SCOTTISHPOWER

London Office
4th Floor,
1 Tudor Street,
London EC4Y 0AH
Tel +44 (0) 141 614 7501

Michael Wagner
Deputy Director, Wholesale Markets
Ofgem
10 South Colonnade
Canary Wharf
London
E14 4PU

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Dear Michael,

Open letter on the Five Year Review of the Capacity Market Rules and NGET's incentives

Thank you for the opportunity to respond to the above Open letter.

We agree that Ofgem is right to recognise that it is not appropriate to make substantial changes to the Rules ahead of the BEIS 5 Year Review process given that it may involve BEIS considering significant changes to the Capacity Market (CM) framework and to policy. We have responded to the BEIS Call for Evidence on its Review and enclose a copy of this by way of background. We also summarise below our broad perspective at the outset of this overall Review process.

The wider context: BEIS' 5 Year Review

We consider that the market-wide Capacity Market (CM) is fundamentally the right mechanism for promoting the necessary investment to help maintain security of supply cost-effectively. Of course, this is subject to ensuring that there is the necessary refinement of the mechanism over time as the annual auction rounds reveal specific unforeseen issues with the design of the CM, and illuminate wider energy market distortions.

In this context, we consider that the objectives of the CM have been undermined by 'hidden subsidies' and distortions in the wider market (for example due to non-cost reflective embedded benefits for distributed generation). Whilst we support the steps that Ofgem and the Government have taken to address these distortions (such as the changes to the embedded benefits regime and the CM supplier obligation), there are a number of other distortions that need to be tackled. For example, the disparity between the network charges paid by domestic generation and by electricity coming in through the interconnectors provides a significant competitive advantage for interconnected capacity. Whilst this issue presents something of a long-term challenge, we consider that it merits further consideration by BEIS and Ofgem working together as part of the Review.

As regards high priority areas in the BEIS Review for improving the CM in the near term, we agree that the Government is right to identify as a priority issue ways of improving the de-rating methodology for interconnectors so as to ensure that they are not over-compensated relative to their real contribution to security of supply. Moreover, we believe that Ofgem has an important role to play in supporting BEIS in its consideration of this important issue with National Grid (as EMR Delivery Body).

We continue to believe that the CM should be focussed on ensuring that there is sufficient capacity available to meet forecasted peak demand. However, taking account of the fact that the CM is not designed to signal investment in specific locations where there is a particular need for steps to ensure system resilience, we consider that there needs to be better alignment of the CM with the ancillary service markets that are used to manage other aspects of security of supply, including flexibility, resilience and Black Start.

In this context, whilst we support the work being done by National Grid to enable shorter-term markets to deliver ancillary services, it is essential to also consider the requirements for longer term ancillary services (as part of a portfolio approach) when capacity is being procured at the T-4 stage.

One potential option could be long term ancillary service contracts aimed at securing the necessary locational capability in areas such as Scotland and the North of England, where current Transmission Network Use of System (TNUoS) Charges discourage investment in new build generation. Better alignment of ancillary service contracting with the CM would help to avoid the risk of the CM underwriting the wrong type of capacity in the wrong locations. In short, we consider that securing a suitable level of area resilience with respect to security of supply must be a further focus under the Review. Accordingly, we would encourage this important area to be considered and worked on across the various teams in Ofgem and joining up with BEIS.

More generally, we welcome Ofgem's commitment to engaging with BEIS on the eligibility of renewables, connection capacity, the penalty regime, testing arrangements and satisfactory performance; a collaborative approach towards considering these issues should help to ensure that there is an effective and robust outcome from the Review process.

Moreover, we believe that BEIS' statutory Review provides a good opportunity to take forward in Parliament the changes to the CM Regulations required to implement Ofgem's Connection Capacity CM Rule change proposals ("Of 15"), thereby ensuring that the intended security of supply is properly procured in subsequent T-4 CM auctions.

We also welcome Ofgem's commitment to working with BEIS and delivery partners on governance issues including the alignment between the Regulations and the Rules to ensure that the governance framework of the CM continues to be fit for purpose in the future. In this context, we consider that one aspect of the overall governance arrangements for the CM that might merit further consideration is the balance between those matters dealt with under the CM Rules and those matters incorporated into the secondary legislation. This is important since the constraints of Parliamentary time mean that it can be more difficult to effect necessary changes in a timely way to those matters incorporated in the Regulations.

<u>Ofgem's priority areas for its Rule change review</u>

As regards the four proposed priority areas for improvement of the CM Rules through the Ofgem Rule change process (as set out in the Open letter), our views are set out below:

(1) More efficient ways to assess and implement changes to the Rules

We share the view that there could be a more efficient way to assess and implement changes to the Rules and that industry should be given greater responsibility in assessing the value of amendments.

We believe that an expert panel or industry working group should be formed. A self-governing group could be formed of elected industry representatives, with Ofgem acting as an *ex officio* Chair, and the Delivery Body providing the secretariat function. Such a panel or working group could play a useful role in efficiently and effectively collating views and helping to prioritise issues as and when they arise.

(2) Whether the objectives of the Rules could be achieved with less burden on participants

We support efforts to simplify the Rules and reduce the regulatory burden from requirements in the Rules. For example, we believe that the permanent removal of Regulation 69(5) of the Electricity Capacity Regulations would improve the management of simple operational error risk in a sensible way. In this context, we would note that the inability to re-submit an application with additional information means that the pre-qualification process can be unduly costly and time-consuming from an industry perspective.

(3) The appropriateness of the secondary trading arrangements

We recognise that allowing non-dispatchable forms of renewable capacity to participate in the CM would raise unique challenges, which need to be overcome in a way that does not create unintended consequences. In this context, we consider that liquid secondary markets that enable such non-dispatchable generators to hedge their positions will be key. Accordingly it is important to take steps to ensure that any barriers to secondary trading are addressed.

As regards the current lack of liquidity in the secondary market (financial and physical), we consider that this is likely to be driven by a number of factors, including:

- Sentiment created from the current healthy level of capacity margins and consequently the perceived low probability of a stress event.
- The onerous process requirements that need to be met to become an Acceptable Transferee who is able to trade.
- The availability of over-delivery payments. (Removing these payments would increase the incentives to sell capacity, especially in the form of financial trades backed by physical capacity above participants' de-rated capacity.)
- The provisions around the transfer of a CM Agreement, including the requirements to meet Satisfactory Performance Day testing placed on both the seller (irrespective of the trade) and the buyer.
- The requirement to notify a physical trade 5 days ahead of delivery and the lack of automation around the processes of receiving notification of a physical trade.

We consider that liquidity in secondary markets is likely to increase if some of the points above are addressed and indeed as renewables begin to participate in the CM and hedge their delivery risk. The final point listed above is of particular importance for the introduction of some renewable technologies and the ability to hedge their forecast output close to delivery.

(4) The appropriateness of NGET's incentives for exercising its functions

Given the length of time that the current incentives framework for NGET has been in place, we agree that this Review offers a timely opportunity to consider if NGET's incentives on dispute resolution, DSR prequalification and demand forecasting remain fit for purpose. Getting the incentives right is obviously a key part of ensuring effective operational delivery of the overall CM process.

More specifically in this regard, we would reiterate the case for the permanent removal of Regulation 69(5) of the Electricity Capacity Regulations as a way of improving the administration of the pre-qualification process (by allowing for better management of simple operational error risks).

We look forward to the further opportunity to engage with Ofgem (and other stakeholders) on these matters through the workshop scheduled for 16 November.

Should you have any questions arising from our response, please do not hesitate to contact me.

Yours sincerely,

Richard Sweet

Richard Sweet
Head of Regulatory Policy