EXPLANATORY MEMORANDUM TO

THE ELECTRICITY CAPACITY (AMENDMENT) REGULATIONS 2015
2015 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.

2. Purpose of the instrument

2.1 This instrument:

- amends the Electricity Capacity Regulations 2014 (S.I. 2014/2043) to enable electricity interconnectors to participate in the Capacity Market from 2015 onwards, and makes a number of minor and technical amendments to those Regulations; and
- amends the Electricity Capacity (Supplier Payment etc.) Regulations 2014 to set the settlement costs levy that funds the budget of the Capacity Market Settlement Body, as from 1st April 2015, and to correct a minor drafting error.

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

3.1 None.

4. Legislative Context

4.1 The Energy Act 2013 ("the Act") 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. The first CFD allocation round opened in October 2014 and the first Capacity Market auction took place in 2014. A second allocation round and Capacity Market auction are planned for 2015.

4.3 These mechanisms were implemented by a suite of secondary legislation and related documents, in particular the Electricity Capacity Regulations 2014 ("the Principal Regulations") and the Electricity Capacity (Supplier Payment etc.) Regulations 2014 ("the Supplier Payment Regulations"). This instrument amends the Principal Regulations to enable electricity interconnectors to participate in the Capacity Market from 2015 onwards, as well as making a number of minor and technical amendments to those Regulations; and it amends the Supplier Payment Regulations to set the settlement costs levy that funds the budget of the Capacity Market Settlement Body from 1st April 2015.

4.4 The amendments made by instrument form part of a wider set of amendments to the existing suite of EMR secondary legislation. For example, wider amendments are being made which implement provisions required as part of the EMR mechanisms successfully receiving State Aid clearance, implement policies the Department has committed to introducing prior to the second CFD allocation round or Capacity

Market auction, and include a number of minor and technical amendments to ensure the drafting gives effect to the previously agreed policy intent. This instrument and another of the amendment regulations also reflect the updated levies for the two EMR companies (the CFD Counterparty and the Capacity Market Settlement Body) to recover their operational costs for 2015/16.

4.5 The full set of amending regulations includes the following:

- The Electricity Supplier Obligations (Amendment & Excluded Electricity) Regulations 2015
- The Electricity Capacity (Amendment) Regulations 2015
- The Electricity Market Reform (General) (Amendment) Regulations 2015

4.6 This instrument is made under the powers in sections 27 to 33, 36 and 40(1) of the Act.

5. Territorial Extent and Application

5.1 This instrument extends to Great Britain.

6. European Convention on Human Rights

6.1 Matthew Hancock, Minister 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 2015 are compatible with the Convention rights.

7. Policy background

7.1 The EMR programme is intended to incentivise investment in low-carbon electricity generation, while improving affordability for consumers, and maintaining energy security. These regulations are concerned with one element of the wider reform package – the Capacity Market.

7.2 The Capacity Market has been established to meet the objectives of:

i. incentivising sufficient capacity to ensure security of electricity supply; and
ii. implementing changes at minimum cost to consumers.

7.3 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. The only capacity excluded from participating are those in receipt of low carbon support (e.g. from the CFD), those receiving a grant under the NER 300 or a Carbon Capture and Support grant scheme or Short-Term Operating Reserve (STOR) providers if they do not meet the eligibility criteria included in The Electricity Capacity Regulations 2014.

7.4 The Electricity Capacity Regulations 2014 set out:

i. The Secretary of State's role in the Capacity Market, 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 has appointed the Electricity Settlements Company).
ii. The process for determining whether a capacity auction is to be held and the auction parameters for a capacity auction.
iii. The process of 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 contained in the Capacity Market Rules 2014 referred to below).
iv. Payment and settlement provisions.
v. Dispute resolution and appeals.

7.5 The primary purpose of this amending instrument is to enable electricity interconnectors to participate in the Capacity Market from 2015 onwards and to be eligible to receive a capacity agreement if successful in a capacity auction. The Principal Regulations are being amended to include, in new regulation 5A, a definition of a new category of Capacity Market Unit, namely an "interconnector CMU". Other amendments are made to the Principal Regulations in order to enable the participation of interconnectors in future T-4 and T-1 auctions, including amending certain definitions so that they apply to interconnectors as well as generators. The Delivery Body will also be required in regulation 7 to provide more information on the capacity to be provided by individual interconnectors in the Electricity Capacity Report. The new regulation 43A provides for a financial penalty to be imposed, similar to a termination penalty under regulation 43, but which can apply in the case of new build interconnector where the failure to reach a completion milestone can be ascertained only where the capacity agreement has already expired.

7.6 After consultation with external stakeholders and to make the Principal Regulations work more efficiently we have made a number of minor and technical amendments to the Principal Regulations. These include:

- a new definition of "half hourly meter" (amendment to regulation 2) to clarify that the term can either refer to a meter that measures electricity on a half hourly basis or a meter that can have its readings aligned to half hourly periods. The latter will enable wider participation from demand side response providers and small scale generators;
- an amendment to regulation 4 (Generating CMU) to allow smaller generators to aggregate capacity with other small generators (different owners), where the total connection capacity is less than 50 MW, in order to allow generating units to aggregate and participate in the Capacity Market. It also amends the definition of registered trading unit to align the Regulations with the original policy intent;
- an amendment to regulation 15 (General eligibility criteria) to clarify that in the case of a demand side response (DSR) CMU, the DSR capacity of the

CMU must be equal to or greater than the minimum capacity threshold, to align the treatment of generation and DSR resources;

- amendments to regulations 29 and 69 to disapply regulation 69(5) in the case of the first and second DSR transitional auctions, enabling applicants to provide additional information to the Delivery Body if they request reconsideration of a prequalification decision; and to exclude participation in both the Electricity Demand Reduction pilot scheme and the first DSR transitional auction, where there is any overlap with the relevant delivery period ;to reduce the risk of providers receiving government funding for the same resource;
- a new regulation 43B to require a capacity provider to repay capacity payments to the Settlement Body if a capacity agreement is terminated on certain grounds which are to be specified in the Capacity Market Rules. This will ensure that the regulations deliver the policy intent that capacity providers subject to certain termination events should repay any capacity payments received between either the date of the termination event or the date of the termination notice (as applicable to the specific ground for termination and which is to be specified in the Capacity Market Rules) and the actual date of termination of the agreement;
- a new regulation 43C to require a capacity provider to repay capacity payments to the Settlement Body in certain circumstances during the delivery year where a metering test certificate or DSR test certificate is held to be invalid. This will ensure the accuracy and the robustness of the meter data and therefore performance data. Where the provider is required to repay any capacity payments from the point of invalidating their certificates until (as applicable according to the Capacity Market Rules) either the Settlement Body issues a metering recovery payment notice or the provider submits a completion notice to the Settlement Body.. A provider who fails to respond to a metering penalty recovery notice is required to repay capacity payments from the start of the relevant delivery year until the date on which the metering recovery notice is issued;
- an amendment to regulation 50 (Reducing capacity payments: failure to demonstrate satisfactory performance) meaning that a capacity provider will forego at least one month's capacity payment where the capacity provider has failed to demonstrate satisfactory performance. This will deliver the policy intention to recover a minimum of one month's capacity payments;
- an amendment to regulation 59 (requirement to provide applicant credit cover) to enable an applicant that has provided credit cover for a capacity auction in respect of an unproven demand side response CMU to not be required to provide further applicant credit cover for any subsequent capacity auction in respect of that CMU except in circumstances specified in Capacity Market Rules. This will ensure that a DSR provider is not providing multiple credit cover for the same resource. Similarly, in the case an interconnector CMU further credit cover is not required to be given unless the credit cover already provided has been drawn down;
- an amendment to regulation 73 to ensure that a successful appellant against a prequalification decision can nominate a lower amount of capacity in the case of a demand side reduction CMU. DSR providers are able to reduce their capacity prior to the auction (DSR bid capacity), however, the current

Regulations do not allow a DSR provider that has successfully appealed against a prequalification decision to nominate a lower capacity; and

- a new regulation 87A, to make transitory provisions for the second T-4 auction, to extend the derogation that applied in the first T-4 auction so that applicants of generating units may declare they have not secured Transmission Entry Capacity (TEC) but will do so at least 18 months ahead of the Delivery Year, and to allow additional time for new build CMUs to demonstrate that they have obtained all relevant planning permissions.

7.7 This instrument also amends regulation 9(2) of the Supplier Payment Regulations to revise the total amount of the settlement costs levy that liable electricity suppliers must pay from 1st April 2015 in order to fund the operational costs budget of the Settlement Body. The opportunity has also been taken to correct a minor drafting error in those Regulations.

7.8 It is expected that the Settlement Body's operational costs will change from year to year, and therefore the process to consult on and amend the settlement costs levy set out in the Supplier Payment Regulations will take place annually, alongside setting the operational costs budget and levy rate for the CFD Counterparty. The Supplier Payment Regulations will have to be amended in time to allow for a revised settlement costs levy to be in force by the beginning of each levy period.

8. Consultation outcome

8.1 The provisions on interconnection and the minor and technical changes set out in this instrument were subject to a six-week consultation. The *Consultation on Capacity Market supplementary design proposals and Transitional Arrangements* was published on 25 September 2014 for stakeholders to provide feedback on the proposals.

8.2 The consultation closed on 5 November 2014 and 37 responses were received. Following careful analysis of feedback from stakeholders during the consultation period, which included page-turning sessions with industry on the draft amendment regulations, Government policy on the approach to the inclusion of interconnected capacity and the minor and technical provisions remains as set out in the consultation document.

8.3 The settlement costs levy required for the Settlement Body to recover its operational costs for 2015/16 has also been subject to a four-week consultation which received five responses. The consultation on the Low Carbon Contracts Company and Electricity Settlements Company[1] operational costs 2015/16 closed on 3 December 2014 and following analysis of responses, the budget for the Capacity Market Settlement Body (the Electricity Settlements Company) will be £3,891,000.

9. Guidance

[1] Electricity Settlements Company Ltd, a company registered in England and Wales with company registration number 8961281 and appointed as the Settlement Body for the Capacity Market under Regulation 80 of the Electricity Capacity Regulations 2014.

9.1 The Government Responses to the consultations on Capacity Market Supplementary Design Proposals and Transitional Arrangements, and the Low Carbon Contracts Company and Electricity Settlements Company operational costs 2015/16, have been published to coincide with the laying of the amendment regulations in Parliament. The Government Responses set out the views of stakeholders and an explanation of the final policy decisions taken.

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 will have a limited impact on bills for domestic and industry consumers, due to a greater amount of generating capacity being available and dampening the response of wholesale prices to potential tightening in security of electricity supply conditions.

10.3 Small businesses, charities or voluntary bodies may see an increase in energy bills, in case the costs of the Capacity Market are not offset by a lower wholesale price. However, this cost is partly offset by the benefit of increased security of electricity supply.

10.4 The impact on the public sector is a possible increase in energy bills, in case the costs of the Capacity Market are not offset by a lower wholesale price. This cost is partly offset by the benefit of increased security of electricity supply.

10.5 An Impact Assessment relating to the proposals allowing the participation of interconnected capacity in the Capacity Market from 2015 onwards is attached to this memorandum and will be published alongside the Explanatory Memorandum on the legislation.gov.uk website. The impact of other minor and technical amendments to the Principal Regulations is expected to be minimal.

10.6 As outlined in the settlement cost levy consultation, the budget of the Settlement Body will be £3,891,000 for 2015/16. These operating costs (when included with those of the CFD Counterparty), are expected to increase household electricity bills by around £0.18 in 2015/16 (at 2014 prices), which equates to less than 0.05% increase in average household electricity bills. We would expect similar percentage impacts for medium-sized businesses and for energy-intensive users (expect any that become exempt during 2015/16).

11. Regulating small business

11.1 The legislation applies to small businesses 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 demand side response providers, may be small or medium sized. It should though be noted that participation in the Capacity Market is

voluntary, so 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, increasing participation.

11.4 Electricity suppliers will also be impacted by the Capacity Market in that they will be charged the costs of the 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 Section 5(4) of the Energy Act 2013 requires the Secretary of State to prepare and lay before Parliament a report setting out how the Secretary of State has carried out his EMR functions. This requires the Secretary of State to report, before 31 December each year and beginning in 2014, on how he has carried out his functions in Part 2 of the Act in order to deliver EMR's objectives. The report must be laid in Parliament and be shared with the Devolved Administrations.

12.2 The first of such reports was laid before Parliament on 6 November 2014. As well as fulfilling the reporting requirement, the EMR Annual Update 2014 provides Parliament and other stakeholders with a forward look of the path ahead and a summary of EMR progress since the Energy Bill received Royal Assent in December 2013.

12.3 In addition, section 66 of the Energy Act 2013, requires the Secretary of State to report to Parliament by the end of 2018 on a number of aspects of the operation of the EMR programme. These aspects include the extent to which the original objectives have been met, whether these objectives are still appropriate and whether they could be delivered in a way that imposes less regulation. This requirement covers CFDs, the Capacity Market and the transitional arrangements from the Renewables Obligation.

12.4 Evaluation will help to provide evidence for whether the EMR programme and its processes are as efficient and effective as possible and on whether the benefits of the programme are being achieved. The Government has commissioned independent contractors with appropriate expertise to provide evaluation of the first CFD allocation, first Capacity Market auction and the Final Investment Decision (FID) Enabling for Renewables process (which awarded Investment Contracts, early CFDs). The outcome of this evaluation will help inform future decisions in relation to the delivery of EMR and DECC's policies more broadly.

12.5 The Government currently envisages that evaluation work over the lifetime of the instruments will include (but not be confined to) an assessment of the extent to which the first round of awards of CFDs under the enduring regime have furthered the

UK's low carbon energy objectives at least cost to consumers; the extent to which the FID Enabling for Renewables process has prevented investment hiatus; the extent to which the first Capacity Market auction has met expectations of providing security of supply; an assessment of whether the institutional framework underlying the programme is fit for purpose and an evaluation of the early impacts of the programme. The timing of these reviews and their outputs are still being considered.

13. Contact

Helena Forrest at the Department of Energy and Climate Change. Tel: 0300 068 6716 or email: Helena.Forrest@decc.gsi.gov.uk can answer any queries regarding the instrument.