



Electricity Market Reform Project
Department of Energy & Climate Change
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3 Whitehall Place
London
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March 10, 2011

Dear Sir,

Electricity Market Reform

Please find First Utility's response to your formal information request below.

While First Utility applauds the fact that DECC has recognised the issues facing the UK market and is taking bold steps to address them, we feel that certain aspects of the proposed package could be complex and expensive to administer while potentially having the unintended consequence of further decreasing liquidity in the UK wholesale electricity market. We would argue that these issues could be relatively cheaply and simply rectified by moving to a single cash out price and placing a requirement upon the vertically integrated incumbent suppliers to sell all of their generated output into the market. We believe that the increased liquidity that these measures would provide, combined with a Premium FIT model which would provide a strong incentive to invest in renewable technologies would be likely to result in a dynamic, secure, low carbon market at a minimal cost to consumers. Greater liquidity would also provide a more level playing field than the current arrangements and assist in the furtherance of competition and the ensuring of increased customer choice. We would even go so far as to say that fully effective retail competition cannot be assured without the existence of a liquid wholesale market.

Current Market Arrangements

Question 1: Do you agree with the Government's assessment of the ability of the current market to support the investment in low carbon generation needed to meet environmental targets?

We agree that decarbonisation of the electricity sector will also require focus on security of supply. These twin aims can only be achieved by significant reform of the way the UK Electricity Market functions, particularly in terms of market liquidity, as this will provide reassurance to market participants and a more level playing field for smaller players.

Question 2: Do you agree with the Government's assessment of the future risks to the UK's security of electricity supplies?

As more conventional generation plant reaches the end of its life or is shut down in line with the Large Combustion Plant Directive (LCPD) and is replaced by a greater proportion of renewable generation plant this will potentially pose significant risks to security of supply, particularly as much of this new plant will only be able to generate intermittently. However, we believe that government intervention to ensure a more liquid forward electricity market should go a considerable distance towards addressing this issue as a more liquid market will provide clear investment signals which should enable the looming security of supply issue to be dealt with before it becomes a serious problem and assist in encouraging greater competition within the market.

Options for Decarbonisation

Feed-in Tariffs

Question 3: Do you agree with the Government's assessment of the pros and cons of each of the models of feed-in tariff (FiT)?

This assessment seems comprehensive.

Question 4: Do you agree with the Government's preferred policy of introducing a contract for difference based feed-in tariff (FiT with CfD)?

We would support the Premium FiT package as we feel that the proposed FiT with CfD is unlikely to address liquidity concerns much beyond the near end of the curve. It is also easier to align with the RO and would likely avoid the unintended consequences that might derive from FiT with CfD, CfDs being fairly complex. It also gives a strong incentive to invest as the Premium FiT provides for payment to be made in addition to the revenues received from selling output in the wholesale market.

Question 5: What do you see as the advantages and disadvantages of transferring different risks from the generator or the supplier to the Government? In particular, what are the implications of removing the (long-term) electricity price risk from generators under the CfD model?

The main advantage is the fact that risk transferral will further incentivise investment in these technologies as generators will only be partially exposed to long term price risk. However, we believe that the CfD model may remove liquidity from the forward market and concentrate it instead in the spot market. This may affect the ability of independent generators to hedge economically as suppliers typically want to purchase forward on behalf of consumers rather than in the spot market.

Question 6: What are the efficient operational decisions that the price signal incentivises? How important are these for the market to function properly? How would they be affected by the proposed policy?

The price signal should incentivise investment although this is dependent on where that price is set, any potential for review going forward and the level at which the market finds itself in the future. These signals are crucial for the proper functioning of the market.

Question 7: Do you agree with the Government's assessment of the impact of the different models of FiTs on the cost of capital for low-carbon generators?

We would argue that Premium FiT provides an equal amount of revenue certainty to FiT with CfD and that it is less complex and easier to manage. This in itself should provide an added incentive to investment.

Question 8: What impact do you think the different models of FiTs will have on the availability of finance for low-carbon electricity generation investments from both new investors and the existing investor base?

We believe that Premium FiT and FiT with CfD will attract greater levels of finance than Fixed FiT as there is more guarantee of achieving a viable revenue stream from the investment under these models.

Question 9: What impact do you think the different models of FiTs will have on different types of generators (e.g. vertically integrated utilities, existing independent gas, wind or biomass generators and new entrant generators)? How would the different models impact on contract negotiations / relationships with electricity suppliers?

We believe that Premium FiT provides a strong incentive to invest and should make the type of technologies that the Government is trying to encourage highly attractive.

It seems likely that Fixed FiT would provide greater revenue certainty than at present but this is largely dependent on where payments are set and how often these are reviewed as it may be in certain cases that the generator could have made more money selling into the market.

FiT with CfD allows the generator to keep any upside which may in itself provide an incentive to invest. However, it does retain some element of risk in that generators will have to pay back the difference if the market price were to be above the strike price and this may discourage investment to some extent.

Question 10: How important do you think greater liquidity in the wholesale market is to the effective operation of the FiT with CfD model? What reference price or index should be used?

Greater liquidity in the wholesale market will be important in relation to the effective operation of the FiT with CfD model as it is the wholesale price that will largely determine whether or not the generator sells at that price. For the wholesale price to be fully reflective of the value that industry participants give to electricity supply at a given time, the market needs to be as liquid as possible, particularly further along the curve in the case that FiTs generators agree to sell output forward.

Question 11: Should the FiT be paid on availability or output?

We believe that this should be paid on output as payment on availability might lead to perverse incentives.

Emissions Performance Standards

Question 12: Do you agree with the Government's assessment of the impact of an emission performance standard on the decarbonisation of the electricity sector and on security of supply risk?

Implementation of an EPS would assist in the decarbonisation of the electricity sector but we feel that limiting generation output could have an impact on security of supply as generators will potentially try to restrict their generating time to higher priced periods. However, on this basis, it seems likely that this plant would still be made available in an emergency situation.

Question 13: Which option do you consider most appropriate for the level of the EPS? What considerations should the Government take into account in designing derogations for projects forming part of the UK or EU demonstration programme?

While we agree that the tighter emissions requirements laid out in Option 2 would provide a stronger signal in relation to the need for decarbonisation, this needs to be carefully considered against the fact that CCS has not yet been tested on a large scale. It might therefore be more prudent to elect for Option 1 at this stage with the potential to review the situation once successful large scale CCS testing has been carried out.

Question 14: Do you agree that the EPS should be aimed at new plant, and “grandfathered” at the point of consent? How should the Government determine the economic life of a power station for the purposes of grandfathering?

Grandfathering of the EPS at the point that new plant gains consent should reassure investors in relation to this potential risk.

Question 15: Do you agree that the EPS should be extended to cover existing plant in the event they undergo significant life extensions or upgrades? How could the Government implement such an approach in practice?

We agree that the EPS should be extended to cover existing plant in this situation provided that the Government elects for Option 1 at this stage. If the Government elects for Option 2, the cost of refitting older plant to meet these more exacting emissions standards might significantly outweigh any benefit provided.

Question 16: Do you agree with the proposed review of the EPS, incorporated into the progress reports required under the Energy Act 2010?

We feel that the EPS should be reviewed once successful large scale CCS testing has been carried out.

Question 17: How should biomass be treated for the purposes of meeting the EPS? What additional considerations should the Government take into account?

Perhaps biomass plant should have a higher allowance than traditional generation plant in order to reflect the fact that it is dispatched later due to its higher marginal costs. This should further incentivise investment in this type of generation plant.

Question 18: Do you agree the principle of exceptions to the EPS in the event of long term or short term energy shortfalls?

We agree with this, particularly if it were to be allowed during an emergency situation when extra generation might be required.

Options for Market Efficiency and Security of Supply

Question 19: Do you agree with our assessment of the pros and cons of introducing a capacity mechanism?

We feel that a capacity mechanism is likely to blunt price signals and will rather act as a substitute for greater liquidity which would enable the market to respond quickly to any supply and demand imbalance. It is also likely to be costly and complex to administer.

Question 20: Do you agree with the Government’s preferred policy of introducing a capacity mechanism in addition to the improvements in the current market?

We believe that a single cash out price and a requirement for the vertically integrated incumbent suppliers to sell all of their generated output into the market would provide greater reassurance to potential market players and greater insulation from cash out and market volatility than the

institution of a capacity mechanism. These measures would also be far cheaper and simpler to introduce and administer than a capacity mechanism.

Question 21: What do you think the impacts of introducing a targeted capacity mechanism will be on prices in the wholesale electricity market?

A targeted capacity mechanism is likely to increase wholesale prices in the short term as costs relating to this will be factored in.

Question 22: Do you agree with Government's preference for the design of a capacity mechanism:

- A central body holding the responsibility;
- Volume based, not price based; and
- A targeted mechanism, rather than market-wide.

As previously stated, we believe that a single cash out price and a requirement for the vertically integrated incumbent suppliers to sell all of their generated output into the market will provide more reassurance and a greater boost to market participation than a capacity mechanism.

Question 23: What do you think the impact of introducing a capacity mechanism would be on incentives to invest in demand-side response, storage, interconnection and energy efficiency? Will the preferred package of options allow these technologies to play more of a role?

We believe that the introduction of a capacity mechanism might weaken the incentive of demand side response to be available when required as the capacity mechanism may reduce the value of that demand side response. It may also have a negative impact on the incentive to build more interconnection with other markets as it seems likely that this interconnection will be less required once a capacity market guarantees available capacity in a tight network situation.

Question 24: Which of the two models of targeted capacity mechanism would you prefer to see implemented:

- Last resort dispatch; or
- Economic dispatch.

We feel that a capacity mechanism is less likely to achieve the Government's aims than steps to ensure greater liquidity by means such as those suggested in our answers to questions 20 and 22.

Question 25: Do you think there should be a locational element to capacity pricing?

We believe that this would simply be an attempt to artificially replicate the locational investment signals that a fully liquid market would provide.

Analysis of Packages

Question 26: Do you agree with the Government's preferred package of options (carbon price support, feed-in tariff (CfD or premium), emission performance standard, peak capacity tender)? Why?

We believe that carbon price support is likely to result in a number of unintended consequences including lack of certainty going forward, the difficulty of setting up a long term scheme and the

difficulty of hedging this risk long term. It will also drive prices up as this cost is factored in and may reduce liquidity rather than increase it. We have already made our point on our preference for Premium FiT. We believe that the EPS requirements should be cautious until CCS is proved as a viable technology. We also believe that more economically efficient and effective measures than the institution of a capacity mechanism could be taken by Government as described above.

Question 27: What are your views on the alternative package that Government has described?

The premium payment package is at least as likely to attract investment as the contract for difference option. In addition, it is likely to provide greater certainty of a return on investment for newer players. However, we feel that the Government's main focus should be on addressing the lack of liquidity in the forward electricity market to start with, perhaps with wholesale reform of the way the traded electricity market functions if it believes that this is what is required. We feel that a requirement for the vertically integrated incumbent suppliers to sell all generated output into the market would go a long way towards achieving this.

Question 28: Will the proposed package of options have wider impacts on the electricity system that have not been identified in this document, for example on electricity networks?

Although it may be that such wide ranging reforms to the UK electricity market will result in unintended consequences in terms of wider impacts on the electricity system, we are unable to identify any at this stage.

Question 29: How do you see the different elements of the preferred package interacting? Are these interactions different for other packages?

We do not feel that the capacity mechanism and carbon price support elements of the package will effectively assist in providing a liquid market and removing barriers to entry. These aims could be more easily, cheaply and effectively achieved by means of a single cash out price and a requirement on vertically integrated incumbent suppliers to sell generated output into the market.

Implementation Issues

Question 30: What do you think are the main implementation risks for the Government's preferred package? Are these risks different for the other packages being considered?

The complexity of the proposed FiT with CfD may lead to delays in implementation. Additionally, the institution of a capacity mechanism and the necessary administrative processes around this may also lead to some delay.

Question 31: Do you have views on the role that auctions or tenders can play in setting the price for a feed-in tariff, compared to administratively determined support levels?

- *Can auctions or tenders deliver competitive market prices that appropriately reflect the risks and uncertainties of new or emerging technologies?*
- *Should auctions, tenders or the administrative approach to setting levels be technology neutral or technology specific?*
- *How should the different costs of each technology be reflected? Should there be a single contract for difference on the electricity price for all low carbon and a series of technology different premiums on top?*

- *Are there other models government should consider?*
- *Should prices be set for individual projects or for technologies?*
- *Do you think there is sufficient competition amongst potential developers / sites to run effective auctions?*
- *Could an auction contribute to preventing the feed-in tariff policy from incentivising an unsustainable level of deployment of any one particular technology? Are there other ways to mitigate against this risk?*

We believe that a falling price auction might be useful in determining an appropriate level for feed-in tariffs for different types of technology. Under this scenario, market players would leave the auction when they considered that the price had fallen to a level at which they were no longer prepared to offer generation. We believe that auctions should be technology specific as the price levels at which participants are prepared to offer generation might vary significantly depending on the costs linked to that particular generation type. A series of different technology premiums would be useful. Prices should be set for technologies rather than individual projects as this could result in unnecessary complexity. However, we feel that some consideration should be given to the location of any capacity as this may also affect its value although this could be determined separately from the auction process.

Question 32: What changes do you think would be necessary to the institutional arrangements in the electricity sector to support these market reforms?

Steps need to be taken by Government to ensure greater liquidity in the UK wholesale electricity market as more liquidity will result in more reflective prices which will then provide the appropriate signals for the necessary investment and remove some of the current barriers to entry which smaller players face. We would support radical reform by Government of the way that the traded market functions if this is what is required to ensure competition.

Question 33: Do you have a view on how market distortion and any other unintended consequences of a FiT or a targeted capacity mechanism can be minimised?

We believe that a premium FiT will provide a strong incentive to invest coupled with simplicity and efficiency of administration when compared to other FiT options. It may be most appropriate to derive the premium for each type of technology from a series of falling price auctions as discussed in our answer to question 31.

Question 34: Do you agree with the Government's assessment of the risks of delays to planned investments while the preferred package is implemented?

It seems likely that there may be delays to the preferred package while potential investors wait to see how this will function in practice.

Question 35: Do you agree with the principles underpinning the transition of the Renewables Obligation into the new arrangements? Are there other strategies which you think could be used to avoid delays to planned investments?

These seem reasonable.

Question 36: We propose that accreditation under the RO would remain open until 31 March 2017. The Government's ambition is to introduce the new feed-in tariff for low carbon in 2013/14 (subject to Parliamentary time). Which of these options do you favour:

- *All new renewable electricity capacity accrediting before 1 April 2017 accredits under the RO;*
- *All new renewable electricity capacity accrediting after the introduction of the low carbon support mechanism but before 1 April 2017 should have a choice between accrediting under the RO or the new mechanism.*

We would favour the second option as this would provide an opportunity for the market to test how any new low carbon feed in tariff would work in practice prior to the cessation of the RO.

Question 37: Some technologies are not currently grandfathered under the RO. If the Government chooses not to grandfather some or all of these technologies, should we:

- *Carry out scheduled banding reviews (either separately or as part of the tariff setting for the new scheme)? How frequently should these be carried out?*
- *Carry out an "early review" if evidence is provided of significant change in costs or other criteria as in legislation?*
- *Should we move them out of the "vintaged" RO and into the new scheme, removing the potential need for scheduled banding reviews under the RO?*

We believe that these technologies should be moved out of the vintaged RO and into the new scheme. This will potentially provide efficiencies by removing the need for RO scheduled banding reviews and allow the new technologies to be considered under the new scheme, thus providing Government and the market with a more cohesive and early overview of how the scheme is likely to work in practice.

Question 38: Which option for calculating the Obligation post 2017 do you favour?

- *Continue using both target and headroom*
- *Use Calculation B (Headroom) only from 2017*
- *Fix the price of a ROC for existing and new generation*

We would favour continuing to use both target and headroom with a review post 2020 when a clearer view of the expected situation in 2027 should be available.

Please do not hesitate to contact me should you have any questions or require any further information.

Yours sincerely,

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