EXPLANATORY MEMORANDUM TO

THE ELECTRICITY CAPACITY (NO. 1) REGULATIONS 2019

2019 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.

2. Purpose of the instrument

2.1 This instrument makes provision for the operation of the GB Capacity Market (one of the main mechanisms for ensuring security of electricity supply to GB consumers) during the 'standstill period' introduced by the annulment of the scheme's State aid approval by the General Court of the Court of Justice of the European Union (Case T-793/14) and pending the conclusion of the European Commission's State aid investigation to re-approve the scheme ("the State aid decision"). In particular, it makes provision for a re-arranged Capacity Market auction to be held in summer 2019 to secure electricity capacity for the delivery year 2019/20 beginning on 1 October 2019. It also makes provision for arrangements following a positive State aid decision, particularly for resumption of collection of charges from electricity suppliers to fund deferred payments to capacity providers.

3. Matters of special interest to Parliament

Matters of special interest to the Joint Committee on Statutory Instruments

3.1 None.

Matters relevant to Standing Orders Nos. 83P and 83T of the Standing Orders of the House of Commons relating to Public Business (English Votes for English Laws)

3.2 The territorial application of this instrument includes Scotland.

3.3 The powers under which this instrument is made cover Great Britain (see section 155 (extent) and section 27 (electricity capacity regulations) of the Energy Act 2013 (c. 32).

4. Extent and Territorial Application

4.1 The territorial extent of this instrument is Great Britain.

4.2 The territorial application of this instrument is Great Britain.

5. European Convention on Human Rights

5.1 The Secretary of State of 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 (No. 1) Regulations 2019 are compatible with the Convention rights."

6. Legislative Context

6.1 Chapter 3 of Part 2 of the Energy Act 2013 ("the Act") provides the Secretary of State with powers to make electricity capacity regulations for the purpose of providing capacity to meet the demands of consumers for the supply of electricity in Great Britain.

6.2 Following the annulment of the Capacity Market's State aid approval by the General Court judgment on 15 November 2018 (Case T-793/14) and pending the conclusion of the European Commission's State aid investigation to re-approve the scheme ("the State aid decision"), the scheme has been in a 'standstill period' for State aid purposes. The UK's State aid obligations during the standstill period require it to cease the grant of State aid pending State aid approval. It has become necessary for the Government to act promptly to make regulations to provide as much legal certainty as possible to industry and the market about arrangements for the operation of the scheme during and after the 'standstill period'.

6.3 This instrument generally provides for these arrangements through modifications to the application of the Electricity Capacity Regulations 2014/2043 ("the Principal Regulations") and the Electricity Capacity (Supplier Payments etc.) Regulations 2014/3354 ("the Supplier Payment Regulations"), rather than amending these regulations. There is precedent for this approach in the Principal Regulations in the provision made for the Demand Side Response transitional auctions. The instrument also makes some amendments of the Principal Regulations. BEIS will publish informal 'Keeling Schedules' showing how the Principal Regulations and Supplier Payments would be read as modified by this instrument.

6.4 This instrument is titled the Electricity Capacity (No. 1) Regulations 2019 as a second instrument is planned for spring 2019 to make provision for future auctions (the nature of which will be subject to the State aid position by that time) and any further provision needed in relation to the re-arranged auction and the operation of the scheme during the standstill period.

6.5 Laid with this instrument are the Capacity Market (Amendment) (No. 1) Rules 2019, which have already come into force. Capacity Market Rules, made under section 34 of the Act, must be laid in Parliament but are not subject to Parliamentary procedure. The Capacity Market (Amendment) (No. 2) Rules will shortly be laid and will come into force on the day on which this instrument comes into force. The Capacity Market (Amendment) (No. 3) Rules are planned to be laid with the second set of regulations described in section 6.4.

7. Policy background

What is being done and why?

7.1 The Capacity Market is one of the main mechanisms to ensure security of electricity supply at least cost to GB consumers. It aims to secure the capacity required to meet peak demand in a range of scenarios through competitive auctions held four-years (T-4) and one-year (T-1) ahead of delivery. It was implemented by a suite of secondary legislation: the Principal Regulations, the Supplier Payment Regulations and the Capacity Market Rules 2014.

7.2 Since it was introduced, eight Capacity Market auctions have taken place. Eligible existing or new electricity generators, interconnectors and Demand Side Response

(DSR) providers bid into the auctions. Successful bidders secure a capacity agreement which obliges them to generate electricity (or in the case of DSR providers, to reduce demand) at times of system stress. Capacity agreement holders ("capacity providers") are paid capacity payments at the auction's clearing price for each de-rated kilowatt (kW) of capacity they have committed to make available throughout the delivery year in case of system stress. Capacity providers face financial penalties if they fail to deliver electricity (or reduce demand in the case of DSR providers) when required to do so.

7.3 On 15 November 2018 a judgment of the General Court of the Court of Justice of the European Union (Case T-793/14) annulled the State aid approval for the scheme on procedural grounds concerning the European Commission's procedure for investigating the UK's notified scheme. The European Commission must undertake an in-depth investigation to approve the scheme, and announced on 21 February 2019 that it had opened this investigation, and would appeal the General Court's judgment to the European Court of Justice.

7.4 Immediately following the judgment, the Secretary of State for BEIS directed the Capacity Market Delivery Body (National Grid) to postpone the one-year and four-year ahead auctions, which were previously planned to be held in January/February 2019, and requested the Capacity Market Settlement Body (the Electricity Settlements Company, or "ESC"), which is responsible for administering all payments under the scheme to halt the making of capacity payments and the collection of charges from suppliers.

7.5 It has become necessary for the Government to act promptly to prepare new regulations to enable a replacement auction to be held in summer 2019 to ensure security of electricity supply in winter 2019/20. The new regulations will also provide as much legal certainty as possible to industry and the market about the arrangements for the operation of the scheme during the 'standstill period' until the scheme can be approved again.

Deferred payments

7.6 The UK's State aid obligations require capacity payments to cease being made unless and until State aid approval is obtained. This instrument modifies the payment arrangements in the Principal Regulations to ensure that, upon State aid approval for the scheme, deferred payments will be made to capacity providers who have met their obligations during the standstill period (subject to any reductions in payments to account for non-compliance). This will also maintain confidence in the scheme amongst capacity providers, many of whom will have made investments, in part, on the basis of the Capacity Market revenues they were anticipating during the standstill period. Over the long term, industry confidence in the Capacity Market as an investable mechanism can be an important driver of security of supply, cost savings and value for money overall.

Re-arranged T-1 auction

7.7 We plan to run an auction in summer 2019 to secure additional capacity. This T-1 auction will be the rearrangement of the postponed T-1 auction originally scheduled for January 2019. As this auction is likely to take place at a time when the scheme has not yet secured State aid approval, the existing Capacity Market regulations must be modified to provide for the auction to award conditional capacity agreements (rather than capacity agreements). Conditional capacity agreements will convert into capacity

agreements, and successful bidders in the auction will be entitled to capacity payments, only if and when the relevant State aid approval is obtained by 1 October 2020. We anticipate that State aid approval will be received ahead of the start of the 2019/20 delivery year on 1 October 2019, allowing capacity payments to be made to successful bidders in accordance with the usual schedule. However, there will be provision for back-payments for successful bidders in the auction if State aid approval is received after that time.

Supplier charges

7.8 The Supplier Payment Regulations provide for the Settlement Body to collect payments from suppliers to meet the cost of making capacity payments to capacity providers. The instrument modifies these regulations to allow the Settlement Body to hold payments made to it voluntarily by electricity suppliers during the standstill period (which are not returned to suppliers on their request) to be set off against their future supplier charge liabilities. The Settlement Body will provide suppliers with a schedule of the payments payable after the standstill period. The Settlement Body will collect the full outstanding supplier charge on a mandatory basis shortly after the standstill period ends. The modifications should help minimise uncertainty and disruption amongst suppliers and their customers by ensuring that suppliers do not face unexpected and unfunded liabilities when any outstanding supplier charge become due on State aid approval. Any shortfall in the supplier charge collected will be made up though enhanced mutualisation and reconciliation processes, backed up by robust enforcement against defaulting suppliers. The Government also intends to consult shortly on its plans to underwrite deferred payments. These modifications will ensure sufficient funds are available to cover the full amount of the deferred payments, which will maintain capacity providers' confidence in the scheme.

Trigger events

7.9 To ensure certainty about the timing of post-standstill processes, whatever the timing and outcome of the State aid decision, this instrument introduces "trigger events" for processes including those for deferred capacity payments and capacity payments for successful bidders in the re-arranged T-1 auction, payment of accrued penalties and termination fees, and the collection of the supplier charge.

Secretary of State's discretion: appeals

7.10 The instrument also modifies the Secretary of State's discretion in dealing with termination notices appealed by capacity providers. This instrument modifies that discretion to allow the Secretary of State to extend the period for compliance before termination by 12 months (rather than 6) for capacity agreements that existed on 15 November 2018. This instrument also modifies that discretion so that in cases where it would involve undue financial hardship to a capacity provider to pay a termination fee or non-completion fee owing to exceptional circumstances arising from the non-payment of capacity payments during the standstill period, the Secretary of State may direct the Delivery Body to withdraw the notice. Where that discretion is exercised, the relevant fee will not be imposed. Both modifications will provide useful flexibility in extenuating circumstances where capacity providers may struggle to meet their obligations and/or pay financial penalties during the standstill period while they are not receiving capacity payments.

Financial penalties under existing agreements

7.11 The policy intention of the modifications to the Secretary of State's discretion is also supported by further modifications that provide that capacity providers will not be required to pay financial penalties they have incurred under existing agreements during the standstill period unless and until State aid approval is obtained. Additionally, the modifications and amendments made by the capacity market rules described in section 6.5 will waive or extend the time for compliance with certain obligations that arise during the standstill period where compliance with those obligations have a high associated cost but are unlikely to materially increase risks to security of supply if waived or extended.

8. European Union (Withdrawal) Act/Withdrawal of the United Kingdom from the European Union

8.1 This instrument does not relate to withdrawal from the European Union / trigger the statement requirements under the European Union (Withdrawal) Act.

9. Consolidation

9.1 There will not be a formal consolidation as this instrument is mainly comprised of new substantive provisions and modifications to the application of the Principal Regulations and the Supplier Payment Regulations, rather than amendments of those regulations. BEIS will publish informal 'Keeling Schedules' showing how those regulations would be read as modified by this instrument.

10. Consultation outcome

10.1 A public consultation was conducted from 19 December 2018 to 10 January 2019 which sought views on the proposed changes to the Principal Regulations, the Supplier Payment Regulations and the Capacity Market Rules. A link to the consultation is available here: https://www.gov.uk/government/consultations/capacity-market-technical-amendments. The Government's Response to the consultation, including a summary of consultation responses and details on the regulatory changes made in this instrument and to the Capacity Market Rules, is expected to be published on gov.uk on 25 February 2019.

10.2 61 responses were received from a wide range of stakeholders, including generators, DSR providers, developers, suppliers, trade associations, investors and others. The vast majority of respondents supported the proposals and favoured Government action to clarify and, as far as possible, maintain operation of the scheme during the standstill period. A small number of respondents did not favour the proposal to restart the collection of supplier charges. Most of those respondents were Energy Intensive Industry operators who were critical of the uncertainty around the supplier charge arrangements and highlighted that this was having a significant cost impact on their businesses – they were unclear whether to manage their load requirement over the winter weekday peaks to minimise their exposure to Capacity Market charges (which supplies pass through to them), and were concerned that if they did (at cost) then ultimately this may be proven to be unnecessary (e.g. if State aid approval for deferred payments is not forthcoming). Two respondents generally disagreed with the Government's proposals to maintain operation of the scheme during the standstill period, which they argue should have suspended all aspects of the Capacity Market, not just the making of capacity payments.

10.3 Following consideration of responses to the consultation, some changes to the proposals have been made, which are detailed in the Government Response. In respect of the re-arranged T-1 auction these include: the award of conditional capacity agreements following the auction which will be converted into capacity agreements if the relevant State aid approval is received before 1 October 2020; and introducing a single deadline for all pre-delivery year key milestones required to demonstrate eligibility for back-payments. In respect of the supplier charge, the Government has decided that the Settlement Body will hold voluntary payments made by suppliers during the standstill period and collect on a mandatory basis only after the standstill period. The reasons for this change are detailed in the Government Response.

11. Guidance

11.1 Guidance on the Capacity Market is produced by National Grid and ESC. It is published on their websites and is available here: https://www.emrdeliverybody.com/cm/home.aspx and https://www.emrsettlement.co.uk/publications/guidance/. Government will work with National Grid and ESC to produce guidance for Capacity Market Units on the delivery year readiness deadline for the re-arranged T-1 auction. Government will also publish guidance on the appeals process for existing capacity agreements and conditional capacity agreements awarded through the re-arranged T-1 auction.

12. Impact

12.1 The impact on businesses is small. There is no impact on charities or voluntary bodies.

12.2 There is no, or no significant, impact on the public sector.

12.3 A separate Impact Assessment has not been prepared for this instrument because this instrument relates to maintenance of the Capacity Market and the existing regulatory standard to maintain three hours' loss of load expectation (LOLE). LOLE is the expected number of hours when demand is higher than available generation during the year before any mitigating or emergency actions are taken, but after all system warnings and System Operator balancing contracts have been exhausted.

12.4 The Capacity Market was subject to a full Impact Assessment when it was first introduced. It will be subject to further assessment as part of a statutory review to meet review requirements under the Energy Act 2013 and the Principal Regulations, which will report to Parliament later in 2019.

12.5 Further details on the impacts are set out in analysis within the Government Response referred to in section 10.1.

13. Regulating small business

13.1 The legislation applies to activities that are undertaken by some small businesses, for example DSR providers and battery developers.

13.2 As capacity providers are not receiving capacity payments during the standstill period, it is more difficult for some small businesses that are capacity providers to manage their cash-flow and comply with some of the agreement obligations that fall on them during the standstill period. While the amendments to the Capacity Market Rules 2014 made by the instruments described in section 6.5 are separate from this instrument, they also reduce cost burden for capacity providers by extending or waiving certain milestones falling during the standstill period that have a high compliance cost but are

not critical to ensuring security of supply. For those participating in the re-arranged T-1 auction, this instrument enables the Government to provide as much certainty about the compressed timelines and award of agreements as far ahead as possible from the delivery year.

14. Monitoring & review

14.1 Statutory review clauses are included in section 66 of the Act (which requires a review five years from the date on which the Act was passed) and regulation 81 of the Principal Regulations (which requires a five-yearly review). The first five-year review, which is intended to satisfy the review requirements under the Act and the Principal Regulations, is underway and a call for evidence was open from 8 August 2018 to 1 October 2018 seeking stakeholder views on the scheme's performance in meeting its objectives. We are now assessing the responses, and in the meantime, on 25 February 2019, will publish a summary of responses received. A report of the review will be submitted to Parliament and published in summer 2019.

15. Contact

15.1 Charles Phillips at the Department for Business, Energy and Industrial Strategy, email: charles.phillips@beis.gov.uk can be contacted with any queries regarding the instrument.

15.2 Dave Buttery at the Department for Business, Energy and Industrial Strategy can confirm that this Explanatory Memorandum meets the required standard.

15.3 Claire Perry at the Department for Business, Energy and Industrial Strategy can confirm that this Explanatory Memorandum meets the required standard.