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CAPACITY MARKET AUCTION

Section 1: SUMMARY

1. The paper considers the following aspects of the auction design in light of responses to the consultation:
 - a. The rules for determining whether there is sufficient competition to hold an auction as well as for clearing the auction;
 - b. The appointment and role of the auction monitor;
 - c. The process for agreeing setting auction parameters; and
 - d. Whether to relax some of the rules against gaming in the auction in the interests of simplification.

Section 2: SUMMARY OF RECOMMENDATIONS

2. In light of responses to the Consultation, a number of measures are proposed to better balance the need to buy capacity against the need to protect consumers against gaming. These measures include:
 - a. The algorithm for deciding the point at which the auction should clear in the event of a “lumpy” supply curve should consider the cost to consumers of buying additional capacity if it raises the clearing price.
 - b. The auction should be allowed to run even if the minimum competition threshold is not met (i.e. 3GW of excess capacity at the price cap) – subject to ministerial approval.
 - c. In the case that the auction has not met the minimum competition threshold, the minister should be able to exercise, within tight constraints, post-auction discretion on the volume to contract.
3. The role of the auction monitor should be amended to only look at whether the System Operator, as Auctioneer, has followed the rules for the auction and should not provide a view on the competitiveness of the auction. The body providing the report should either be a party contracted by the System Operator with an obligation to report directly to the Secretary of State, or it should be the Government Actuarial Department. The approach taken should be consistent with the proposal for the CfD auction monitor.
4. The principle of the price maker/taker threshold, as well as the requirement on directors to sign the Certificate of Ethical Conduct, should also be retained. However rules obligating companies to establish “Chinese walls” to prevent dissemination of knowledge about a company’s bidding behaviour should be removed as providing unnecessary admin burden.

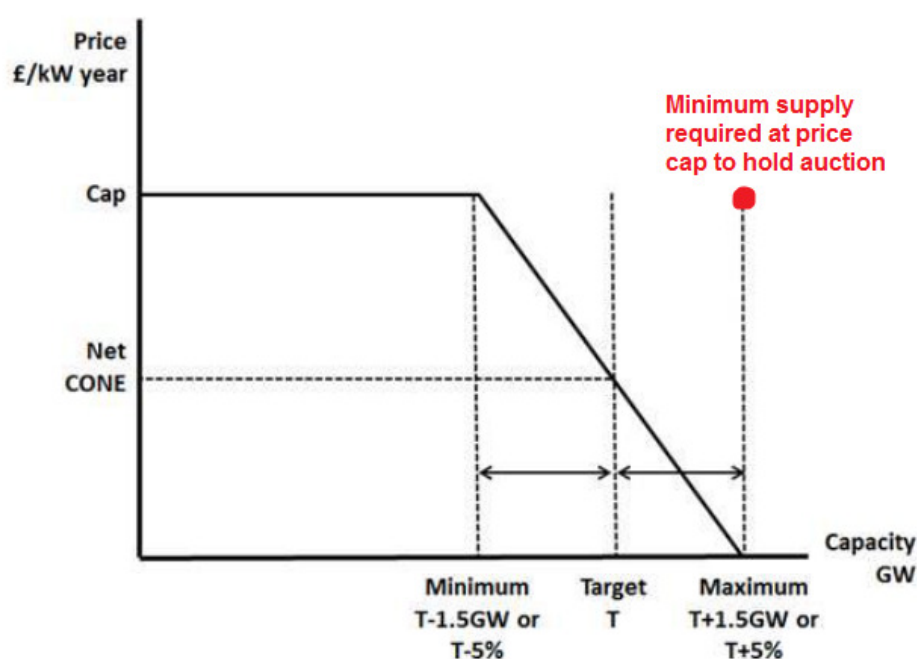
Section 3: RULES FOR CLEARING THE AUCTION

5. The baseline auction design policy established an algorithm for deciding whether to buy too much or too little in the case that supply curve is lumpy and does not

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neatly intersect the demand curve. However it is proposed that this algorithm should be amended to consider whether buying less would benefit consumers by driving down the price in the auction (an approach called “maximising consumer surplus”).¹

6. Responses to the consultation indicated parties were worried that the first auction might not have sufficient capacity to meet the minimum competition threshold of having 3GW excess capacity at the price cap. Respondents thought that such a scenario would indicate a high need for capacity and/or that the price cap had been set too low – rather than that the auction was uncompetitive.



7. We have therefore considered proposals to better balance checks against an uncompetitive auction with the potential need to contract capacity even in an undersupplied market.
8. DECC considers it prudent to amend the mechanism to enable the Secretary of State to let an auction proceed even if this barrier is not met. However in this case, given that there will be heightened concerns about bidders in the auction having market power, it is prudent to introduce a series of additional safeguards to protect consumers:
 - a. The System Operator should continue to reveal excess supply following each auction round – however this value should be rounded to the nearest 1GW (rather than rounded to the nearest 500MW in an auction which meets the regular minimum competition requirement).

¹ The algorithm in the baseline policy was to maximise social welfare, and so would not consider the impact of the procurement level on the size of consumer payments as this was seen simply as a transfer of welfare from consumers to producers.

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- b. To continue the descending clock auction beyond the point it would ordinarily clear until supply drops a further 1GW, and to then allow the Secretary of State post-auction discretion to select a level of capacity up to 1GW less than the point at which the auction would normally clear.
9. It should be noted that these proposals enable Government to exercise monopsony power in the auction (i.e. the market power associated with Government acting as sole buyer). This could be seen as inefficient from an economic perspective as it considers the gain to consumers from buying less to drive down the price while ignoring the reduced producer welfare that occurs as a result, and as it increases uncertainty the price at which future auctions will clear (and so could increase bids). However given that the Secretary of State will only have discretion to do so in undersubscribed auction, this should reassure investors in forming expectations of subsequent years' clearing prices. It could also be seen as efficient from an economic perspective, in the event that the minimum competition criteria is not met, as it mitigates the market power that could be exercised by producers (and so actually leads to a situation that is more economically efficient for society).
10. Following previous discussion at the Project Board and Expert Group, it is also proposed that the approach to price decrements in the auction be amended:
 - a. The first auction should be allowed to run up to 4 days, with 4 rounds per day. This should ensure that the price decrements should remain small (i.e. £2-5) and that parties have more time to consider their bids in light of the outcome of the previous round.
 - b. The decrements should be rounded to the nearest £1 and should be approximately equally sized.
 - c. The provisional price schedule should be announced prior to the auction.

Section 5: ROLE AND APPOINTMENT OF AUCTION MONITOR

11. Respondents to the Consultation raised three issues around the role and appointment of the Auction Monitor:
 - a. **The role of the monitor:** Respondents mostly thought that the role of the monitor should be to check that the Auctioneer has followed the rules of the auction and not to consider competition issues, such as investigating allegations of collusion.
 - b. **The appointment of the monitor:** The response to the consultation indicated most parties thought National Grid was not best placed to appoint the auction monitor, particularly if the monitor had a role in reviewing competition in the auction – although some respondents suggested ways in which this could be mitigated (for instance by involving the National Audit Office, or an industry panel in the appointment process).
 - c. **The investigative powers of the monitor:** The response to the Consultation illustrated significant concern among respondents that the monitor's powers to compel information from participants had been drawn

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too broadly – such that the monitor could compel information relating to any aspect of the bidder's business – and that it could do so without oversight by the Regulator.

12. Following these responses, DECC has held discussions with the National Audit Office – which indicated that it would be difficult to run any audit process where the monitor also held a role in investigation competition complaints in the auction.
13. It is therefore proposed that the Auction Monitor should focus only on ensuring the auctioneer followed the rules of the auction – as is consistent with the proposals for the role of the auction monitor in the CfD allocation process.
14. There are then two viable options for the body to carry out the role of validating the auction. One is that a rule is put in place to require National Grid to contract a party to provide an independent audit directly to the Secretary of State. Another option is for Government to nominate the Government Actuarial Department as the monitor – as they have experience in validating other allocation mechanisms (such as the random allocation of Premium Bonds). In either case, the monitor will be able to view bids during the auction but will have no powers to compel bidders to provide information.
15. The CfD design team is currently evaluating the two options above for the CfD allocation process, and it is proposed that the Capacity Market should adopt the option that is consistent with the CfD decision.

Section 6: SIMPLIFICATION OF THE AUCTION RULES

16. DECC's Simplification review has considered a range of areas in which the Capacity Market design could be simplified. Consultation responses revealed a nearly-unanimous view that proposed anti-gaming rules are unnecessary and impose excessive administrative burden and regulatory risk. This section therefore sets out more detail on the review of the necessity of some auction measures that parties asked to be repealed:
 - a. **Requirements for "Chinese Walls":** Respondents argued that this was legally unworkable and could create significant administrative burden on small companies, where it would be difficult to restrict knowledge of their capacity's auction bids. Requiring reporting on how parties would comply with the rule (currently an obligation within the Certificate of Ethical Conduct) would also add significant administrative burden. Given the significant downsides to retaining these requirements, we have recommended that they be **repealed**.
 - b. **Price Maker/Taker Requirement:** Respondents argued that this requirement would have little deterrent value and that the threshold had been set far too low (and so would cover a wide number of plants). One respondent also pointed out (correctly) that DECC's analysis of existing plant bids in the first auction overlooked how plants might try to recover a

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proportion of their losses in the intervening years until the first CM delivery year – and were therefore likely to be an underestimate. DECC recognises that it is important not to see the threshold at too low a level – and will undertake further analysis of bids in the first auction (including how plants might seek to recover interim losses) before finalising the level of the threshold. However the existence of the threshold is still thought to provide a safeguard against uncompetitive bidding – and the administrative burden should be minimal so long as the threshold is set appropriately – so it is recommended that the requirement be **retained**.

- c. **Certificate of Ethical Conduct:** The Certificate of Ethical Conduct adds no additional requirements on a company except that a Board must sign a document stating that they are complying with the law. This is required in other equivalent auctions and although it does not alter the standard of what the company must do it has been seen to have a very practical effect of calling the Board's attention to its obligations. We have therefore recommended that this requirement be **retained**. However there is scope for minimising the administrative burden by providing a pro forma template and by allowing parties to submit a single form for all units in their portfolio.