Briefing

BURGES SALMON

The Capacity Market

May 2016

Capacity for Debt? Funding issues and the Capacity Market

The Capacity Market, which was introduced as part of the Government's Electricity Market Reform, was established to ensure security of electricity supply in light of the increasing diversity of generation technologies in the UK market.

Previous articles from the Burges Salmon team have set out the details of the Capacity Market and tracked recent updates and consultations. This article looks to provide a high-level overview of the opportunities presented by the market and look at some of the potential issues that prospective investors might encounter.

Bankability

The Capacity Market includes a number of features that make debt investment opportunities attractive. Long-term contracts (in some cases), monthly payment flows, fixed prices indexed annually to CPI and a "creditworthy counterparty" means that funders looking for opportunities should be looking at this market.

The list of Capacity Contracts awarded in the first two auction rounds is publically available at **https://www.emrdeliverybody.com/CM/CMDocumentLibrary.aspx.**

Capacity Contract

Whilst often referred to as a "Capacity Contract", this term is slightly ambiguous as there is no bilateral contract between the capacity generator and the settlement body responsible for making and receiving payments (the Electricity Settlements Company Limited). Instead a "Capacity Contract" is the combination of three different elements:

1. the obligations under legislation (the Electricity Capacity Regulations 2014);
2. the capacity market rules set out by Ofgem (the Capacity Market Rules 2014); and
3. a capacity notice that the generator receives when it is successful in an auction. The capacity notice will set out the price the generator will be paid, the generating capacity and the term (one, three or fifteen years).

This arrangement means that instead of a delivering energy pursuant to a traditional contract, a generator's obligation to deliver energy is effectively a statutory obligation which applies to the registered holder of a capacity agreement notice, against a statutory right to receive monthly capacity payments.

The primary obligation of the generator is to deliver electricity of a specified quantity during system stress periods as notified by National Grid Electricity Transmission (NGET). NGET will provide 4 hours' notice after which the generator must either comply with their obligations to generate or face penalties for its failure to do so.

Payment mechanics

All payments are made between the generator and the electricity supplier via the settlement body.

These payments will include:

- a regular, monthly payment as set out in the capacity notice from the settlement body to the generator;
- any additional payments from the settlement body for over-generation by a generator (applied annually); and
- any penalty fees deducted from the generator for failure to meet their obligations to generate during a stress period (deductions are applied on a monthly basis).

Payments to the generators are funded by electricity suppliers who pay a monthly charge to the settlement body.

Penalties

In order to ensure the security of supply, on each occasion which there is a failure to generate, the penalty rate is set at 1/24th of the relevant auction clearing price, adjusted for inflation. However, there is a penalty cap of 200% of a plant's monthly income and 100% of its annual income. Penalties will only apply where NGET gave the requisite 4 hours' advance notice of a stress period.

Over-generation

There remains scope for generators to extract upside from supplying electricity outside of their Capacity Contract, both via a PPA outside of the Capacity Market and by over-supplying during stress periods.

In any given stress period, any capacity generated over the amount specified by NGET may entitle the generator to an over-generation payment. These payments are funded out of the penalty fees received by the settlement body. The settlement body calculates the rate of payment as the lower of, (a) the penalty rate (as set out above) and, (b) the total penalty revenue, divided by the total volume of over-generation over the last year.

continued

Potential investors might wish to note the potential for equity upside and/or mitigation of revenue risks that this overpayment mechanic creates.

Termination and cure periods

Termination under a Capacity Contract is defined in the Capacity Market Rules 2014 and covers a number of scenarios such as insolvency of the generator, failure to meet key milestones in new build contracts, failure to deliver copies of key agreements to the delivery body and production of electricity by a generator who has submitted an 'Opt-Out Notice'.

Generators are subject to tests throughout the term of their contract which have consequences for the generator if they are not passed. In particular, generators are subject to metering tests which, if not complied with, can result in the termination of their Capacity Contract. However there is no termination right per se for a failure to respond to a call for generation, even on a repeated basis.

The rules also set out certain cure periods in respect of a termination event. Following service of a termination notice, a generator has 20 working days to write to the Secretary of State to apply for an extension of the notice, which can be for up to 60 days in certain circumstances. Within the notice period the generator is then able to set out a cure plan in which they will aim to demonstrate how and when they will comply with the requirements under which the notice has been brought.

The Secretary of State is obliged to consider the cure plans submitted pursuant to a termination notice and has wide ranging powers under the legislation to rescind a termination notice or extend the time period in which a generator must comply with their obligations under the Capacity Contract by up to 6 months.

Direct Agreements

Due to the fact that there is no bilateral, contractual agreement in place, funders will not be able to protect their position by way of a direct agreement, in contrast to the position under, for example, CfDs. This means funders will need to apply careful scrutiny to the range of termination rights that could apply under the Capacity Market and be satisfied that generators have adequately mitigated the risks. Funders may also ask for some contractual rights to be involved in any appeals process undertaken by the generator further to receipt of a termination notice.

Taking security

There is specific provision under the Capacity Market Rules for generators assigning their rights under the Capacity Market by way of security. The precise nature of that security interest will need to be the subject of legal advice, since the right to receive payment is a statutory right and not a contractual right.

The Capacity Market Rules imply some further conditions of which funders must be aware. Funders can take security over both the generating equipment and the Capacity Contract. However both of those security interests must be registered on the Capacity Market Register, by notifying NGET in the prescribed form.

Additionally, on the enforcement of any security, both the generating equipment and the Capacity Contract must both be transferred together to an "Acceptable Provider" who meets the requirements set out in the rules. This prevents the transfer to any generator who has been in default within the last year, who cannot meet the prescribed credit cover or who does not hold a pre-qualification certificate.

Future developments

The Government published its response to its March 2016 consultation focussing on ensuring sufficient, reliable capacity in 2017/18 and beyond. Amongst other areas, the response sets out aims to:

- bring forward the next auction to January 2017;
- increase the overall capacity secured under the Capacity Market; and
- tighten incentives for capacity delivery.

Key Contacts

For further details or to discuss the Capacity Market more broadly, contact Nathan Curtis or James Phillips.

Nathan Curtis
Partner
+44 (0)117 307 6215
nathan.curtis@burges-salmon.com

James Phillips
Partner
+44 (0)117 902 7753
james.phillips@burges-salmon.com

Burges Salmon LLP, One Glass Wharf, Bristol BS2 0ZX Tel: +44 (0) 117 939 2000 Fax: +44 (0) 117 902 4400
6 New Street Square, London EC4A 3BF Tel: +44 (0) 20 7685 1200 Fax: +44 (0) 20 7980 4966

www.burges-salmon.com

BRM1091 05 16