

# Fundamental Market Reform?

**THE CARBON  
CATALYSTS  
GROUP**

**December  
2010**

Fundamental reform of the electricity market has been promised for some time. In view of changes already proposed, it has always been puzzling what fundamental reform could possibly amount to. Now we know - both DECC and the Treasury have published consultation papers setting out the details.

**A NEW FOSSIL FUEL LEVY** will 'top up' the costs of EU ETS Allowances (ERUs) incrementally from implementation until a long-term carbon price is reached at a level that has yet to be determined. The intention is to increase the costs of fossil-fuel generation, making other forms of generation comparatively more attractive.

If the cost of ERUs rises, as expected, the level of fossil-fuel top up needed will be lower. But there is a very large gap between ERU prices now and where nuclear investors say they must be. The UK-directed 'hit' for its fossil-fuel plants will be substantive.

(Chris Huhne periodically claims that the fossil fuel levy is not a subsidy for nuclear plant because it benefits all renewable plant and creates a level playing field. In saying this, he overlooks the fact that the UK has specifically directed subsidies for renewable plant which are intended to be strengthened by this government and not removed to be replaced by this levy.)

The levy is planned to take effect in April 2013.

**A NEW EMISSIONS PERFORMANCE STANDARD** will underscore the hit on coal plant already made by the new fossil fuel levy. In addition to the levy, it is proposed to impose a total (and presumably steadily decreasing) limit on carbon emissions by coal plant.

**A NEW FEED-IN TARIFF** will replace the Renewables Obligation. The proposal is not surprising: we have long known that FIT schemes are far more effective than the RO.

The government's preference is for a FIT combined with a contract for differences. The generator sells at market

price and receives as subsidy the difference between that price and a pre-determined subsidy rate.

There are 'design' difficulties with this option so two other forms of FIT are outlined. The obvious safe choice is the form of the FIT currently in place.

**A NEW LOW-CARBON OBLIGATION** will be imposed on suppliers. This effectively extends the "Renewables Obligation to nuclear and CCS". To ensure targets are reached, the obligation will have to involve some kind of banding to incentive renewable (as against nuclear) plant.

**CAPACITY PAYMENTS** will be introduced to incentive construction of flexible reserve generation. So central planning is to take over from the market. The level of generation margin will, government believes, not be sufficient if left to the market, so it intends to introduce rules to ensure that there is as much generation margin as it decides it wants.

Questions about the form of the capacity payment (who gets it, for what and who administers it) are apparently up for grabs. But I don't expect many will take bets against National Grid being the scheme's henchman.

Final DECC proposals will be issued in a White Paper late next spring; and changes will be implemented before the end of this Parliament.

Much of this, including the Treasury's levy proposals, is very like what was on the table during the last government. The real departures from that policy are replacement of the RO by a FIT (something the last government should have contemplated and which it simply failed to do) and centrally controlling - and maintaining - generation capacity margin.

This last may yet prove to be fundamental by virtue of knock-on effects on the pricing that emerges from the balancing mechanism and on market dynamics.