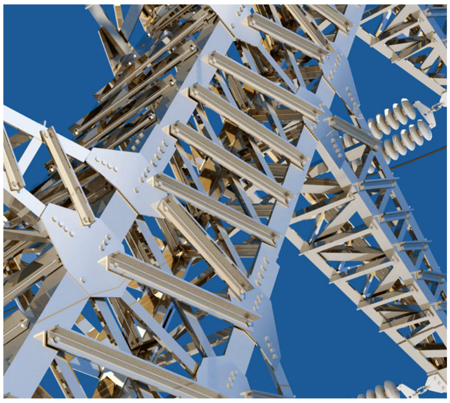
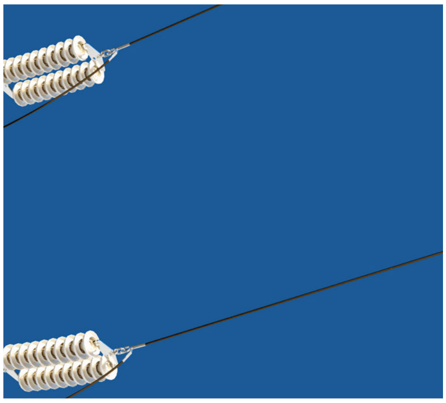
Briefing

April 2016

SHEPHERD+ WEDDERBURN

Solving the "energy trilemma" through capacity market insurance

With a legacy of underinvestment in energy, and faced with a number of existing power stations scheduled to close by 2020, the Government sought to stimulate investment in energy through the introduction of the Energy Act 2013 (the **Act**). The Act aimed to address what has been described as the energy trilemma of keeping the lights on, at an affordable price, whilst moving towards a low carbon electricity market. The Act introduced the Electricity Market Reform framework which implemented two main instruments, namely Contracts for Difference and the Capacity Market. It is the latter of these two instruments that was grabbing headlines at the end of last year due to the holding of the second Capacity Market auction in December.

What is the Capacity Market?

The Capacity Market is a form of electricity insurance for the United Kingdom and aims to provide security of supply at the least cost to the consumer. This electricity insurance is achieved by offering capacity providers a steady, predictable revenue stream (through capacity agreements obtained by capacity providers as part of competitive Capacity Market auctions (discussed further below)) in return for agreeing to deliver electricity when needed. If capacity providers fail to deliver, when called upon to do so, they face the prospect of penalties (although these are capped at an amount equal to the annual payment).

In simple terms, how does the Capacity Market auction process work?

The auction process is competitive and each potential capacity provider submits into the auction the minimum price at which they would accept a capacity agreement (the **Exit Price**) as well as their capacity. The auction commences at a high, capped price and slowly descends. As the price descends so too does the remaining capacity as potential capacity providers are priced out of the process. Eventually, a price is reached at which remaining capacity from potential capacity providers equals the capacity the United Kingdom requires to be obtained from the Capacity Auction (the **Clearing Price**). Once the Clearing Price is reached, the auction process closes and successful capacity providers (i.e. those capacity providers whose Exit Price was below (or equal to) the Clearing Price) receive a capacity agreement at the Clearing Price.

The results of the second Capacity Market auction

The second Capacity Market auction held in December 2015 sought 44.7GW of capacity for delivery in 2019/20 and attracted interest from potential capacity providers representing over 57GW of capacity. The auction process closed on 10 December 2015 with approximately 46.4GW of capacity being obtained at a clearing price of £18/kw/year (compared to a clearing price of £19.40/kw/year in the first Capacity auction, albeit the first Capacity Auction procured a higher capacity than the second Capacity Market Auction).

What is potential capacity providers' experience of the Capacity Market auctions?

A number of our clients successfully secured capacity agreements for new generation projects in the second Capacity Market auction. One such client was Eider Reserve Power, which successfully secured 15 year capacity agreements for four projects, namely Ashford Power Ltd, Beaufort Power Ltd, Brecon Power Ltd and Wednesbury Power Ltd. Michael Davies, Director of Eider Reserve Power found the Capacity Market auction process to be *"very straightforward and well organised by National Grid"*.

The future of the Capacity Market

We wait with anticipation to see how the Capacity Market evolves. With capacity in place for 2018/19 and 2019/20 at what has been described as a relatively modest cost, the Government may well feel that the Capacity Market is achieving its aim of providing energy insurance. It does, however, remain to be seen the extent to which the Capacity Market is assisting in generating investment in truly new generation projects. Only time will tell. It will also be interesting to see how obligation trading and volume reallocation develop as capacity providers are called upon to provide capacity, and how the secondary M&A market will develop as the Capacity Market matures.

For further information or advice on any of the issues discussed in this briefing note, please get in touch with Danny Lee or John Morrison.

Danny Lee
Partner
T +44(0)131 473 5141
M +44(0)787 649 5998
E danny.lee@shepwedd.co.uk

John Morrison
Solicitor
T +44(0)131 473 5719
M +44(0)791 240 6017
E john.morrison@shepwedd.co.uk