StagEnergy

Mark Downham,
EMR Markets,
OFGEM
9 Millbank,
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23 January 2015

Dear Mark,

RE: CAPACITY MARKET – THE NEXT AUCTION AND BEYOND

The purpose of this letter is not to submit any specific rule changes. We are generally happy with the implementation and outcome of the first auction, although somewhat surprised at the low level of the clearing price.

As a developer of new flexible generation capacity, our main concerns relate to the political and regulatory uncertainty surrounding (a) the assumptions to be used by National Grid to determine future capacity requirements, and (b) the likely impact of DECC's proposed capacity market design changes on the ability of independent generators to compete effectively in future auctions.

We appreciate that Ofgem is currently consulting on the existing rules but you have also invited comments on possible future changes and, as you are well aware, whatever DECC decides at the end of March will have a significant impact on the regulations and rules impacting the 2015 auction. The prospect of further policy changes post the Election aggravates severely the uncertainty faced by investors, developers and equipment suppliers.

We therefore welcome this opportunity to summarise our main concerns going forward. Stag Energy is a leading new entrant into the UK generation market with some 1500MW of new flexible generation capacity under development. We are expecting to be in a position to bid 600-1000 MW in the next auction.

Over the last two years we have engaged extensively with DECC to ensure the capacity mechanism design will facilitate new investment, contribute to security of supply and minimise costs to consumers. Looking forward, our concerns relate to the assumptions driving the capacity margin assessment and the need to ensure that new build can compete effectively in any future auction.

CAPACITY MARGIN EXPECTATIONS

The Government has repeatedly stressed that 30GW of new conventional gas generation will be required by 2030 to provide system support in covering peak demand shortfalls due to the intermittent nature of much low carbon generation. Gas will also be required to cover base load support and to compensate for

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the closure of coal generation, the retirement of old nuclear and inefficient CCGT and the probable delays in the commissioning of new nuclear.
It is our view that the electricity market is being designed with extremely tight margins and on the basis of some very aggressive assumptions at the time of peak demand:

a) High levels of generation from wind and solar,
b) Optimistic energy savings from industrial and residential consumers and the likely size of DSR contribution (currently 2GW) in the T-1 auction,
c) Interconnector supply availability where reliability of supply is very difficult, or impossible, to define four years in advance

At T-1, these factors have a high probability of combining to place the UK in a vulnerable position with respect to energy security, with insufficient time to respond with new build.

ENCOURAGING NEW BUILD AND COMPETITION
Looking to future auctions, we are keen to ensure that there are no changes to the rules and regulations that would impact negatively on the ability of independent generators to secure the funding to bring forward new entrants and greater competition in the market.
In particular, in connection with the two recent DECC consultations on the future design of the capacity mechanism, we are concerned to ensure that:

- Only new capacity investment qualifies for a 15 year contract. Encouraging expensive refurbishment of existing plant will (a) provide unnecessary subsidies to existing plant that would have been likely to stay open, and (b) defer the essential investment in

- new plant needed to compensate for intermittent renewable generation and to meet base load requirements. We note with some regret that DECC has decided (20 January 2015) to reject this simple approach to defining what constitutes "new" plant and has instead opted for a more complex definition "which provides for greater flexibility for the appropriate use of existing assets". We will be concerned to try and ensure that the final solution (to be decided by end March 2015) provides for a clear definition that does not discourage investment in new generation.

- No rule is introduced which would discount the capacity payment to new plant on a 15 year contract so that it equates to the payment made to existing plant which secures a one year contract. (i.e. Price Duration Curve PDC) Such a policy appears at first sight to avoid the problem of over paying for long term contracts but in fact it would require the Government to become a forecaster of future capacity prices and would likely (a) increase the short term wind fall gain to existing plant and the "Big Six", and (b) make it extremely difficult for new entrants to commit to costly development programmes based on a volatile revenue framework that may change radically on an annual basis.

We were pleased to see that DECC has decided (20 January 2015) not to introduce PDC's into the next auction but will investigate the idea further. We take the view that PDCs are unacceptable in principle and that any methodology would involve an arbitrary forecast of future capacity prices which could undermine the primary goal of the capacity market, which is to ensure adequate security of supply.

On the general issue about the value for money of the capacity mechanism, our view is that the Government must use a market based auction to provide the "missing money" in the system. This need has been created by the rapid growth of subsidised renewable generation (operating outside the market) and the lack of competition due to vertical integration. These factors combine to create an environment where new gas generation will have to run at much lower load factors and much more uncertainty regarding wholesale market revenue.

Further growth in intermittent renewable generation will simply aggravate the "missing money" problem and it is highly unlikely that any Government would tolerate the rise in peak electricity prices that would be required to remunerate back-up plant capacity. Intervention is therefore unavoidable to ensure the availability of adequate capacity. It is important to note that capacity payments are an insurance premium and not a subsidy – gas is by far the cheapest and relatively clean new capacity available.

It has been argued elsewhere that greater energy efficiency is an easier and cheaper route to solving the capacity problem and that the capacity mechanism is too expensive. In our view the potential for significant demand side reduction (DSR) (even with incentives) has been over-estimated.

At the domestic level demand is relatively unresponsive to price changes and consumers have limited flexibility. A report by Frontier Economics and Sustainability First for DECC in 2012 said that there could be no significant DSR in the domestic sector "unless it was automated and directly controlled". This would necessitate extensive metering, the emergence of aggregators and a major shift in consumer investment and attitudes.

At the non-domestic level it has been estimated (Element Energy/De Montfort University report for Ofgem in 2012) that technically non-domestic DSR could reduce winter peak demand between 0.6 and 2GW. But again there are significant barriers including "lack of focus on energy issues, concerns over reducing production and service levels, lack of awareness of DSR measures and insufficient/unclear economic case for action". Greater energy efficiency should always be encouraged, as it is within the current capacity mechanism, but the evidence for the impact of DSR is inconclusive and will not by itself deliver cost effective security of supply.

I hope that you find these observations useful and I am sure that these issues will move rapidly up the agenda in the coming months once DECC has reported on its recent consultations and next Autumn Energy Statement. In the meantime please do not hesitate to get in touch if you would like to have a more detailed discussion on the future of the capacity market.

Yours sincerely,

George Grant
Chairman