The material in this paper is work in progress and is not a statement of government policy or policy intent

CAPACITY MARKET'S TREATMENT OF NEW RESOURCES

Section 1: Introduction

1. This paper presents recommendations in respect of the Capacity Market's treatment of new and refurbishing plant. The options are informed by stakeholder responses to the EMR consultation and further policy development resulting from the internal 'mini-project' review.

Section 2: Recommendation

2. The views of the Expert Group are invited on the recommendation to adopt option one (redefining the financial commitment milestone and the delivery checkpoint for refurbishing plant), noting the requirement to finalise proposals for the operation of cure periods.

Section 3: Background

3. There was mixed stakeholder support for the consultation proposals on the treatment of new and refurbishing plant. The main representative points were:
   - Commercial pressures are sufficient to incentivise timely delivery – addition checks are not required.
   - The 12 month test of 50% planned expenditure is either inappropriate or will not work in practice, primarily on the basis that expenditure will be low at the 12 month point, that the construction plans are indicative and that the test will not give any confidence of true development status.
   - Checking financial commitment at the 12 month point would be a more appropriate measure of assessing performance.
   - It is inappropriate to require the completion of refurbishing projects within 24 months of the auction; questions posed as to why completion has to be in advance of the delivery year.
   - The 50% substantial completion milestone was seen as arbitrary, with Termination Fee 2 being excessive and creating an unnecessary risk and cost.
   - Some respondents saw the completion milestones and termination provisions as overly generous, allowing for new projects not to show up for two winters without penalty – creating a liability for stress event penalties combined with an ability to trade obligations would provide the best delivery incentive.
   - Others consider the termination proposals excessive and a disincentive for new investment, whilst others consider them acceptable provided there is a robust appeals route in which to challenge the application of termination notices.

Options

4. In light of this representation and further policy development, three options are presented for the EG's consideration – detailed on the next page.

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Parameter	Option one	Option two	Option three
Financial commitment milestone	Redefine milestone to cover i) incurred expenditure of at least [10%] of total project costs or ii) evidence of project commitment	As Option one but applied six months **and** 12 months post auction	Remove
Substantial completion milestone ('long stop date')	Other proposals may mitigate need to address the 'missing two winters' point. However may need to revisit in light of proposals for cure periods – details to be determined.	As Option one	Remove
Termination fee	Specify termination fee one as £15/kW of capacity obligation (£7.5m for a 500MW unit) and termination fee two as £25/kW of obligation (£12.5m for a 500MW unit). These figures are the result of the calculation referenced in the recent consultation (rule 6.10.4) with a Net CONE value of £29/kW. This replaces the net CONE formula of the current approach.	As Option one	Remove
Refurbishment milestone	Apply definition of new Financial commitment milestone and move the long stop date to the start of the delivery year (rather than two years post auction). Implications of failing long stop date remain as per current draft with exception that de-rating is adjusted to the lower of the pre or post refurbishment level	As Option one	Remove

Credit support (collateral)		No credit support lodged in pre-qualification window. If Financial Commitment Milestone is not met six months post auction (see above), lodge credit support to cover termination fee one in full. If Financial Commitment Milestone conditions are still not met at 12 month point draw down collateral and terminate agreement	Remove
Penalties at time of system stress			Create a distinction between operational volume and volume subject to penalties in periods of system stress. All new CMUs that are not operational in stress periods would be penalised at £10/kW for level of deficit between operational level and capacity obligation. Capacity payments would be received by the level of capacity that was operational as per consultation proposals.

NB – all other design parameters remain as per the consultation proposal unless referenced in the above table.

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Details and rationale of options

5. The rationale for the proposed amendments is provided in context of the significant development costs which an applicant is likely to have incurred in order to meet the CM's pre-qualification requirements and to deliver an operational unit in the delivery year. These are made up of i) application fees for a connection offer ii) securities to cover period between connection offer and commissioning of the plant iii) planning consents and iv) construction costs. There is considerable variability across the range of costs – from application fees of a per MW fee in the range of £105/MW to £235/MW, through to consenting costs in the range £1,500/MW to £7,000/MW[1]. It is not possible to quantify the securities and construction elements due to their project specific nature.

6. The bid bond proposal for unproven DSR capacity was calibrated at £4,420/MW to broadly align their incentives to deliver on their pre-qualification applications with a generator's sunk pre-qualification costs. It is however proposed to retain the differential treatment of new generation and unproven DSR capacity on account of their different lead times and scale and therefore impact on the security of supply implications and risk profile of other providers.

Amending the definition of the Financial Commitment Milestone

7. Stakeholder representation has indicated the need to refine the milestone applied 12 months post auction in order to make it a more meaningful test of a project's status, given the gaming potential associated with the current proposal. It is therefore proposed to adopt a two pronged approach similar to the CfD method – based on either the percentage incurred expenditure of total project costs or demonstrable Board and project commitment to the project. This should provide <u>significantly</u> more certainty as to the genuine development and commitment status of a project than the consultation proposal.

Financial Commitment milestone – proposed text

A prospective CMU is considered to have met its Financial Commitment Milestone if within 12 months of the capacity auction it has provided the Delivery Body:-

- invoices, payment receipts and other Supporting Information [to be defined] with respect to the Project as the Generator considers relevant to evidence that it has spent [ten per cent (10%)] or more of the Total Project Costs

  or

- such documents and any Supporting Information to evidence that all of the commitments listed below (the Project Commitments) have been made entered into

[1] National Grid DSR Bid Bond paper – July 2013

- a copy of a resolution of the prospective CMU's board of directors (or an equivalent management committee or body) to:
  i. undertake the Project;
  ii. approve the total financial commitments required to commission the Project (the "Total Project Spend"); and
  iii. approve a timetable for undertaking the Project which resolves that the Facility can reasonably be expected to be commissioned no later than the start of the Capacity Agreement's first delivery year;

- a Directors' Certificate certifying that:
  i. the Generator has, or will have, sufficient financial resources to meet the Total Project Spend,
  ii. any contracts entered into and provided as Supporting Information, are in the reasonable opinion of the Generator
     (a) legal, valid and binding; and
     b) entered into with one or more counterparties who are each able to perform their obligations under such contract;

- Supporting Information evidencing that the Generator has, or will have, sufficient financial resources to meet the Total Project Spend, including where applicable that any Project Finance Agreements have been entered into;

- Supporting Information evidencing:
  i. Entry by the Generator into an engineering, procurement and construction (EPC) contract for the Prospective CMU, providing for the supply and installation of the major components of the prospective CMU

  or

  ii. Entry by the Generator into an agreement for the supply of major components representing [20%] of the Total Project Spend

8. Another option (option 2) is to use the milestone as a collateral trigger for plant which is unable to demonstrate the required project commitment at the six month point. This approach would enable the collateral requirement to be more precisely targeted at those units that are genuinely unable to demonstrate the relevant levels of commitment rather than the current generic requirement on all new plant.

Timing and design of Substantial Completion Milestone ('long stop date')

9. Stakeholder representations have raised concerns over the cliff edge nature of the termination provisions applying at the 18 month long stop date. Concerns also exist regarding a new plant's ability to be delayed by two winters, with resultant impacts on the margin levels and the risk levels of other capacity providers, with minimal consequences

for the defaulting plant. Whilst other measures currently under consideration should accommodate the two winters issue, the timing of the Long Stop Date may need to be brought forward, potentially to the 12 month point, as proposals for cure periods between the milestone and termination point are further refined. It is not considered appropriate to include cure periods into the current timeline, as this would result in the actual termination point being pushed back into the third delivery year of the agreement.

10. An additional proposal included in the options above (option three) is to dispense with the Substantial Completion milestone and implied termination events and collateral requirements, on the grounds that market incentives and CM penalties are a sufficiently strong incentive to deliver on time. Under this proposal penalties would be applied at times of system stress on the deficit between the unit's capacity agreement and their volume of operational capacity. The resource would only receive payments for that capacity which had been proved to be operational.

Termination Fees

11. Stakeholder views were mixed on the concept and proposed level of termination fees proposed. Concerns were also raised about the potential barrier to entry presented by collateralising termination fee one. Various options are proposed in the aforementioned table – from hardwiring the level of both termination fees into legislation, rather than retaining the current net CONE based formula, through to moving the collateral requirements to post auction or removing the collateral requirements entirely. It is not proposed to revisit the level of the termination fee per se; the proposed levels are designed to be of a level which incentivises delivery, in conjunction with the pre-qualification sunk costs, and for termination fee two includes an element of the damage caused by the resource's delay. Previous papers have addressed the justification of the levels.

Refurbishment long stop date

12. Under this proposal the requirement for existing plant undergoing refurbishment to demonstrate the substantial completion milestone for their work 24 months after the auction would be pushed back to the start of the capacity agreement's first delivery year. The requirement to demonstrate financial commitment at the 12 month point would remain. This would provide a longer window in which the refurbishment could be undertaken, and therefore longer potential relief periods, and enable the provider to more effectively manage their CM obligations in the intervening years between the auction and delivery year (for example where they had acquired obligations at a capacity auction for such intervening years). In addition it is proposed that the de-rating adjustment applied for failing the completion milestone would be the lower of their pre and post refurb capacity – currently not specified.

13. It is proposed that the other implications for failing the substantial completion milestone remain as per the current policy proposal – reduction in agreement term from three to one year and restrictions on auction participation for the subsequent couple of years.

Financial exposure comparison

14. 525 MW unit on a ten year agreement which gains full operational status to the level of their capacity agreement 12 months after the start of the first delivery year.

Capacity obligation:	525MW
Capacity price:	£40/kW
Annual capacity revenue:	£21m
Pre-qualification costs:	£0.8m - £3.8m (excluding construction & connection offer securities)

Comparison of options:

Parameter	Option one	Option two	Option three
Credit support (collateral)	£7.9m (pre-qualification window) lodged pre-auction	<u>May</u> have to lodge £7.9m collateral six months post auction	None
Payments	Forfeited £21m payment	Forfeited £21m payment	Forfeited £21m payment
Penalties	None	None	£10/kW for deficit at times of stress

Option evaluation

14. **Option one** - This option may present barriers to entry for independent plant that would be required to provide up-front credit support for all new plant. However, whilst it is acknowledged that this option is light touch relative to a commercial client engineer approach, it does reduce the risk that providers default on their agreement shortly after the auction by building on the applicants pre-qualification sunk costs – thereby helping to provide consumer value for money. It also significantly strengthens the consultation's reporting proposal (milestone monitoring by National Grid, accompanied by independent technical assessment) with a more robust 12 month milestone check utilising the two pronged approach of incurred expenditure or demonstrable project commitment.

15. **Option two** – This option is attractive from an investability perspective, with targeted collateral reducing the potential barriers to entry associated with the generic credit support approach for all new plant. It also helps address implementation concerns over

assessing credit support in time for the 2014 capacity auction. There are concerns however as to whether this would adequately address the risk of a cardboard plant which sets the auction clearing price but reneges on their agreement after the auction clears - their sole incentive being the pre-qualification sunk costs.

16. It is acknowledged that options one and two retain a distinction between new plant which is unable to deliver in a delivery year and an existing plant which also fails to deliver. This is proposed on account of the requirement to have additional certainty and oversight of a new build plant's status in advance of the delivery year. Option three, however, addresses this distinction.

17. **Option three** – whilst this option allows for a greater alignment between new and existing resources, it is likely to have impacts on the investability of the mechanism and increase uncertainty due to the lack of reporting controls. There is the risk the penalties may not be effective, given their unsecured status, stress events fail to materialise (and therefore no test periods) and that the new proposal presents implementation risks. This option is linked with the definition of system stress considered in the penalty regime paper (expanded definition, higher frequency and lower penalty rate) which may increase the penalty/payment risk exposure beyond investable levels.

Recommendation

18. It is proposed that option one is progressed. Details of potential cure periods between the Substantial Completion Milestone and the application of a termination notice are to be worked up over the next couple of weeks.