

UK Electricity Market Reform: An Update – Capacity Market

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In our August Alert "UK Electricity Market Reform - what does it mean for future generation projects?" we reviewed the UK Government's proposals, as set out in an energy White Paper¹, to achieve its commitment to "transform the UK's electricity system to ensure that our future electricity supply is secure, low carbon and affordable". As noted in our Alert, there was one aspect of the Government's plans which was set out in scant detail within the White Paper and which was in need of expansion: this was the introduction of a "Capacity Mechanism", details of which were to follow.

Some of those anticipated details were provided on 15 December 2011, when the Government issued the Technical Update to its White Paper (**the Update**). This sets out the UK Government's decision to legislate for a capacity mechanism in the form of a "Capacity Market", intended to provide sufficient capacity security to meet the changing needs of the market and to ensure a secure and consistent supply of electricity to the market, avoiding both surplus and insufficient demand, and removing the risk of blackouts.

Following the publication of the White Paper, the Government has been consulting on two capacity mechanism options: (1) a targeted mechanism in the form of a Strategic Reserve; and (2) a market-wide mechanism in which all providers willing to offer reliable capacity are incentivised to do so. The consultation closed on 4 October 2011, and concluded that option (2), a market-wide "Capacity Market", should be implemented.

The Capacity Market

What is the Capacity Market? - This Capacity Market model envisages meeting supply demands through a central auction system, by a mechanism that (if it works as the Update anticipates) will represent a consistent and forward-facing approach to maintaining supply levels against changes in capacity demand. The Capacity Market approach will provide incentives to suppliers which are intended to ensure that a reliable supply is available, as and when required, to meet changing capacity demands. The incentives will apply both to generation, and also to non-generation supply such as demand-side response and storage.

How will it work? - The Capacity Market mechanism would be market-wide, with the overriding objective of ensuring a determined volume of capacity. It would broadly introduce the following:

1. -- Estimating the total volume of reliable capacity that will be required by the market, forecasting a number of years ahead
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The Government will review advice as to the volume of capacity that will be required in any given year, and, reviewing this against corresponding projections of reliable capacity available, will decide how much capacity should be contracted.
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2. -- Contracting for the required total volume from a pool of providers, using a central auction process
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Capacity providers will be invited to offer the particular quantity of capacity that they can provide in any delivery year into an auction. This central auction system will then allow a review of the relevant capacity offers, to ensure that there will be adequate capacity to meet demand. Providers will be selected from the auction and contracted to provide a pre-determined level of capacity. The auction process will be separate from providers continuing to sell capacity into the market as usual.
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3. -- Incentivising providers to ensure that they are available to meet capacity demands when needed.

If a provider is successful in an auction, it will receive 'availability payments' in return for providing reliable capacity whether or not that capacity is used, although the Update does not set out in detail how these payments will be calculated. This revenue will secure a steady income stream for providers within a delivery year. There will also be penalties applied, to ensure that providers deliver the capacity they have been contracted to provide.

What does this mean for the industry?

The Government's focus appears to be consumer-based, with an emphasis on minimising the costs to consumers of achieving a secure capacity supply. The Update does not give a steer as to how the Capacity Market will impact on the industry, or indeed whether there will be financial implications relating to participation (or non-participation) in the auction process. The Update envisages that the costs of meeting capacity demands will be shared amongst suppliers and so, ultimately, that the capacity contracts placed will be paid for by consumers. However, in return for this, consumers will receive a stable capacity supply and the market will, presumably, benefit from a level of certainty. The Update gives little guidance as to how punitive any penalties will be should a provider fail to meet the capacity that is contracted to it, nor whether providers can be "prohibited" from participation in the auction process if there is deemed to be excessive non-compliance. For details like these we will have to wait for further proposals.

Next steps

The Government will now begin to consider and take high-level decisions on the type of detailed mechanism that will be required to allow the Capacity Market to work efficiently. A detailed design process is to be carried out, in conjunction with stakeholders. The Government will also decide when it will run the first auction process, which will be based on future estimates of reliability of supply.

Given the uncertainty over long-term projections of consistent supply, coupled with the market's strong reliability in meeting demand to date, the Government intends to base its decision on when to run the first auction process upon future estimates of reliability of supply, such that the mechanism will only commence once a shortfall is anticipated. In the meantime, the Government will work alongside stakeholders on the detailed mechanism design and will provide a policy update by May 2012, which is in line with the Government's intention to introduce legislation to implement the objectives set out within the White Paper in Spring 2012.

Concluding Remarks

It appears that the market will have to "watch this space" to see how and when the Government decides to implement the first auction, and to see the outcome of the development of the detailed mechanism design. Until the mechanism is defined in more detail, we will only be able to guess how the Capacity Market may work in practice

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