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# Oxford Energy Comment

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## Back to the Future: Electricity Market Reform Update

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### Introduction

The Government has published what is called a "technical update" to its electricity market reform proposals. The new publication adds some detail to the original proposals, particularly in relation to the delivery of the proposed FiT CfDs and capacity payments (new readers are referred to an earlier OIES comment *Return of the P-word,* dated July 2011, for an explanation of the various pieces of jargon). Many important questions about the new system remain unanswered; nonetheless the overall direction is now even clearer than in the original document – towards a planned electricity system whose function is to deliver the Government's policy objectives. The main delivery agency will be the System Operator (SO - part of the National Grid) so we are in effect returning to something rather like the old arrangement under which the CEGB both operated the system and secured investment in generation in line with an agreed plan. Market elements remain but it is clear that it is the Government that will be in the driving seat.

### Institutional Structure

In the new system both FiT CfDs and Capacity Market will be implemented by the SO, but its role will be akin to that of a civil service. The Government will be responsible for "setting the policy approach and … for taking final decisions on key rules and parameters", while the SO will "provide independent expert advice … and administer" the FiT CfDs and Capacity Market. For the Government to determine the policy approach does not mean just high level direction – it will involve getting into a lot of detail. The Government will of course "set out the broad decarbonisation and security of supply objectives" but it will also explain "how it envisages the market functioning in order to meet these objectives". The Government will define "the roles and responsibilities of the organisations involved; details of the payment mechanism; …. the detailed design of the two mechanisms, including standard contract terms for the FiT CfD and the level of capacity to be commissioned". This is in fact a rather greater degree of Government involvement than in the days of the CEGB, as the paper implicitly recognises – it notes that "the Government does not underestimate the scale of intervention in the electricity market this represents" but makes the point mainly to justify the failure, at this stage, to fill in much detail. It is also novel, in that the SO is a private organisation, not a nationalised industry like the CEGB, yet will be performing major public functions.

**FiT CfDs**

The mechanisms for delivery of these contracts are now somewhat clearer but the paper does little to clarify their content and structure. The mechanism will involve the Government developing a "delivery plan" in consultation with the SO. The plan is to include "vision and objectives; enduring design elements; and regularly revised design elements." The SO for its part will "administer the contracts and auctions in accordance with the statutory framework and the published plan". The document makes it abundantly clear that while the SO may, for instance, advise on matters such as the strike price, Ministers will take the decisions. Furthermore, it is still a little unclear who will actually sign the contracts and act as counterparty – the document says that payments will flow from counterparty (or counterparties) to generators (or vice versa) "as defined in the contract", which seems to leave a number of options open. Little progress has been made on the actual form and content of the FiTs; while the document talks about enduring design elements it does not say what these will be or (at this stage) what changes can be made to contractual terms, beyond saying that there would be "clear and transparent procedures". More details should be available early next year.

**Capacity Market**

The overall structure of the capacity market, on the other hand, is now much clearer; the Government will take a decision, on the basis of advice from the SO (and others) on the volume of capacity to be contracted, looking a number of years ahead to a "delivery year" in relation to which auctions for capacity will be held. The idea is clearly to stimulate the construction of new capacity, though both existing and new plants will be eligible. Auctions will be run by the SO and successful bidders will receive revenue (additional to their direct sales into the market) for providing reliable capacity (or face penalties if the capacity is not available when needed). Again many details remain to be filled in – not just how much capacity will be contracted for and when, but also, for instance, the size of the penalties and whether low carbon generators will be eligible for support under this arrangement. It is clear that it will take some time to develop the full system – the document talks about a detailed design phase stretching through 2012 and 2013.

The Government says that it is in principle keen to encourage **demand response** bidding (ie bids to reduce demand at peak times) but it is not clear how well suited the arrangements will be to this task. Framing the auctions round a future delivery date is clearly designed with the construction of supply side options in mind (these normally come on stream in fairly large increments) rather than the development of demand side response, which tends to be gradual and diverse, as large numbers of separate consumers are aggregated into a collective response capacity over time. The paper suggests that secondary markets (ie between the capacity auction and delivery year) might be one way out, but at this stage it is difficult to see how significant or liquid such markets are likely to be and there appears to be nothing in the paper to encourage demand response specifically (though the Government hints that there may be some proposals to come in an electricity systems policy due in 2012).

## Costs and price signals

There is also a large unanswered question in the proposals: exactly how the costs of the new arrangements will be passed through into prices - it is clear that the costs, of both FiTs and Capacity Market, will be passed on by the SO to suppliers, but not how this will be done. There could, for instance, be a simple flat-rate surcharge on each unit, which would be administratively simple and reduce any risk to the SO but would severely blunt any price signals; this could be very harmful in economic terms as intermittent sources increase their market share and the costs of peaking and reserve capacity grow in proportion. There is an obvious case for dynamic pricing of some sort to encourage demand response; indeed, this is referred to in the paper, but in an oddly off-hand and non-committal fashion. The paper says that "depending on how" capacity costs are allocated, suppliers "may" have an opportunity to reduce their share of these costs by incentivising consumers to avoid peak prices, for example by offering time of use tariffs. It is a bit surprising that the Government does not come off the fence on this important point, or at least open up the options for discussion – this will be a crucial aspect of the future market and it seems unsatisfactory to treat it as a mere incidental.

## Other issues

A large number of other matters are also left for consideration during the detailed design stage – eg encouraging storage, the position of interconnections, application to devolved governments, how the new arrangements fit into the Government's overall public spending framework, and how they relate to European State Aid rules. Perhaps an even bigger question (not raised in the paper) is whether DECC has, or is able to develop, the capacity, particularly in terms of human resources, to make all these major decisions about the operation of the electricity system. It will in effect be the main electricity planning authority for the UK – not a task the Government has traditionally undertaken.

## Interim arrangements

With all these questions outstanding, it is not surprising that the process of detailed design, and securing primary and secondary legislation, is expected to last until at least 2014 (and could easily take longer). If no investment takes place during this period, the Government's environmental and security objectives could both be seriously jeopardised. The paper therefore says that "DECC will enter into discussions with relevant developers with a view to considering what form of comfort might be given to support the taking of" early investment decisions. The idea is sound but what is on offer might not in practice provide much comfort – the paper sets out some relevant characteristics for such projects and invites developers to get in touch with the Government about them, but then adds the caveat: "Potential developers should note that even if DECC agrees that a project has the required characteristics …. this should not be treated as an indication that the Government will offer any comfort in relation to that project or that DECC will commence or continue discussions with the developer….Final decisions on offering any comfort to developers will rest with Ministers". At best, this suggests that the Government has very little idea at this stage what it really wants; at worst, it implies that whatever objective criteria are set, Ministers will end up making decisions on an ad hoc basis – which would increase uncertainty and open the decisions up to legal challenge.

## Conclusions

It is becoming increasingly clear that the electricity market reforms involve a wholesale rewriting of the liberalisation settlement and a venture into an uncertain future. Given the magnitude of the task, it is not surprising that the details are taking a long time to elaborate. However, it is somewhat ironic that the UK, which was one of the pioneers of liberalisation, should now be the first country to start down the path of what might be called "post-liberalisation". As with liberalisation itself, it will be some time before the implications are clear, whether for investors, consumers or the industry. But one thing does seem clear – that in many ways it will involve a reinvention and transformation of DECC itself and a major challenge to UK traditions and practices of governance.