EXPLANATORY MEMORANDUM TO

THE ELECTRICITY CAPACITY (SUPPLIER PAYMENT ETC.) REGULATIONS

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.

2. Purpose of the instrument

2.1 This instrument makes provision about payments to be made by and to electricity suppliers in relation to the Capacity Market established by the Electricity Capacity Regulations 2014 ("the Principal Regulations"). In particular, it imposes an obligation on electricity suppliers to pay a Capacity Market supplier charge to fund capacity payments payable to capacity providers under the Principal Regulations, and a settlements costs levy to fund the cost of administering those payments. The instrument confers functions on the Settlement Body appointed under the Principal Regulations in relation to the calculation, determination and administration of such payments.

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 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. The Capacity Market provisions of the 2013 Act (Part 2, Chapter 3) give powers to make both regulations and rules for the purpose of providing capacity to meet the demands of consumers for the supply of electricity in Great Britain.

4.2. This instrument complements the Principal Regulations and the Capacity Market Rules 2014. Forthcoming amendments to the Principal Regulations are also envisaged that would allow electricity interconnectors to participate in Capacity Market auctions from 2015. In anticipation of such a future inclusion of interconnected capacity, the opportunity has been taken to amend the definition of "providing electricity" in regulation 3 of the Principal Regulations.

4.3 This instrument is made under powers in sections 27, 28, 30 to 33, 36 and 40(1) of the 2013 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 (Supplier Payment etc.) Regulations 2014 are compatible with the Convention rights.

7. Policy background

7.1. The Electricity Capacity (Supplier Payment etc.) 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 goes 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 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.

7.4 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.

7.5 The Capacity Market will be funded by electricity suppliers, and this instrument makes provision for the necessary payments. The Government has made clear that the Capacity Market, as with all EMR programmes, will be an industry funded scheme. This means that the Capacity Market will be funded in the same way as other EMR schemes to support low carbon electricity generation such as the Contracts for Difference scheme. Although it should be noted that the Capacity Market payment model is not a contractual counterparty model as is used for

Contracts for Difference. Instead it relies on a system of statutory obligations that seek to ensure that payments are reliable and robust.

7.6 The payment model for the Capacity Market seeks to ensure that capacity providers that have been successful in the auction receive capacity payments in the relevant delivery year. These capacity payments will be funded by a compulsory levy on all licensed electricity suppliers, as set out in this instrument. These payments will be secured with credit to ensure that capacity providers receive their capacity payments in the event that a supplier defaults.

7.7 The amount each supplier will pay for the Capacity Market will be based on their share of net demand between 4pm and 7pm on working days (i.e. weekdays other than bank and public holidays in England and Wales) between November and February (inclusive). This will be initially based on a forecast of net demand provided by suppliers, then reconciled using actual demand data once it becomes available.

7.8 The Capacity Market will operate alongside the electricity market and the National Grid's existing services which ensure moment to moment balancing of the system.

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'.

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. With respect to payments by suppliers, changes were made to better align the Capacity Market and Contracts for Difference payment regimes ensuring a consistent approach was taken to the Settlement Body, Counterparty and Settlements Services Provider's role. In addition, the payment timetable was reduced and the method of assigning share of Capacity Market charge to suppliers to reduce variability was simplified.

9. Guidance

9.1 The Government Response to the consultation has been published (June 2014) and 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 A further document, *Implementing Electricity Market Reform*, was published alongside the Government Response. The document is intended to provide a comprehensive source of information on EMR policy design ahead of the first CFD allocation and Capacity Market auction. The document provides stakeholders with

detail on EMR policy decisions and sets out how these fit within the legislative framework for EMR.

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 payments should be partly offset by a reduction in electricity prices due to 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 An Impact Assessment for the Capacity Market has been published and is available at https://www.gov.uk/government/consultations/proposals-for-implementation-of-electricity-market-reform

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 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 business 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 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 the Principal Regulations.

13. Contact

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