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CAPACITY MARKET SUPPLIER CHARGE METHODOLOGY

1. Summary

- 1.1. Suppliers will fund the capacity market, including both payments to Capacity Providers and the administrative costs of the Settlement Body and Settlement Agent. Current policy is that suppliers will be charged each month based on their forecast market share over the peak demand Triad periods. This approach is intended to enable suppliers' charges to be calculated in advance and also to incentivise reduction in peak demand and further encourage DSR through its association with peak demand periods.
- 1.2. Suppliers raised concerns around this peak charging approach in advance of, and in response to, the EMR implementation consultation. Responses to the consultation show that most of the large suppliers and several smaller suppliers believe better charging approaches are available. However, there was moderate support for the peak charging methodology from other stakeholders, including generators, developers of generation plant and suppliers of business/industrial customers.
- 1.3. Though there is no unanimously supported alternative, there is broad support from large suppliers for basing charges on suppliers' forecast share of demand over the entire year. However, DECC believes it remains desirable from a policy perspective to maintain a link between supplier charging and times of peak demand in order to provide an incentive to reduce demand for capacity, with the effect of incentivising DSR and encouraging suppliers to offer time of use tariffs; a charge based on annual demand would remove this link.
- 1.4. We have therefore decided to change the charging methodology to an approach under which supplier charges are based on suppliers' forecast market share between 4pm – 7pm across the winter period, i.e. from the start of November to the end of February (the same period from which the Triads are taken). Further details of this solution can be found in paragraphs 3.2 – 3.4. We believe this is a reasonable compromise which takes account of the principle concerns from suppliers relating to the variability of a peak-charge approach without losing the demand reduction incentive.
- 1.5. **Following consideration of stakeholder input, DECC has concluded that the CM supplier charging methodology will be changed as set out below. We ask that the Expert Group notify us of any questions or concerns regarding the considerations and conclusions set out in this paper.**

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2. Supplier Concerns

Current charging methodology (peak charging)

- 2.1. Under the current methodology suppliers are charged each month based on their market share over the peak demand Triad periods, based on forecasts provided by suppliers. The three Triad peak periods in each Capacity Year will be determined using actual data in accordance with the existing National Grid Methodology for determining Transmission Network Use of System Charges. By three months before the start of each Capacity Year, suppliers will need to estimate their market share over the expected Triad periods. The estimates will be replaced with actual information when available from BSC data, and payments reconciled accordingly.
- 2.2. This current methodology has the following benefits:
 - Recovers the right amount of funding to cover the basic Capacity Payments to each Capacity Provider for the year, and for each month (the monthly weightings for charges and payments use the same methodology);
 - Produces monthly supplier charges, which DECC believes are relatively simple and predictable;
 - Associating supplier charges with market share across the Triad periods of peak demand reflects that the CM acts as an insurance against scarcity, and recognises that the annual charge for the CM should reflect the maximum possible scarcity, i.e. that which could occur in periods of peak demand (i.e. the worst case scenario);
 - Associating supplier charges with market share across the Triad periods adds a further incentive for DSR that is not part of CM (suppliers will seek to reduce their demand over the peaks to reduce their CM charges and incentivising DSR is one way of doing this); and
 - Facilitates simpler and cheaper credit arrangements for suppliers.
- 2.3. Key factors in developing, and considering changes to, the CM supplier charging approach, are that charging ensures sufficient funds are obtained for payments, avoids over-collection of funds or use of a buffer fund, incentivises reduction of peak demand (encouraging DSR response) and determines accurate charges in timeframes that facilitate government accounting. Consideration must be given to the degree to which changes, or an alternative approach, would align with, or disrupt, other elements of the capacity market design must be considered (e.g. interaction with the penalties and over delivery payment arrangements) and the impact on implementation of the CM arrangements.

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Supplier concerns with Triad peak charging methodology

- 2.4. Suppliers raised concerns previously, which they reemphasised in response to the consultation. Suppliers raised the following concerns with the current charging methodology:
- The use of forecast market share means suppliers' ultimate liability for CM charges will vary from that initially calculated, and suppliers would need to manage the risk of their final CM charge being significantly larger than the initial charge;
 - The charging methodology should be predictable to suppliers (to reduce the cost of managing risk, which would be passed to consumers), transparent (so customers can understand the charge) and cost reflective in its allocation of CM costs to consumers;
 - It is particularly difficult for suppliers to accurately estimate their share of demand over the Triad periods, and the current methodology also requires suppliers to predict when the Triad periods will fall – suppliers would be better able to predict market share over a whole year (because it is less variable);
 - Suppliers already try to reduce demand over the Triad periods and the current approach won't have any material additional impact;
 - The methodology discriminates against suppliers with a greater proportion of domestic, rather than industrial, customers because industrial customers are able to respond to incentives to reduce demand over Triad periods; and
 - Since suppliers will pass the charge to consumers, the current methodology discriminates against customers of suppliers with a relatively high proportion of domestic customers (and therefore domestic customers' funding of the CM could be disproportionately high compared with industrial customers).
- 2.5. Suppliers have not supplied any quantitative evidence to substantiate these concerns, e.g. to demonstrate the relative volatility of Triad periods and the difficulty of Triad forecasting.
- 2.6. While it can be said that suppliers with a greater proportion of domestic customers will be more adversely affected by a peak charging approach, we do not believe this constitutes unfair discrimination. Rather, it exposes different types of customers to the costs of their energy use.
- 2.7. We also do not think it is correct to say that domestic customers would be unable to respond to incentives at times of peak. It is unlikely that domestic customers would be exposed to real-time prices, and so would be unlikely to respond to Triad incentives, but domestic customers will increasingly be able to respond to time of use tariffs (are starting to be offered) and this will increase significantly with the roll out of smart meters. Charging suppliers according to average annual market share would actually dull existing incentives for

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suppliers to offer time of use tariffs and for reducing energy use at peak, and could therefore compromise the benefits associated with the roll out of smart meters¹.

3. Assessment of charging approaches

- 3.1. Consultation responses showed some support for the current peak charging methodology from stakeholders, including generators, developers of generation plant and suppliers of business/industrial customers. However, taking into account the opposition from other stakeholders to the current approach, we consider that an alternative charging methodology should be adopted, under which supplier charges are based on suppliers' forecast market share between 4pm – 7pm across the winter period (November to end of February).

New charging approach: forecast share of demand between 4pm – 7pm in the winter period

- 3.2. Under the changed charging approach supplier charges are based on suppliers' forecast market share between 4pm – 7pm across the winter period (November to end of February). Proposals of this nature were discussed with suppliers prior to the consultation, and elements of this approach were put forward in several consultation responses.
- 3.3. This combines elements of several alternative approaches, and retains a clear association with times of peak demand while removing the specific association with the Triad periods. Suppliers will need to forecast their share of demand, but not predict the Triad periods and their demand over those specific periods. We believe this reduces the variability between charges based on forecast and actual data, compared with the current peak charging methodology, and therefore reduces the risk identified by suppliers. Under the new approach supplier charges would be weighted each month, aligning with the weighting of payments to capacity providers, as under the current charging approach.
- 3.4. We acknowledge that the incentive to reduce peak demand is somewhat reduced under the winter 4pm-7pm approach. However, reduction over peak is already effectively incentivised via TNUoS charging, and the proposed approach retains the link whilst reducing uncertainty for suppliers (and so reducing the costs passed on to customers as a result of managing this uncertainty). We also consider that a 4-7pm charge may better facilitate time-of-use tariffs for domestic customers, over time.

¹ The Impact Assessment estimates £6.3bn of consumer benefits from Smart Meters inducing customers to reduce their energy consumption.

https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/78666/IA-Feb.pdf

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Alternative most supported by suppliers: forecast share of annual demand

- 3.5. Energy UK had previously proposed a supplier charge based on demand share over a whole year, which had broad support among its members. This was reflected in the consultation responses received, where this option was the most well supported of those put forward by respondents that do not support the peak charging approach.
- 3.6. Suppliers maintain that they would be better able to forecast their demand for a whole year accurately, compared with forecasting demand over the peak Triad periods, though this has not been substantiated. Once the demand forecasts are obtained they would be used to determine monthly supplier charges in the same way as under the current peak demand methodology, so no Buffer Fund or additional reconciliation would be required under this approach.
- 3.7. A supplier charge based on demand share over a whole year would have some of the benefits of the current peak demand methodology, but its removal of the association with peak demand would remove the feature that charging would reflect that the CM insures against scarcity, and that the CM magnitude should reflect scarcity in periods of peak demand as well as removing the additional incentive on DSR that is not part of CM (though the latter means the possibility of double reward for DSR in the CM is removed without implementation of separate measures).
- 3.8. An annual demand approach would, depending upon how it is implemented, be very different from the peak charging approach and would therefore be likely to cause significant disruption to implementation of the CM arrangements. For instance, suppliers would like to see monthly reconciliation of charges with actual data as it becomes available each month, compared with the peak charging approach, under which reconciliation occurs once each year when suppliers' actual demand over the Triad periods is known.

Initial Elexon view

- 3.9. Elexon provided a high level initial view on the charging approaches in this paper, noting that a formal impact assessment would be required to identify detailed impacts, on implementation timescales or costs, of any change. Elexon believe that the main consideration around CM settlement impact is on the timing of reconciliation runs and reconciliation calculation.
- 3.10. Under both the current peak charging approach and the new winter 4pm-7pm approach, final data for reconciliation would relate to the period from the beginning of November to the end of February. However, under an approach based on annual demand the complete data would relate to the period up to the end of the year. This is the end of September for a capacity year running from

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October to September, six months after the end of the period relevant for the other two approaches

Ruling out a fixed unit charge

- 3.11. There was support from suppliers for a fixed unit (£/MWh) charge, but such an approach is not being given further consideration. Suppliers argue that a fixed unit charge would be simpler and reduce the costs passed on to customers (because Government would assume the risk of varying charges through central administration of a 'Buffer Fund')
- 3.12. We do not believe that it would be necessary or desirable to implement a Buffer Fund for the CM. Intentional over-collection of a levy (required in order to implement a Buffer Fund, which would be needed because a unit charge would not accurately recover the required funding for CM payments each month and across the year) is not in accordance with Government accounting procedures. This approach has been taken for the collection of the CfD supplier levy due to the increased variability associated with these payments. CM payment flows are more certain and this, along with the additional complexity that such a fund would introduce, means that the case for introducing such a buffer fund under the CM is weak.