2nd Capacity Market Auction: What can we learn from the Prequalification Results?

Summary
With capacity margins at their lowest levels for a decade, and the Government keen to promote new gas capacity, the outcome of the next capacity auction due in December is eagerly anticipated. The process is well under way, with the updated prequalification results published on 15 October. On the same day, DECC confirmed the final auction parameters. Much like last year, this year’s auction is over-subscribed with about 15GW of capacity set to lose out on capacity agreements.

DECC has also published a consultation document, which proposes tightening the reporting requirements on large scale new build assets. This could have a bearing on the participation of large scale CCGTs in future auctions.

This briefing note analyses the results of the pre-qualification and what it might mean for the auction results.

Details:
In last year’s Capacity Market Auction, DECC procured 49.3GW of de-rated capacity at £19.40/kW for delivery in 2018/19. The auction also brought forward 2.4GW (de-rated) of new build capacity, potentially including a new large scale CCGT at Trafford.

On 15 October, National Grid published the updated public notification of all pre-qualified capacity (subject to appeals to Ofgem). On the same day, DECC confirmed the target capacity to procure at 44.665GW for delivery in 2019/20. These announcements have given us an insight on the possible outcome of the auction due to commence on 8 December:

Excess Supply over Demand
Going into the 2nd Capacity Market auction, there was concern in the market about the effect of interconnector participation on the total supply. However given the de-rating factors applied to interconnectors, the decisions taken by interconnectors, and closures decisions, the excess supply margin over demand is the same as in the last year’s auction of around 33%.

A total of ≈59.2GW has prequalified to deliver the demand of 44.665GW. This means that over 14.5GW of capacity prequalified will miss out on a capacity agreement.

With the margin of supply over demand about the same as last year, it would be reasonable to expect the clearing price to be not that dissimilar to the outcome of the first auction (£19.40/kW).

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New build:
The participation from sub 100MW plants has increased from last year (2.7GW this year vs. 2.3GW last year), while the interest from large scale gas has reduced (5.8GW this year vs. 7.5GW last year).

Most notably, Thorpe Marsh plant’s capacity (owned by the same developer’s as Trafford Power) has halved and Abernedd (SEE’s CCGT) & South Hook CHP plant has decided not participate in this year’s auction.

We note the importance of this year’s auction for Carrington Power Station. Carrington is an ESBI power station due to commission in 2016 eligible to participate as a new-build in the CM but lost out a long-term capacity agreement last year. This is the last auction the plant can apply to secure a long term agreement unless there are delays to commissioning running into next year.

DECC consultation:
In the Capacity Market Consultation Document, DECC has announced its intention to remove the provision of Price Duration Equivalence (PDE) i.e. discounts applied to future clearing prices applicable to new build capacity. The decision on PDE removes the risk of discounts to the clearing price for new build plants in future auctions.

The consultation also seeks to tighten the reporting and credit cover requirements on for new build generating plants. We don’t expect the proposal of increased reporting requirements, or increasing credit requirements, to have an impact on bid strategy. But, if implemented, this could have an impact on the participation from Independent Power Producers in the next auction.

From the Consultation Document, DECC seems concerned about the delivery of large scale new build generating units, tightening the pre-qualification and credit cover requirements for >400MW new build units, proposing that:

- The >400MW new build generating units will be required to present a “finance ability test” at the pre-qualification stage. This requires the applicant to provide evidence on financial commitment from Equity and/or Debt at a “Minimum Acceptable Auction Bid” (minimum clearing price acceptable) for the project.

- The >400 MW new build generating units could face an increasing credit cover requirements between the auction being awarded and the Financial Commitment Milestone (FCM) date from £5/kW to £15/kW based on two Financial Commitment Tests (FCT). At the 1st FCT, 5 months after the applicant is required to provide evidence that 100% of debt and/or 100% of equity has been secured or the credit requirement would increase to £10/kW. Subsequently, at the 2nd FCT, 11 months after the auction, the applicant needs to provide evidence that 100% of stated debt and 100% of equity has been secured or the credit cover could increase up to £15/kW (Figure 3 seeks to illustrate the new arrangements).

In addition, the FCM will be brought forward from 18 month to 16 months after the auction results day for all CMUs. The reporting frequency for all new build will be increased to 3-monthly reports till the Financial Commitment Milestone. This will take effect immediately while other proposed changes will be implemented from the next auction onwards.

Interconnector Participation:
One of the main headlines is that ElecLink (new build interconnector) has chosen not to participate in the T-4 although it aims to be operational by 2017. However, ElecLink should be able to participate in the T-1 auction to secure revenues for the 2019/20 delivery year.

NEMO, new interconnector to Belgium has conditionally pre-qualified providing an additional 540MW of de-rated capacity.

Given de-rating factors of 6% on Moyle and East West Interconnector, the two have chosen to Opt-Out of the Capacity market. The other two existing interconnectors, Britned and IFA have successfully prequalified providing 1.9GW of de-rated capacity.
Opt-Out decisions:

10 GW of capacity has opted-out due to closure. This includes Longannet and Eggborough, which did not get a capacity agreement and has decided to close. A number of these closure decisions will take effect, on current plans, by April 2016.

Existing plants:

The capacity from the existing plants that prequalified (≈49GW) is enough on its own to meet demand requirement. Like last year’s auction we can expect further closures from existing plants that are unsuccessful after the auction. Such closures could improve the prospects for new build in future auctions.

The consultation document does not propose any changes to the design that would significantly affect the bidding behaviour of existing plants in the current auction, but does propose a number of other changes, including:

- Removal of the refurbishing category from future auctions.
- Changes to the Secondary trading to encourage liquidity and competition in the secondary market.
- DECC is seeking view on the timing and the capacity set aside for the T-1 auctions.

DSR Participation:

The DSR participation in the T-4 auction has declined. However, it should be noted that in a parallel process, DECC is holding its first Transitional Arrangement Auction (TA) for delivery in 2016/17 on 26 January 2016. TA have been put in place for the interim period to ensure that demand-side capabilities are fully utilised— and to encourage more DSRs to participate. This will help bring to light the true potential and costs associated with DSR.

The pre-qualification window for auction has also concluded where ≈1600MW of DSR (964MW) and generation units (636MW) have pre-qualified or conditionally prequalified to meet the demand of 900MW of demand. The initial demand was set at 1500MW but the Secretary of State reduced the demand to encourage liquidity in the market and ensure best value for money.

This the first market-wide auction allowing for DSR participation. The main players in the DSR (946MW) in the auction are Kiwi Power and EnerNOC from an aggregator point of view while Tata Steel has bid 4 of its manufacturing sites into the auction. We have noticed the Big 6 players playing the role of aggregators, with the participation from EdF and E.On.

Depending on the clearing price we see a trend from more energy companies to introduce DSR-type products for its customers. It is the first step to drive further investment in a consumer-led model for the energy market.

Overall, it remains to be seen whether the 2nd Capacity Market auction is successful in bringing forward new CCGT build. Whatever the outcome of the next auction, the Government will no doubt be seeking to assess whether the design of the Capacity Market is right for bringing forward new CCGTs in the future.

While the October 2015 Consultation does not have any direct impact on the results on this year’s auction, the strict proposed reporting requirements could have impact on the participation from large scale CCGTs in future auctions.