EXPLANATORY MEMORANDUM TO

THE ELECTRICITY CAPACITY (NO. 2) 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 amends the Electricity Capacity Regulations 2014 (S.I. 2014/2043) ("the Principal Regulations") to:

- allow a one-off Capacity Market auction to be conducted in early 2020 to secure electricity capacity for the delivery year 2022/23 ("T-3 auction");
- extend the requirement to reduce capacity payments to offset support received under other schemes to cover support received by renewable technologies able to participate in future capacity auctions; and
- modify the calculations used to determine a capacity provider's obligation to repay capacity payments following a termination event.

2.2 The instrument also makes further provision for the operation of the Capacity Market 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) by amending the Electricity Capacity (No. 1) Regulations 2019 (S.I. 2019/862) ("the Standstill Period Regulations") to:

- extend State aid related modifications to credit cover requirements to upcoming capacity auctions;
- modify credit cover requirements applicable following a positive State aid decision to avoid unnecessary duplication of credit cover; and
- correct several minor drafting errors.

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. 2) 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 aid pending State aid approval.

6.3 The Standstill Period Regulations, which came into force on 10 April 2019, made provision for the continued operation of aspects of the Capacity Market during the standstill period, and arrangements following a positive or negative State aid decision. This was primarily achieved by modifying the application of the Principal Regulations and the Electricity Capacity (Supplier Payment etc.) Regulations 2014 (S.I. 2014/3354) ("Supplier Payment Regulations").

6.4 This instrument amends the Principal Regulations and the Standstill Period Regulations. It is titled the Electricity Capacity (No. 2) Regulations 2019 because it follows the Standstill Period Regulations and includes amendments which form part of a wider package of changes related to the annulment of the Capacity Market's State aid approval. The instrument also includes amendments to the Principal Regulations which are not related to the annulment of the Capacity Market's State aid approval.

6.5 Laid with this instrument are the Capacity Market (Amendment) (No. 3) Rules 2019 and the Capacity Market (Amendment) (No. 4) Rules 2019 which make changes to the Capacity Market Rules 2014 ("the Rules") and which have already come into force. The Capacity Market (Amendment) (No. 5) Rules 2019 – will shortly be laid and will come into force alongside this instrument. Capacity Market Rules, made under section 34 of the Act, must be laid in Parliament but are not subject to Parliamentary procedure.

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, securing the capacity required to meet peak

demand through competitive, technology-neutral 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 Rules.

7.2 Auction bids are made by Capacity Market Units ("CMUs") – the unit of generation or demand side response ("DSR") in respect of which a capacity agreement is awarded. The nature of a CMU can vary widely, for example from a large nuclear, coal or gas plan to DSR or a small battery. DSR is where a business (or a number of businesses aggregated together) temporarily turns down the amount of electricity it is using or an industrial process– or where it switches to off-grid back-up generation, so as to meet its own needs without imposing demand on the transmission system.

7.3 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 and to face financial penalties if they fail to deliver.

7.4 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 European Commission's State aid approval for the scheme on procedural grounds. The European Commission is currently carrying out an investigation into the original State aid notification for the Capacity Market (as required by the Court) and is also appealing the judgment. 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.

7.5 On 9 April 2019 the Government made the Standstill Period Regulations. These regulations made provision, amongst other things, for the one year ahead auction for delivery year 2019/20 to be re-arranged and run prior to State aid approval, and for aspects of the Capacity Market to continue to operate during the standstill period.

7.6 The arrangements put in place by the Standstill Period Regulations are currently the subject of judicial review proceedings. These proceedings allege, amongst other things, that running a T-1 auction and continuing to operate aspects of the scheme during the standstill period breaches the UK's obligations under State aid law.

Replacement T-3 auction

7.7 Following further consultation, the Government is introducing regulations to allow the Secretary of State to replace the postponed T-4 auction for the 2022/23 delivery year (originally scheduled for February 2019) with a one-off three-year ahead ("T-3") auction, providing greater certainty to investors. The T-3 auction would be run in early 2020 to ensure security of electricity supply in winter 2022/23.

Credit cover

7.8 Applicants seeking to enter certain types of CMU into a capacity auction are required to provide and maintain credit cover to participate in the auction. This obligation helps ensure applicants who bid for a capacity obligation based on an unproven or not-yet constructed CMU deliver what they have said they will. For successful bidders, the requirement to maintain credit cover persists after the auction until they have discharged the obligation in respect of which credit cover is required (e.g. constructing

their new-build CMU). If a successful bidder subsequently fails to discharge their obligations they are penalised by having their credit cover drawn down.

7.9 The Standstill Period Regulations suspended credit cover requirements in relation to capacity agreements which existed on 15 November 2018. This instrument amends the Standstill Period Regulations to extend the provisions suspending credit cover requirements to the three capacity auctions likely to be rescheduled for early 2020 (the T-1 auction for delivery year 2020/21; the T-3 auction for delivery year 2022/23 and the T-4 auction for delivery year 2023/24) with some minor modification. The effect of this extension is that credit cover for these upcoming capacity auctions will also be suspended until after State aid approval is obtained.

7.10 As the T-3 auction for 2022/23 and the T-4 for 2023/24 are expected to both take place in early 2020, this instrument seeks to reduce the burden that parallel credit-cover requirements might otherwise create by allowing a capacity provider who is entering the same CMU into both auctions to collectively satisfy the credit cover requirements for both auctions rather than posting credit cover in the full amount required for each auction. The requirement to post additional credit cover for the T-3 auction is also shortened to nine months after the publication of auction results (from twelve months) to accommodate the shorter period between the auction and the start of the delivery year.

7.11 Following State aid approval suspended credit cover obligations for upcoming auctions and existing capacity agreements will be re-imposed at the same time, and credit cover for upcoming auctions will be required to be posted before the deadline for re-posting withdrawn credit cover for existing capacity agreements. This instrument introduces a mechanism to ensure the order in which credit cover is provided (or re-posted) does not prevent capacity providers from accessing existing exemptions which would ordinarily allow credit cover provided for a prior auction which is still in place to be taken into account when assessing whether credit cover for a subsequent auction needs to be provided.

Renewable Technologies participation in the Capacity Market

7.12 Prior to recent changes to the Rules, only certain types of renewables were able to participate in the Capacity Market because the Rules did not provide a means by which to assess the contribution that these technologies make to security of supply. These technology classes were not originally provided for because it was assumed they would invariably be in receipt of other Government subsidies (e.g. Contracts for Difference, Renewables Obligation, Feed-in-Tariffs) which make a CMU ineligible to participate in the Capacity Market to prevent over-compensation through receipt of multiple forms of State aid.

7.13 As there is now evidence that additional types of renewables may be looking to build and operate on a subsidy-free basis, the Rules have been amended to allow these technology classes to participate in the scheme. This change reflects the technology-neutral market-wide nature of the Capacity Market.

7.14 The exclusion of plant which benefit from Contracts for Difference, Renewables Obligation, or Feed-in-Tariffs payments is maintained, and these remain the most likely alternative sources of support; but to ensure that there is no risk of over-compensation new provisions are also introduced in the Rules requiring participants to declare any other forms of state support they may receive, so that their CM payments can be adjusted to reflect these other benefits, where they exist.

7.15 This instrument supports the changes to the Rules which allow additional classes of renewables to participate by extending regulation 49A of the Principal Regulations to State support received in relation to low-carbon generation which capacity providers will be required to declare under the Rules (referred to in the Rules as "relevant benefit"). Regulation 49A requires support declared by a capacity provider under the Rules to be deducted from capacity payments until fully offset. This prevents cumulation of State aid where a capacity provider receives capacity payments and other support in relation to the same CMU.

7.16 As "relevant benefit" may be received after some capacity payments have been paid, the Settlement Body will also be required to directly recover outstanding support from a capacity provider if it cannot be fully offset by deductions from remaining capacity payments. The amount of support directly recovered in this way cannot exceed the total amount of the capacity payments paid to the capacity provider.

7.17 The Government will continue to monitor whether the funding declaration mechanism in the Rules needs to be extended to additional support schemes or types of CMU.

Miscellaneous additions and corrections to the Principal Regulations and Standstill Period Regulations.

7.18 The Government has identified other minor and technical drafting issues which are corrected by this instrument, including improvements to the way in which the capacity payments repayable are determined following certain termination events and correction of three minor drafting errors in the Standstill Period Regulations.

Timing

7.19 In normal years, the annual Capacity Market auction cycle includes two types of auction – a T-4 (roughly four years ahead of the delivery year) and a smaller T-1 (one year ahead). A T-1 (for 2019/20) and a T-4 (for 2022/23) had been planned for January/February 2019. These auctions could not be held in accordance with the regular timetable as a result of the annulment of the Capacity Market's State aid approval.

7.20 The Standstill Period Regulations allowed the postponed T-1 auction for 2019/20 to be rearranged, and this auction has now been held on 11 and 12 June 2019. As noted, this instrument makes changes to allow a new T-3 auction for 2022/23 to be held, which would replace the postponed T-4 auction for this delivery year. This auction, if held, is likely to be scheduled for early 2020 between the standard T-1 auction for 2020/21 delivery year and the T-4 auction for the 2023/24 delivery year.

7.21 In order to allow the upcoming auctions to take place at this time, and in the right sequence, the associated operational processes for all three auctions would need to begin in late July 2019.

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 are no plans to consolidate the legislation amended by the instrument. BEIS will publish an informal 'Keeling Schedule' showing how the Principal Regulations would be read as modified by this instrument.

10. Consultation outcome

10.1 A public consultation was conducted from 7 March 2019 to 4 April 2019 which sought views on the proposed changes to the Principal Regulations and the Capacity Market Rules. A link to the consultation is available here: https://www.gov.uk/government/consultations/capacity-market-further-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, was published on gov.uk on 30 May 2019.

10.2 42 responses were received from a wide range of stakeholders, including capacity providers, generators, interconnectors, suppliers, local authorities, NGOs and trade associations. The majority of respondents broadly supported the proposals to replace the delayed T-4 auction with a T-3 auction in early 2020, to allow certain renewable technologies to participate in the CM and to make a minor modification to the Principal Regulations relating to the determination of the capacity payments repayable following certain termination events.

10.3 The Government has responded to concerns from prospective bidders that the requirement to provide credit cover for the T-3 and T-4 auction at the same time could be unduly burdensome as outlined in section 7 above.

11. Guidance

11.1 Guidance on the Capacity Market is produced by National Grid and Electricity Settlements Company. 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/.

11.2 Guidance on the funding declaration requirements for low-carbon technologies will be published.

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 used.

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 (see section 14).

13. Regulating small business

13.1 The legislation applies to activities that are undertaken by some small businesses, for example DSR providers, battery developers, and some renewables projects. 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. The postponement of the T-4 auction for 2022/23 following the State aid judgment has also resulted in uncertainty for small businesses regarding the potential for future revenue streams. In providing for an auction which would not otherwise occur, the legislation under consideration creates an opportunity for some small businesses, on a voluntary basis, to compete for additional revenue streams, and they will only participate and be bound by the legislation where they see a net benefit to themselves in doing so.

13.2 To minimise the impact of the requirements on small businesses (employing up to 50 people), the approach taken is to ensure that the general provisions made by the instrument are not detrimental to small businesses compared to other companies, and to extend existing flexibilities for unproven DSR and interconnectors (often small businesses) in relation to credit cover. For those hoping to secure agreements for the 2022/23 delivery year by participating in the T-3 auction, this instrument enables the Government to provide as much certainty as possible about the arrangements for the auction and the compressed timelines. The T-3 auction mechanism has been designed to replicate as far as possible the process associated with a T-4 auction. The requirement to post credit cover for upcoming auctions is postponed during the standstill period, and changes are made to avoid the duplication of credit cover requirements between the T-3 and T-4 auctions, easing pressures on cash flow.

13.3 The basis for the final decision on what action to take to assist small businesses was the recent public consultation (as outlined in Section 10) in which, as noted, the majority of companies and business organisations who responded supported the proposals.

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. A summary of responses to this call for evidence was published on 7 March 2019. 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 Chris Skidmore at the Department for Business, Energy and Industrial Strategy can confirm that this Explanatory Memorandum meets the required standard.