

EXPLANATORY MEMORANDUM TO
THE ELECTRICITY CAPACITY (AMENDMENT) REGULATIONS 2017
2017 No. [XXXX]

1. Introduction

- 1.1 This explanatory memorandum has been prepared by the Department for Business, Energy and Industrial Strategy and is laid before Parliament by Command of Her Majesty.
- 1.2 This memorandum contains information for the Joint Committee on Statutory Instruments.

2. Purpose of the instrument

- 2.1 This instrument:
- amends the Electricity Capacity Regulations 2014 (S.I. 2014/2043) (“the Principal Regulations”) in various respects. In particular, it clarifies regulations on credit cover, ensures consistent usage of de-rated capacity; amends the name, but not the substance, of current capacity market warnings and makes provision for deductions from the amount of credit payable to a capacity provider of a prospective Capacity Market Unit (“CMU”) where expenditure incurred in respect of the CMU has been funded through certain risk finance schemes.
 - amends the Electricity Capacity (Supplier Payment etc.) Regulations 2014 (S.I. 2014/3354) (“the Supplier Payment Regulations”) so that certain calculations will be based on gross demand instead of net demand from 2018 onwards.

3. Matters of special interest to Parliament

Matters of special interest to the Joint Committee on Statutory Instruments

- 3.1 The Capacity Market (“CM”) was implemented by the Principal Regulations, the Supplier Payment Regulations and the Capacity Market Rules 2014 (“the Rules”). Together, those instruments establish and govern the CM, which is designed to ensure that sufficient capacity is available to ensure security of electricity supply. The CM enables certain, regular payments to be made to capacity providers, in return for which those providers must be available and produce electricity (or reduce demand for electricity) when asked to do so. These rights and obligations comprise CM agreements. Compliance with certain CM obligations is secured through the provision of financial collateral (known as credit cover) and through provision for the termination of CM agreements with associated termination fees.
- 3.2 These Regulations come into force on the day after the day on which they are made¹. This is to ensure that they are in effect as far ahead as possible of the first stage, prequalification, in the process for the capacity auctions that will happen in winter 2017/18. This is intended to give participants certainty about the legal framework for

¹ With the exception that the changes in relation to the Supplier Payment Regulations (Regulations 3, 4(2) and (3) and Schedule 2) do not come into force until 1st January 2018.

the auctions and allow participants time to familiarise themselves with the detail of the new legislation. The underlying policy has been the subject of consultation, as described in section 8 below.

Other matters of interest to the House of Commons

- 3.3 Disregarding minor or consequential changes, the territorial application of this instrument includes Scotland.

4. Legislative Context

- 4.1 The Energy Act 2013 contains powers enabling the Secretary of State to implement measures to reform the electricity market to encourage low carbon electricity generation and ensure security of supply. The reforms which have been implemented are known as Electricity Market Reform (EMR).
- 4.2 The two main mechanisms for reform are the Contract for Difference (CfD) and CM. These Regulations are concerned only with the CM. A total of five CM auctions have taken place since 2014 including the first of two Transitional Arrangement (TA) auctions, in support of Demand Side Response (DSR) and a Supplementary Capacity Auction (SCA) relating to 2017/18 delivery.
- 4.3 These Regulations make various changes to the Principal Regulations to:
- clarify the drafting relating to the requirement to maintain applicant credit cover and correct an unintended double liability on capacity providers;
 - reflect changes to the de-rating arrangements DSR CMUs;
 - amend the name, but not the substance, of the current capacity market warning to avoid any possible confusion;
 - make provision, through changes to the payment mechanics, for the settlement body to make deductions from the amount of credit payable to a capacity provider of a prospective CMU where expenditure incurred in respect of the CMU has been funded through certain risk finance schemes.
- 4.4 In addition, they also make changes to the Supplier Payment Regulations to allow for the capacity market supplier charge and settlements costs levy to be collected based on “gross demand” instead of “net demand” in relation to delivery years and financial years from 2018 onwards.
- 4.5 Some elements of this package also require consequential changes to the Rules, which will be made and laid before Parliament in accordance with section 41 of the Energy Act 2013.

5. Extent and Territorial Application

- 5.1 The extent of this instrument is Great Britain.
- 5.2 The territorial application of this instrument is Great Britain.

6. European Convention on Human Rights

- 6.1 Jesse Norman, Parliamentary Under Secretary of State at the Department for Business, Energy and Industrial Strategy, has made the following statement regarding Human Rights:

“In my view the provisions of the Electricity Capacity (Amendment) Regulations 2017 are compatible with the Convention rights.”

7. Policy background

- 7.1 The CM has been established to meet the objectives of:
- incentivising sufficient capacity to ensure security of electricity supply; and
 - implementing changes at minimum cost to consumers.
- 7.2 The CM is designed to achieve these objectives by incentivising investment in new capacity and getting the best out of existing assets by offering all capacity providers (new and existing power stations, electricity storage and capacity provided by voluntary demand reductions) the opportunity to participate in capacity auctions.

Calculating the capacity market supplier charge and settlement costs levy based on gross demand

- 7.3 From the first capacity delivery year, the costs of the CM will be levied on electricity suppliers according to the supplier's share of total demand at peak times over winter. The basic principle is that those who use more electricity should pay more of the costs of ensuring that electricity is available, and this is measured by the demand that they place on the transmission grid i.e. their net demand.
- 7.4 Under these arrangements, suppliers can contract to obtain some electricity not from larger generators connected to the transmission grid but from 'embedded' generators (i.e. smaller generators connected to the lower voltage distribution network). By meeting some of their needs this way, the suppliers reduce the 'net' demand they place on the transmission grid and thus pay a reduced share of the CM costs – with other suppliers that contract with embedded generators to a lesser extent having to pay more. It is expected that suppliers will pass on most of this saving to the embedded generator.
- 7.5 These arrangements could unintentionally lead to embedded generators receiving double payment for what is really only one contribution to security of supply – they could receive payment both for providing capacity through the CM, and for “reducing” electricity demand on the grid, via their contracts with suppliers. This could potentially give them a competitive advantage and distort the outcome of CM auctions.
- 7.6 This instrument addresses the issue by amending the basis of the CM supplier settlement calculations from net- to gross- demand so that suppliers' costs are calculated on the basis of the demand they place on both the transmission and distribution networks.

Clarifications to credit cover requirements and removal of unintended double liability

- 7.7 Provisions within the Principal Regulations specify the period for which applicant credit cover must be maintained and when the Settlement Body should draw down this applicant credit cover. However, these do not currently cover all the scenarios under which credit cover has or must be lodged. This instrument clarifies the requirement to maintain credit cover until a CMU has fully discharged all of the Financial Commitment Milestone and connection agreement requirements against which it has been lodged and for which a failure to meet would otherwise trigger a termination event.

- 7.8 In addition, it has emerged that circumstances may align to place an unintended double liability on a party whereby they become liable for their applicant credit cover being drawn down against a date based trigger, whilst also being liable for a termination fee for the same event. The policy intent was that the former would secure against the latter and this instrument addresses this issue.

Changes to de-rating arrangements for DSR

- 7.9 Currently, DSR providers are able to reduce their de-rated prequalification capacity prior to an auction (their 'bid capacity'). However, whilst the prequalification capacity is de-rated, the nominated lower bid capacity is not which reduces the reliability of the capacity secured. This instrument amends the definition of 'DSR bid capacity' to ensure Unproven DSR CMUs are appropriately de-rated.

Capacity market warnings

- 7.10 The System Operator must publish a Capacity Market Warning when triggered by events set out within the Rules. This instrument amends the name of the Capacity Market Warning to that of Capacity Market Notice. The substance of the notice remains unchanged.

Preventing Selective Overcompensation

- 7.11 Risk finance schemes, specifically the Enterprise Investment Scheme (EIS), the Venture Capital Trust (VCT) and the Seed Enterprise Investment Scheme (SEIS) support certain enterprises that might otherwise struggle to access finance. Where investment through risk finance schemes funds capital expenditure on prospective CMUs that also win a capacity agreement, this could put those projects at a competitive advantage. This instrument contains a new Regulation to complete the solution to prevent such overcompensation. The Regulation requires that where a capacity provider of a prospective CMU has funded capital expenditure on the CMU by investment received through risk finance schemes, the amount of that expenditure is deducted from the amount of credit payable to the capacity provider until the total amount of expenditure has been offset. These arrangements will apply to capacity payments from October 2017 onwards.

8. Consultation Outcome

- 8.1 The Government consulted in September 2016 and in October 2016 on proposed changes to the Principal Regulations, the Supplier Payment Regulations and the Rules and posed questions on wider issues of interest to stakeholders.
- 8.2 The September 2016 consultation ran from 26 September to 21 October and the Government response was published on 16 November 2016. This consultation was concerned with a single issue: overcompensation of participants in connection with certain risk finance schemes that have provided tax reliefs to incentivise investment in prospective CMUs. This built on an earlier consultation in March 2016 about how to avoid potential over-compensation and proposals to exclude capacity funded through certain risk finance schemes.
- 8.3 A total of thirteen responses were received, with seven respondents in broad support of the proposal or advocating further action and six respondents generally opposed to the proposal or promoting more limited action. The Government, having considered the responses received, concluded that the proposal set out in the consultation was the

most proportional approach to address the issue of potential overcompensation in the CM. Amendments to the Rules came into effect in November 2016 as the first part of implementing the arrangements set out in the consultation, and apply to capacity agreements awarded in auctions from December 2016 onwards. These Regulation changes complete the arrangements by setting out the payment mechanics, as set out above.

- 8.4 The October 2016 consultation ran from 28 October to 23 December 2016. The Government response was published on 22 March 2017. This consultation focused on a broad range of issues relating to the CM, only some of which would require changes to the Principal or Supplier Payment Regulations: clarifications to credit cover; de-rating arrangements for DSR; amendments to the name of the capacity market warning and changes to the collection of CM supplier charge and settlements costs levy from net to gross. The remaining items consulted on required either no immediate changes or could be implemented through changes to the Rules. These included: setting delivery milestones for T-1 auctions, not implementing any derogations from the requirement to hold connection agreements ahead of T-1 auction prequalification; clarifying the drafting around total spend declaration; amending certain metering provisions; reviewing the position on pre-auction credit cover for unproven DSR and amending specific termination provisions in the CM.
- 8.5 Each of the proposals was supported by a majority of respondents, with the exception of the proposed changes to DSR credit cover requirements, where responses were mixed. The Government, having reviewed the consultation concluded that all proposals, with the exception of the review of DSR credit cover requirements, were appropriate and proportionate and should be implemented. The Government also decided to extend the derogation from the requirement to hold connection agreements ahead of T-1 auction prequalification for one further year.
- 8.6 The Government Response to each consultation sets out full details of the consultation proposals, summaries of the stakeholder responses and explanations of the final policy decisions taken:
- The Government’s response to the September 2016 consultation: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/569551/161116_Selective_overcompensation_in_the_CM_response_letter.pdf
 - The Government’s response to the October 2016 consultation: <https://www.gov.uk/government/consultations/capacity-market-proposals-to-simplify-and-improve-accessibility-in-future-capacity-auctions>

9. Guidance

- 9.1 In 2014 the Government Published “*Implementing EMR*”. This document provided a comprehensive source of information on the final design of EMR ahead of the first CFD allocation and CM auction. The document provided stakeholders with detail on EMR policy decisions and set out the legislative framework for EMR.
- 9.2 In addition, National Grid as the Delivery Body for the CM is required to publish guidelines for each capacity auction (auction guidelines).

10. Impact

- 10.1 In terms of overall societal costs, the Government’s analysis indicates that any impact arising from either the switch to gross-charging or the measures preventing

overcompensation should be broadly neutral, albeit there is likely to be some redistribution of costs across individual suppliers, generators, and consumers. Overall costs could come down as the changes are intended to remove potential distortions in the market and so could lead to more effective competition and more efficient investment and dispatch decisions. If this occurs, any cost savings would likely be passed on to consumers.

- 10.2 The impacts associated with the other changes are expected to be small scale. Generally they are intended to remove potential barriers to competition in the CM by simplifying and improving accessibility.
- 10.3 An assessment of the impacts of the CM changes will be published as an analytical annex to the Government Response:
<https://www.gov.uk/government/consultations/capacity-market-proposals-to-simplify-and-improve-accessibility-in-future-capacity-auctions>

11. Regulating small business

- 11.1 The legislation applies to small business and there are no restrictions on the size of business or organisation participating in the CM.
- 11.2 It is expected that the CM will primarily impact electricity generators which are mostly classed as large businesses, although some capacity providers, particularly those that are embedded generators or DSR providers, may be small or medium sized. It should though be noted that participation in the CM is voluntary, so there will only be an impact on those small businesses that elect to apply and participate in the CM.
- 11.3 Those that do participate will be impacted by the additional administrative costs associated with participation, although these impacts should be mitigated as businesses that do participate, of all sizes, will have a more secure and predictable funding stream. The CM is also expected to reduce barriers to entry to the wider energy market, increasing overall participation.
- 11.4 Electricity suppliers will also be impacted by the CM in that they will be charged the costs of the CM and will need to recover the costs from consumers. The design of the CM and the switch to charging suppliers based on their gross demand should ensure costs are recovered from suppliers in a fair and equitable manner. The additional administrative requirements arising from the CM are likely to have a greater impact on small and medium suppliers.

12. Monitoring & review

- 12.1 The CM addresses fundamental failures in the electricity market, and is therefore expected to be required for at least ten years and for as long as additional capacity remuneration is needed to ensure security of electricity supply.
- 12.2 As the CM is intended to be a transitional measure, regular reviews take place. The first review must be completed within five years of the Principal Regulations coming into force and will lead to the publication of a report which sets out the objectives of the CM, assesses the extent to which these objectives have been achieved and the extent to which they remain appropriate or could be achieved in a way that imposes less regulation.

12.3 Subsequent reviews must be published at intervals not exceeding five years. In addition to the five yearly reviews further informal or ad hoc reviews may be undertaken.

13. Contact

13.1 Simon Dawes at the Department for Business, Energy and Industrial Strategy (Telephone: 0300 068 6079 or email: simon.dawes@beis.gov.uk) can answer any queries regarding the instrument.