



Auction

Capacity Market workshop

26 March 2013



Main issues on auction design

- LT contracts for new / existing
- Derating and Opt Out
- Prequalification requirements
- Definition of “refurbishing plant”
- Price Makers and Takers
- What information is shared during auction process



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Feedback from previous Expert Group

- Previous feedback from stakeholders on auction:
 - Existing plant (not just refurbishing plant) may have significant going forward costs
 - We may not be in a rising market
 - Discriminating against existing plant can distort outcome of auction – leading to higher costs for consumers



Rationale for differential treatment

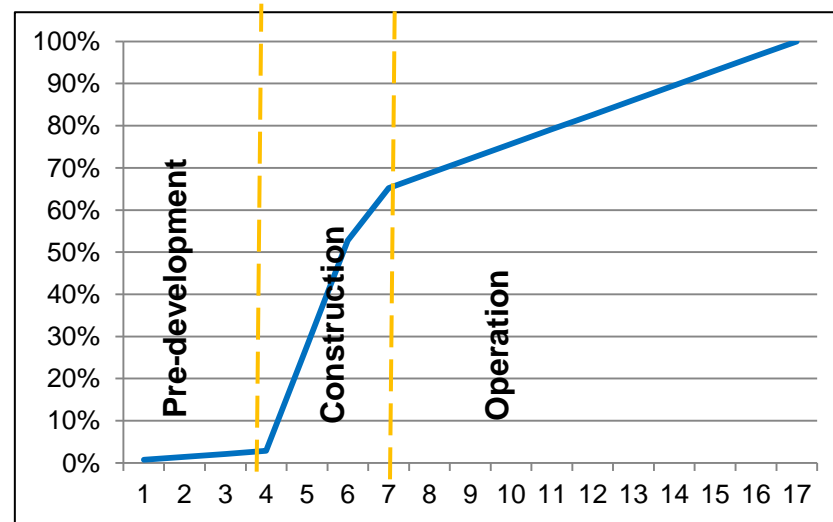
- LT contracts do not distort the market unless there is a *falling* price
 - but we expect a *rising* price as power sector decarbonises
- Providers should take future price into account when bidding
- But we recognise LT contracts important for project finance:
 - New build may need greatest level of project finance
 - Existing plant can fund regular maintenance costs through balance sheet
- So proposed auction approach gives a *level* playing field for investors – i.e. it does not distort market
- LT Contracts pro-competitive as particularly helpful to independents
- Alternative approach – LT contracts open to everyone – risks delays to implementation of 2014 auction and can lead to too much lock in



Indexing long term contracts

- Indexing is designed to provide a level playing field for new, refurbishing and existing plant
- Capacity payments will be partially indexed to the Consumer Price Index
- Level of indexing will reflect an estimate of the proportion of capacity costs that are exposed to inflation
 - Uniform across all plant and projects

Cumulative fixed cost profile for OCGT plant





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Opt Out

- Participation in CM will not be mandatory:
 - Administratively difficult to estimate price
 - Could add to regulatory risk – which is not the objective of the exercise!
- But if plants opt out we will reduce demand accordingly:
 - Avoids overprocurement
 - Mitigates potential abuse of market power
 - Creates incentives to “opt in”
- Plant that is uncertain about status but not wanting to participate in auction should choose to “opt out” – no requirement to then stay open
- If “opt out” plant closes or wishes to opt back in, SO can buy more in year ahead auction



De-rating

- Central derating of all plant:
 - We recognise plant owners know best; BUT
 - Incentives to self-derate might not be optimal – leading to bias in estimates
 - Important to mitigate market power
 - Central derating estimates should be right *on average*
 - Parties over- or under-ascribed capacity can trade in secondary market to optimise position
- Derating applied by SO on mechanistic basis
 - Algorithm to be developed based on historical data
 - Can use combination of plant-specific and technology-aggregated data

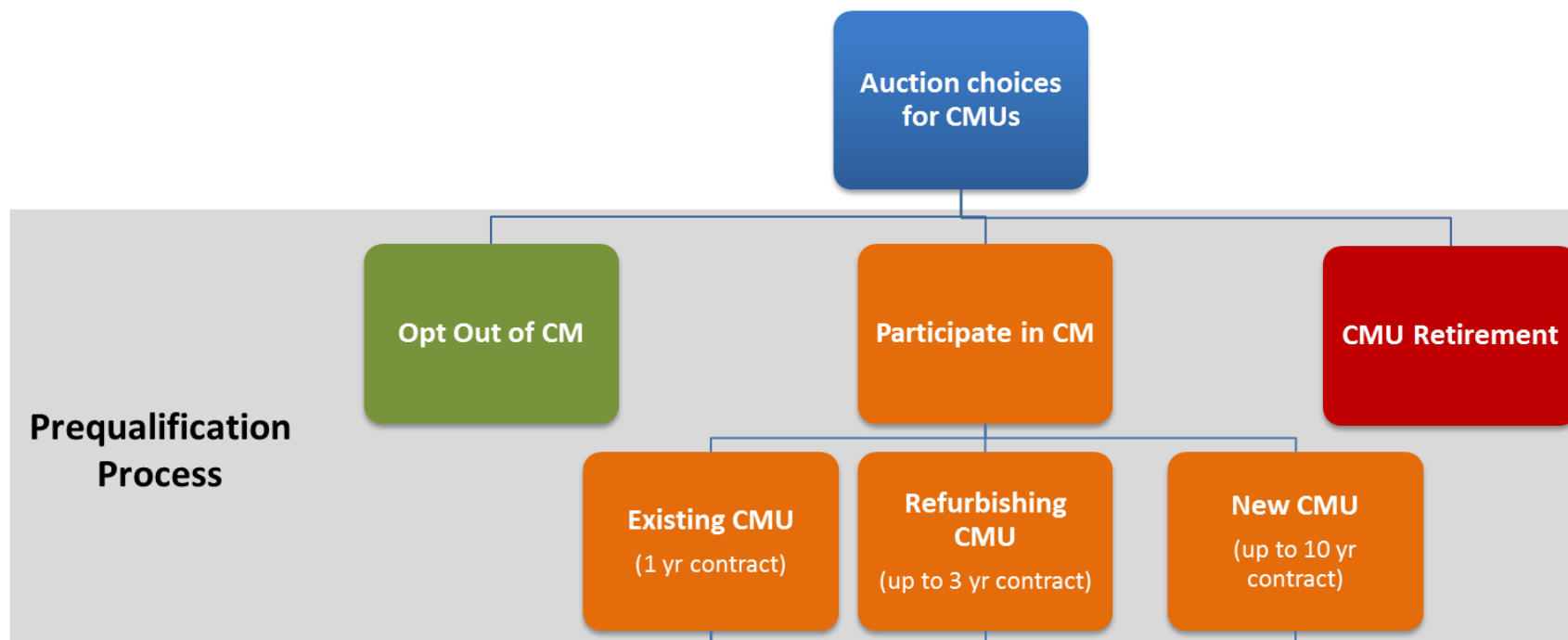


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Prequalification Process



At Prequalification phase:

- Plants have to commit to opting in/out or retiring
- Investors wanting LT contracts must demonstrate business case
- Plants *do not* have to explain “price maker/taker” status at Prequal
- Opt out plants *do not* have to commit to stay open in delivery year
- No Board-certified submissions required



Pre-qualification - requirements

- Mechanistic process to confirm eligibility of prospective Capacity Providers
- Mandatory process for licensed generators
- Capacity Market Unit level
- Deadline four months ahead of auction
- Existing generators required to demonstrate:
 - credit reference check
 - Valid TEC* (*where appropriate for size of plant)



Pre-qualification

- Generator undergoing refurbishment
 - Business case if long-term contract
- New build required to demonstrate:
 - valid Development Control Order
 - construction milestones
- Additional administrative requirements for all:
 - Grid Code compliance,
 - Valid connection agreement for delivery year
 - CfD/RO status of bid capacity
- Output of process: each Capacity Market Unit is considered eligible or ineligible; if the former a de-rated capacity will be assigned by the SO.
- Appeals process will enable the resolution of any disputes relating to eligibility or de-rating; aim to resolve in sufficient time for auction to run to schedule.



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Long term contracts for existing plant

- Refurb status assessed as part of the Prequal phase – with time for appeal before start of auction
- Existing plant eligible for contract up to 3 years if they are refurbishing
- Award of a longer contract is in recognition of something more than normal maintenance and should reflect a change to the plant's capability or significant costs
- Principles for distinguishing “existing” from “refurbishing” plant:
 - Materiality
 - Long term impact
 - Performance
- This would cover:
 - Conversion of CCGT to OCGT
 - Boiler replacement
 - Supercritical technology conversion (e.g. material to IED plant)
- But would exclude LT maintenance



Long term contracts for existing plant

- Assessing projects would involve meeting the following thresholds:
 - The capital investment is such that it cannot be funded out of plant operating cashflows and would require either corporate or debt financing (and that evidence is provided of this)
 - The life extension resulting from the investment is at least [10] years (certified by independent experts)
 - A significant improvement in plant efficiency, emissions, reliability or capacity is observed and measured.
- Further work needed to set *quantitative* thresholds



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Competition in the Auction

We are looking to mitigate gaming risk in auction through number of tools:

- Hold auction 4 years out
- Demand curve
- Capping price in auction at multiple of CONE
- Reducing demand according to “opt out”
- Centrally derating plant
- Requirements on Existing plant wishing to be Price Makers
- Portfolio cap on liabilities
- Investigation of plant unsuccessful in auction that stays on
- Scrutiny of bids above a price threshold from existing plant



Price Makers and Takers

- We recognise that existing plant may have significant net going forward costs
- We think requirement for Board-approved justification will lead plants to price more reasonably and will give useful information for Ofgem to investigate suspected market abuse
- We want to balance:
 - Administrative burden on plants to justify bid; with
 - Tools for mitigation of market power

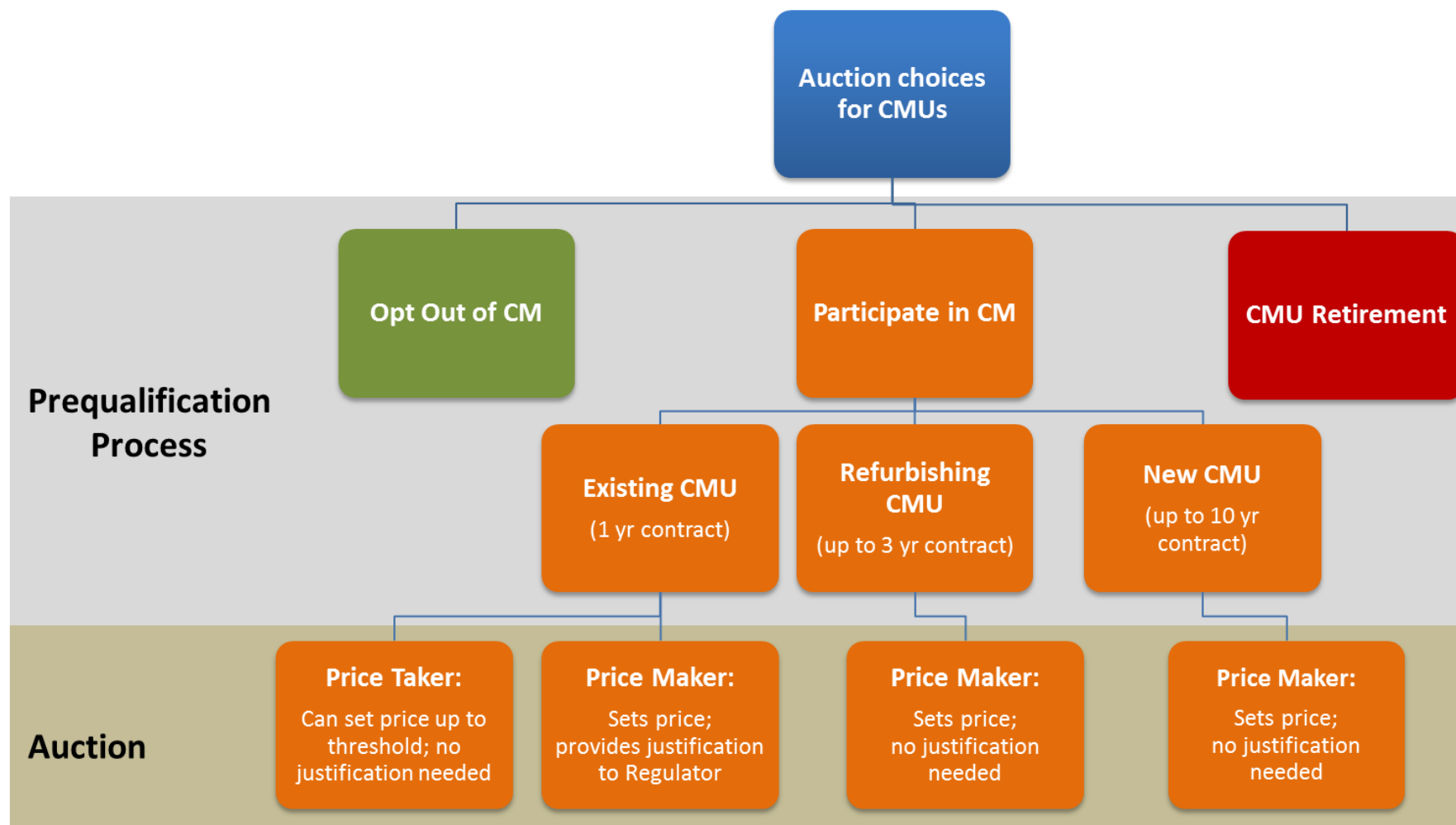


Price Makers and Takers

- We think following balance is appropriate:
 - Any plant (inc existing) can set price in auction
 - No requirement for New or Refurbishing plant to justify bid prior to auction
 - No requirement for Existing plant to justify bid if below a threshold – around £30/KW year
 - Existing plant must provide Board-approved justification prior to auction
- How will threshold be set?
 - Level should be *above* what most existing plants need to bid
 - No scientific formulation of threshold – we do expect some plants may reasonably need to bid above this level
 - Can be expressed as % CONE or according to typical Opex costs (£/KW)



Overview of process





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Information Flows

What information should be shared with investors?

Prior to prequalification:

- Target derated capacity sought through CM
- Total derated capacity assumed outside of CM
- Rules for derating plant
- Rules for distinguishing Refurb from Existing plant
- Demand Curve

Post prequalification:

- Total amount of derated capacity assumed from “Opt Out”

But not:

- Which plants are opting in / out
- Which existing plants qualified for long term contracts



Information Flows

During auction (after each round):

- Total derated capacity offered

But not:

- Which plants have offered

After auction:

- List of capacity contracts – including contract length
- Capacity clearing price

But not:

- Who was a price maker / taker, what justifications were given