



By Email

Johannes Pelkonen, Harry Parsons
and Chris Thackeray
GB Wholesale Markets Team
Ofgem

28th May 2019

Dear All,

Five Year Review of the Capacity Market Rules

Thank you for the opportunity to respond.

The review focusses largely on qualification rules. Avoiding the big questions is understandable given the status of the capacity mechanism in the European court, but this has the effect of delaying the addressing of the standard set of regulatory questions for the refinement and development of capacity mechanisms.

Capacity mechanisms are acts of faith, essentially taking the view that markets cannot by themselves resolve the “missing money problem” or prevent loss of supply by contract abrogation. Statements about what the capacity mechanism has and has not achieved and will and will not achieve are largely conjectural because the counterfactual of an efficient and complete wholesale market is not fully considered.

Capacity mechanisms have been implemented around the world, as a response to perceived or actual current/potential role of markets in delivering adequate electricity production capacity to satisfy scenario projection of peak demand, including risk factors, to a given security standard. The mechanisms are inherently initially designed from a central generation, top down, administered perspective.

We believe that there is general consensus that future electricity will be more decarbonised and decentralised, with more democratised and digitised participation. Capacity mechanisms will therefore need to adapt over time.

We believe that the focus of the regulator, as distinct to the government, should be continuously (approximately annually) to make minor changes to the capacity mechanism, that fall within existing policy, in order to address: i) inevitable design deficiencies; ii) the ability of the industry to accommodate change incrementally; iii) development of the market, particularly with respect to democratisation and digitisation. We have briefly introduced these below.

Please also see answers to some of your consultation questions appended to this letter.

I hope our response is helpful.

Yours sincerely,

Chris Harris
Head of Regulation
07989 493912

Cc: Paul Finch, Regulatory Advisor

[npower](#)

Npower Group Ltd
Trigonos
Windmill Hill Business Park
Whitehill Way
Swindon
Wiltshire SN5 6PB
T +44(0)1793/87 77 77
F +44(0)1793/89 25 25
I www.npower.com

Registered office:
Npower Group Ltd
Windmill Hill Business Park
Whitehill Way
Swindon
Wiltshire SN5 6PB

Registered in England
and Wales no. 8241182

Appendix to npower's response to Ofgem's policy consultation – Five Year Review of the Capacity Market Rules

The regulator's focus should be on annual incremental changes in:

- i) Security standard – There is unfortunately some inconsistency and instability in terminology for capacity mechanisms. We believe that the best metric is Unserved Energy Expected, i.e. expectation of uncontracted loss of MWh due to failure at Grid Supply Point divided by expectation (or actual) annual load served. This affords attention to the scale of outage as well as duration. Contracted interruption is a commercial opportunity for load and should play no part in the standard. Voltage reduction is more closely related to adequacy (“enough” power) as distinct to resilience (“stability” of power) and there is a case for having adequacy and resilience metrics;
- ii) Conservatism factor used for grid resilience – It is standard to apply an uplift to demand to allow for grid balancing, whether it be locational or to maintain frequency. This is so large as to act as an excessive comfort factor and an excess cost;
- iii) De-rating – Mature capacity markets replace de-rating factors by deficiency payments, which are themselves partly solved by secondary markets. De-rating should be eliminated and in the short term replaced by deficiency payments supported by performance bonds (to ensure payment);
- iv) Deficiency- There should be an ex-post deficiency penalty which approaches the value of lost load and therefore becomes effectively punitive. To avoid ex post shortages, there should be a less punitive ex ante deficiency regime;
- v) Secondary trading – Secondary trading and deficiency mechanisms support one another;
- vi) Storage – Storage plays a complex role in aggregate system adequacy. In the short term, storage can support frequency response (but not as fast as inertia) and more sustained reserve. However in the medium term, beginning in minutes, storage has substantial latent demand and changes from being productive resource to addition to demand. The participation mechanisms for storage in the capacity mechanism need to be refined;
- vii) Interconnection – Interconnectors do not produce power. In addition they can withdraw power from Great Britain. The interconnection rules should increase their focus on the actual generation capacity at the other side of the interconnector, any conflicting claim or national recall rules on the capacity;
- viii) Recall – International treaties and rules, and their strength, need to be considered. For example a generator could commit capacity abroad but be required by system rules or national laws to abrogate the international contract;

- ix) Demand for capacity function – This should be modified slightly for each auction. The key changes are the cap and floor price, the slope, and a developing kink in the function;
- x) Recognition that voltage reduction is only partially lost load – Voltage reduction addresses adequacy more than it does resilience. The value of lost load for voltage reduction is considerably less than that for entirely lost load. It is worth considering the extent to which voltage reduction can be considered as a capacity offer, with a given strike price;
- xi) Recognition of large industrial Demand Side Response in the form of interruption – This is a commercial opportunity not involuntary reduction and should be removed from the capacity calculation and lost load security criterion;
- xii) The appropriate obligation base in terms of kW and hours; The two extreme are pure capacity with the obligation based on Triad (demand in the three separated peak half-hours) to pure commodity (demand over the whole year). At winter weekday peaks, the current obligation is about halfway in between the two extremes. To create the right demand signals the obligation should move closer to the triad method;
- xiii) The effect of the capacity mechanism on the wholesale market – the capacity mechanism forecloses development of the wholesale market to become complete by the development of options;
- xiv) The potential for development - for example the inclusion of strike prices- The market foreclosure can be partly resolved by the introduction of strike prices in capacity – so called reliability options;
- xv) Locational capacity – It does seem likely that as the market decentralised and over-build of transmission is avoided, that regional capacity mechanism is best.

npower's answers to certain questions in Ofgem's policy consultation – Five Year Review of the Capacity Market Rules

The objectives of the Rules

Question 1: Do you have any views on the interactions between the CM and other wholesale markets; such as forward markets, the balancing market, and markets for ancillary services?

The markets should be opened up as much as possible. The trend has been to do so, such as single cashout in balancing, and standardisation of reserve contracts. The capacity mechanism forecloses the forward market (suppressing the true peakiness and denying opportunity). It distorts the ancillary service and balancing mechanisms. Such distortions are natural as more mechanisms and markets are layered onto each other, especially when the intersections are unnatural ones (such as the preclusion of capacity payments to generators who provide capacity but have unrelated subsidies).

What is important is that the gaps and overlaps are gradually reduced. With capacity payments so large, they have a significant effect on generator build, but in the absence of strike price there is inadequate signal for generator type (e.g. open or combined cycle gas turbine). It is important that the capacity mechanism development is frequent and incremental so that recipients who have made commitments do not find themselves over or under compensated in relation to reasonable expectations. The impact of auctions in relation to older coal and gas is a matter of conjecture and thence the incentivisation for new gas fired stations (CCGT/OCGT) is uncertain. We have also had limited system stress events and the small number of Capacity Market Notice publications provide limited data on the impact on short-term markets. Revenue from the Capacity Market can be stacked in most cases with revenue from the wholesale and ancillary services markets, although some elements of Capacity Market design bias large-scale generation and risk foreclosing an increasingly decentralised market.

Question 2: Do you have any evidence that design choices in the CM are driving inefficient outcomes in other markets?

The Regulations and Rules create barriers to entry for non-exporting or 'behind the meter' generators, which could make a positive contribution to security of supply during a system stress event by reducing demand for imported power. Not being able to access revenue from the Capacity Market could make these generators less competitive in other ancillary markets such as STOR.

The definition of non-CMRS distribution unit/CMU in the Regulations and Rules limits participation from non-exporting generation CMUs with multiple units. If the aim of the Regulations is to keep metering pathways the same for generating units within the same CMU then the requirement to export to the distribution network is not required and should be removed from the definition of non-CMRS distribution unit in the Regulations and non-CMRS distribution CMU in the Rules. In addition, the requirement to determine connection capacity in the Rules and evidence output during pre-qualification via a letter from a Supplier or a balancing services obligation, and to also provide a connection agreement are barriers for non-exporting generation CMUs with single and multiple units. These could be easily addressed by requiring these units to provide G59 or G99 documentation at prequalification and, if further assurance is required, to demonstrate one Satisfactory Performance Day before the start of the delivery year. It should be possible to implement these changes without significantly impacting existing processes used by NGESO during prequalification and prior to the start of the Delivery Year.

Question 3: Do you have suggestions for how these markets can be better aligned and how any inefficiencies can be mitigated?

The list of Relevant Balancing Services in Schedule 4 of the Rules should be updated, to include Balancing Mechanism actions as more aggregators become Virtual Lead Parties and participate in the Balancing Mechanism under the Wider Access processes that NGESO are developing as part of the implementation of Project TERRE. As a general principle we would encourage Ofgem to align their review with the BEIS 5-year CM review. In a wider context, approaches such as the redesign of the supplier hub model could support effective participation of decentralised supply in the wholesale and ancillary services markets.

Ofgem's Rules change process

Question 4: Do you have any views on whether the proposed membership of the CM Advisory Group is appropriate, the form of participation from industry, along with any further points regarding meeting frequency and function?

Industry participation should be representative but not introduce risk of bias and in particular we would encourage appropriate levels of representation from non-traditional providers of capacity.

Question 5: Do you believe the proposed framework and function of the CM Advisory Group is appropriate and would better facilitate the efficient operation of the CM Rules change process?

Utilising the Advisory Group for screening of proposals is a good idea. It is very time consuming to review 100+ change requests every 12 months. Additionally, change requests are sometimes rejected on the basis of requiring changes to the Regulations or NGESO systems. An Advisory Group could fully explore dependencies and constraints in these situations to find solutions or give a fuller account to industry as to why such requests cannot be progressed.

Question 6: Do you have any feedback on our proposal to move to an 18-month implementation timescale; consulting on rule amendments which would subsequently be implemented the following Delivery Year?

It would be important to ensure that any prioritised rule change proposals identified in one Delivery Year could be implemented in the next Delivery Year where possible.

Regulatory burden – Prequalification

Question 7: Do you have any views on the proposed process, the implications of the change to the Prequalification procedure and whether it would be a positive change in removing an administrative burden?

Support - allowing evergreen submissions for CMUs that haven't changed would reduce the administration required during prequalification.

Question 8: Do you believe the current length of the Prequalification window is appropriate and if allowing Prequalification submissions to take place throughout the year would be beneficial?

Allowing submissions throughout the year would be welcome. Six week submission windows over summer can be challenging from a commercial decision making perspective and in respect to Director signatures as people are more likely to be on annual leave.

Question 10: Do you have any feedback on the amendments to the Prequalification data items listed in Table 1?

We support removing these requirements from prequalification. A lot of the relevant information will be collected during the Metering Assessment and Metering Test.

Secondary trading arrangements

Question 12: Do you have a view on which of the sub paragraphs of Rule 9.2.6(d)(i) – (ix) should only apply to Eligible Secondary Trading Entrants and which to the other categories of Acceptable Transferees?

We believe a liquid and well-functioning Secondary Trading market should be encouraged. The Rules should seek to ensure consistency between information required at prequalification and that required to become an Eligible Secondary Trading Entrant. At this point, the criteria for becoming an Acceptable Transferee should provide the assurance that the obligation being traded can be met, which is covered in sub-paragraphs (i), (ii), (iii) and (ix) of Rule 9.2.6(d) and should apply to all parties. The only point of difference would be for prequalified CMUs to demonstrate that they do not have an agreement for that Delivery Year.

Question 13: Is it appropriate to allow all parties who have prequalified for the CM for that year to become prequalified for secondary trading? Are there any unintended consequences?

Yes it is appropriate, as the criteria for becoming an Acceptable Transferee should provide the assurance that the obligation being traded can be met. We do not believe there are any unintended consequences.

Question 14: What form should a register of Acceptable Transferees take? How should it be populated? And who should be responsible for maintaining it?

The register should hold key information required to be able to enter into discussions on Secondary Trading, e.g. CMU de-rated capacity, applicable delivery year(s), applicable date range, company, contract details. Provided de-rated capacity requirements, and minimum thresholds can be met, it should be possible to secondary trade between different CMU generation types as this would serve to increase liquidity in the Secondary Trading market.

Question 15: Do you agree that it would be desirable to allow obligations to be traded between parties in amounts greater than or equal to 0.5MW?

Yes, it would facilitate better management of DSR portfolios. It should be clarified whether the 0.5MW threshold relates to rated or de-rated capacity

Question 17: Do you believe that the current period of three months in which NGESO have to notify a Secondary Trading Entrant of the Prequalification decision is appropriate or do you feel this should be shortened? Do you have any suggestions on a revised length of this period?

It should be shortened to align with the decision period at prequalification.

Question 19: Do you think it is appropriate to extend the defined trading window to the results day of the T-4 Auction for the relevant Delivery Year?

Yes, we are very supportive of this as it would increase flexibility for Capacity Providers and help create a more liquid secondary trading market.

Question 21: Does it continue to be appropriate for Transferees to be required to meet their SCM prior to engaging in trading?

Yes, Transferees should be required to provide appropriate levels of assurance.

Question 22: How should we address the risk of a trade being withdrawn where a Transferor is terminated after a trade has been registered?

The Termination Fees that a Transferor would be subject to are such that a Transferor would not have a strong negotiating position in a Secondary Trading situation and would therefore potentially not be remunerated to an extent where speculative behaviour in the Capacity Market would be considered attractive.

Question 24: Are there any amendments that could be made to the SPD framework following a secondary trade, specifically relating to partial agreement trades?

We would be supportive of an approach where any outstanding SPD obligations pass to the Transferee on a pro-rata basis. There is a risk that capacity providers would use Secondary Trading to trade out SPD obligations but given the SPD obligations should be delivered in the Winter of the Delivery Year according to the Rules, this would represent the period where payments are higher due to the Weighting Factor. In addition, data on secondary trades should make it easy to track trading behaviour.

Other changes to the Rules

Question 25: Do you believe the options presented related to SPD data submission are suitable and are there any options we may not have considered in order to help mitigate the impact on capacity providers?

When settling up settlement meter data pathways capacity providers should be advised to check existing contracts relating to electricity supply, data collection and data aggregation and to establish relevant contact points to support issue resolution.

Question 26: Which aspects of a CMU configuration do you think should not be able to be amended following Prequalification?

Those elements that relate to assurance at prequalification, e.g. generating technology class and de-rated capacity. Extending the defined secondary trading window as per question 19 would give additional flexibility to Capacity Providers where changes to CMU configuration are required to manage unforeseen operational issues.

npower response: Ofgem's Five Year Review of the Capacity Market Rules (May 2019)

Question 30: How should we differentiate between firm and non-firm connection agreements at the Distribution level?

This could be done by de-rating as suggested but we would encourage further dialogue to ensure any de-rating is appropriate for both the season and the region, i.e. local constraints often relate to the scale of renewable generation, which we would expect to be tangibly different during times of system stress.

Question 31: How should Distribution-connected generators with non-firm connection agreements be de-rated to accurately account for their contribution in a stress event?

This could be managed as part of a NGENO workshop to discuss with industry experts and a consultation as per battery and renewable de-rating decisions.

NGESO's incentives and role in the CM

Question 35: Do you agree that a demand forecasting accuracy incentive remains appropriate?

Demand forecast incentive creates incentive to make the defined measured demand match the forecast. The incentive to get demand forecast right should fall to suppliers and consumers. There is very likely in practice to be an incentive to over forecast but the overestimate could be hidden within one of the metrics.

Question 37: Do you agree that the DSR Prequalification incentive should be replaced by an incentive intended to drive NGENO to aid smaller providers, new entrants, and innovators navigate the CM?

Clearly, the DSR element is a matter of great debate right now. There is no easy answer. The presence of any demand has manifestly the potential to reduce that demand and hence DSR should not really fail. In practice committed DSR can be non compliant, i.e. deficient, and should therefore be subject to deficiency payments. The presence of demand is some evidence of ability to pay deficiency payments and hence less prequalification should be required than by generators, which may disappear

Question 40: Does the separation of the EMR Delivery Body from NGENO continue to remain appropriate given the separation of NGENO from the rest of NGENO plc?

The number of bodies continues to proliferate excessively. Markets such as the capacity market should be integrated with the other markets and hence handled predominantly by Elexon.