

**DRAFT EXPLANATORY MEMORANDUM TO
THE ELECTRICITY CAPACITY REGULATIONS 2014**

2014 No. [XXXX]

1. This explanatory memorandum has been prepared by the Department of Energy and Climate Change and is laid before Parliament by Command of Her Majesty.

This memorandum contains information for the Joint Committee on Statutory Instruments.

2. Purpose of the instrument

2.1 The Electricity Capacity Regulations 2014 establish a Capacity Market which is designed to ensure that sufficient electrical capacity is available to ensure security of electricity supply. The Capacity Market will enable 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.

2.2 This instrument contains provisions about:

- i. The Secretary of State's role, such as how and when the Secretary of State will determine whether to run a capacity auction, as well as providing for the Capacity Market to be implemented and administered by a combination of the Secretary of State, the Gas and Electricity Markets Authority, a Delivery Body (National Grid Electricity Transmission plc) and a Settlement Body (to which position the Secretary of State intends to appoint the Electricity Settlements Company Ltd).
- ii. The process for determining whether a capacity auction is to be held and the auction parameters for a capacity auction.
- iii. Determining eligibility and holding capacity auctions, issuing capacity agreements, establishing and maintaining a register of capacity agreements and terminating a capacity agreement (with further detailed provision about each of these matters to be contained in the Capacity Market Rules 2014 referred to below).
- iv. Payment and settlement provisions.
- v. Dispute resolution and appeals.

3. Matters of special interest to the Joint Committee on Statutory Instruments

3.1 This instrument defines a number of terms as having the meaning given in the Capacity Market Rules 2014 ("the Rules") and, in a few cases, defines terms as having the meaning given in electricity industry codes (documents maintained under licences granted pursuant to section 6 of the Electricity Act 1989). This approach has been taken in cases where terms need to have the same meaning in these Regulations as in the Rules or the relevant code and either (a) the definitions are of a technical nature, or (b) the defined terms are principally used in the Rules and limited references are made to them in this instrument. The persons who will need to

understand the meaning of such terms are principally persons administering, or electing to participate in, the Capacity Market, who will in any event need to know the contents of the Rules as well as this instrument, and are likely already to be familiar with industry codes.

3.2 Part 9 of the Regulations provides that requirements placed on any person other than the Secretary of State, the Gas and Electricity Markets Authority or the Settlement Body under this instrument or the Rules are to be treated as if they were relevant requirements on a regulated person for the purposes of section 25 of the Electricity Act 1989. Therefore, a breach can be treated, in effect, as if it were a breach of a licence condition allowing the enforcement authorities to obtain an order to secure compliance, and/or impose financial penalties.

4. Legislative Context

4.1 The Energy Act 2013 (“the 2013 Act”) makes provision for Electricity Market Reform (EMR), legislating for measures to reform the electricity market to encourage low carbon electricity generation and ensure security of electricity supply.

4.2. The electricity market reforms will be implemented by a suite of secondary legislation and related documents. The suite includes the following:

- Contracts for Difference (Allocation) Regulations 2014
- Contracts for Difference (Definition of Eligible Generator) Regulations 2014
- Contracts for Difference (Standard Terms) Regulations 2014
- Contracts for Difference (Electricity Supplier Obligations) Regulations 2014
- Electricity Market Reform (General) Regulations 2014
- Electricity Capacity Regulations 2014
- Capacity Market Rules 2014
- Modifications to the Transmission Licence of National Grid Electricity Transmission plc. (NGET) which deal with preventing conflicts of interest; and
- Consequential code and licence modifications

4.3. This instrument is being made under powers in sections 27 to 33, 34(3) to (6), 36, 38(a), 40(1) and 63 of the 2013 Act to introduce a Capacity Market as part of the EMR programme to reform the electricity market and to ensure security of electricity supply.

4.4 Alongside this instrument, the Secretary of State will also be making the Capacity Market Rules 2014 (“the Rules”) under powers in section 34 of the 2013 Act, which in combination with this instrument will bring the Capacity Market into force. The Rules will provide the detail for implementing the operating framework set out in this instrument and contain technical and administrative rules and procedures for how the Capacity Market will operate. The Rules are to be laid in draft before both Houses of Parliament for 40 days and are subject to a procedure equivalent to the draft negative procedure for statutory instruments before they can come into force.

4.5 The Secretary of State also intends to make further regulations under Part 2, Chapter 3 of the 2013 Act at a later date, to make provision about certain matters which are not included in this instrument. These are provisions which do not need to

be in force before the commencement of prequalification for the first capacity auction, which the Government intends subject to state aid approval to hold before the end of 2014. The principal matters to be covered by a further instrument are:

- Provision for payment:
 - (a) by electricity suppliers, of charges to fund the making of capacity payments and the Settlement Body's costs of performing its functions (except for the period up to 31st March 2015, for which provision is made in this instrument); and
 - (b) to electricity suppliers, of a share of the amount of capacity provider penalty charges collected by the Settlement Body, after deducting the cost of making over-delivery payments under this instrument;
- Provision for subsequent adjustment of payments ("reconciliation") where further data becomes available to the Settlement Body after payment calculations have been made; and
- Provision for modifications to apply to the payment calculation formulae in Schedule 1 to this instrument in cases where a capacity agreement is traded under the Rules for part of the duration of that agreement.

5. Territorial Extent and Application

5.1 This instrument applies to Great Britain.

6. European Convention on Human Rights

6.1 Michael Fallon, Minister of State at the Department of Energy and Climate Change has made the following statement regarding Human Rights:

6.2 In my view the provisions of the Electricity Capacity Regulations 2014 are compatible with the Convention rights.

7. Policy background

7.1 The Electricity Capacity Regulations 2014 form part of the implementing legislation for the Government's EMR programme which is intended to incentivise investment in secure and low-carbon electricity generation, while improving affordability for consumers.

7.2 EMR is the Government's response to the challenges facing the electricity sector, which include:

- The UK faces very rapid closure of existing capacity as older, more polluting plant go offline;
- The need to transform our generation mix to respond to the challenge of climate change and meet our legally-binding carbon and renewable targets; and
- The expectation that electricity demand will continue to increase over the coming decades.

7.3. These challenges amount to a significant investment challenge, with an estimated £100 billion of further investment needed in the sector up to 2020. Without this intervention the market is unlikely to deliver this investment at the scale or pace required or achieve the diverse generation mix needed to meet the carbon and renewables targets and ensure security of electricity supply.

7.4 As a result, EMR has been designed to deliver two new mechanisms to incentivise the required investment and address market failure; Contracts for Difference (CFDs) and the Capacity Market. This instrument, in combination with the Rules will bring the Capacity Market into force.

7.5 The Capacity Market is being established to meet the objectives of:

- i. Incentivising sufficient capacity to ensure security of supply.
- ii. Implementing changes at minimum cost to consumers.
- iii. Avoiding unintended consequences: minimise design risks and ensure compatibility with other energy market policies.
- iv. Designing a mechanism that can be implemented in time for a first capacity auction in 2014.

7.6 The Capacity Market will achieve these objectives by incentivising investment in new capacity and get 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. The only capacity excluded from participating are those in receipt of low carbon support (e.g. from CFD), those receiving a grant under the NER 300 or a Carbon Capture and Support grant scheme or STOR providers if they do not meet the eligibility criteria included in this instrument.

7.7 Those successful at a capacity auction (“capacity providers”) will then receive a certain, regular payment in return for which capacity providers commit to being available when additional electricity supply is required at times of peak demand. In return for this revenue (“capacity payments”) they must deliver electricity when required or face penalties.

7.8 The majority of capacity providers will be eligible for one year capacity agreements, however, some capacity providers, if they meet certain thresholds contained within this instrument, will be eligible for a capacity agreement of between three and fifteen years in duration.

7.9 The Capacity Market consists of six operational stages:

- i. **Amount of capacity:** where the Secretary of State will decide the amount of capacity for which capacity agreements are to be auctioned. This will be the total amount of capacity needed, with some deductions for capacity which will be on the system, but which does not participate in the Capacity Market.
- ii. **Eligibility and prequalification:** where applicants eligible to offer capacity participate in a prequalification process run by National Grid.

- iii. **Auction:** where applicants who have successfully prequalified enter a competitive central auction also run by National Grid, four years (with a further auction one year) ahead of delivery. Successful bidders are awarded capacity agreements, which provide for a steady payment for capacity in return for a commitment to deliver energy when required in the deliver year(s), or face a penalty.
- iv. **Secondary market:** where, between auction and delivery and in the delivery year(s), participants adjust their position through either financial or physical secondary trading, e.g. to take on a greater or lesser obligation, or if a new build that is facing delays to commissioning can find alternative capacity to meet the temporary shortfall.
- v. **Delivery:** capacity providers receive payment if they provide capacity in the delivery year in periods of system stress. Financial penalties may apply if they do not deliver the amount of energy set out in their capacity agreement.
- vi. **Payment:** the costs of capacity agreements will be met by suppliers. The payments will flow from suppliers, via the settlement body, to providers of capacity. Where penalties are applied to capacity providers, the funds will flow from them, via the settlement body, to suppliers. Much of the detail of this will be set out in Supplier Payment Regulations which will follow this instrument in due course.

7.10 The Capacity Market will operate alongside the electricity market and the existing services National Grid contracts to ensure moment to moment balancing of the system.

7.11 Subject to the affirmative resolution of this instrument and state aid approval, the first capacity auction will take place in December 2014 for delivery of capacity from the winter of 2018/19. In advance of this, two transitional auctions for demand side capacity will be run in 2015 and 2016 to help grow the demand side industry (demand side response – DSR – is a broad term that refers to a range of mechanisms designed to reduce peak demands on the electricity system, potentially delivering a number of benefits including reduced cost of electricity supply) and ensure effective competition between traditional power plants and new forms of capacity.

8. Consultation outcome

8.1 The Capacity Market policy set out in this instrument was subject to an 11-week consultation in October 2013 as part of a consultation on ‘Electricity Market Reform: Consultation on Proposals for Implementation’. Alongside the consultation document, a draft version of this instrument (and the Capacity Market Rules) was also published for stakeholders to provide feedback.

8.2 Consultation events took place during the 11-week consultation period and 123 responses were received to the EMR consultation of which approximately 80 responded to the consultation questions related to the Capacity Market.

8.3. In response to views expressed, the Government simplified the design of the Capacity Market, whilst retaining measures to prevent consumers paying too much,

and to protect against potential market abuse. Government sought to reduce investment risks and costs by increasing the maximum length of capacity agreements for new generating plant from ten to fifteen years, and modifying the rate at which penalty charges apply to capacity providers who do not provide electricity when required, and the level of caps on such charges, underpinned by more rigorous testing requirements.

8.4 A more detailed analysis of the consultation responses and outcome can be found in the Government Response to the consultation published alongside this instrument.

9. **Guidance**

9.1 The Government Response to the consultation informing this and the other instruments set out in paragraph 4.2 have been published to coincide with the laying of regulations in Parliament. The Government Response sets out the views of stakeholders in response to the previously proposed policy positions, and an explanation of the final policy decisions taken.

9.2 Published alongside the Government Response is the *Implementing EMR*. This document is intended to provide a comprehensive source of information on the final design of EMR ahead of the first CFD allocation and Capacity Market auction later this year. The document will provide stakeholders with detail on final EMR policy decisions and set out how these fit within the legislative framework for EMR.

9.3 In addition, National Grid as the Delivery Body for the Capacity Market is required by this instrument to publish guidelines for each capacity auction (auction guidelines).

10. **Impact**

10.1 The costs of capacity agreements will be met by suppliers, with payments flowing from suppliers, via the settlement body, to providers of capacity.

10.2 The Government expects that the Capacity Market to have a limited impact on bills for domestic and industry consumers, as the costs of capacity should be partly offset by a reduction in electricity prices and a reduction in the financing costs for the investment needed in new capacity.

10.3 The impact on small business, charities or voluntary bodies is a possible increase in energy bills, although this cost is partly offset by increased security of electricity supply.

10.4 The impact on the public sector is a possible increase in energy bills, although this cost is partly offset by increased security of electricity supply.

10.5 The key monetised impacts include:

- i. Energy system costs, which include costs from building additional capacity and the associated impacts on fuel and carbon costs. The

impact on energy system costs have a lifetime Price Value (PV) of £0.3 billion. Distributional analysis shows that this cost is largely borne by consumers through electricity bills.

- ii. Business administrative costs have an estimated PV to 2030 of £112 million.
- iii. Institutional costs to procure capacity for the Capacity Market, have an estimated PV to 2030 of £41million.
- iv. Reduced energy unserved, which reduces the likelihood of blackouts and voltage reductions.

10.6 An Impact Assessment for the Capacity Market is attached to this memorandum and will be published alongside this Explanatory Memorandum on the legislation.gov.uk website.

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 Capacity Market.

11.2 It is expected that the Capacity Market will primarily impact electricity generators which are mostly classed as large businesses, although some capacity providers, particularly those that are DSR providers, may be small or medium sized. It should though be noted that participation in the Capacity Market is voluntary, so (with the exception of indirectly facing a limited increase in electricity bills noted in section 10) there will only be an impact on those small businesses that elect to apply and participate in the Capacity Market.

11.3 Those that do participate will be impacted by the additional administrative costs associated with participation, although these impacts should be mitigated as business that do participate, of all size, will have a more secure and predictable funding stream. The Capacity Market is also expected to reduce barriers to entry, increasing participation.

11.4 Electricity suppliers will also be impacted by the Capacity Market in that they will be charged the costs of a Capacity Market and will need to recover the costs from consumers. The design of the Capacity Market should minimise any adverse impacts on the financial flows of suppliers but the additional administrative requirements are likely to have a greater impact on small and medium suppliers.

12. Monitoring and review

12.1 While the Capacity Market is not intended to be a permanent measure, it does address fundamental failures in the electricity market, and is therefore expected to be required for at least ten years once implemented and for as long as additional capacity remuneration is needed to ensure security of electricity supply.

12.2 As the Capacity Market is intended to be a transitional measure, regular reviews of the Capacity Market will take place. Provision for this is included in this instrument and means that the Secretary of State must review the Electricity Capacity Regulations 2014 and the functions that have been conferred on Ofgem by the

Capacity Market Rules 2014 and any subsequent updates to this instrument and / or the Rules.

12.3 The first review must be completed within five years of this instrument coming into force and will lead to the publication of a report which sets out the objectives of the Capacity Market, 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.

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

13. Contact

Will Lochhead at the Department of Energy and Climate Change Tel: 0300 068 2912 or email: will.lochhead@decc.gsi.gov.uk can answer any queries regarding the instrument.