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31 March 2016

Dear Helena,

We are grateful for the opportunity to comment on the proposals for reform to the capacity market. This response will comprise of two parts. The first consist of observations on the backdrop and strategic direction of the capacity market, as set out in the introduction to the consultation document. The second consists of responses to specific consultation questions where Citizens Advice has views.

Part 1- Introduction and backdrop

Consumers clearly have an interest in secure electricity supplies and the adequate reserve capacity that entails. However, that interest does not and cannot extend to supplying them at any price, and consumers should not be obliged to pay more than necessary in order to provide them. The more the capacity market is tweaked to force up the auction clearing price, the more strained will be the claim that the policy is entirely within consumers' interests.

At present, there appears to be a mismatch between the government's aspirations for the capacity market, and the way the market is designed. The first two auctions have demonstrated fairly conclusively that if gas powered generation is the answer the government is looking for, the capacity market currently asks the wrong question. If government intends for it to deliver gas generation, either the market design, or market circumstances, need to change. The questions the government should ask itself are: is gas generation necessarily the only desirable outcome? If it is, what capacity market design will lead to that outcome? And, is that design compatible with the government's responsibility to look after the interests of consumers?

In general, markets are good at finding creative solutions to open-ended questions. What they are not good at is delivering a pre-ordained outcome in an orderly way. The largely unanticipated outcome of significant volumes of diesel generation prevailing in the first two auctions demonstrate the inherent unpredictability of markets. The consultation document makes clear that the government is measuring the success of the capacity market by its ability to bring forward new gas capacity. What it does not do is adequately explain why gas capacity should be more desirable than less expensive alternatives. Nor does it

explain why, if new gas capacity is the only outcome that will satisfy government that the policy has succeeded, the policy bothers with also routing money to other forms of new and existing generation. If the government really wants new gas capacity, would it be more affordable to auction funding for constructing new gas power stations directly, than to go through the rigmarole of a supposedly technology neutral auction that in practice must deliver a pre-ordained outcome in order to be politically tolerable? There is a risk that in combining the processes of a market with the decision-making characteristics of a central plan, we will end up with the worst of both worlds, satisfying nobody.

It is particularly troubling that the consultation specifically cites the desires of industry and investors that the government buy more of their products and guarantee them higher prices and thus better returns, without providing a countervailing view of those who will be required to pay. Under-buying is a risk in capacity auctions, but so is over-buying. Given inescapable political risk resulting from undersupply and possible curtailment - no minister will ever want to see disruptions or blackouts on their watch - it is already likely that capacity assessments will err on the side of caution and over-procure supply. While some of the proposals here are reasonable (see part 2 of this response), we are concerned that in the round this consultation is a statement of intent to err even more fully on the side of increased procurement, which will ultimately drive up costs for consumers.

Part 2 - Responses to consultation questions

Q5-10 - Penalties for non-delivery

Citizens Advice believes there is a case for raising the penalty fees liable to developers who fail to deliver agreed capacity. Non-delivery, whether due to the 'winner's curse' phenomenon or simply an unrealistic bidding strategy, imposes significant costs on consumers if, as is occurring now, policy needs to be amended and potentially costlier replacements procured. Evidently, even a £33mn liability was insufficient to prevent SSE from closing Fiddler's Ferry in breach of its capacity agreement. The credibility and continued effectiveness of auction policy mechanisms depends on the results at auction translating into outcomes in the marketplace. If bidders find they would rather pay a fine than fulfil their obligations, it suggests the fines are too low. Additionally, as the proposals described in this consultation intend to raise the clearing price for the auctions,

we would expect bidders to take on additional risk in exchange for the additional returns they are going to receive.

Q23-24 - Proposed 2017/2018 auction

The case presented in the consultation document offers a weak justification for the proposed new auction. While it may be the case that market conditions have changed significantly and a new auction is necessary, this case is not made in the consultation, which rests on a vague assertion that capacity is lower than was anticipated in 2014.

Recent reassurances from National Grid, Ofgem and DECC muddy the waters further. Were they so sanguine about capacity because this extra procurement round was in planning? Is the government's view that those reassurances are no longer current given changes in market circumstances? Or does this proposal provide additional security on top of the degree of margin described in those reassurances? Again, the current consultation offers little guidance on the department's thinking.

In both cases, we would be comforted if the government could make its reasoning and evidence base clearer than it has so far. We do not rule out the possibility that the proposed changes are justified; the evidence is simply absent from what has currently been put forward.

There are further practical concerns about running an auction for such a close date that also falls ahead of future years for which capacity has already been procured. Given that existing capacity with contracts for 2018/19 onwards has already committed, under threat of a large penalty fine, to be available beyond the winter of 2017/18, what is gained by providing an effective windfall in capacity payments for a winter they are obligated to survive through? Is the sufficient time for new build gas generation of the type the government desires to be developed, especially in a T-1 auction with only 1-year agreements available? If not, will the extra auction exacerbate the issues with diesel generation highlighted in the introduction part of the consultation document?

Companies will also have begun developing and implementing price hedging strategies for the winter of 2017/18. Before the government goes ahead with this proposal, we would be eager to see any assessment of what it expects the effects on wholesale prices to be, and what if any consequences this would have for energy consumers. Changing the arrangements at such short notice could prove cheaper than the alternative way of providing capacity via the National Grid's

contingency balancing reserve, but again there is little in the consultation to substantiate this possible benefit. The introduction states that the costs of the reserve have been going up, but expresses a desire for the costs of the capacity market to also rise. The relative balance of these two sets of cost increases is not clear.

Q15-18 - Demand side response

Citizens Advice has previously expressed support for finding ways to accommodate DSR in the capacity mechanism¹, and continues to believe that it constitutes a viable alternative to construction of traditional generation in providing affordable security of supply. We also agree with the government's view that, given its obvious maturity and competitiveness, there are no grounds for allowing small scale (mostly diesel) generation to participate in the Transitional Arrangements under the guise of unproven DSR. We agree a legal declaration is the simplest way to achieve this within the current ruleset, and expect that a suitable verification and testing regime would highlight when this has been broken.

I trust that this response is clear, but would be happy to discuss any matter raised within it in more depth if that would be helpful.

Yours sincerely

Simon Moore

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https://www.citizensadvice.org.uk/global/migrated_documents/corporate/response-to-decc-consultation-on-capacity-market-supplementary-design-proposals-and-transitional-arrangements.pdf