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POLICY UPDATE ON DSR PARTICIPATION IN TRANSITIONAL ARRAGEMENTS AND CAPACITY MARKET

1. Summary

Transitional Arrangements

- Issue One: Participants moving from T-4 CM auctions into the TA.
- Issue Two: Aligning Transitional Arrangement (TA) in-year testing with enduring regime testing
- Issue Three: Adjustments to TA penalty regime

Capacity Market

- Issue Four: Baselining CDR CMUs
- Issue Five: Capability testing, verification checks and 2014 delivery
- Issue Six: Metering for type 3 and 4 CMUs and 2014 delivery
- Issue Seven: Returning bid bonds for partial delivery

2. Recommendations

- Issue one: **Continue with current policy proposal** barring participants from moving from the Capacity Market into the Transitional Arrangements.
- Issue Two: **Align in-year testing** of resources across Transitional Arrangements and Capacity Market
- Issue Three: **Reduce penalty rate in the TA** to correct omission in condoc rules.
- Issue Four: Consider **some changes for simplification**, but **not permit exceptions of Triad avoidance** or inflation of baseline
- Issue Five:
    - **Spilt the prequalification verification checks for all existing CMUs.**
    - Note the timing for capability checks in 2014.
- Issue Six: Update on metering implementation, 2014 and recommend **post auction verification of metering**.
- Issue Seven: **Not returning bid bonds pro rata, but seeking to mitigate this risk for providers and mitigate optimism risk for the system.**

3. Background and proposed changes to policy design

Issue One: Participants moving from T-4 CM auctions into the TA

Background:

- The first Capacity Market (CM) auction will be held in 2014 and the first Transitional Arrangements (TA) auction in 2015. Currently, participants cannot enter a TA auction once they had been awarded a CM agreement from a previous CM auction, even if they are for different delivery years. For example, a provider with an agreement from the 2014 T-4 auction to deliver in 2018 could not participate in the TA auctions in 2015 for delivery in 2016. This is intended to deliver the aims of the TA to target support at participants who were not yet able

to compete in the main CM. Participants winning agreements in the 2014 CM auction must be confident of their ability to deliver in 2018, given that they cannot guarantee to be successful in the subsequent TA auctions, and therefore do not require interim support.

- During the consultation, some stakeholders proposed that providers be allowed to participate in the 2014 T-4 auction and then use the Transitional Arrangements auctions to fund the intervening years until 2018. They argue this will give DSR providers long term certainty from 2014, allowing them to sign and fund longer agreements with their customers.

Proposed changes to baseline policy design:

- **It is proposed that we do not change the policy** to permit the participation of DSR in the T-4 and subsequent TA auctions. DSR providers using the TA as bridging finance between T-4 and the delivery year are sophisticated players who do not need the support of the TA. This would represent poor value for money for consumers and risks crowding our less mature participants. Additionally, this increases the risk that there will be insufficient capacity to participate at T-1 when we have set aside capacity for it and guaranteed to procure 50% of the set aside. Were we to allow the move from T-4 to the TA, we would have to reduce the amount we set aside for T-1 to mitigate this risk, reducing our flexibility.

Issue Two: Aligning Transitional Arrangement (TA) in-year testing with enduring regime testing

Background:

- Currently there are different in-year testing requirements in the TA and the CM.
- Transitional Arrangements – tests were intended to mimic stress events with the assumption that actual stress events were unlikely to occur in 2016/17 and 2017/18.
    - No minimum number of tests, but a minimum of five dispatches a year comprising stress events and tests. Thus in a year with four stress events, providers would be tested once, in a year with no stress events a provider would be tested five times. Some leeway required for late stress events after tests have taken place.
    - The tests are treated like stress events: i.e. a provider cannot nominate the time of the test in advance, they will receive 4 hours warning and will be penalised for non-delivery at the same rate as for a stress event.
- Capacity Market – tests were intended to check the capacity is available throughout the year.
    - Providers are required to declare 3 settlement periods over the winter in which they delivered capacity. SPs can be during stress events. For DSR demonstrations must be declared ex-ante and a maximum of 6 declarations can be made, of which 3 must be successful.

- If providers fail to prove their capacity over winter, National Grid will spot test them by ordering them to dispatch with 6 hours' notice[1] and penalising non-performance.

Proposed changes to baseline policy design:

- **It is proposed that we align the two testing regimes to bring the TA in line with the CM.** As currently constructed, the TA testing could be more onerous than the CM, contrary to the aims of the TA to be a less onerous scheme.
- **It is also proposed that we amend the rules to allow DSR to declare delivery during stress periods ex-post** as generation can, instead of ex-ante as with other demonstrations.

Issue Three: Adjustments to TA penalty regime

Background:

- The penalty regime in the TA is intended to mirror the penalty regime in the CM, but at a lower level. As currently drafted, the rules cap the penalty at 100% of annual payments, all other aspects are the same.

Proposed changes to baseline policy design:

- **It is proposed that the penalty rate is lowered and the cap decreased to de-risk participation.** The original policy intent was to set penalties lower than in the CM, however this was inadvertently omitted from the consultation draft. The CM penalty regime is will be coming back to the Expert Group separately on 7th February.

Issue Four: Baselining CDR CMUs

Background:

- The energy demand of Customer Demand Response (Type 4) CMUs is baselined taking the average of 3 sets of settlement periods (17 SPs in total): the same day of the week for 6 weeks, 3 settlement periods one year ago and 10 if the previous 14 days. Anomalies such as Christmas would be removed and delivery of balancing services for National Grid would be added back in to avoid adversely impacting the baseline.
- DSR respondents to the consultation advocated changes to the baseline:
    1. Reducing 17 SPs down to around 6
    2. Removing the use of previous year's data
    3. Allowing providers to remove triad and DNO services delivery from their baseline, allowing them to offer both services without offsetting the delivery of one against the other.

[1] 6 hour's notice gives providers time to sell their energy output from the test. Note: this notice period may still not permit Type 3 and Type 4 CMUs enough time to sell. We have been indicated that most DSR could not sell with less than 2 days' notice – however, it is unclear whether they need to sell the energy in order to deliver.

4. Taking the average of the highest SPs in the baseline. E.g. if the baseline contains 6 SPs, take the average of only the top 5 to remove anomalous days.
5. Including a 'day-of' adjustment comparing the day of the stress event (before the CMW is issued) with the baseline.

- National Grid is looking at the technical suggestions (points 1, 2, 5) and will make a recommendation to DECC. DECC are considering the interaction with Triad and the removal of the lowest demand SPs from the baseline (3 and 4).

Proposed changes to baseline policy design:

- **It is proposed that NG is asked to consider the technical suggestions with a view to simplifying the baseline if appropriate and flagging any changes to processes that would occur.**
- **It is proposed that no change is made to the policy regarding Triad and other services.** Removing the SPs with lowest demand from the baseline artificially inflates the baseline, requiring DSR to be de-rated more strongly to compensate. This adversely impacts DSR providers who are not offering other services or who have more stable demand profiles generally. If we were to remove the lowest demand SP and not further de-rate the resource to compensate, we would be under-procuring in the auction and overpaying DSR's capacity.

Issue Five: Capability testing, verification checks and 2014 delivery

Background:

- Capability tests are required by all Customer Demand Response applicants to prove the capacity exists. To enter the auction as proven CDR, providers must obtain a CDR Test Certificate prior to the opening of the prequalification window. In 2014, the enactment of secondary legislation falls at the same time the prequalification window opens so there will be no opportunity for CDR to take a test before pre-qualification opens.
- Currently, pre-qualification verification checks are required for all existing CMUs (not just DSR) covering metered output and metering set ups. These checks will take place in the six week period after the prequalification window closes and before the prequalification results day. Elexon have highlighted that the complexity and potential volume of these checks makes completion within 6 weeks difficult. Assuming 1,500 existing CMUs apply (generation and DSR), Elexon would need around ten metering experts over the six-week period, working full-time to meet their obligation. Elexon would struggle to recruit metering specialists due to the short term nature of the contract (6 weeks) and the expertise required.

Proposed changes to baseline policy design:

- **It is proposed that in 2014 CDR providers enter the auction as unproven capacity and lodge a bid bond or as proven capacity using performance in the balancing services to prove their capacity**. No tests for dispatching capacity would be carried out until after the auction. The timing allows both

unproven and some proven CDRs to participate in 2014. If the current Rules were not amended, only unproven CDRs would be able to apply in 2014, which increases the risk of non-delivery of capacity and increases costs for some providers. The ability of National Grid to confirm performance in the Balancing services in 2014 will depend to some extent on the parity of CMU definition with balancing services units and will be reviewed after further work on the CMU definition.

- **Additionally, we propose splitting the verification of metered data and metering set ups into two stages: pre and post auction.** Applicants will continue to submit all the information required for the checks during pre-qualification.
- During the prequalification stage, Elexon will undertake the first check to confirm the applicant's metered output and that the meter data is from the assigned meter. Elexon will undertake the second check after the auction: a review of the set-up and location of metering connections and readings for all existing CMUs. If the applicant's verified data from the second check is different to the amount in the agreement, the applicant will either have their obligation reduced in line with their actual capacity or will seek another provider to cover their capacity gap. If there is a concern with the applicant's metering, the applicant will be required to correct the issue.
- These amendments will enable Elexon to complete the first check within the pre-qualification window, providing sufficient certainty for the auction. In addition, for T-4 auctions the changes will also allow time for capacity agreements to be amended prior to the following T-1 auction, which will enable any extra capacity to be auctioned.
- Elexon is currently exploring what simplified first checks can be undertaken for existing CMU Type 3 applicants in 2014.

<u>Issue Six:</u> Metering for type 3 and 4 CMUs and 2014 delivery

<u>Background:</u>

- Legislation will be laid setting out the four types of metering available to type 3 and 4 CMUs[2]. Currently, providers are required to have their metering in place by pre-qualification and provide details of their metering set up. This will not be possible in 2014. The legislation will come into force in August requiring system changes by delivery partners and meter operators, and metering changes by providers. We need to allow at least 6 months between the legislation coming into force and the metering requirements on delivery partners, meter operators and providers going live.

<u>Proposed changes to baseline policy design:</u>

- **It is proposed that the metering requirements commence from March 2015** to allow time to implement changes after the legislation is enacted. Providers would then be required to submit their metering information by April 2015, allowing Elexon to carry out metering checks. Providers would be permitted to

[2] Non-CMRS CMUs and CDR CMUs – embedded generation and DSR

prequalify in 2014 using data from existing balancing services metering. Note the interaction with testing and checks in Issue Five.

Issue Seven: Returning bid bonds for partial delivery

Background:

- Unproven DSR is required to post a bid bond of £4,420/MW during pre-qualification, returnable upon completion of a capacity test between the end of the auction and the beginning of the delivery year. To avoid the incentive to make overly optimistic estimates of the capacity a provider thinks it can achieve, the bid bond is only returned if the full capacity is delivered. If a provider manages partial delivery, the bid bond is kept and the obligation lowered to match the proven capacity. E.g. if a provider posts a bond for 100MW (£442,000), but is only able to deliver 80 MW, the bid bond is forfeit and the obligation reduced to 80MW.
- Stakeholders advocated returning the bid bond pro rata to delivery so that in our previous example the provider receives 80% of the bid bond back and loses the remaining £88,400. This approach risks providers making optimistic estimates of what they can deliver if they are only risking a proportion of the bid bond instead of the full amount. By comparing the rate of the bid bond with the potential revenue, it appears this is usually a risk in the provider's favour.
- 1MW of capacity:
    - Bid Bond £4,420/MW
    - Potential annual revenue £30,000-60,000/MW[3]
- The bid bond is ~15%-7% of the potential revenue per MW. These numbers are based on bid bond versus revenue, not bid bond versus profit which could bring those numbers closer together, however the numbers here indicate there is an incentive for providers to place optimistic bid bonds. This risks a capacity shortfall in the delivery year, a risk that is exacerbated if the capacity was procured in T-1 because there is no further opportunity to make up the shortfall.

Proposed changes to baseline policy design:

- **We propose not moving to a pro rata return of bid bonds unless the risk for optimistic estimates can be mitigated.** Other areas of CM design impact on how significant this risk is: e.g. if stress events were more frequent, DSR's potential profit may reduce which would mitigate this risk somewhat, however some DSR is likely to retain that incentive (i.e. DSR which is cheaper to dispatch.). Until other areas of the design settle, it is difficult to quantify how big the risk is and it will remain difficult in the absence of any information about how revenue will relate to profits.
- **We will also seek to mitigate the bid bond risk for providers**. Some options to mitigate the risks to provides and to security of supply include:
    - To only pro rata the bid bond return after 90%. Delivery below 90% would still result in the loss of the full bid bond meaning optimistic estimates would be limited to 10% of total unproven DSR.
    - To increase the bid bond to a higher proportion of the estimated revenue.

[3] Based on clearing price of £30-£60kw

- Additionally, to avoid the loss from the market of the undelivered capacity, **we are considering not reducing the obligation to the level delivered**. The capacity is then retained in the market. The DSR provider is incentivised to trade out the capacity it cannot deliver (in our previous example, the remaining 20%) to avoid penalties in a stress event. There is a risk that the provider may not trade out the undelivered capacity and instead retain the remaining 20% (and get paid for it), even knowing it cannot deliver it, and hope that a stress event does not occur or occurs off peak when it can deliver its Load Following Obligation with its 80% of actual capacity. Further work is needed once the rest of the design is settled to understand the implications of this proposal.

4. Policy Implications

- Wider Impacts
    - All the proposals have been discussed with National Grid and Elexon.
    - Several of the decisions in this paper are dependent on changes made elsewhere in the design.
    - The proposed changes to verification checks better enable the delivery bodies to complete pre-qualification within the timeframe and spread resource requirements over a longer time.
- Simplification: Aligning testing regimes simplifies the rules and aligns the TA and the CM. Splitting the verification checks reduces the burden on delivery bodies during pre-qualification.

5. Next Steps

- Feedback sought from the Expert Group on the above proposals and further insight welcome on quantifying the issues, particularly on the bid bonds.
- Interactions with other policy areas are being monitored and suitable adjustments will be made.