



Capacity Market Consultation on proposals to improve security of supply and align with net zero (Phase 2) and call for evidence on Ten-year Review

Open Consultation Response from Mercia Power, Ltd

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Mercia Power, Ltd welcomes the opportunity from DESNZ to respond to this consultation on the Capacity Market.

Mercia Power operates Capacity Market contracted reciprocating gas generating engines (gensets) in the power response market. Our engines run intermittently when demand for power is higher than generation, typically when wind and solar generation is low. The current fuel source for our engines is natural gas. We are beginning to explore the future role of Hydrogen to decarbonise our fleet while ensuring energy security in Great Britain. As a Capacity Provider (CP) who has participated since inception, we can offer a unique perspective on the changes being considered and hope that this can prove valuable in the evolution of the CM.

We are pleased to see the direction of travel from the first CM consultation that was issued in early 2023. For Part A, we generally agree with the issues raised, but would also highlight that the core principle of the CM needs to focus on Security of Supply. Rather than over complicate the wholesale market, it would be best to utilise existing mechanisms (such as the UK ETS) to help drive the transition to Net Zero. One specific point we would like to raise in this response is around incentivising and enabling CPs to decarbonise. For example, we currently run our engines on natural gas, but are exploring how we may convert our plant to run on hydrogen in the future. From our experience of the CM, there are currently no provisions that would clearly allow this transition under our existing contracts.

For Part B, we welcome the review of the how the CM has performed and have highlighted our experience in the response to specific questions, namely around the administrative burden of the prequalification process and around how alignment to Net Zero is being rolled out. Furthermore, the assessment from the Technopolis review was a holistic view of the status of the CM. We broadly agree with the analysis that the CM has historically achieved its objectives, but a serious consideration of futureproofing how this mechanism works going forward is needed. We understand that this will also be a big part of the upcoming REMA work, expected soon.

Thank you again for the opportunity to voice our view on this consultation and we look forward to the response.

Responses to Individual Questions

Part A: Consultation on proposals to improve security of supply and align with net zero.

Questions on Chapter 5

1. *Do you agree with the proposed changes to the timelines for ESC Volume Ve-allocation activities and the Volume Re-allocation window? Are there any unintended consequences of these changes?*

This is not an aspect that Mercia Power have had to use as part of the CM, so we do not have an opinion on this.

2. *Do you have any comments on supporting changes to other settlement activities that may be required following the changes to Regulation 41(2)? Do you have any comments on the correction to Regulation references in Rule 10.5?*

This seems like a sensible approach, no additional comments to add.

3. *Do you agree with the proposed temporary rule change to operational requirements for Existing Generating CMUs which are mothballed? Does this proposal create any unintended consequences?*

Yes, we agree, this is a sensible approach.

4. *Do you agree with the proposed amendment to Regulation 50 so that it aligns with the policy intent and CM Rules, in that failure to meet EPTs are to be treated in the same ways as failure to meet SPDs across suspension of payments? Does the proposed amendment have any unintended consequences?*

Yes, we agree, this is a sensible approach to align rules and regulations. However, we would note that there could be unintended consequences of further changes to an already complex document and adding unnecessary confusion and uncertainty. A solution to this would be to provide a redlined document to clearly show any amendments being made.

5. *Do you agree with the proposed amendment to add further detail to Regulation 16 (2) to clarify that that a CMU can only be prequalified where no CfD has been awarded in respect of it, even if the CfD is for a later delivery period, unless the CfD in question has expired or been terminated? Does the proposed amendment have any unintended consequences?*

We align to the Energy UK answer on this question.

Questions on Chapter 6

6. *Do you agree with the proposals that we have put forward to help address barriers faced by storage CMUs in managing battery degradation? Specifically:*
 - *The introduction of a definition of Permitted Augmentation under Rule 4.4.4; and*
 - *Enabling the level of EPT requirement to be appropriately reduced when secondary trading occurs.*

Yes, this proposal makes sense to help enable certainty for Battery Energy Storage Systems in the CM. As highlighted in our introduction, we are also considering converting our natural gas sites to run on hydrogen at some point in the future. A similar mechanism to permitted augmentation to allow for fuel switching within a CM contract might be also useful to consider in future consultations.

7. *Do you foresee any unintended consequences which could arise from the proposals set out in question 6?*

We align to the Energy UK answer on this question.

8. *Do you believe that other supporting changes are required to accommodate the proposals set out in question 6, for example changes to testing arrangements?*

We align to the Energy UK answer on this question.

9. *Noting the considerations outlined in section 6.1 of the consultation, do you have any further comments or concerns regarding the retention of the EPT framework for storage CMUs? Are there any further required changes which have not been identified or considered?*

We align to the Energy UK answer on this question.

10. *Do you have any further views on the proposed 3-year or 9-year agreement proposals?*

We have no further views on the proposed 3-year or 9-year agreement proposals.

11. *Do you agree with the proposed introduction of Declared Long Stops, both 12- and 24-month options, to accommodate low carbon projects with long build times in the CM?*

While we support the introduction of Declared Long Stops, we would challenge why these would be limited to low carbon technologies only. The universal issue with delays currently is access to grid connections, which are a significant challenge to any CM participant. Limiting this benefit to only low carbon technologies could compromise the other goals of the CM, specifically energy security that is cost effective for the end consumer. There are other levers in the wider energy market that incentivise low carbon technologies, so it may not be needed in the CM.

12. *Does the option to declare a (12-month) Long Stop Date provide developers with any benefits versus relying on the existing Long Stop Date process?*

This should be available to all auctions and all CM participants.

13. *Does a Declared Additional (24-month) Long Stop Date, Rule 6.7.7 (if applicable) and the existing 120 working days from a Notice of Intention to Terminate provide sufficient time for slippage, and if not, what would be an appropriate amount of time which would need to be considered?*

Given the current situation with grid connection timelines, it is difficult to know if this is sufficient time.

14. *Do you foresee any unintended consequences which could arise from the introduction of the declared long stop dates?*

A key unintended consequence, if these declared long stop dates are focused on low carbon technologies only, could be a compromise of the other two objectives of the CM, namely security of supply and cost effectiveness for the consumer.

15. *Do you agree with the proposed eligibility criteria for CMU's seeking to utilise the Declared Additional (24-month) Long Stop?*

No, we do not agree with the CM taking a step away from a technology neutral stance. Please see our response to Questions 11, 12 and 14.

16. *Do you agree with the proposed operational conditions for a Declared Additional (24-month) Long Stop?*

Yes, the proposed operational conditions make sense.

17. *Do you have views on the relationship between a CMU utilising the Declared Additional (24-month) Long-Stop and its role as Price Maker versus Price Taker in the CM auction(s)?*

Yes, there could potentially be an unintended consequence where a CMU is unable to deliver in the first year of a T-4 agreement but is still a price setter for that year and artificially brings the price down for other CMUs by taking up capacity that others would have to deliver. An alternative may be to introduce a longer auction (such as T-6) so that those with longer lead times could have better certainty.

18. *Are there any further required changes for the implementation of a Declared Additional (24 month) Long-Stop which have not been identified?*

No additional comment.

19. *Do you agree with the proposal for partial redaction of addresses on the CM registers for domestic DSR CMU components?*

This does not impact Mercia Power, however it does make sense for the wider CM.

20. *Do you agree with our proposed changes to component reallocation? If so, what percentage do you propose would be appropriate to set as the new limit?*

We agree with the alignment to GDPR. We do not think there needs to be a limit, however, as the core issue seems to be around IT infrastructure to manage component reallocation. The focus should be on ensuring this infrastructure is fit for purpose.

21. *Do you agree with the above proposed changes to the Extended Years Criteria? Are there any unintended consequences of these changes?*

Yes, we agree this is good to clarify.

22. *What are your views on the creation of new GTCs for DSR and which new classes should be created? Please provide evidence to support your response.*

We have no opinion on this.

Questions on Chapter 7

23. *Do you have any comments or concerns regarding our proposal to publish the fossil fuel emissions data (as stated above), disclosed in the Fossil Fuel Emissions Declaration on the Capacity Market Register?*

While Mercia Power supports the need to get to Net Zero, this seems like an extra administrative burden and a policy drift for the CM. Emissions data is already reported to both the Environment Agency and the UK ETS and therefore this can be linked if required. We would not be in favour of this if it required any additional administrative burden to our current emissions reporting.

Part B: Ten-year Review call for evidence

Questions on Chapter 12

1. To what extent, how and why has the CM been contributing to its intended objectives?

The objectives of the CM, as set out in its original impact assessment, are:

- *Security of Supply: to incentivise sufficient investment in capacity to ensure security of electricity supply.*
- *Cost-effectiveness: to implement changes at minimum cost to consumers*
- *Avoid unintended consequences: to minimise design risks and complement the decarbonisation agenda.*

Overall, until recent years, the CM has done a successful job in achieving the above objectives. However, we would highlight that in the last two auctions, the strike price has greatly increased. Some of this was due to external influences outside the control of the UK (such as the Russian invasion of Ukraine), however, this is also due to increasing uncertainty in the wider UK wholesale energy market.

In our view, this is partially because the scope of the CM has widened beyond the above objectives and focused more intently on achieving Net Zero. Unfortunately, this is starting to look as if it will come at the expense of security of supply and cost-effectiveness to the consumer. The cost of the CM to the consumer has tripled in the last two years because of a divergence of core objectives. There are other strong mechanisms in place to help incentivise and achieve Net Zero in the electricity system. It is critical to keep the CM focused on security of supply, in a cost-effective way, because ultimately it is this focus on ensuring a reliable and affordable energy system that will enable the overall energy transition.

2. How have the different elements of the CM achieved the objectives above?

We have considered the different elements of the CM in the table below:

Element of CM	Mercia Power Comments
1. Auction design	Mercia's experience with the auction design would indicate that this element of the CM is working to help achieve the overall CM objectives.
2. Parameter setting	<p>Historically, these have achieved the objectives of the CM, however it will be important to adapt this element of the CM for the future to ensure it continues to meet the objectives of the CM.</p> <p>For example, there is currently no mechanism should our gas reciprocating engines wish to switch to Hydrogen to update/amend this. (This is also a challenge for the agreement management element). While Hydrogen is not currently available, this will have to be a consideration for the future if it does become an option for CMUs.</p> <p>Additionally, we would challenge the inclusion of wind and solar technologies in the CM at all, though they are heavily de-rated, they still are not technologies that necessarily satisfy the core objective of security of supply.</p> <p>Finally, we would suggest that the size limitations might be lowered from 1 MW, as to allow new and more distributed entrants in the CM – this could potentially help</p>

	to both diversify suppliers and introduce a level of competition to bring costs down, addressing all the objectives of the CM.
3. Agreement management	<p>Whilst the CM has had good historic success in maintaining security of supply, we would express that this is in spite and not because of this element.</p> <p>We would also express, from our perspective, that this element fails from a cost effectiveness perspective, as well as a reduction of risk.</p> <p>The entire experience to pre-qualify and manage a contract is clunky and onerous. This makes it difficult for new entrants, potentially with more cost-effective technologies or processes, to enter the CM.</p> <p>The pre-qualification process is repetitive and labour intensive. The appeal dispute process (for issues like typos) is unnecessarily onerous. It would be helpful for the EMR team to have some further degree of autonomy to correct minor issues with applicants in the pre-qual period.</p> <p>The new portal system has been delayed for several years now and there is concern among the industry that when it does come online, it might no longer be fit for purpose.</p> <p>If ITE approval is brought into this element of the CM, it would add cost and administrative burden for CM providers.</p> <p>Some of these issues could be solved by specific points of contact/customer team for CM providers in the EMR team.</p>
4. Penalty system	We have not yet had experience with this element of the CM directly, but from our understanding, it seems to be an element that is achieving the core objectives.
5. Termination fees	We have not yet had experience with this element of the CM directly, but from our understanding, it seems to be an element that is achieving the core objectives.

*3. To what extent would you agree that over the last 5 years the CM has achieved these objectives?
Please supply as much evidence as possible to support your answer.*

Broadly, we agree that the CM has achieved the above objectives over the last 5 years. However, as we outlined in our response to Question 1, the last two years has seen increasing expense to the CM, which challenges particularly the cost effectiveness of the CM. This seems to be down to several reasons, some out of control, such as Russia’s invasion of Ukraine and the effect this has had on global energy prices. However, other reasons that can be influenced seem to be impacting this deviation from the core objectives, namely increased uncertainty for CM providers. This uncertainty stems from know what will be implemented in terms of reaching Net Zero and how it impacts how the CM operates. It also seems like increased strike prices are partially being influenced by the high derating factor for batteries, that need higher prices to be profitable.

4. Have these objectives been equally achieved or has the CM performed better against some objectives than others, and if so, what are the main reasons for your view?

In terms of the security of supply, the CM has delivered fully, however, as discussed in our answers to Questions 1 and 3, the objectives around cost effectiveness and avoiding unintended consequences to reach

net zero we would say have been less achieved. We would point to the increased prices in recent years, as well as the reduction of CM providers due to uncertainty of the future of the CM. These recent impacts could subsequently negatively affect the security of supply the CM is intended to provide.

5. Do you agree that the objectives of the CM are still appropriate?

Given the current trends in energy, the key objective of Security of Supply that is most cost effective to the consumer is still a very relevant objective, perhaps even more so than when the CM was first implemented.

6. To what extent do existing delivery assurance mechanisms in the CM achieve the CM's objective of ensuring security of supply?

Pointing to the overall outcomes of the CM, where there has never been a System Stress Event, it is easy to conclude that these mechanisms are driving the behaviours that help to achieve the CM's objective here. However, there is a risk that future years may struggle, depending on the proportion of intermittent generation (such as wind) that is allowed in and the softening of rules to accommodate these technologies.

7. To what extent has the CM incentivised sufficient investment in capacity to ensure security of electricity supply?

Looking historically from its inception, the CM has adequately incentivised new capacity. However, more recent trends in new capacity should be monitored to ensure that this continues to be the case. We are concerned that recent uncertainty, particularly in the regulation of the CM and wider wholesale market, will lead to a lack of investment that could be problematic in the future.

8. What are your views on the resilience of the CM to both longer term and shorter-term energy trends?

The CM so far has been resilient to energy shocks of the past 2-3 years. However, depending on how future changes are implemented, this resilience could be eroded. Please also see our answers to Questions 1 and 3.

9. To what extent does the CM reduce the cost of capital and investment risks for CM participants?

The CM has helped to underpin investment cases and attract affordable forms of funding for projects. Unfortunately, other external forces, namely continued regulation uncertainty across the wider energy market, such as REMA, SCR and the Windfall tax, has offset this benefit in recent years.

10. To what extent would you agree with the above statement that low clearing prices signal the scheme's cost effectiveness when compared to the value of lost load?

This has generally worked well for the CM, until the last two years. What seems to be happening now is that the high de-rating factor for BESS is influencing the clearing price, driving the cost of the CM up. Previously, gas generation, derated at approximately 5%, was the price setter, but now that BESS are needing stronger business cases and are dealing with derating factors of approximately 85%, this is causing distortions.

11. What are your views on the effectiveness of the controls and delivery assurance frameworks within the CM to mitigate against gaming and the potential abuse of market power?

From our experience, these frameworks appear to be effective.

12. Are there distortions in the interaction of the various markets (wholesale, ancillary, CM), or their charging arrangements, which impact the effectiveness of the CM?

Our experience is that distortions are a normal part of the market, however their cause should be understood if they are to be managed properly. (See response to Q11 on the derating factors of BESS). However, the CM's key objective of Security of Supply at the most cost-effective point should be central to any consideration of how it operates, and the risks of scope creep should be appropriately considered.

13. What are your views on the effectiveness and operation of the existing rules within the CM to support the transition to net zero? (You may want to consider emissions limits, and barriers faced by low carbon technology in accessing the CM). Please provide evidence to justify your answer.

While we fully support the transition to Net Zero and are working with our own company towards these goals, our view is that the CM is not the right mechanism to focus on achieving Net Zero. There are other mechanisms in the wholesale market, such as CfDs and the UK ETS, that are working to achieve this and have been also very effective in driving the right behaviour in recent years to decarbonise the GB Electricity System. Simplicity in the transition is better than complexity for many reasons. It allows a variety of market entrants, such as SMEs and start-ups to participate and drive competition and innovation. Additionally, Security of Supply and Affordability are two other key issues that need to be considered. Solutions that consider these three objectives (the Energy Trilemma) will create a more sustainable solution overall that benefits everyone.

14. Are there any other improvements to the CM that would help support the transition to net zero? Please provide evidence to justify your answer.

The CM staying technology neutral and focussed on Security of Supply should be ultimately the core objective. However, one key blocker we have discovered recently is in our ability to change the fuel of our engines, which currently run on natural gas. If we wanted to switch to a lower carbon fuel, such as Hydrogen, there is currently no mechanism we can find in the CM that would allow us to amend our current contracts. Allowing this level of flexibility overall could drive the right incentives for businesses to be able to build a case to transition in the coming decades, whilst still ensuring Security of Supply.

15. To what extent do the current institutional arrangements support an effective change process? Please provide suggestions on how issues with governance arrangements can be addressed and evidence to support your views.

We do not have much experience with the change process in the CM, so do not have a position on how the current institutional arrangements support this.

16. To what extent do the defined and allocated roles and responsibilities support effective administration and delivery of the annual CM prequalification, delivery, and payment processes? Please provide suggestions on how any issues can be addressed and evidence to support your views.

Our current experience of the administration and delivery aspects of these CM processes were presented in further detail in our response to Question 2. Overall, the process can be fairly complex and onerous and anything that can be done to simplify the overall process, particularly for prequalification, would be welcome.

17. Please provide any suggestions you have for improving the management of fraud and error risk in the CM.

We have no suggestions for this question.

18. Considering new, higher risk technologies coming into the CM, does the continued policy intention for secondary trading set out above remain appropriate? If not, why not? Please explain your reasoning.

Increasing the liquidity of secondary trading seems like a sensible course of action. It could help to de-risk the new technologies coming into the CM and could also help to drive costs down.

19. Are there any further issues on secondary trading that you feel cannot be addressed through CMAG and Ofgem, as they may require significant policy, rules or regulation change? If so, what are these issues and why do you feel they need to be addressed? Please explain your reasoning.

No further issues to be raised on this issue.

20. What are your views on the findings of the Technopolis evaluation and independent research?

The Technopolis evaluation clearly presents the variety of views on key issues in the CM. We agree that the CM is a complex mechanism in a wider wholesale market and many aspects must be balanced and considered. From our perspective, there were some specific findings that resonated with us in the report that are worth highlighting:

- 1. Process Evaluation:** We agree with the findings that the overall auction design is delivering the expected results for the DM. However, we are also experiencing challenges with the Prequalification and Application parts of the process, which are overly onerous. There are perhaps some quick wins in accelerating a new portal and doing some process mapping to improve the overall experience for all stakeholders.
- 2. Impact Evaluation:** We also agree that the CM has delivered requirements, leading to no SSE thus far and avoiding unintended consequences. However, we do have a concern, as expressed in some of the feedback in the report, that the misalignment between the CM and Net Zero presents significant risk. Aspects like the derating factors for batteries erode the business case for these technologies. We are generally of the opinion that of some CMA holders that it is better to keep the CM simple and technology neutral whilst leveraging existing decarbonisation mechanisms (such as the UK ETS) to drive overall behaviour.

21. Do you have any further views based on your experience of the CM's performance, particularly in the last five years but also since its implementation, that we should consider in the context of the Ten-year Review?

We would strongly reiterate our point from Question 20 about the need to simplify rules and maintain focus on the core objective of the CM to provide Security of Supply in the most cost-effective way to the consumer.

22. Please provide suggestions on how any issues raised in the report can be addressed and provide evidence to support your views.

There are three main areas to offer suggestions on improvement of issues:

- 1. Look at ways to incentivise technology evolution** – To help incentivise low-carbon technologies, there needs to be a mechanism to allow for high-carbon technologies, to upgrade their technology within existing contracts. For example, we could switch to hydrogen engines from natural gas ones, or convert our generation to other technologies, but there is no way currently to do this in our existing contracts.

2. **Improve the administrative process**- Particularly around the prequalification process. Look at doing some customer experience process mapping to see how this can be made easier for all stakeholders.
3. **Establish and stick to clear objectives for the CM** – Noting that the CM is a singular mechanism in a wider wholesale market, think about how it ensures Security of Supply at the best value to the consumer. Utilise other existing mechanisms to drive market behaviour for Net Zero and consider the interactions between those mechanisms and the CPs.