The material in this paper is work in progress and is not a statement of government policy or policy intent

EHANCING THE INVESTABILITY OF THE CAPACITY MARKET

SUMMARY

1. While the capacity market is not intended as an investment contract or to address all investment risks, we recognise that investors are concerned as to lack of certainty or the level of risk and liabilities which they may face. This paper deals primarily with governance and change control, in the light of concerns raised by a range of respondents to the consultation. Other key areas such as the penalty regime are addressed separately.

2. DECC's intent is that the design should be as investable by as wide a range of investors as possible, but still balancing this against key principles of ensuring it retains sufficient performance incentives to ensure security of supply.

SUMMARY OF RECOMMENDATIONS

3. DECC proposes to clarify the protection to investors against future rule change by:-

    a. Including a set of objectives within the Capacity Market Regulations governing future rule change and which Ofgem must take into account when introducing any such change.
    b. Including provision (likely to be within the Capacity Market Register) that the key terms in relation to duration, capacity obligation and price, together with the maximum levels of penalty liability or termination fees of an existing "Capacity Agreement" would continue to apply in relation to that capacity agreement.

4. This responds to calls for clear objectives to be set out for rule changes and is also intended to give a high level assurance as to key terms continuing to apply.

GOVERNANCE AND CHANGE CONTROL

<u>Stakeholder issues</u>

5. A key theme from the consultation responses is a call for greater clarity as to the governance process under the Capacity Market Regulations and Rules. There is concern as to the role of Ofgem in making changes to and administering the Rules and in also determining any appeals and there are calls both for clear objectives to be set out governing future rule changes and for specific rights of appeal to the Courts.

6. There is some concern as to the lack of a private law contract and the inability to properly address the change in law risk. Some call for a private law contract or a right to payments to be secured via a contract with the counterparty body. It is also noted that it may require the capacity market to have been in operation for some time before lenders gain confidence.

7. There are also calls for preservation of the commercial bargain and grandfathering of key terms or preservation of the commercial bargain to be considered if making changes to the Rules.

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Current Design

8. The current design does not give any express protection against future changes to the Capacity Market Rules or Regulations. The Regulations do however state that a capacity agreement is for the period of delivery years for which it is awarded which does give an assurance as to an enduring term.

9. A specific right of appeal against Rule changes is not possible under the existing legislation and hence the only appeal route would continue to be via judicial review. The proposed objectives for changes to the Rules Change objectives will be a key part of answering industry concern as to future governance.

Market Risks

10. Importantly, generators face market and regulatory risk in the energy market which are reflected in wholesale energy prices and managed via their market position or their contracts. The capacity market was not intended to fundamentally change how that risk is allocated. DECC therefore does not consider it to be necessary or appropriate to offer full protection against changes to other industry documents or codes as if it were an investment contract.

PROPOSED CHANGE TO POLICY DESIGN: GRANDFATHERING OF CAPACITY AGREEMENT TERMS

11. DECC proposes that the key terms of a Capacity Agreement are "grandfathered" such that the main terms endure for the duration of the agreement (subject to any future regulation to the contrary)

12. These key terms would be:

    a. agreement length;
    b. capacity price and entitlement to payment (still subject to the principles of the payment model);
    c. capacity obligation and de-rating figure (unless adjusted by the performance monitoring provisions proposed for the penalty regime which is an adjustment mechanism known at the start of the agreement);
    d. completion milestones and termination fees applicable
    e. the maximum liability for penalties.

13. A compensatory mechanism is not proposed as although it may be an alternative route to give further certainty and would allow prices to be adjusted against specific changes, it would add considerable complexity to the Regulations and in agreeing the consequence of any change. Moreover, plants would continue to receive energy market revenues which may also reflect certain changes.

14. We have not considered a private law contract to be a viable option. It is not possible under existing primary legislation and despite investor concern from both utilities and independents it is not necessarily compatible with the policy intent of this being a market mechanism rather than an investment contract.

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15. Grandfathering of key terms is in part already within the Capacity Market Regulations, which state that the capacity agreement (and by inference the key terms of the price and capacity obligation denoted in the capacity agreement) is for the period of years stated at the time of issue.

16. Additionally, a "new" part of the above proposal relates to the maximum liability for penalties (and is intended to give additional investor comfort for new build projects on a long term agreement, but also gives clarity to existing plants on annual contracts). While changing the liability caps for an on-going project would in any case be unlikely as it represents a departure from the commercial bargain envisaged at the time, this nonetheless provides additional clarity for investors..

17. It provides a reassurance that, in the event of detailed changes to the Rules relating to the penalty regime, in applying any such change to on-going projects the overall liability level is maintained. Grandfathering of the key terms rather than grandfather the entire "capacity agreement" means that operational issues such as stress events and penalties can be managed on a consistent basis as rules do change. Otherwise, there is increasing chance long term of having plants operating under different stress event criteria and penalties. The need for practical rule changes going forward is acknowledged by respondents who do not call for preserving the entire agreement.

18. The concept of a "better of" approach i.e. that the capacity provider can opt to transfer to the "new" rules, is not considered appropriate as we are only giving assurance as to the high level commercial deal on which he initially priced.

19. This would add high level assurance as to preserving the commercial deal, intended to be of help to investors generally and to those requiring project finance, although it is recognised that in itself it does not address all concerns. Establishing the objectives for Rule changes is important in giving parallel assurance as to how changes will be made.

<u>Proposed Change</u>

20. Our proposal is therefore to:

    a. Include objectives within the Capacity Market Regulations governing future rule change and which Ofgem must take into account when introducing any such change; and
    b. Include provision that the key terms in relation to duration, capacity obligation and price, together with the maximum levels of penalty liability or termination fees of an existing "Capacity Agreement" would continue to apply in relation to that capacity agreement. (This provision is envisaged as being included within the Capacity Market Register).

21. Specifying objectives which must be taken into account in making rule changes will answer a key concern from both utilities and the independent generators. While the grandfathering of key terms clearly does not afford the same level of protection as a private law contract, it does also provide a parallel assurance as to the commercial terms.