

04 October 2018

**SUBMISSION ON CAPACITY MARKET AND EMISSIONS PERFORMANCE STANDARD REVIEW**

**Responses to Call for Evidence questions**

**1. Do you believe there is a need to maintain the Capacity Market? What conditions would be necessary for the Capacity Market to be withdrawn?**

We agree with the case for the Capacity Market (CM) to ensure the security of supply of electricity. There will clearly be scope for further review once it has been operating longer and a stress event has been triggered.

It is perhaps a little premature to discuss when the scheme should end. Although prices have been dropping, we have not reached the post-2025 period expected to create significant challenges for the system. This is also noted in the Call for evidence, which highlights an expected rise in clearing prices as older plants are retired. It is vital that the CM responds adequately at this point. To this end, we would ask that the next substantial review is conducted shortly after the 2021 T-4 auction process. At that point, we will have a clearer view on nuclear new-build and any possible supply gap in the post-2025 period and also on whether the Capacity Market is driving necessary investment.

It is also worth noting that the current price is too low for manufacturers bidding into the market with Demand Side Response (DSR). This would suggest the system is not geared correctly; DSR should be the most flexible way of providing capacity over the longer term, does not struggle with grid connection issues, and is a no-regrets measure that does not lock the country into unsuitable infrastructure such as diesel farms. One option would be to consider a separate pot for DSR supply. This would reflect the fact that CM payments are only a top up for generation whereas they are an offset in additional CM charges for manufacturers. It would also help if contracts lasted for more than one year. This would at least reduce the administrative burden of repeated applications and give the industry more certainty to plan against. Another option would be to offer DSR participants a bonus where they deliver, this would keep overall costs low while still rewarding DSR in the event it is needed.

Supporting demand management might also become more of a priority if the signal to load manage currently provided by Triads is removed as a result of Ofgem's reforms to network charging.

Finally, it is disappointing that the Energy Demand Response pilots were not taken forward on a more permanent basis. While prices were high, this could be addressed through making the scheme simpler and more appealing to

participants and it should also be noted that energy efficiency improvements are permanent with multi-year benefits. We offered some thoughts on this and comparisons in our 2016 report *Upgrading Power*.

## 2. Do you believe the current objectives of the Capacity Market remain appropriate?

Yes in general. However, we do have a continuing concern about the cumulative impact of the main levies placed on electricity bills. This is a particular issue for energy-intensive industries trying to compete internationally against companies not exposed to the same charges.

There is an absence of consistent data exploring the extent of the electricity price disparity remaining after EII relief, which sectors are most affected, the causes and wider impacts. One of our repeated requests to the government has been for a more thorough analysis, as done by other EU countries<sup>1</sup>. However, figures compiled by UK Steel showed the disparity in 2017/18 for steel producers – a sector that is particularly energy intensive and trade exposed – to be £17/MWh compared with France and £18/MWh compared with Germany. This meant UK steel plants paid over 50% more for electricity than their key EU competitors, costing the sector as a whole £43 million/year. This is equivalent to 17% of steel company earnings that year. UK Steel is currently producing figures for 2018/19 but early indications point to a further increase in the disparity, with reports of differentials within individual companies of up to around £26/MWh.

Against that backdrop, it should be noted that this year's subsidies to suppliers will add £0.7bn to the approximately £10bn of levies supporting low-carbon generation. This will rise to around £1bn next year.

The CM should theoretically help reduce wholesale costs. However, analysis by Ofgem of the 2017 early auction suggests it reduced costs for consumers by only around £150m compared to the £380m in payments it committed to suppliers.<sup>2</sup> This would suggest that CM is not delivering value for money, or potentially over-procuring capacity.

Given this, the CM's currently growing impact on bills, and that the need for it is partly driven by other decarbonisation measures, it seems sensible to track the implications for electricity consumers alongside that of measures such as Contracts for Difference (CfDs). The government should also consider its impact on EIs specifically and whether exemptions might be necessary to preserve competitiveness. Although not a major component of some sectors' bills it is an area where the government could act to help reduce disparities between UK and EU electricity prices.

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<sup>1</sup> See for example PWC/CREG, 2017, *A European comparison of electricity and gas prices for large industrial consumers*

<sup>2</sup> See Ofgem's annex to *State of the Market report 2017*

**3. Do you think the arrangements outlined in section 3.1 are adequate to ensure sufficient capacity is secured through the auctions to deliver security of supply?**

**4. What are your views on the split between the T-4 and T-1 auctions and the amount of set aside?**

This seems reasonable. However if there seems likely to be a significant shortfall in light of new forecasts two or three years out, T-2 and T-3 options could be considered.

**5. Has the Capacity Market been successful in supporting investment in capacity (new and existing), both directly and indirectly? If not, please identify any changes that need to be made.**

It is hard to assess this without the counterfactual and information on how much of the capacity secured is new.

**6. Do the current 1, 3 and 15 year agreement lengths support investment in capacity and do they deliver against the objective of cost-effectiveness?**

As above, longer-term contracts could also be considered for DSR to reduce administrative burdens and provide stability to plan against. A separate pot could also be considered or some kind of bonus for DSR after it responds to help compensate for the loss of income over that period.

**7. Should penalties be adjusted to strengthen incentives for delivery during stress events? If so, how should penalties be adjusted? Please provide a view on the methodology and factors to consider when setting penalties.**

We remain in general very concerned that the penalties are significantly too low in the CM. A non-delivery is not expected to happen, so penalties must reflect this. This is particularly important if non-dispatchable technologies are bidding in the CM. If this protection is not put in place, the cost of failing to deliver in all but the most extreme circumstances should not be lower than the reasonable cost of the supplier finding some form of back up.

**8. Do the current arrangements relating to credit cover and delivery milestones provide sufficient incentives / assurance that capacity will be delivered, with particular reference to DSR?**

Yes

**9. Do the termination events and fees need to be adjusted to create the right incentives for delivery? If so, how? Please provide a view on the methodology and factors to be considered.**

We believe the termination fees should be significantly increased to reflect the adequate costs to the system of non-delivery. Greater transparency on terminations would allow others to respond/step up instead, either through T-2 or T-3 auctions or secondary trading.

**10. Do any other changes need to be made to ensure delivery of capacity by the different types of technology?**

**11. To what extent does the CM design ensure capacity resources are used in the most effective manner during stress events? Do you have any ideas on how it can further be improved?**

**12. Do the de-rating factors correctly recognise the contribution made by different technologies to security of supply? What changes need to be made?**

We would agree that concerns around the de-rating of interconnectors need investigation and that the approach might need reform if renewables are to compete in the market.

**13. Do you think there are there sufficient safeguards in place to reduce the risk of over-procurement? If not, what changes could be made to further reduce the risk of over-procurement?**

Given the aforementioned Ofgem analysis<sup>3</sup> suggesting that the CM has only saved consumers £150m compared to the £380m in payments it committed to suppliers, there would be a concern of potential over-procurement or lack of value for money.

**14. Do you believe that the auctions have been sufficiently liquid to date and to ensure strong competition? If not, how could we improve liquidity and competition?**

The current auctions favour generators over DSR, which hinders competition.

**15. What further changes are needed to better facilitate the participation of new, innovative or smart technologies, including from DSR, in the Capacity Market?**

See Q1 on incentives for DSR.

**16. How could we go about allowing augmentation of batteries?**

**17. Please provide any other ideas on how to improve cost effectiveness of the Capacity Market.**

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<sup>3</sup> See Ofgem's annex to State of the Market report 2017

See Q1 on incentives for DSR.

**18. What are the main distortions in competition that need to be addressed to ensure a level playing field in the CM auctions?**

**19. Are there distortions in the interaction of the various markets (wholesale, ancillary, CM) or their charging arrangements which impact the effectiveness of the CM?**

**20. How could the Capacity Market better complement the decarbonisation agenda, whilst still ensuring technology neutrality?**

We agree that the CM should not undermine the decarbonisation policies, as it would be counter-intuitive to spend public money on high-carbon energy generation through the CM while spending public money on low-carbon energy generation through the CfDs, FITs, and RO. However, it should be recognised that the main purpose of the CM is to ensure the security of supply at the lowest possible price.

**21. Should wind and solar be allowed to participate in the Capacity Market? Why?**

We welcome the inclusion of wind and solar in the CM to compete on a level playing field with the current technologies. However, understanding that the aim of the capacity market is to deliver electricity during times of system stress. For intermittent technologies, such as solar and wind, to bid into the CM, this should be on the premise that they can do just that, whether by themselves or in combination with storage technology. If they are unable to deliver, there should be significant penalties to deter developers from bidding into the scheme with unsuitable technologies. As highlighted in our answer to Q7, we believe the current penalties are too low. The CM already allows other low-carbon technologies, such as biomass, which are renewable and dispatchable, to bid into the scheme. It would be inappropriate to use the CM as a proxy CfD or RO scheme to fund renewables but should enable delivery of electricity during times of system stress at the lowest possible cost. Assuming that solar and wind projects were able to be successful in bidding in an auction, it would presumably be because they were able to bid at a lower price than other technologies, lowering the overall cost of the CM scheme. It would furthermore be vital to ensure the correct de-rating of these technologies.

Any renewable generators wishing to bid into the CM must provide adequate backup. This was the approach recommended by Professor Helm in his Cost of Energy Review for allowing cost-effective technology-neutral energy markets more generally. It might also stimulate further demand for DSR helping to address the problems mentioned elsewhere in this response.

Any introduction of wind and solar should be done carefully, with a pilot phase in which the number of projects contracted is limited.

**22. What factors need to be considered to enable renewables to participate in the Capacity Market whilst ensuring security of supply?**

See answer to Q21

**23. What factors need to be considered to enable the participation of hybrid projects in the Capacity Market?**

**24. What factors need to be considered when developing the de-rating methodology for wind and solar? What approach could be taken to de-rating hybrid CMUs?**

**25. For co-located projects, do you think that all components of the site (both the CM eligible and the non-CM) will be able provide their full capacity during the system stress event due to local distribution or transmission network constraints?**

**26. What lessons can be learnt from the participation of renewables in other overseas capacity markets?**

**27. Is the current de-rating factor methodology for interconnectors appropriate for assessing their contribution to security of supply? Are there any particular challenges or risks you wish to highlight?**

We would echo the concerns in the Call for Evidence and support review of the de-rating methodology.

**28. What other factors need to be considered to ensure that interconnectors and domestic capacity providers compete on a level playing field? Please provide ideas on how any issues you have identified can be addressed.**

**29. How could we facilitate direct participation of overseas capacity in the future?**

We would welcome overseas capacity if it is able to bid at a lower cost and thereby lower the overall cost of the CM. However, this should be approached with caution. It might not be palatable for UK billpayers to be subsidising investment in other countries. The wider benefits of building new capacity or keeping existing capacity in the UK running need to be considered alongside the pure CM price of contracting it. Furthermore, as with the potential inclusion of solar and wind, including overseas capacity should be done on the premise of being able to electricity during times of system stress, with significant penalties in the case of non-delivery.

**30. To what extent do the current institutional arrangements support an effective change process? Please provide suggestions on how issues can be addressed.**

**31. To what extent do the defined and allocated roles and responsibilities support effective administration and delivery of the annual processes related to pre-qualification, delivery and payments? Please provide suggestions on how issues can be addressed.**

**32. Please provide any suggestions you have for improving the management of fraud and error risk.**

**33. Are there any lessons from overseas capacity mechanisms that could be useful in improving the GB Capacity Market?**

Emissions Performance Standard Review

**34. To what extent has the EPS been achieving its objective? Please provide evidence to support your views.**

**35. Is this current objective of the EPS still appropriate? Could it be achieved in a way that imposes less regulation?**

**36. Have any issues arisen in the operation of the EPS which should be considered**

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