

DECC Consultation – Energy Market Reform Design proposals for a Capacity Market



EFET response – 20 December 2013

The European Federation of Energy Traders (EFET¹) welcomes the opportunity to provide its views on the proposed implementation measures for the Energy Market Reform in Great Britain. The comments hereunder focus on Chapter 4 of the consultation document published on 10 October 2013, namely the detailed design proposals for the GB capacity mechanism.

During the last two years EFET has followed the ongoing discussions around capacity mechanisms in various Member States closely. We produced a position paper in 2011 setting out our general views on capacity mechanisms. While in 2013 our discussion paper assessed some of the design features of capacity mechanisms if such interventions are implemented²

The context for this discussion is that most EU Member States, including the UK, currently have significant over-capacity in generation compared to demand. This is borne out by the latest ENTSO-E report on generation adequacy³ and current forward spreads. These largely do not yet signal the need for new build, at least not for gas fired plant.

Some adjustment to companies' generation portfolios is therefore likely in coming years and this will take place in parallel to significant and uncertain increases in the share of renewable generation. This raises the possibility that the outcome is not optimal in a socio-economic sense or does not fulfil particular political objectives. Under these circumstances, there could be some rationale for limited intervention.

¹ The European Federation of Energy Traders (EFET) promotes and facilitates European energy trading in open, transparent, sustainable and liquid wholesale markets, unhindered by national borders or other undue obstacles. We currently represent more than 100 energy trading companies, active in over 27 European countries. For more information, visit our website at www.efet.org.

² *EFET Discussion Paper on Capacity Remuneration Mechanisms*, February 2013, available at: http://www.efet.org/Cms_Data/Contents/EFET/Folders/Documents/EnergyMarkets/ElectPosPapers/~contents/Z5Z2WKTWJ8DB8F3A/EFET-discussion-paper-Capacity-Remuneration-Mechanisms_February-2013.pdf

³ *Scenario Outlook & Adequacy Forecast 2013-2030*, April 2013, available at: <https://www.entsoe.eu/about-entso-e/system-development/system-adequacy-and-market-modeling/soaf-2013-2030/>

At the same time, we consider that such interventions should only be decided by governments if a thorough and transparent analysis has been carried out showing that support mechanisms for capacity would be indispensable or unavoidable, for a definite period of time. Markets are capable of solving most or all of the issues currently being discussed. Indeed one of the core functions of markets is to balance supply and demand and provide incentives for investment. We do not find the “missing money” arguments for capacity mechanisms very persuasive. There is already a significant proportion of demand that could respond to price levels and this will increase as smart metering is extended.

Likewise the existence of a problem posed by price spikes has been much overstated. Price spikes manifest themselves in the spot and balancing markets. Meanwhile, at least 90% of electricity is bought and sold in forward markets and we would normally expect projections of tighter supplier-demand conditions to incentivise more forward contracting so that there is spare capacity to contract to manage price risks. In any case only a very small proportion of total demand is affected by price spikes and these costs are faced by supply businesses rather than being seen by customers themselves. The political acceptability of price spikes is therefore rather an issue of serious analysis of the problem in the media and in political circles. Recent discussions in the UK have underlined the reality that it is average bills over the whole year that are important to consumers. The fact that market participants may financially benefit from tight peak periods should not hide the fact that they do operate at a loss in other periods. As long as customer prices over the year remain stable and system security and generation (and load) adequacy are preserved, there should be no undue public intervention on the standard functioning of the market.

Finally we are sceptical of some of the concepts that are being used in the capacity mechanism discussion in the UK in terms of “reliability standard” and “target capacity margin”. It is not appropriate, in a market framework, to treat demand as an exogenous factor or for this to be assessed and evaluated by Ministers, regulators or panels of “experts”. Likewise we reject the idea that a mechanism is needed to incentivise new investment, reduce risk or to make projects “bankable”. Dealing with wholesale commodity markets is a central discipline of commercial decision making in the energy sector which should not be supplanted, partly or entirely, by regulatory structures.

In summary, although EFET can accept the existence of separate revenue streams to reward capacity, these must remain subordinate to the energy (MWh) market in order to avoid major distortion of the role of markets. The EU is currently in the process of integrating national electricity markets through the development of network codes. The Capacity Allocation and Congestion Management (CACM) network code will be tabled by the European Commission for adoption during 2014 and couple day-ahead and intraday electricity markets. Badly designed capacity mechanisms will distort the outcome of this process and reduce the significant benefits of integration.

In this context, the development of continuous intraday trading across interconnectors is also a necessary step to improve UK security of supply and successfully integrate higher shares of renewable production. The current stalling of the NWE intraday project is problematic and needs to be rapidly resolved by Ofgem through changes to the interconnector licences.

As far as DECC's proposed mechanism is concerned, the main overarching issues that EFET finds inadvisable are as follows:

- **All capacity should be treated equally:** longer contracts for new investment are not necessary or justified and will increase costs to consumers. Segmentation of the capacity products will be a barrier to secondary trading of capacity. We are surprised that there is no impact assessment of this aspect of the proposal.
- **Participation of non-GB capacity:** capacity mechanisms should take into account the contribution of "foreign" generation. A first step could be to calculate the contribution of interconnection to local needs and reduce the amount of capacity required at a local level. In the longer run the Electricity Balancing network code, which will be in force by 2018, should provide a framework for sharing and exchange of balancing reserves and energy. This should address the issues associated with assessing delivery.
- **Energy delivered penalties:** Energy delivered penalties have the potential to distort dispatch decisions and distort market outcomes. An availability model, as being discussed in France, is preferable. However, the fact that penalties will only be applied in very restricted circumstances is welcome. One risk we see is that the proposed "capacity market warnings" might lead to under-contracting if market participants assume that the system will always be long in these circumstances. This underlines the importance of also reforming cash out to ensure that incentives to trade out imbalances are maintained, particularly during stressed periods. We welcome the fact that Ofgem intends to reform the balancing rules so that the market has a higher incentive to balance supply and demand. This will allow much of the perceived problem to continue to be dealt with through the existing energy market structure and avoid distorting the integration of markets.
- **Minimised centralised management processes and maximised scope for independent decisions by market participants:** as an overriding principle, the capacity mechanisms should not be overly bureaucratic and administrative interventions such as caps and pricing rules should be kept as simple and minimal as possible. All administratively determined outcomes need to be well understood and transparent to avoid introducing regulatory risk and damaging the integrity of price formation.

The attached Annex provides responses to some of the 91 questions set out in the consultation document where we consider the questions being raised are important for the integrity of the energy market or European integration.

ANNEX RESPONSES TO SELECTED INDIVIDUAL QUESTIONS

2 What are your views on the proposed approach for setting the amount to contract in each Capacity Market auction?

The approach for setting the amount to contract is bureaucratic, over-centralised and is unlikely to lead to an efficient outcome. We do not have much confidence in an administrated process to provide for a stable investment framework given the growing politicisation of the energy sector.

If, a centralised approach is deemed to be unavoidable, then it is crucial that mechanism is fully transparent and robust. Market participants need to be able to forecast future capacity prices in order to take efficient (investment) decisions.

3 Do you think the proposed value for net-CONE (£29/kW per year) and the proposed auction price cap (1.5 * net-CONE) are appropriate for the first auction? If not, do you think that the proposal for a transitional price cap of around £75/kW is appropriate to allow for a wider range of projects to set the price in the first auction(s)?

It is not consistent to introduce a measure to reward capacity which is supposedly “market based” and then impose a cap on the outcome of that process. Companies should be able to assess for themselves how much to bid in any capacity auctions and to what extent they account for revenues from the power market. To a large extent the process is circular since the power market outcome will itself be affected by the amount of capacity contracted. Both the net cone calculation and the £75/KW cap are arbitrary outcomes. Finally one of the academic justifications used to support capacity markets is the idea of caps on MWh prices. It does not make much sense to introduce a capacity market but then also apply a cap in that market.

The introduction of a capacity price cap seems more logical if new capacity is entitled to enter into longer term capacity agreements. However, such different treatment is fundamentally wrong and there is no need to allow new capacity to enter into such longer term agreements. Equal treatment with equal capacity agreement lengths of one year for all capacity providers will then also remove the perceived need to introduce a cap.

4 Do you think that the price of new entrant bids in the auction should inform the net-CONE set in subsequent auctions?

We disagree with the discriminatory treatment of existing \ new capacity and the idea of caps on the outcome of the supposedly “market based” mechanism

8 Do you think the proposed limitations on eligibility for participating in the Capacity Market are appropriate? For example, do they give rise to particular issues for any technology type?

All capacity should be allowed to participate on equal terms and decide for themselves how much capacity to offer into the market. It does not make any sense to prevent participation in the capacity market merely because it has received a subsidy under another support mechanism.

9 Are you aware of any solutions that might permit interconnected capacity to participate within the Capacity Market that would meet the Government’s criteria as set out in this document?

Interconnected capacity should be able to participate in the mechanism in order for it to be consistent with internal market legislation. As a first and easy step, we recommend taking into account the contribution of foreign generation implicitly by decreasing the local need by the amount of reliable power that can reasonably be taken into account as a contribution from interconnections.

An explicit contribution of foreign capacities will require a more complex EU wide approach on capacity products (for each specific system needs). The Electricity Balancing network code currently in preparation should, by 2018, facilitate explicit contribution by requiring a much higher level of cooperation between transmission system operators (TSOs) in the area of balancing and reserve procurement and activation.

10 What are your views on the approach to pre-qualification, including the submission criteria, time allowed for the process and the deadlines industry will be required to meet?

The pre-qualification process is very burdensome and bureaucratic and is an obstacle to effective competition. Many existing DECC rules and European legislation pieces such as REMIT already set a framework to avoid market abuse and manipulation.

**12 Do you think the proposed methodology for de-rating capacity, and the proposed range, is robust?
What are your views on the proposals for the auction to credit units at the fuel-type average availability level, rather than the unit’s selected de-rating figure?**

EFET fundamentally disagrees with the concept of administered de-rating of capacity. It should be up to market participants themselves to evaluate the reliability of their own plant. Indeed this is one way that competitors differentiate themselves in wholesale markets. Companies should be able to choose whether they invest heavily in the reliability of an individual CMU and increase its rating, or vice-versa.

The proposals provide perverse incentives to market participants since it is better to be *less* reliable than the average de-rating chosen (i.e. the will be an adverse selection problem).⁴ Capacity providers will end up, in aggregate, being less reliable and less flexible than the market needs. In addition, it is not clear whether there is a dispute process with respect to de-rating. Our view is that this is necessary.

**17 What are your views on the proposal for price takers and price makers?
What is the lowest price taker threshold that should enable the most existing plant to participate in the auction without needing to qualify as a price maker?**

We disagree with the discriminatory treatment of different types of capacity in the proposal. This will not support the objectives of delivering reliable capacity in an efficient way and will increase bills for consumers and damage the functioning of the market. All capacity should be able to offer into the mechanism on the same basis.

⁴ Akerlof’s “Market for Lemons”

18 Do you agree that that the relevant considerations to be taken into account when setting the capacity agreement length for new plant are the extent to which:

- **long term capacity agreements can reduce financing costs;**

Long term agreements, such as RES support schemes, merely transfer the financing costs onto another party, either suppliers or consumers themselves. There is no overall economic welfare gain. Often, the political issues created by this risk transfer increase regulatory uncertainty, and the overall effect is negative.

- **investors in new plant value capacity prices beyond the term of their capacity agreement;**

Investors in new plant should be responsible for their own commercial decisions. They should make their own projections about the market and other revenue streams in the same way as owners of existing plant.

- **long term capacity agreements risk locking in volumes of capacity which is not needed; long term capacity agreements risk locking in high prices; long term capacity agreements impact the ability of existing plant on one year contracts to compete?**

All of these are a strong possibility in the event of discriminatory treatment of new\existing capacity. The worst possible outcome is that existing capacity is closed as a result of this intervention (due to lower prices in both the MWh market and MW auction) and the new investment is not, in the end, delivered.

19 What do you consider to be the appropriate maximum agreement lengths for new, refurbishing and existing capacity?

The capacity product should be defined on an annual basis for all capacity. Anything else will discriminate between different providers and lead to an inefficient, high cost outcome.

20 Do you think financial thresholds are appropriate for distinguishing between new and refurbishing plants?

21 Is a 'price only' (i.e. selected on price alone, irrespective of the length of agreement) or a dual auction comparing bids for around 10 and 25 years more appropriate? If the latter, how should the preference be established?

See above. We disagree with these different categorisations. Financial thresholds also introduce incentives to keep costs high which is not in the best interests of customers.

25 Should the Capacity Market create requirements for participants to bid fairly and to not engage in collusion or market manipulation etc.?

There are already very significant legal requirements on companies in the form of Competition law and REMIT. Additional requirements are unnecessary and counterproductive and undermine the supposed market based nature of the intervention.

- 30 Do you have any comments on the proposed provisions for secondary trading of capacity? Are there any better approaches? Do you consider there are additional measures or design changes that the Government can take to facilitate a liquid hedging market around penalties for under-delivery?**

The proposed design does not seem capable of supporting secondary trading at all. The excessively bureaucratic and centralised nature of the auction, the cumbersome qualification procedure and the rules on opting out of the auction are all insurmountable barriers. Financial trading is also impossible due to the rules restricting the potential payments for over-delivery.

In addition, penalty caps as proposed mean that market participants will value capacity differently, which is likely to negatively impact competition.

- 33 Do you agree that liability for penalties should be conditional on the issue of a Capacity Market warning. If so, is the proposed four-hour period appropriate?**
- 34 Do you think the proposed penalties applicable for non-delivery both more than and less than four hours after a Capacity Market warning are appropriate?**

In general, EFET disagrees with the use of penalties to incentivise delivery of energy. Even if capacity mechanisms are implemented, the energy (MWh) market should be the only tool for providing incentives to redispatch. Once Ofgem has revised the balancing arrangements to incorporate better signals on market participants to balance their position there may no longer be any need for penalty arrangements at all. The penalty should be based on proven capacity and up to the TSO to dispatch. The current rules for penalties have a number of perverse outcomes, including the potentiality of a plant that causes a stress events being able to avoid penalties by submitting a PN of 0.

However, if penalties are to be implemented we agree that this should only be the case where **both** a CMW has been issued, **and** a demand reduction incident has occurred.

- 35 Do you think that a penalty cap of between 101 – 150% of a unit’s annual capacity payments achieves an appropriate balance of consumer value for money, delivery incentives and investability?**

As noted above, we would consider a regime without penalties, and with incentives provided by the wholesale market and balancing regime, to be a better basis for delivery incentives.

- 36 Do you agree with the proposal that penalty caps should be determined at the portfolio level? If so, do you agree with the approach for determining portfolio structure?**

The portfolio approach does not make much sense given that the whole scheme is based on capacity offered by individual CMUs which have to pre-qualify individually. A portfolio approach is somewhat of a disincentive to trade in a secondary market, but can be considered a reasonable pragmatic solution since higher availability of a plant will compensate for lower availability of others (although we do not think this is really workable in any case).

- 37 Do you think that the proposal to apply different penalty rates to units depending on their balancing mechanism status is appropriate and offers value for money to consumers?**

No. All capacity providers should face the same incentives and the scheme should not discriminate between providers.

- 38 Do you think that over delivery payments are an important design feature for providing efficient despatch incentives and facilitating secondary trading?**

It would be preferable to have a scheme without over- and under-delivery payments and where incentives were purely provided by wholesale and balancing markets. This will give the least distortion to the EU internal market.

- 39 What are your views on the proposals for identifying and spot testing participants' ability to deliver when needed?**

Cumbersome checks and testing should be avoided. Providers will have to declare availability under REMIT and the Transparency Regulation and misleading the market is illegal. A simple ex-post evaluation is all that is necessary.

If better incentives in the wholesale market and balancing arrangements are introduced via the cash out review, capacity providers will always produce up to their availability.

- 48 Do you agree with the necessity of transitional arrangements to help build the capability of the DSR sector?**

- 49 What are your views on the proposed transitional arrangements and do you think they will prove effective i.e. over 2 time limited stages and with the parameters set out?**

We do not agree with the DSR arrangements to the extent that these allow for capacity provision on anything other than a Y+4 basis. DSR may well play an important role in the capacity mechanism. However, then DSR should be equally treated compared to generators. It also remains possible for providers of DSR to offer this into wholesale markets, for example the day-ahead auction or the intraday market. This will help the performance and liquidity of these markets and the effectiveness of market coupling.

- 53 Do you have any comments on the charges being calculated for the purposes of Capacity Market settlement?**

- 54 Given the Government's objective to link the costs of the Capacity Market with the drivers of those costs, and the desire to facilitate demand side participation in the Capacity Market, are you aware of an alternative to the peak charging methodology that might better meet those objectives?**

Our understanding of the rationale for the capacity mechanism is that a certain amount of spare capacity is required throughout the winter period to give comfort to policy makers about the resilience of the system. We can however also imagine that capacity scarcity can occur on hot summer days with no or little wind generation. Unless system needs are clearly identified in a particular period, we do not, therefore, think it makes sense to target charges on particular periods. In any case, there should already be good incentives from the wholesale market on consumers and their suppliers to reduce consumption at peak periods with higher hourly prices. Introducing a further signal risks unhelpful dilution of the

energy market signals and will distort the outcomes of the wholesale market. In addition, “peak demand” cannot be accurately assessed for consumers that are currently still on non HH meters so the signal will not be correct anyway. A more sensible approach would be to allocated charges on the basis of total MWh demand over the year, or alternatively over the winter season.

84 Has the Government got the right balance between ensuring investors have sufficient certainty to bring forward the investment in capacity we need, and ensuring consumers’ interests are protected? Can the proposed design of the Capacity Market be simplified without sacrificing the ability for the mechanism to deliver the Government’s objectives?

EFET does not think that the balance is right in the proposed GB scheme. The academic rationale for capacity mechanisms that exists is not at all to do with incentivising new investments. Providing “certainty” to investors should not be the focus of the scheme and does not act in the interests of consumers. In summary, the DECC proposal does not protect the interests of consumers since they are de-facto cross subsidising new investment.

If the scheme is to be implemented, it should focus on the perceived problem of generation adequacy and provide a simple incentive to generation capacity that does not discriminate and does not undermine the energy (MWh) market. The simplest and most efficient way to do this is as follows:

- a single-year capacity product,
- an availability model,
- incentives for delivery based on wholesale and balancing markets, strengthened by cash-out reform,
- simple ex-post checks based on REMIT and Transparency Regulation disclosure.
- A decentralised scheme that reduces the need for regulatory interventions and thus the risk of inefficiencies is preferable.

87 Is there more that could be done to ensure the proposed design supports the delivery of wider Government objectives such as the development of the internal energy market?

The capacity market intervention will inevitably dilute the effectiveness of the internal market and will increase consumers’ bills as a result. This is a political decision on which EFET does not comment. This negative impact may be mitigated if more effort is made to implement the Third Package in the UK. A key improvement would be the implementation of continuous intraday trading across the interconnectors with the CWE region. Combined with the market coupling initiative, this would largely *ensure* that energy flowed into the UK in the event of a tight situation.

It is obvious that the capacity mechanism needs to take account of the contribution of non-GB capacity to be compatible with the internal market rules. Ideally this would be through direct participation of capacity providers. An alternative is to adjust the quantity of capacity contracted to reflect the contribution of interconnectors.