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Briefing note

December 2011

UK Electricity Market Reform: Some more technical detail announced

Following July's Electricity Market Reform White Paper[1], the Department of Energy and Climate Change (DECC) has now published a technical update paper[2] giving some additional detail on the reforms, in particular on the Capacity Mechanism, the institutional framework and the Renewables Obligation transition. In addition, the paper invites expressions of interest from projects which seek early comfort on the Feed-in Tariff reforms to enable low carbon investment decisions to be taken. The reforms are still a work-in-progress with much detail still to be developed over the next couple of years. This briefing provides a summary of the major new details announced.

Key Issues

- Capacity Market
- Operating the Framework
- Enabling Investment
- Renewables Obligation transition
- Next Steps

Capacity Market

In the White Paper, DECC consulted on two options for a capacity mechanism: a targeted Strategic Reserve and a market-wide Capacity Market mechanism. DECC has now decided to implement an auction-based Capacity Market as the most cost-efficient way of ensuring continuity of supply (and the most popular option for stakeholders). In particular, DECC believes that electricity bills may reduce slightly since this mechanism ought to prevent high price spikes.

The Capacity Market will work as follows: The Government will decide on the volume of reliable capacity to be procured annually for a specified "delivery year" in the future[3]. Capacity will be procured through a central auction run by the System Operator (see below) in which providers would bid for capacity contracts. The Government will decide when that auction should take place[4]. Providers will offer a quantity of reliable capacity for the delivery year into the auction.

All capacity providers (including demand-side response, "DSR") would be able to take part. Successful providers will then receive availability payments for providing reliable capacity (or reductions in demand under DSR) whenever needed during the delivery year. Between the auction and delivery year, providers will be able to trade capacity through a secondary market. In practice, capacity costs will be paid for by consumers through their suppliers.

[1] See our client briefing: "Electricity Market Reform White Paper – Increasing Investor Confidence" – July 2011.
[2] Planning our electric future: technical update – December 2011, DECC.
[3] Probably about 4 years in advance.
[4] DECC suggests that the first auction could be run in 2015.

Detailed design work on the Capacity Market will take place in 2012 / 2013. This will cover, among other matters:

- Criteria for determining the volume of capacity to be contracted.
- How to define "reliable capacity", i.e. determining the extent of the provider's commitment.
- Evidence required for providers to demonstrate capacity.
- Any distinction as to how new and existing capacity is treated.
- How DSR and other techniques, such as electricity storage and interconnection, should be treated.
- Whether penalties should be market-based or administrative penalties and how to manage the risk of uncapped liabilities on investors.
- How the interaction between the Capacity Market, the FiT CfD (see below) and the Renewables Obligation (RO) should be managed; and the extent to which Fit CfD- and RO-funded plants should allowed to take part in the Capacity Market.

Operating the Framework

DECC has decided that the System Operator within National Grid will implement and run the FiT CfD (a Feed-in Tariff based on Contracts for Difference[5] to support low carbon generation) and the Capacity Market mechanism. National Grid already performs a role similar to the Capacity Market by running the Short Term Operating Reserve by procuring additional power in times of high demand.

The Government will retain considerable control over the arrangements by setting policy through a Delivery Plan, including:

- On the FiT CfD: designing eligibility, setting contract terms for new projects, determining the timing for a move toward an auction price mechanism[6].
- On the Capacity Market: deciding the level of capacity to be procured and auction design.

The System Operator will also advise the Government on policy whilst Ofgem will continue to regulate the market including monitoring generator and supplier compliance through licence conditions.

The first Delivery Plan is anticipated in 2013.

Enabling Investment

The Government has recognised that there will be delays in investment decisions for low carbon generation projects whilst the details of the form and contents of FiT CfD contracts go through the policy development, legislative process and contracting stage. As a result, the Government is prepared to offer some comfort (through products or arrangements) to allow those investment decisions to be taken in advance of FiT CfD implementation. No further detail is given, although the update paper notes that comfort will need to be State Aid compliant which suggests that some form of grant aid might be proposed.

DECC has set out eligibility criteria for organisations to begin discussions with them on securing comfort, which are broadly as follows:

- The project is a qualifying low carbon generation type.
- There is a real risk of delay or cancellation if comfort is not received before 2014.
- Credible plans exist for commencement of generation on or after 2016.
- The project is not eligible for RO support, or RO accreditation is unlikely before 31 March 2017.

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5 These are described in more detail in the briefing mentioned in note 1 above.
6 DECC suggests this could be from 2017.

DECC intends that comfort given to a developer on the FiT CfD will disqualify that developer from RO support.

DECC has stated that it will require expressions of interest from developers who wish to enter into discussions about comfort with them to be made **by June 2013** although this date may change. Legislation may well be needed to authorise the giving of such comfort and a further update on DECC's proposals will be published in Spring 2012.

Renewables Obligation

In the White Paper, the Government described the transition from RO to FiT CfD and the move to fixed Renewable Obligation Certificate (ROC) support from April 2017. The technical update paper gives some additional detail on this.

The fixed ROC system will come into effect in 2027 for the last 10 years of the scheme. It will work as follows: Ofgem will still issue ROCs to generators. A Supplier Levy will be introduced under which a fixed ROC Institution (possibly Ofgem) will buy ROCs at the fixed price and recoup the cost from suppliers in line with market share. The fixed ROC price will be set at the 2027 buyout price plus 10 % (and will remain index-linked).

There will be an expiry date for submission of ROCs to the fixed ROC Institution although generators can choose to sell ROCs to third parties who would then sell to the fixed ROC Institution.

Next Steps

DECC intends to introduce primary legislation for the reforms in Spring 2012 with the intention that legislation is passed by Spring 2013.

In early 2012, DECC will provide further technical detail on the FiT CfD and Emissions Performance Standard. A response to the Renewable Obligation banding review will follow in Spring 2012. The results of further work on electricity demand and electricity system policy are also anticipated by Summer 2012.

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