

# Energy UK's Vision for the Five Year Review of Electricity Market Reform

23<sup>rd</sup> May 2018

## 1. Background

- 1.1. In its July 2011 White Paper, the UK Government committed to a series of reforms known collectively as Electricity Market Reform (EMR) in order to respond to the trilemma facing the UK; mitigating climate change by decarbonising electricity generation, ensuring security of supply and minimising the cost of energy to the consumer.
- 1.2. The Energy Act (2013) was the primary legislation which enabled EMR and mandated that the raft of policies be reviewed after five years. The Review is due to commence in 2019 and provides an opportunity to fulfil the separate obligation to the European Commission to review the Capacity Market midway through its ten-year State Aid approval tenure.
- 1.3. Energy UK is the trade association for the GB energy industry with a membership of over 100 suppliers, generators and stakeholders with a business interest in the production and supply of electricity and gas for domestic and business consumers. Our membership encompasses the truly diverse nature of the UK's energy industry – from established FTSE 100 companies right through to new, growing suppliers and generators, which now make up over half of our membership.
- 1.4. Our members turn renewable energy sources as well as nuclear, gas and coal into electricity for over 27 million homes and every business in Britain. Annually, the energy industry invests over £11bn, delivers £88bn in economic activity through its supply chain and interaction with other sectors, and pays £6bn in tax to the Treasury.

## 2. Energy UK Recommendations – Contracts for Difference

The Contracts for Difference (CfD) framework has been a successful tool for delivering investment and bringing forward low cost low carbon generation. It is important that the CfD regime (based on competitive auctions) continue to maintain the momentum in sector as this joint industry and Government effort has meant that cost reduction targets for offshore wind of £100/MWh were met four years ahead of target and the last auction saw clearing prices well below expectations at 57.50/MWh.

In driving substantial cost reductions and stimulating innovation, the regime has benefitted the UK consumer, economy and delivering cost-effective decarbonisation. We, therefore, support the continuation of the CfD framework so as to provide the stable investment climate that developers and the supply chain need and believe that the Five Year Review should focus on refinements to the scheme.

### 2.1. Introduce Revenue Stabilisation CfDs

The cost reductions in established low carbon technologies, such as onshore wind, means that the required strike prices are now approaching current wholesale price levels. However, wholesale market revenues under a subsidy-free, merchant based approach are highly risky. Even as the costs of low carbon technologies come down, low marginal cost, high capex low carbon technologies are exposed to wholesale price fluctuations caused by fossil fuel price volatility, whereas conventional price-setting gas generation is not. Therefore, in order to compete on a level playing field these technologies need technology-agnostic, revenue stabilisation contracts to be able to contribute to the longer term cost-effective decarbonisation

of the sector. The CfD significantly reduces this risk and by de-risking the investment reduces the cost of capital for a generation project. This leads to lower strike prices and levelised cost of energy (LCOE) which ultimately consumers benefit from.

Whether the CfDs lead to overall payments from consumers or pay back to consumers will depend on whether the forecast materialise. Regardless, provision of such contracts will ensure that consumers are accessing the cheapest new electricity sources needed. We and our members would recommend that the Government consult on models for a revenue stabilisation CfD.

## 2.2. Provide Advance Notice of Future Auctions at Regular Intervals

Mature low carbon technologies are currently the cheapest form of new, large-scale generation<sup>1</sup> and are ready to deliver in locations where they are supported by local communities. These technologies also deliver significant economic benefits including a sustainable UK supply chain and long term employment<sup>2</sup>. Developers would welcome clarity over future CfD allocation rounds and are ready to help deliver decarbonisation at lowest cost to consumers.

With no announcement regarding future CfD auctions being held for mature technologies there is concern that there could be significant impacts if developers withdraw from the sector (which in turn could have an impact on the impacts competitiveness of any future auctions).

Even for less-established technologies, the lack of visibility of future allocation rounds beyond spring 2019 is holding back the development of a thriving UK supply chain. The industry would welcome further visibility of auction rounds, which would allow business throughout the supply chain to plan for future investment.

We recommend that the Government announce a series of future CfD allocation rounds, which is needed to deliver a strong pipeline which will maximise competition and create supply chain opportunities in-line with the Industrial Strategy. A timetable for future CfD auctions should be established out to at least 2025 in line with the funds committed. This would echo the approach adopted with the Capacity Market which has a degree of certainty that its annual auctions will take place, if not the exact date.

## 2.3. Optimise the CfD Design

The Five Year Review of EMR provides a prime opportunity to optimise the design of the CfD through amendments to features such as the Milestone Delivery Date (MDD).

Whilst to date it has been possible for projects to meet the current twelve month Milestone Delivery Date (MDD), this is sub-optimal and no longer appropriate for lean development projects in a competitive (rather than previously demand-led) environment. We consider that an extension to the MDD period of eighteen to twenty-four months would help to lower risk and cost across the industry. An extension to the MDD period would allow developers time to run additional tender rounds with suppliers, assess new suppliers and negotiate financing. This could help to promote innovation as well as benefitting the UK supply chain and reducing the overall cost to consumers.

There may also be benefits of an MDD extension (including lower financing costs) to other technologies. We recommend that Government seeks advice from the Low Carbon Contracts Company given their operational experience on this matter.

The non-delivery disincentives in the CfD contract may not be sufficient to deter speculative bidding. This issue could be addressed by introducing bid and delivery securities into the

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<sup>1</sup> BEIS report, 'Electricity Generation Costs' available [here](#) (November 2016)

<sup>2</sup> Scottish Power/BVG Associates report, 'Economic Benefits from Onshore Wind Farms' available [here](#) (September 2017)

regime. It is worthwhile exploring their use in other European markets and the opportunities and benefits they could provide to the UK's CfD regime.

### **3. Energy UK Recommendations – Capacity Market.**

Energy UK members continue to believe that the market-wide Capacity Market (CM) is fundamentally the right mechanism for promoting the necessary investment to maintain security of supply. Added to which, in facilitating competition, it has helped deliver substantial cost benefits to the consumer. However, it is important to continually assess whether the current design is fit for purpose in terms of delivering effective competitive outcomes based on a level playing field. Furthermore, the wider interaction of the CM with ancillary services should be considered in any future changes to the CM. This is vital to maintaining security of supply cost effectively.

#### **3.1. Renewables Participation in the Capacity Market**

During her speech to the Aurora Spring Forum on the 20<sup>th</sup> March 2018, the Climate Change and Energy Minister, Claire Perry, announced that the forthcoming Five Year Review would consider whether or not to include renewable energy sources in CM auctions. Energy UK and our members believe that the CM should be entirely technology neutral, allowing for innovation and facilitating decarbonisation.

In the short term, enabling renewables not in receipt of low carbon support, either those that have never received support or those that have reached the end of their support period, to access the CM could be a helpful way for those technologies to stack different revenue streams. However, this does not imply that access to the CM is an alternative to a revenue stabilisation CfD which will continue to be the main driver for new build low carbon generation.

As the Delivery Body, National Grid should aim to consult with industry as soon as is practicable to ensure that renewable plant is de-rated appropriately and can participate in CM auctions as soon as possible. A number of our members have already voiced support for an Equivalent Firm Capacity calculation methodology to be used for the de-rating, at least in the interim.

National Grid already models the capacity provided by renewables through the forecast they undertake ahead of issuing their recommended CM procurement volume. One option for de-rating renewables would be the adaptation of this model.

This could be delivered by Ofgem taking forward CP263 which will expand Schedule 3 of the Rules to include technology classes which are not currently in receipt of a Low Carbon Exclusion as defined under Regulation 16. The omission could be resolved if a Wind Generation Class and a Solar Generator class were added to the Schedule 3 list of Technology Classes section of the CM Rules. Other renewables such as biomass and hydro are already listed.

#### **3.2. Enable Greater Innovation Including Hybrid Sites**

Presently neither the CfD nor the CM allow for hybrid sites (sites with multiple technologies) or aggregated sites (asset portfolios not necessarily geographically located together) to bid into either auction. The advent of lower cost electricity storage and the continued growth in flexible plant means that these types of sites are now coming forward and policy change is required to facilitate them. We understand that including hybrid sites is likely to require a more complex solution than that which would allow established renewable technologies to participate in the CM. Accordingly, whilst we believe that National Grid should be consulting on the de-rating factors for hybrid sites, members accept that this is likely to be on a longer timescale than established technologies and should form part of the Five Year Review.

### 3.3. Reform of the Termination Fee Regime

The Minister's comments on a potential review of fees and penalties is another area where Energy UK and our members would not only welcome change but would fully participate in identifying any possible amendments. We believe that both administrative and termination fees should be reviewed in light of the Five Year Review. Despite the best efforts of Government and industry at the commencement of EMR, distortions and discrepancies have materialised in the regime. Such reform would, however, require changes to Regulations.

There is currently a £5-35/kW differential for termination fee for events which are similar in nature. Additionally, some termination events do not have a fee attached to them – this does not make for a level playing field. It can be argued that there should only really be a differential for an event that's pre or post a T-1 auction as this auction would provide the opportunity for the market to remedy any issue. However, this represents one possible approach rather than a complete answer. For example, improved access to secondary trading could provide a market-based solution to manage risks of non-delivery of capacity. We and our members would welcome the opportunity to work with Government on this issue to ensure that the CM is fit for purpose.

### 3.4. Review of the Penalty Regime

Energy UK members believe that the Five Year Review provides an ideal opportunity to consider if the CM penalty regime is fit for purpose. The extent of government and industry effort at the commencement of EMR is evidence of how difficult it is to design an appropriate penalty regime. Some members hold the view that the current risk of participating in the market is too low, and that it should be possible for non-performing CMUs to lose more than the income they receive from the scheme. The decision to cap penalties for non-delivery at 100% of annual payments was taken by DECC in an attempt to sufficiently de-risk the CM and encourage participation from a broad set of developers and investors. Whilst it may be too early to draw any firm conclusions about the impact this has had, it would be prudent for BEIS to assess the security of supply risks of relatively soft penalties for non-delivery.

Given the importance and difficulty in designing a penalty regime that is fit for purpose, Energy UK recommends that this work-stream should include a series of workshops between CM participants, Ofgem and Government. Energy UK members are committed to engaging constructively in this work-stream with a view to taking this forward in a timely and effective way.

### 3.5. Undertake a Review of the Capacity Market Rules

The complexity of the CM Rules and inconsistencies in their application have continued to cause difficulties for industry, acting as a barrier to entry for new market participants and a burden on existing developers. The Five Year Review of EMR is a prime opportunity for rationalising the Rules.

We recognise, however, that to do so poses a significant administrative burden on both Ofgem and BEIS, who are unlikely to be in a position to recruit additional members of staff. Energy UK would, therefore, be happy to host a series of workshops between CM participants, National Grid, Government and the regulator to revisit and amend the CM Rules accordingly. In doing so we could assist in ensuring that the CM Rules are fit for purpose and existing issues, omissions and contradictions are rectified ahead of the next round of auctions. Once the CM Rules had been revisited we would similarly encourage National Grid to work with industry and Ofgem to review the Guidance which could also take place this year. This would additionally provide an opportunity to develop and issue a consolidated version of the CM Rules and Regulations.

We are also acutely aware of the backlog of changes that Ofgem has not been able to tackle in the 2018 CM Rules review, many of which are of importance. It would be valuable to make sure that this backlog can be properly addressed for next year, rather than rolling forward indefinitely.

### 3.6. Consider Improvements in Capacity Market Governance

The existing governance arrangements have caused some confusion for industry. There have been a number of eventualities where the delineation of responsibility between Ofgem, BEIS and National Grid has been unclear for CM participants. Moreover, industry considers that too much of the CM framework is contained within legislation, which requires Parliamentary time in order to implement any changes. To resolve this issue, Energy UK members believe that a lot of the existing Regulations could sit within the CM Rules. Such a change would have the added benefit of facilitating quicker interpretation, as a lot of the effort of having to go between the CM Rules and Regulations would be removed. We think it makes sense for both BEIS and Ofgem to continue to have the powers to change the CM Rules.

In order to act more cohesively, Energy UK members believe that there could also be an expert panel or working group with self-Governance and Ofgem acting as an *ex officio* Chair. The Delivery Body could provide the secretariat function. Such a panel or working group would be able to efficiently and effectively collate views and to prioritise issues as and when they arise.

In recent years the closing of the CM Rule Change window has overlapped with prequalification when participants are focussed on the latter. By holding an additional CM Rule Change consultation period later in the year or by extending the window it would enable developers to more comprehensively and constructively feed into the process. It would also alleviate the burden on the regulator who would no longer have to face a single annual deluge of proposals. This would also allow for more time in the development of CM Rule Changes, enabling more robust proposals to be put forward.

That said, we welcome the 'exceptional circumstances' approach that allows consideration of Rule changes outside of the Regulator's annual review. This should certainly be retained.

## 4. **Energy UK Recommendations – Overarching Issues**

### 4.1. Hold a Review of OFTO Arrangements in Tandem with the Five Year Review

A number of our members recommend changes to the OFTO regime, including a move away from the original proposal for the development of an OFTO market. Whilst not covered by the Five Year Review of EMR, we support the recommendation in the [Offshore Wind Industry Council's Sector Deal](#) calling for a review of OFTO arrangements to take place in parallel with the Five Year Review.