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2012

EUROPE

Great Britain heralds significant market intervention with new capacity market

by Adam J. Langridge | Squire Sanders (UK)

AS PART OF its ambitious electricity market reform (EMR) programme, the UK government's Department of Energy and Climate Change (DECC) recently published a technical update to its earlier white paper.

The update confirms DECC's decision to introduce a new GB-wide capacity market (GBCM) comprising: (i) estimates by DECC of the total volume of reliable capacity needed by the market a number of years ahead; (ii) providers of capacity contracting with the SO for the required level of reliable capacity through a central auction several years in advance of delivery; (iii) secondary trading of capacity between auction and delivery; (iv) successful capacity providers receiving availability payments; and (v) the cost of the scheme being paid for by suppliers.

The goal of GBCM is straightforward. It is designed to incentivise investment in an appropriate level of flexible back-up generation to support an increasing portfolio of intermittent renewable capacity and a fleet of inflexible new-build nuclear, and prevent a potential capacity shortfall expected around 2020 as a result of the decommissioning of a large portion of the UK's existing generation capacity. DECC acknowledges the GBCM represents a significant intervention in the market and for this reason will be leading a detailed design phase during 2012-2013. Key design issues are likely to include:

When will GBCM start? DECC is leaving it open for government ministers to decide when the first capacity auction will run, a decision which will "depend on the security of supply outlook" at the time. However, the next general election in the UK could take place in 2015 and, given that DECC has indicated that the first capacity auction could take place that year, there is a real risk that this decision could become politicised. Recent negative media comment concerning wind farms 'being paid not to generate' could easily be replaced by criticism of a system which 'pays generators for doing nothing', especially in the context of rising electricity bills and continuing austerity.

How will the auctions work? The technical update contains no real detail on how the auctions will work in practice. It is not entirely clear at this stage, for example, whether and to what extent capacity market auction models used elsewhere in the world, for example the PJM capacity market in the US, will influence the design of GBCM.

Who will participate? The update suggests that GBCM may be open to a wide range of market players, including generators (though precisely which reliable generators needs to be defined), consumers, interconnector operators, and possibly traders. DECC is considering whether CfD-FIT-supported generators should be entitled to participate in GBCM and we assume this question will be resolved during the design phase. Also, achieving a high level of involvement from the demand-side will almost certainly be dependent upon the success of the UK's planned roll-out of smart metering, while including interconnected capacity is likely to add to the scheme's overall complexity.

What will a capacity contract look like? Successful capacity auction bidders will enter contracts with the SO which will entitle them to availability payments for making capacity available in a delivery year while at the same time exposing them to 'penalties' for any failure to generate when called upon to do so. In designing the capacity contract, DECC will need to consider a range of issues, including whether different duration contracts could be offered to different types/ages of plant, how the penalties should be levied, the type of any collateral to be provided and whether and how availability payments made under such contracts should decrease over time as the capacity margin improves.

How will the consumers pay? It is not entirely clear at this stage how the cost of the GBCM will be passed through to consumers. For example, will all consumers be required to pay the same pound-per-megawatt cost or will a consumer with a baseload profile pay less than one with a profile containing more peak demand?

With such a complex mechanism the overall balance achieved during its initial design will be critical. What's more, DECC, Ofgem and National Grid undoubtedly have their work cut out if they are to deliver GBCM by 2014 in conjunction with CfD-FIT contracts, another significant limb of EMR. But market design and timing constraints are just two of the many challenges. Complex interactions with other ongoing UK regulatory programmes (for example liquidity and smart-metering) are likely to influence outcomes and increase overall risk. GBCM will also need to be compliant with EU law, obtain state-aid clearance, and be compatible with EU third package measures to promote a single European market in electricity. While all these loose ends are pulled together over coming months, potential investors in new plant will be watching developments with interest. ■

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