



Department of Energy & Climate Change,  
4th Floor, Area D  
3 Whitehall Place,  
London, SW1A 2AW

Tuesday 27<sup>th</sup> Sept 2011

Dear Mr Wieckowski

### **Consultation on Capacity Mechanism**

I am replying to the invitation to respond to the consultation on behalf of MMGenR8 Limited, a company established to invest in new Mid-Merit Generation plant. In a difficult investment environment, MMGenR8 requires long-term certainty of revenue for its projects. We therefore urge the establishment of clear and transparent long-term incentive measures that support new entrants, prevent market abuse and minimise the risk of stranded development costs caused by changes of policy.

We would like to make three points.

- 1. The Capacity Mechanism should not apply to any form of generation which is subject to any other form of government support mechanism.**

Generation that is Sustainable (Renewable and nuclear) or energy efficient (Combined Heat and Power) is given support in the form of ROCs, LECs, FITs or FIT CfDs based on the amount of energy that they produce. It should not be necessary to reward such capacity twice by paying them for capacity as well as energy.

- 2. The Capacity Mechanism should only be paid to generation units that are free to generate as directed by a System Operator.**

Less than 10% of UK electricity is traded on a day-ahead basis or within the Balancing Mechanism. The other 90% is subject to forward contracts or options, or is reserved for balancing within the portfolios of Integrated Generation and Supply businesses. Capacity Payments should not be made to units that are contracted elsewhere.

- 3. Capacity Payments should be at a level which is sufficient to finance new capacity.**

The Capacity Mechanism is designed to cope with the problem of declining mid-merit capacity caused by the closure of coal, oil and early gas-fired power stations. At a lower level of Capacity payment, the life of some older plant can be extended by a few years. This will do nothing to solve the imbalance problems expected at the end of this decade.

We think that the System Operator should be required to procure a mixture of short and long-term capacity (As is currently the case for the NGC STOR programme). Long-term capacity contracts should only be awarded for newly constructed generators (as will be the case for CfD FITs).



MMGenR8's responses to the questions posed are as follows:

**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?**

Only a Targeted Mechanism, with a significant proportion of Capacity reserved for new entrants, can support the required increase in capacity. A Market-wide Mechanism may prevent the closure of end-of-life plant for a few more years, but will not solve the problem caused by the closure of coal, oil and gas generators by the end of the decade.

**Question 2: How long should the lead time for Strategic Reserve capacity procurement be and why?**

There should be a balance between the procurement of long and short term reserve, as there currently is in STOR. Allowing for planning, engineering and financing time, new entrant capacity will take about 4 years to become available. Strategic Reserve Capacity procured at the start of 2013 might expect to be available by the start of 2017. Any delay to this programme could cause a serious shortfall in capacity.

**Question 3: Should the length and nature of contracts procured by the Strategic Reserve procurement function be constrained in any way?**

There is an overlap between the Balancing Market, the Standing Reserve (STOR) requirement and the proposed Capacity Mechanism. The procurement process and mechanisms for all three need to be co-ordinated. This means that NGC has to be the System Operator for all three markets, taking account of the interaction between them.

To provide certainty, a growing proportion of contracts should be procured on a long term (15 year) basis. Only new capacity should be eligible to bid for long-term contracts.

**Question 4: Which criteria should providers of Strategic Reserve be required to meet?**

Short-term providers should have to prove that the capacity is available or under construction, either by physical evidence or in the form of a Demand Response Contract. Other criteria should be contractual- as in the STOR contract- bidders are required to sign up to the terms of the tender before they can participate.

The System Operator should publish the criteria by which it will compare bids for Strategic Reserve and apply them transparently. Such Criteria would include response time, ramp rates, and Utilisation costs.

Long-term providers should be allowed to bid for contracts against an agreed development plan, as is currently the case for STOR. In the event that a successful long term bidder fails to meet specific milestones (such as concluding site leases, obtaining planning and environmental consents or obtaining financing, then the System Operator should have the power to cancel a Reserve Contract.

Potential new entrants should not be disadvantaged by being required to pay deposits when bidding for Standing Reserve.



**Question 5: How can a Strategic Reserve be designed to encourage the cost effective participation of DSR, storage and other forms of non-generation technologies and approaches?**

DSR should be encouraged, specifically by making provision for aggregation of DSR by suppliers and traders.

The object of a Strategic Reserve is to provide the System Operator with the option to provide more capacity to balance supply and demand in the most economic manner. The value of the option depends on the reliability of the generation.

Capacity cannot be made available if it is already contracted by someone else for the supply of energy. Interconnectors should only be made available if they are able to provide capacity and energy when required.

**Question 6: Government prefers the form of economic despatch described here. Which of the proposed despatch models do you prefer and why?**

The cost of capital for new investments with uncertain income is much higher than that for those with a long-term contracted revenue. The System Operator should therefore procure Reserve on a basis that reflects costs of Utilisation and rewards capital investment in Availability.

The despatch of units should be the task of the System Operator (which should also operate the BM and STOR). The SO should be required to minimise the cost of the whole system subject to constraints of reliability and capacity margin.

Due to the interaction between the markets, a consistent but flexible approach should be taken by the SO, specifically to prevent abuse of market power.

**Question 7: How would the Strategic Reserve methodology and despatch price best be kept independent from short-term pressures?**

The SO should be free to despatch SR at any price that is justified by the objective of managing the system in the most economic way. The price paid for capacity should be obtained by tender from those who are prepared to commit capacity to the SR.

**Question 8: Do you agree that a Strategic Reserve should be periodically reviewed? If so, who would be best placed to carry out the review and how often should it be reviewed?**

The System Operator for the Strategic Reserve should be required to prepare and publish a plan for the reserve setting out:

- The requirement for reserve over the next fifteen years.
- The expected cost of procuring that reserve on both a long and short-term basis.
- The mix of long- and short-term reserve to be contracted.

The SO should annually enter into long and short-term contracts by tender for the quantities required, less volumes contracted in previous years.

The System Operator's performance in acquiring contracts should be monitored by a body to which the SO is accountable, and the plans reviewed in the light of changing supply and demand.

Long-term contracts should be Grandfathered.



**Question 9: Into which market should Strategic Reserve be sold and why?**

This should be a matter for the SO. As STOR manages many of the functions of supporting the BM, it is more logical to provide SR into the day-ahead market. SR could be sold in the form of options of forward contracts up to a year in advance, provided that it meets its objectives and rigorous Risk Management controls are imposed on the SO.

**Question 10: Do you have any comments on the functional arrangements proposed for managing a Strategic Reserve?**

The Energy Market is continuously evolving. The previous Capacity Market under the Pool was complex. It is impossible to be proscriptive and design a structure that will survive for many years.

To attract new investment, there will have to be clear and simple contracts between a credit-worthy System Operator and prospective new investment companies. These contracts should be grandfathered so that they are not affected by any changes in the structure of the UK Electricity Market.

**Question 11: Given the design proposed here and your answers to the above questions, do you think a Strategic Reserve is a workable model of Capacity Mechanism for the GB market?**

Yes, we think that a Market-wide Capacity Mechanism is also feasible, but will be much less likely to attract much needed new investment in Mid Merit Generation.

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

There should be a single buyer for all contracts. Suppliers are not acceptable counter-parties – as evidenced by the default of TXU and others in the Renewable Obligation Certificate Market.

**Question 13-25 Market Wide Capacity Mechanism:**

The GB Electricity market is a bilateral market with over 90% of volume traded more than a day ahead of delivery. A significant volume of trades take place between counter-parties who are not subject to regulation by Ofgem and who will have no obligation to comply with systems established in the EMR. There is relatively little liquidity in the UK traded market; balancing of supply and demand is largely carried out within the portfolios of six major integrated generator/suppliers.

The volume of additional capacity that will be required to stabilise the forward and Balancing Markets is uncertain. NGC state that an additional 2,000 MW of capacity will be required for STOR, and it is estimated that up to 6,000 MW of mid-merit capacity will be withdrawn from service over the next five years. Some commentators have suggested that a Capacity reserve should be of the order of 2,000 MW or 3% of the UK total installed capacity.

MMGenR8's view is that 2,000 MW of new flexible capacity is the minimum that is required to ensure that the balancing market is stabilised, so that demand and supply can always be balanced at realistic prices.

A Market-wide Capacity Mechanism will simply not attract new investment.

A Capacity Market is designed to cope with extreme circumstances, ensuring that demand can always be met at an acceptable cost to the electricity industry and the Economy. When extremes occur, there is a significant risk of financial default, as in the case of Enron, TXU and Others. We therefore think that it is essential that a single credit worthy entity, ultimately backed by the whole electricity



industry, underwrites the supply of capacity by entering into contracts with a large number of independent providers.

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

We agree that the risk of a capacity shortfall is significant. Without a Capacity Mechanism, prices in short-term markets could rise to very high levels. There is potential for market abuse by dominant, vertically-integrated Suppliers.

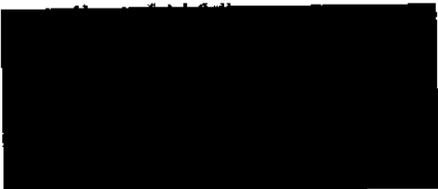
MMGenR8 believes that at least 2,000 MW of new flexible generation capacity is required. The capital cost of this would be about £1 billion, less than 1% of the capital cost envisaged for new nuclear and renewable generation investment. A Capacity Mechanism is an essential, but small, part of the cost of Sustainable Generation.

We are opposed to the introduction of a Market-wide Mechanism, since this will add considerable costs to participants, which will inevitably be passed through to Industry and Consumers.

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

We would like to see a Targeted Capacity Mechanism, operated by the same System Operator as STOR. The amount of Reserve should be determined by forward estimates of the balance of flexible, intermittent and inflexible capacity as new developments in nuclear, renewable and fossil generation are proposed.

New flexible generation capacity is required as a consequence of the closure of flexible coal, oil and gas plant. Investment will only be made in such capacity if the revenue is predictable and long-term contracts are available from a credit worthy counter-party. A Targeted Mechanism can provide the certainty necessary for such investments, a Market-wide mechanism cannot do so.



Managing Director

MMGenR8 Limited

