OFF AND RUNNING – THE CAPACITY MARKET

THE CAPACITY MARKET IS A GOVERNMENT INITIATIVE THAT FORMS PART OF THE ELECTRICITY MARKET REFORM (EMR) PROGRAMME. WHILST OTHER LIMBS OF EMR ARE AIMED AT DECARBONISATION AND AFFORDABILITY, THE PRIMARY AIM OF THE CAPACITY MARKET IS TO ENSURE SECURITY OF SUPPLY. BY JAMES PHILLIPS, PARTNER, AND PREMILA PATEL, TRAINEE SOLICITOR, BURGES SALMON LLP.

The Capacity Market aims to achieve this by providing certain, regular payments to contracted Capacity Market units (CMUs) which must be available to produce electricity or reduce demand when the system is under stress. The key feature of the Capacity Market is an auction process, pre-qualification for which has already taken place for the first auction round commencing in December 2014. Each auction will determine the successful participants and the price paid to them for making themselves available to respond to calls for electricity generation or a reduction in consumption.

The following DECC diagram, Diagram 1, illustrates an overview of the Capacity Market. Each aspect is considered in more detail below.

Framework and institutional arrangements

The powers for the creation of the Capacity Market are set out in the Energy Act 2013. The Electricity Capacity Regulations 2014 and the Capacity Market Rules 2014 are among the more detailed secondary legislation governing the operation of the scheme, both of which came into effect on 1 August 2014 following EU State Aid clearance to the scheme.

National Grid Electricity Transmission (NGET) will act as the Delivery Body for the implementation of Capacity Market. This involves supporting the auctions and management of each delivery year. NGET will administer the scheme in tandem with a number of delivery partners, including Ofgem.

Delivery obligations

Successful capacity agreement holders are obliged to deliver electricity or reduce consumption by a specified quantity during system stress periods as notified by NGET. NGET will give four hours' notice whereupon the participant must comply with the demand notice or face penalties for not complying with its obligations. Payments under capacity agreements are spread over the year and paid monthly. For any capacity generated over the amount specified in a stress period notice, the provider may be entitled to an over-delivery payment.

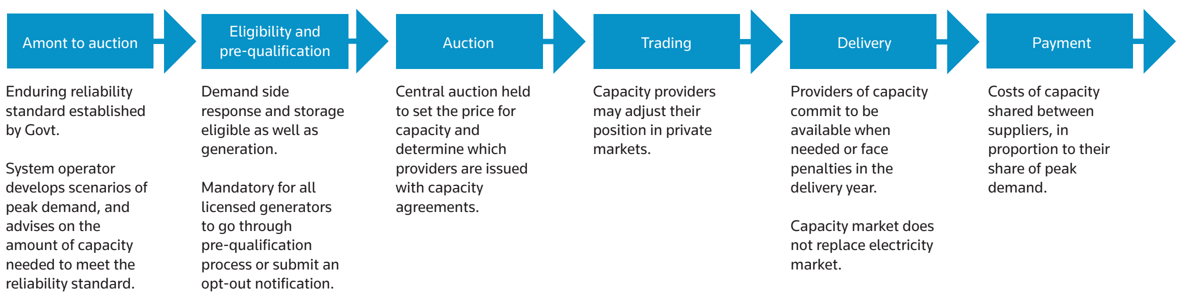
The penalty rate for an obligation will be set at 1/24th of the relevant auction clearing price adjusted for inflation. So as not to disincentivise participants, penalties will be capped at 200% of a plant's monthly income and 100% of its annual income. These penalties will not apply where no advance warning of a stress period were given.

Over-delivery payments will be funded from the penalty payments received. These will be paid out at the end of the year at the lower of the penalty rate or the total penalty revenue divided by the total over-delivery volume.

The penalty regime is complemented by a testing regime (including spot testing) to ensure capacity providers are in fact complying with (and are capable of complying with) their obligations. Providers completely failing to deliver during the course of stress events in two months or more will have their testing requirements doubled as a consequence.

DIAGRAM 1

AN OVERVIEW OF THE CAPACITY MARKET



Source - DECC

The Government has confirmed that 15-year Capacity Agreements are available to new capacity. This is longer than 10-year agreements set out in its consultation in October 2013. The longer agreements should provide sufficient certainty to unlock investment and encourage suppliers to build plants and participate in the scheme with reduced financial risk.

Amount of capacity secured

The Government has confirmed that it will procure a total of 53.3GW of electricity generating capacity, which equates to more than 80% of the peak electricity use in Britain today. On an annual basis, the amount of capacity contracted will be based on a loss of load expectation (LOLE) which is the number of hours per year where demand is expected to exceed supply.

Each demand curve will be constructed around the target capacity level (for 2014, 53.3GW) required to meet the reliability standard (for 2014, 3 hours LOLE) and an estimate of the reasonable cost of new capacity. The demand curve will be determined annually by the Government in advance of capacity auctions. The demand curve should enable the trade-off between cost and reliability, so that less capacity is procured in a given year if the price is very high. The existence of an auction price cap, plus flexibility to procure less capacity if the price is high, should reduce the risk of participants pushing up prices by exercising market power. The auction cap price determines the top of the demand curve and for the 2014 auction the cap is £75 per kWh (at 2012 price levels). The capacity price will be adjusted to account for changes in the consumer price index (CPI).

Eligibility and pre-qualification

The Capacity Market has been designed to be technology neutral, with any demand or generation capacity above 2MW potentially being eligible to participate independently. It is not confined to electricity generation projects; demand side response (DSR) or electricity storage capacity is also seen as important and eligible in the scheme. With limited exceptions, capacity already receiving support under the Renewables Obligation, a FIT CfD, a small scale FIT, RHI, New Entrant Reserve 300 or UK CCS commercialisation programme will not be eligible. The Government has also recently outlined proposals for interconnected capacity to be eligible for schemes as an existing plant and be included in the 2015 auction.

There is a pre-qualification stage four months ahead of the auction which will confirm the eligibility and bidding status of all potential capacity. The Capacity Market register will show which CMUs have qualified, the status of the plant (i.e. existing/new/to be refurbished) and the de-rating factor to be applied to each plant. For existing CMUs to prequalify, they must demonstrate their historic performance. New-build CMUs will have to provide evidence of planning consent and connection agreement, a detailed construction plan and details of their expected capital expenditure relative to the duration of the capacity agreement being sought.

The Government has sought to simplify the pre-qualification process. Generating units will now be able to be combined as one CMU where they are within the same trading unit. The Government has also decided to extend the deadline by which relevant planning permission has to be demonstrated regarding the 2014 capacity auction. Applicants will now have 15 working days before the auction (not pre-qualification), to provide copies of the relevant certification which includes relevant planning permissions and connection agreements.

Following pre-qualification, the Capacity Market register will display which CMUs qualified for the auction and what de-rating factor was applied. It will also confirm which CMUs said that they would be unavailable for the auction, but their capacity will not be deducted from the demand curve. During the auction, the register will show how much spare capacity there is at the conclusion of each auction round. After the auction, the register will also show how much spare capacity there was in each round, but not the price at which individual units exited. It will also show which CMUs received capacity agreements and what obligations they have taken on. The register will be publically available, which is intended to provide the greater transparency which was called for during the consultation process.

The results of the first pre-qualification process were published on 3 October 2014. A total of 513 applications were submitted, equating to nearly 70GW of de-rated capacity. NGET has accepted 62.5GW as eligible to participate in the auction with approximately 9GW of new capacity, 7GW of which is made up of eight potential new large gas power stations. 8GW of de-rated capacity opted out of participating in the December 2014 auction although these projects could still choose to participate in the capacity market in the future.

The auction process

National Grid will run the first auction in December 2014 for delivery of capacity from winter 2018/19. The auction will be ‘pay as clear’. This means all participants will receive the clearing price set by the marginal bidder. Bidders are only compared on prices bid rather than on plant characteristics. The Government has not factored in a plant’s emissions as part of its bid assessment process, signalling an immediate focus on security of supply as a priority, rather than emissions reduction.

Capacity providers will offer capacity at a particular price and then further rounds are held at lower and lower prices until the auction discovers the minimum bidding price at which the sufficient capacity is supplied. Successful bidders will be awarded capacity agreements on the basis of the lowest bid. The auctions will be run four years ahead of delivery (T-4 auctions) and one year ahead of delivery (T-1 auctions). The Government intends to procure a total of 53.3GW of capacity for the first capacity year in 2018/19. Only 50.8GW will be auctioned at the first auction in December 2014, with the balance to be contracted via a T-1 auction in 2017.

On a first glance, it may seem questionable value for money to the electricity consumer to pay some capacity providers more than they would have bid. However, the Government is persuaded that this will avoid the risks of participants trying to play the system by bidding based on a guess of what the clearing price might be, rather than its true costs.

To mitigate market power, bidders will be classified as either 'price takers' (who cannot bid above a relatively low ceiling) or 'price makers' (who can). New entrants and DSR resources will be classified as price makers, and will be free to bid up to the overall auction price cap which, for 2014 auction is set at £75 per kWh.

Existing plant will be able to bid for capacity agreements with a maximum duration of one year unless they require major refurbishment, in which case they can bid for an agreement of up to 3 years. New-build CMUs will be able to bid for up to 15-year agreements to provide revenue security to encourage project finance for new-build plants.

Financing considerations

There is a revised financial commitment test in the rules which requires either certain capital expenditure to have been made by participants within certain timeframes or evidence to be provided of sufficient financial resources to meet the total project spend.

CMUs have the freedom to trade their obligations. Trading is an important tool for investors to be able to manage the risks associated with holding a capacity obligation. The Government believes that there is no necessity for it to intervene and create an organised market for capacity obligation trading as it is assumed that it will follow a similar model that the electricity commodity market has taken. The Government has also introduced secondary trading arrangements to enhance participants' ability to trade. This would potentially enable A to trade with B and make an agreement after a stress event has incurred so that B takes on A's liability for penalty. The Capacity Market will operate in tandem with the electricity market, within which participants will continue to generate a large proportion of their revenue.

The Settlement Body will be responsible for paying CMUs monthly capacity payments and collecting and enforcing penalty charges. These payments are funded by electricity suppliers, who are required to pay a supplier monthly charge to the Settlement Body by 5 working days after the start of the month. The Settlement Body pays capacity payments (and any over-delivery payments) to providers monthly.

To alleviate concerns of potential investors that future changes to existing Capacity Agreements could undermine investments, the Government has specifically introduced provisions so that the key terms of these agreements are grandfathered for successful applicants, including:

(a) agreement length;
(b) capacity price and entitlement to payment;
(c) capacity obligation and de-rating figure;
(d) completion milestones and termination fees; and
(e) maximum liabilities for penalties.

Legal status and disputes

Capacity agreements are unusual in that they do not create contractual relations nor are they in the form of a standard private law contract. Further, they cannot be disclaimed and can only be terminated in accordance with the Rules. The obligation to deliver energy is effectively a statutory obligation which applies to the registered holder of a capacity agreement notice. Breach of the obligation has the consequences set out in the Rules and would result in reduced or suspended payments or the set off of penalties against payments otherwise due.

Although system stress cannot be declared during situations of force majeure, there is also no relief from the capacity obligation when the force majeure event is on the part of the participant. This therefore means that a provider could be affected by a force majeure event and, unlike a standard commercial contract; it could still be liable to meet capacity requirements.

A prescribed dispute resolution process is available to resolve settlement issues or other disputes. An application for Judicial Review is the ultimate action which a supplier or participant can take if it is unhappy with the response from the Settlement Body, National Grid or Ofgem (as appropriate) in respect of a dispute.

Amendments under consideration

There is a live consultation entitled "Electricity Market Reform: Consultation on Capacity Market Supplementary Design Proposals and Transitional Arrangements" which closes on 5 November 2014. This consultation seeks industry feedback on a number of technical and administrative changes to the scheme. As mentioned, interconnectors are being considered for inclusion in the Capacity Market for 2015 and this consultation seeks industry comment on this. Other changes being considered include procedures for enabling enhanced obligation trading. The amended secondary legislation based on this consultation will come into force in 2015 before the T-4 auction for delivery in 2019/20.

Conclusion

The Capacity Market is still in its early stages of development and there will come improvements over time as lessons are learnt in the first delivery year. However, it seems that following Ofgem guidance and Government consultations on the issue, industry comments and considerations have, to some extent, already been taken into account.

The Government's main concern with the Capacity Market scheme is to ensure that there is sufficient financial incentive and certainty, in the form of guaranteed revenue streams, to enable new projects or major refurbishments to be funded. Whilst some commentators remain to be convinced that the Capacity Market will deliver security of supply in the most cost-effective manner, it is already evident from the pre-qualification round that it has created opportunity and fresh investment in the market. ■