electricity. In case of gas-fired generation, beyond the existence of flexible plant, appropriate transport infrastructure needs to be kept in place, and adequate supply needs to be available at peak times. The latter requirement implies a liquid gas market, and market liquidity is among other things a proportional function of total market size. If the rest of the Government's energy policy does not provide adequate incentive for gas to still play a role in the UK's energy mix, then long term availability might prove a problem and the higher cost of fuel could jeopardize the peak-shaving effect of flexible plant paid for through this capacity mechanism.

Our recommendation, as outlined in the response to the questionnaire below, goes in the direction of creating a market-based mechanism for the procurement of necessary capacity, such as a capacity obligation, with an eye at not giving unfair advantages to vertically integrated businesses, as such advantage might translate into entry barriers for independents, whereas it is important to ensure that a level playing field is put in place. This implies a certain amount of centralized control over how much capacity is required, and a certain attention to design issues that can assure the right amount of liquidity. Please find below our response to the specific consultation questions.

Sincerely,

[Redacted Signature]
Head of Governmental & Regulatory Affairs, Natural Gas
[Redacted Name]

Targeted Capacity Mechanism

Question 1: Does this table capture all of your major concerns with a targeted Capacity Mechanism? Do you think the mitigation approach described will be effective?

The conclusion that we draw is that a strategic reserve is not the preferable option to create a capacity margin compatible with the future backup requirements of the UK electricity system. Notably, it would be a top-down approach, with the potential to create further market distortion; nor would it be flexible enough to provide the right amount of spare capacity at every point in time. We have therefore disregarded questions 2 to 11.

Market-wide Capacity Mechanism

Question 12: How and by whom should capacity in a GB market be bought and why?

An obligation imposed on suppliers to buy capacity in either an auction or bilaterally seems the most appropriate mechanism, as this would send the right market signals for capacity to be built. The central buyer would replicate the distortion outlined in the strategic reserve mechanism. The two methods of auctioning (primary market) and bilateral trading (secondary market) can co-exist, as is the case in the current Renewable Obligation: the more liquid a market, the more the price for capacity will reflect its actual value. The comparison with the Reliability Pricing Model in force in the American PJM transmission system, brought forward in the proposal in order to make the case for giving suppliers the possibility to self-supply capacity, works only to some extent: market structure is different, and due to market concentration in the GB electricity market, this may create a possibility to self-supply capacity from an integrated players portfolio which may limit the benefits of the mechanism in ensuring additional capacity for peaks.

In order to provide potential developers of new plant with enough certainty as to the return on their investment, we would recommend that the determination of the amount of capacity needed is made centrally, as in the Capacity Market option outlined in the consultation document. Central regulation will also be required in order to ensure adequate liquidity in the capacity market, namely to create a level playing field between vertically integrated companies and independents (see response to Question 20).

Furthermore, the design features that we recommend through the responses to questions 13 to 25 are also oriented towards providing sufficient guarantees for investors.

Question 13: What contract durations would you recommend for a Capacity Market?

Durations of one year for existing plant and up to 20 years for newly built capacity seem appropriate. In addition to the duration of the contract the most critical element is the level of the payment where new build capacity is concerned.

Question 14: How long should the lead time for capacity procurement be? Should there be special arrangements for plants with long construction times?

Contracts with lead times shorter than construction time are not ideal from a developer's perspective. In order to foster investment in new plant, lead times should be defined by plant technology, making it possible to contract capacity before the final investment decision is made. The mechanism should reward those technologies that can respond quickly and flexibly and can be built rapidly.

Question 15: Should there be a secondary market for capacity? Should there be any restrictions on participants or products traded?

Yes. See answer to question 12.

Question 16: 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?

A reliability rating should be given, and certain types of generation excluded from the capacity mechanism altogether, as it must not be forgotten that what is needed is an effective tool to back-up intermittent generation. The existence of unreliable generators in the capacity market (and the ~~no~~ physical backing ~~or~~ ~~name plate capacity~~ options in the case of the reliability market proposal) is not efficient. Appropriate financial compensation for outages or high prices is not a valid substitute for actual capacity.

Question 17: How should the reference market for reliability contracts be determined and what would be an appropriate reference market if it is set by the regulator? How could any adverse effects of choosing a particular option be mitigated?

The most sensible choice is to enable reliability contracts that imply physical delivery, and therefore the option in which suppliers specify the reference market for individual contracts. This would avoid the risk of making the whole capacity market a financial game, enabling it to provide physical capacity.

Question 19: For a Reliability Market, what level of physical back up (if any) should be required for reliability contracts and how should it be monitored?

Regulatory de-rated capacity. See answer to Question 16.

Question 20: Do you agree that a vertically integrated market potentially raises issues for the effectiveness of a Reliability Market? If so, how should these issues be addressed?

A liquidity requirement, similar to the one that is being brought forward by Ofgem for the wholesale electricity market, could be replicated in the capacity market, for example by imposing vertically integrated companies to auction a share of the capacity that they would normally use in order to fulfil the capacity obligations imposed on their supply branches.

Question 21: 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?

Either a plant has a FiT CfD or a capacity contract, not both μ given that the meaning of a capacity mechanism is to provide flexible backup for intermittent low-carbon generation.

Question 25: What is the most appropriate design of Capacity Market for GB and why?

A capacity obligation whose amount is centrally set each year, and with a primary (auctions) as well as a secondary market (trading or reliability contracts). See our responses to questions 12 to 24.

Capacity Mechanism Assessment**Question 26: What are your views on the costs and benefits of a Capacity Mechanism to industry and consumers?**

The cost of a capacity mechanism is a necessary by-product of the Electricity Market Reform, ensuring there is sufficient generation capacity to meet demand at all times. In previous responses to the EMR consultations and other DECC policy work in this area, Statoil have highlighted that the Governments climate objectives can be achieved at a lower cost and with fewer market distortions than the current chosen solution. This would require a larger role for gas fired power generation beyond 2020 which has lower capital costs, and as it replaces coal fired generation it would reduce significantly emissions of carbon dioxide. In addition, without the investment uncertainty in CCGTs created by the EMR, there would be no need to create a subsidy mechanism for gas fired power stations through the capacity mechanism. This would have resulted in lower costs to consumers.

The way to keep the cost of a capacity mechanism as low as possible is to reward the technologies that provide the best match between flexibility requirements, environmental sustainability, and costs.

Question 27: Which Capacity Mechanism should the Government choose for the GB market and why?

Provided that we discarded the strategic reserve option for the reasons explained in the response to question 1, we believe our answers to questions 12 to 24 cover all our remarks and preferences as regards the current proposal for capacity payments based on a market mechanism. We take the opportunity to reiterate that we would have liked a more comprehensive approach to flexible generation i.e. including considerations on infrastructure development and securing long-term volumes.