

October 4th, 2011

Mr. Matt Wieckowski
Department of Energy & Climate Change
4th Floor, Area D
3 Whitehall Place
London
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Dear Mr. Wieckowski,

Consultation on possible models for a Capacity Mechanism

In general, we are not in favour of a Capacity Mechanism as this distorts the supply demand discovery function in the market and makes it difficult for independents to compete. We believe that the case has not yet been proven for a Capacity Mechanism and feel it is inappropriate to institute such a mechanism until such time that a liquid wholesale market with vigorous competition has been developed and subsequently demonstrated not to deliver the capacity desired.

In addition, we believe that a number of unintended consequences may derive from the creation of a Capacity Mechanism. Payment for capacity may reduce the "energy only" price, leading to a) UK capacity payments cross subsidising European consumers via the flow of subsidised UK power through UK – European electricity interconnectors; b) peaking plants modifying their load duration curve, so that higher carbon intensity plant is incentivised to run for longer periods of time and c) an increase to barriers to entry as the increasingly layered regulation deriving from the introduction of modifications to the market such as the Capacity Mechanism deters potential new entrants and removes the threat of new entry as a driver of market competition.

However, in the event that the Government decides that a Capacity Mechanism should be created, our responses below outline the form that we feel this should take.

Targeted Capacity Mechanism

Q1. Does this table capture all of your major concerns with a targeted Capacity Mechanism? Do you think the mitigation approach described will be effective?

We believe the major concerns are appropriately captured and believe that the mitigation approach described should be reasonably effective in reducing these concerns.

Q2. How long should the lead time for Strategic Reserve capacity procurement be and why?

We believe that a period of three to four years should be sufficient.

Q3. Should the length and nature of contracts procured by the Strategic Reserve procurement function be constrained in any way?

It would be desirable for contracts for Strategic Reserve to be limited to a certain maximum so that the Reserve fleet can be modified within a sufficient timeframe to respond to wider market changes

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affecting the need for that Reserve. We feel that a five year maximum would be suitable, although we are also aware that a five year contract might not be of sufficient length to secure debt and equity funding from investors. The Government will have to balance these two considerations in its final decision as it feels is appropriate. However, we also believe that the nature of the contracts should not be constrained so the body responsible for procuring Strategic Reserve will be given freedom of choice in this respect so it is able to find the most cost effective solution.

Q4. Which criteria should providers of Strategic Reserve be required to meet?

Plant required to meet Strategic Reserve demand should be flexible and predictable. Therefore, hydro generation (particularly pump storage) would be useful while wind generation would not be due to its unpredictability. For more conventional plant, such as gas and coal, it may be suitable to require these to maintain a certain available generation margin at times of year when electricity demand is likely to be high (i.e. very hot days in the Summer and very cold days in the Winter). This could be notified by the network on a day ahead basis.

Q5. How can a Strategic Reserve be designed to encourage the cost-effective participation of DSR, storage and other forms of non generation technologies and approaches?

This all depends on the incentive provided. Perhaps the payment for DSR could in some way be linked to the payments made for Strategic Reserve provision at the time or the size of the overall demand imbalance on the network. It would probably be useful to tender for DSR provision as this would be mainly carried out by large industrial sites. It is also worth making the point that, once smart metering technology is rolled out nationwide at the domestic level, there may be a risk that the Capacity Mechanism dampens interest in innovative tariffs that encourage demand shifting during periods of peak network demand.

Q6. Government prefers the form of economic despatch described here. Which of the proposed despatch models do you prefer and why?

We believe that economic despatch, being fixed, would be more likely to distort price signals at times of high network stress and might lead to plant not being called on that might have been. However, we appreciate that the Government and Ofgem are taking certain steps to try to address this. We agree that last resort despatch is more difficult to calculate from a price point of view, but the fact that this should theoretically be used more rarely than economic despatch makes it more likely that a reflective price will be assigned to Strategic Reserve in this case. Therefore, if Government is confirmed in its belief that a Capacity Reserve mechanism is required, last resort despatch would be our preferred option.

Q7. How would the Strategic Reserve methodology and despatch price best be kept independent from short term pressures?

It is generally in short term situations that Strategic Reserve is most required. However, we believe that last resort despatch is likely to result in Strategic Reserve being called on less often than if economic despatch were to be used. Last resort despatch is therefore less likely to result in distortion of short term price signals.

Q8. Do you agree that a Strategic Reserve should be periodically reviewed? If so, who would be best placed to carry out the review and how often should it be reviewed?

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It is imperative that Strategic Reserve be periodically reviewed so that it can be established whether it is performing as it was designed to and in the most economically efficient manner. We would suggest that Ofgem would be best placed to determine this and would suggest a review be carried out every three years.

Q9. Into which market should Strategic Reserve be sold and why?

We believe that Strategic Reserve should be sold into the balancing mechanism as its purpose is clearly aligned with this and it can then be considered as part of the total stack. If it were to be sold into the day ahead market this might result in a confusing duplication of signals between this and the balancing market.

Q10. Do you have any comments on the functional arrangements proposed for managing a Strategic Reserve?

These seem appropriate.

Q11. Given the design proposed here and your answers to the above questions, do you think a Strategic Reserve is a workable model of Capacity Mechanism for the GB market?

Please see our answer to Question 6 above.

Market-wide Capacity Mechanism

Q12. How and by whom should capacity in a GB market be bought and why?

We do not believe that it would be appropriate for capacity to be purchased by single suppliers as it may then become very complex from a network coordination point of view. We would suggest that, if a market wide capacity mechanism is launched, it should be purchased by a central body or by National Grid Transmission. The costs of this can then be passed through to the wider market as required.

Q13. What contract durations would you recommend for a Capacity Market?

No more than five years as provision needs to be made for advances in smart metering technology and the generation and demand mix within the UK which may then affect the requirements for the nature and structure of a Capacity Market.

Q14. How long should the lead time for capacity procurement be? Should there be special arrangements for plants with long construction times?

As with our answer to Q2 above, we believe three to four years should be sufficient. We do not believe that there should be special arrangements for plants with long construction times as these will have been built as a response to price signals in the wider market rather than exclusively to participate in a Capacity Market.

Q15. Should there be a secondary market for capacity? Should there be any restrictions on participants or products traded?

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We do not believe that there is any requirement for a secondary market for capacity as we feel that a system of last resort despatch should be operated which will reflect the true value of Reserve Capacity and will provide little opportunity for a secondary market to function. However, we agree that there may be possibilities for a secondary market in DSR. However, participants would have to meet certain criteria before being able to participate, such as demonstrating that they can make the necessary demand reduction when required.

Q16. What are the advantages and disadvantages of making a central, administrative determination of (i) the capacity that can be offered into the market by each generator; (ii) the criteria for being available; and (iii) the penalties for non-availability? In outline, how would you suggest making these determinations?

We agree that it would be inappropriate to rely on wind generation, for example, in the same manner as more traditional generating plant. We also agree that "de rated capacity" figures should be used for less predictable plant. With relation to the penalties for non availability, these should be derived from the price that would have been paid had the plant come on as required – this should then provide an appropriate incentive to be available if possible. However, last resort rather than economic despatch should go some way towards circumventing this problem as plant would be less likely to be called on as this would only be done once all other available plant was already in use.

Q17. How should the reference market for reliability contracts be determined and what would be an appropriate reference market if it is set by the regulator? How could any adverse effects of choosing a particular option be mitigated?

Our view is that a last resort despatch mechanism should be used with the reference market being the highest accepted price offered through the Balancing Mechanism for the day in question. This should then provide a suitable incentive for capacity to be made available as agreed and avoid any distortion of price signals which a Capacity Mechanism might create.

Q18. For a Reliability Market, how should the strike price be determined? If using an indexed strike price, which index should be used?

The strike price should be set at the same level by the same method as described in our answer to Question 17 above.

Q19. For a Reliability Market, what level of physical back up (if any) should be required for reliability contracts and how should it be monitored?

As stated in our answer to Question 15, First Utility is not in favour of a secondary traded market for reliability contracts as this may potentially result in unforeseen consequences. Rather, we would suggest that participants be required to demonstrate ownership of the appropriate amount of capacity or planning permission to construct such capacity within the lead times agreed.

Q20. Do you agree that a vertically integrated market potentially raises issues for the effectiveness of a Reliability Market? If so, how should these issues be addressed?

We do not believe that this should be an issue provided that contracts are between each supplier and a single body, i.e. National Grid Transmission. We do agree, however, that vertical integration might reduce the attractiveness of contracts of this type to parties outside the Big Six.

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Q21. What could we do to mitigate interactions between a Capacity Market (especially if a Reliability Market) and Feed In Tariff with Contract for Difference without diluting the effectiveness of either?

We do not believe that there should be an issue here as the two mechanisms are priced in different ways and are designed to fulfil different requirements. We feel it is unlikely that generating units of the size and type which will be likely to participate in the FiTs scheme will also be appropriate to participate in any Capacity Market as these are designed to increase the level of non carbon generation in the UK market rather than to provide emergency margin in a tight network situation.

Q22. How can a Capacity Market be designed to encourage the cost effective participation of DSR, storage and other non generation technologies and approaches?

We would suggest something similar to the Balancing Mechanism, whereby DSR participants could be paid for reducing consumption at the appropriate time. However, we believe further consideration should be required as to where the price for this should be set although we believe this can be derived to some extent from the level of payment made to those providing capacity under the Capacity Mechanism.

Q23. Do you have any comments on the functional arrangements proposed for managing a Capacity Market?

These seem appropriate although they may need to be modified dependent on which form of Capacity Market the Government opts for.

Q24. Do you think that a trigger should be set for the introduction of a Capacity Market? If so, how do you think the trigger should be established, and how should it be activated?

A trigger mechanism may be appropriate to ensure that a Capacity Market is not introduced until it is definitely required in order to avoid distortion of price signals and possible disruption of the merit order within the balancing mechanism. We would suggest that a predetermined number of NISMs being issued by National Grid within the Winter period in any given year might be an appropriate signal although we feel it most appropriate for the Government to determine what that number should be.

Q25. What is the most appropriate design of Capacity Market for GB and why?

We feel that last resort despatch introduced as a result of a trigger mechanism with no secondary market is the most appropriate model as this will ensure that investment and price signals are not blunted thus avoiding an inefficient allocation of resources and possible stranded assets.

Capacity Mechanism Assessment

Q26. What are your views on the costs and benefits of a Capacity Mechanism to industry and consumers?

It could be argued that a Capacity Mechanism will insulate the market to some extent from short term price shocks caused by tight network situations. However, this results in distortion of peak price signals against which investors would normally make their plant investment decisions. This could then mean that this investment is delayed or only made for new plants that fall under the Capacity Mechanism, potentially worsening the problem and resulting in steady evolution from a

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strategic reserve towards a market wide capacity subsidy. The blunting effect of a capacity mechanism on imbalance prices could also mean that the incentives for market participants to cover uncontracted positions may be lessened.

Q27. Which Capacity Mechanism should the Government choose for the GB market and why?

Please see our answer to Question 25 above.

Please do not hesitate to contact me if you have any questions or would like any further information.

Best regards,



Regulation Manager

