EXPLANATORY MEMORANDUM TO

THE ELECTRICITY CAPACITY (AMENDMENT) REGULATIONS 2016

2016 No. [XXXX]

1. Introduction

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

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 establishes an additional Capacity Market auction (the Supplementary Capacity Auction) for delivery in 2017/18; increases termination fees and credit cover payable under the Capacity Market scheme; makes provision in relation to the transfer of Capacity Market obligations; and makes a number of other amendments, including in relation to the second Capacity Market transitional auction; and
- makes various minor amendments to the Electricity Capacity (Supplier Payment etc.) Regulations 2014 (S.I. 2014/3354) ("the Supplier Payment Regulations").

3. Matters of special interest to Parliament

Matters of special interest to the Joint Committee on Statutory Instruments

3.1 The Capacity Market 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 Capacity Market, which is designed to ensure that sufficient capacity is available to ensure security of electricity supply. The Capacity Market 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 Capacity Market agreements. Compliance with certain Capacity Market obligations is secured through the provision of financial collateral (known as credit cover) and through provision for the termination of Capacity Market agreements with associated termination fees. The circumstances in which termination fees are payable and which fee level is payable are set out in the Rules and the fees payable at each level are provided for in the Principal Regulations. Following consultation on proposals to enhance the arrangements to secure compliance with Capacity Market obligations, the termination fee levels and credit cover obligations in the Principal Regulations are increased in certain cases by Part 2 of Schedule 1 to these Regulations.

3.2 These Regulations come into force on the day after the day on which they are made. This is to ensure that they are in effect as far ahead as possible of the first stage in the process for the capacity auctions that will happen in winter 2016/17, which is the prequalification process. This is intended to give participants certainty about the legal framework for 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 – the Contract for Difference (CfD) and Capacity Market – are now operational. These Regulations are concerned only with the Capacity Market. The first two auctions for Capacity Market agreements took place in 2014 and 2015 and the first of two demand side response transitional arrangements auctions within the Capacity Market scheme took place at the beginning of 2016.

4.3 These Regulations make various changes to the Principal Regulations to:

- make provision for the Supplementary Capacity Auction for delivery in 2017/18;
- ensure that Capacity Market obligations are met;
- facilitate the trading of Capacity Market obligations;
- reduce the class of participants eligible to take part in the second of two demand side response transitional arrangements auctions;
- align existing requirements to review Capacity Market legislation (which mirror those placed on regulations affecting business) with the requirements in the Small Business, Enterprise and Employment Act 2015 which had effect from 1st July 2015; and
- make miscellaneous and minor amendments, including in relation to the process by which parameters for Capacity Market auctions are set.

4.4 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 after the coming into force of these Regulations.

4.5 These Regulations also make miscellaneous and minor amendments to the Supplier Payment Regulations, principally in relation to the time at which various obligations under those Regulations must be discharged.

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 Amber Rudd, Secretary of State at the Department of Energy and Climate Change, has made the following statement regarding Human Rights:

"In my view the provisions of the Electricity Capacity (Amendment) Regulations 2016 are compatible with the Convention rights.".

7. Policy background

What is being done and why

7.1 The Capacity Market 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 Capacity Market 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.

New Supplementary Capacity Auction for 2017/18

7.3 Delivering energy security is the number one energy priority for the Government. UK electricity market conditions have changed considerably since 2014, when the Capacity Market was established. The huge reduction in global commodities prices has lowered consumers' energy costs but has made a significant part of generating plant unprofitable. In consequence, there have been several closures announced earlier than was anticipated in 2014, and other generating plant may be at risk. These Regulations make provision for a Supplementary Capacity Auction for delivery in 2017/18. Running this auction mitigates the increased risk to security of supply in 2017/18. This will help ensure that the System Operator remains equipped to meet the Government's reliability standard.

Reform of the capacity market

7.4 In 2015 the Government reviewed the Capacity Market mechanism to ensure it remains fit for the purpose of bringing forward new capacity, particularly gas generation, as older plant such as coal comes off the system. Industry and investors indicated that the mechanism retains their confidence; is the best available approach to securing long-term security of supply; and that regulatory stability is of crucial importance. At the same time, there were arguments for greater incentives on those with agreements to honour those agreements. The Government has therefore proposed a package of measures, to be implemented by these Regulations and associated amendments to the Rules, which will incentivise the delivery of capacity with agreements and make other improvements to the system as set out in consultation documents.

7.5 The measures will increase incentives to ensure that new build capacity that wins an agreement has the appropriate incentives and is exposed to a robust assurance regime to deliver as per their agreement. They will include a ban on failed projects from participating in future auctions, increased monitoring and reporting milestones, and increases in credit cover for projects which cannot demonstrate sufficient progress by the 11-month stage. Taken together, and on top of the existing requirements, these should materially increase the incentives on projects to have robust delivery plans in place from an early date and, if they are to fail, encourage them to fail early, allowing more time for National Grid to seek alternative sources of supply.

Secondary trading

7.6 These Regulations also include measures to ensure that a secondary trading market can develop which supports investment in Capacity Market units. Such a market would support agreements by allowing the management of risk relating to non-delivery and penalty exposure during periods of planned and unplanned outages whilst compensating for any uncertainty regarding over delivery rates. These changes would improve the current regulatory framework by dealing with the interaction between transfers of agreements and the penalty regime.

The DSR transitional auction

7.7 The demand side response (DSR) transitional auctions are aimed specifically at the DSR sector in recognition that it is a relatively small and immature sector and not in a position to compete in the main Capacity Market auctions. The DSR transitional auctions were intended to provide DSR with a viable route to market by offering targeted, additional support in the two years preceding full delivery in 2018/19. The first transitional DSR auction took place in January 2016 and around 800MW of capacity was procured. The results suggest that generation-derived DSR, which includes both small-scale embedded generation and back up generation, is well established relative to turn-down (true) DSR. Government is keen to ensure that funding through the next DSR transitional auction is targeted to those types of DSR resource that need it most, and these Regulations therefore refine eligibility for the second DSR transitional auction to only turn-down DSR.

8. Consultation Outcome

8.1 The Government consulted in October 2015 and in March 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 In total, 44 responses were received to the October 2015 consultation and 161 responses were received to the March 2016 consultation. Responses were received from a wide range of stakeholders, including energy suppliers, generators, consultants, interconnectors, renewables companies, environmental groups, UK trade associations, private investors and others. The Government Response to each consultation sets out the views of stakeholders in response to the consultation proposals, and an explanation of the final policy decisions taken.

8.3 The October consultation covered a set of proposals based on the results of the first Capacity Market auction and issues where more detail was required, such as secondary trading. The March consultation built on that consultation and the responses received to propose further reforms.

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 Capacity Market auction. The document provided stakeholders with detail on final EMR policy decisions and set out the legislative framework for EMR.

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

10. Impact

10.1 The Government's analysis points towards an increased risk to security of electricity supply in 2017/18 and a risk of a sharp increase in wholesale prices if the Supplementary Capacity Auction is not implemented. The Supplementary Capacity Auction insures against these risks.

10.2 The gross cost of capacity agreements awarded through the Supplementary Capacity Auction will be met by suppliers, with payments flowing from suppliers, via the settlement body appointed under the Principal Regulations, to providers of capacity. Suppliers will pass through costs to consumers.

10.3 The impact on consumers (including domestic, industrial, small businesses, charities, voluntary bodies and the public sector) could be a possible increase in energy bills, although this should be partly offset by a reduction in wholesale electricity prices. The impact could also result in saving on the energy bills in a scenario where further power stations were to close. The consumers should also benefit from security of supply being maintained.

10.4 The estimated benefit of the proposed increases in termination fees and credit cover requirements, in terms of a reduction in non-delivery risks, is expected to outweigh the impact on auction costs over a ten year horizon.

10.5 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 impacts 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 businesses that do participate, of all sizes, will have a more secure and predictable funding stream. The Capacity Market 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 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 & 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 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 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 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.

12.3 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 Jonathan Robinson at the Department of Energy and Climate Change Telephone: 0300 068 5944 or email: jonathan.robinson@decc.gsi.gov.uk can answer any queries regarding the instrument.