



**Government Response to the House of Commons
Energy and Climate Change Select Committee Report into
the draft Energy Bill**

Presented to Parliament
by the Secretary of State for the Department of Energy and Climate
Change
by Command of Her Majesty

November 2012



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Introduction

Electricity Market Reform (EMR) aims to ensure the investment in secure, affordable and low carbon electricity we need to replace current ageing energy infrastructure. EMR provides the incentives, working with the market, to deliver £110 billion of investment needed in the electricity sector over the next decade. With energy the biggest infrastructure sector in the economy, EMR will stimulate investment, growth and jobs, as well as meeting our energy and climate goals.

EMR will be implemented through the Energy Bill, introduced into the House on 29 November. Given the significance of the EMR proposals, a draft Bill was published in May 2012, and the Energy and Climate Change (ECC) Select Committee carried out pre-legislative scrutiny of the EMR proposals within the draft Bill. The Committee published its report on 23 July.

The Government is grateful for the ECC Committee's thorough scrutiny process, which was helpfully conducted within a compressed period. This allowed the Government time to consider the Committee's report and amend the Bill before introduction.

The EMR provisions examined by the ECC Select Committee consist of Chapters 1 to 7 of Part One to the draft Bill, amended versions of which now form Chapters 1 to 9 of the Bill as published for Introduction. These cover:

- Contracts for Difference (CfDs);
- Capacity Market;
- Conflicts of interest and contingency arrangements;
- Investment Contracts;
- Access to markets;
- Renewables Obligation (RO): transitional arrangements; and
- Emissions Performance Standard (EPS).

As a result of the pre-legislative scrutiny process, the Government has made some significant changes to the EMR provisions of the Bill.

The full Government response to the Committee's recommendations is set out in this report. The key changes we have made to the Bill following the PLS process are:

- clarity of the EMR objectives on the face of the Bill (new Part 1, Chapter 1);
- a single counterparty to the CfD contract to ensure a robust private law contract;
- powers to allow Government intervention to ensure independent generators can access the market (new Part 1 Chapter 6);
- powers to allow Government intervention to improve market liquidity (new Part 1 Chapter 6);
- a two-stage registration and allocation process for CfD contracts, to give generators early certainty of CfD allocation and price; and

- amendment to the EPS provisions so that Carbon Capture Storage (CCS) demonstration projects now come within the regime.

In this response we have also clarified the arrangements for ensuring value for money and transparency in respect of any “investment contracts” agreed through the final investment decision (FID) enabling process, in advance of EMR implementation.

Alongside this response we have published an updated EMR Overview Document, along with annexes on CfDs, the Capacity Market, Institutional Framework, EMR Delivery Plan and Implementation Roadmap¹. These publications provide further detail, particularly on the operation of the CfD (including a Heads of Terms for the CfD contract) and Capacity Market design, which were also requested by the Committee in its report.

During the scrutiny period, a group of members of the House of Lords also came together to review the EMR provisions, and their report was published on the DECC website². The Government has responded to the House of Lords group and this response is also available on our website.

¹ <http://www.decc.gov.uk/assets/decc/11/policy-legislation/EMR/5351-annex-e--indicative-electricity-market-reform-im.pdf>

² <http://www.decc.gov.uk/en/content/cms/legislation/energybill2012/energybill2012.aspx>

Government Response to Recommendations

Overarching recommendations

The recommendations, and our responses to them, have been grouped by subject area rather than numerical order, for ease of reading.

1. We recommend that in order to increase confidence and ensure that there is an opportunity for rigorous Parliamentary scrutiny, the Government should publish draft secondary legislation, including a model Contract for Difference, in time for formal consideration of the Bill. (Paragraph 26)

While the pace and scale of the EMR work has meant that it has not been possible to produce secondary legislation in time for the Introduction of the Bill, the documents published in parallel to the Bill's Introduction contain significant additional detail on the Electricity Market Reform (EMR) programme, including a significant amount that will appear in secondary legislation. In particular, a detailed 'Heads of Terms' setting out the key terms for the model Contract for Difference has been published in parallel to the Bill. The Government will develop secondary legislation during the passage of the primary legislation and consult on it during 2013. Full implementation of EMR remains on track for 2014.

2. We note that despite the Secretary of State's assertion that the objectives of the Bill were clear, they are not set out formally on the face of the Bill. (Paragraph 29)

The Government agrees that it would be helpful to set out the aims of the EMR programme clearly on the face of the Bill. In response to the Committee's recommendation, we have included on the face of the Bill a duty on the Secretary of State to have regard to the key objectives of EMR: carbon reduction (including the commitment to meeting our EU 2020 renewable energy target); security of supply; and affordability for consumers (new Part 1, Chapter 1). We have also made these aspects clearer in non-legislative documents being published alongside the Bill.

7. We recommend that Clause 1, subsection (1) of the Bill be amended to read "The Secretary of State may make regulations about Contracts for Difference for the purpose of encouraging low carbon electricity generation in order to achieve legally binding carbon budgets at least possible cost to consumers". (Paragraph 43)

While we have not included any further text within the body of this section, we do not consider this necessary as the duty on the Secretary of State as outlined under Recommendation 2 (above) will apply to certain functions of Part 1 of the Bill, including when setting up the CfD scheme and the capacity market, or when making changes to them. The legal effect is the same.

10. We recommend that Clause 20, subsection (1) of the Bill be amended to read “The Secretary of State may by regulations make provision for the purpose of providing capacity to meet the demands of consumers for the supply of electricity in Great Britain, while achieving legally binding carbon budgets at least possible cost to consumers” (Paragraph 46)

While we have not included any further text within the body of this section, we do not consider this necessary as the duty on the Secretary of State, as outlined under Recommendation 2 (above) will apply to the whole of Part 1 of the Bill. The legal effect is the same.

11. We recommend that the long title should be amended to read “Make provision for Contracts for Difference and investment instruments in connection with encouraging low carbon electricity generation in order to achieve legally binding carbon budgets and provide security of supply at least cost to consumers [...]”. We recommend that the long title should be further amended to delete “Contracts for Difference” and insert “support mechanisms”. (Paragraph 47)

The long title of the Bill has to reflect the whole Bill, which is of course wider than EMR, and is usually an issue for Parliamentary Counsel. While we have not made this change directly, we believe that the upfront duty outlined in Recommendation 2 (above) will serve to provide clarity at the start of the Bill. This duty outlines the matters that the Secretary of State will have regard to when carrying out the key EMR functions. These matters, as outlined in Recommendation 2, are the key objectives of EMR; to meet our climate change targets as set out in the Climate Change Act 2008; to ensure security of supply; to take into account the cost to consumers; and meet legally binding EU targets for the use of energy from renewables sources.

34. Given that the Government (and the Committee on Climate Change) see nuclear playing a key role in the future energy mix, Government should consider how carbon and security objectives could be delivered if no new nuclear is forthcoming. (Paragraph 146)

Different technology mixes to meet decarbonisation and security objectives have been considered as part of the strategic work of the Department. While it is theoretically possible to meet our decarbonisation objectives without new nuclear, it would be very difficult to do in practice. We would also expect the costs of meeting the objectives to be significantly higher without new nuclear, as it is a proven technology and expected to be the cheapest low carbon source of electricity in the future. The Government recognises that there is uncertainty about future costs and development for all technologies, and agrees that EMR must be robust to all future outcomes. EMR has therefore been designed to be flexible to different outcomes and to allow opportunity for all forms of generation to come forward, to ultimately provide a least cost mix. The long-term vision is a market where low carbon generators compete fairly under a robust and stable carbon price. New nuclear power should be able to contribute as much as possible to the UK's need for new capacity within that competitive framework and

be consistent with the Coalition's commitment to 'no public subsidy' for nuclear power.

Contracts for Difference

16. The Coalition Agreement states that "We will encourage community-owned renewable energy schemes where local people benefit from the power produced". However, the Renewable Obligation has not delivered community-owned schemes and the proposed CfDs are also unlikely to work for community schemes. A simple Fixed Feed-in Tariff would be a more appropriate form of support. We therefore recommend that this Bill provides for the Energy Act 2008 to be amended to allow for the eligibility threshold for small-scale FiTs to be extended to at least 10MW and potentially up to 50MW in size. (Paragraph 70)

We have recently announced changes to the small scale Feed-in Tariffs (FiTs) scheme to ensure that communities are supported. From December, community schemes will be able to take advantage of a tariff guarantee. It should be noted that community-owned schemes are, in any case, usually much smaller than 5MW and so a change of the kind proposed by the Committee is unlikely to achieve the intended benefit.

It should be noted that DECC is also preparing a community energy strategy document which may consider the scale of what is defined as community energy. Currently, what we view as "community-owned schemes" are usually much smaller than 5MW. Hence a change of the kind proposed by the Committee is unlikely to achieve the intended benefit.

18. We recommend that the Government abandons the multiparty concept and reverts to a single counterparty payment model, with a contract and counterparty design that is legally enforceable. (Paragraph 94)

Whilst the Government believes the initial payment model and legal framework that was published in the draft Energy Bill could have functioned effectively, the Government accepts concerns of the Committee, industry and investors and has considered whether this is the right model to attract investment. The Government accepts the Committee's recommendation. The concerns derived principally from the perceived complexity and novelty of the proposed model with specific concerns regarding:

- the absence of a single counterparty to sign contracts with;
- the mechanism for resolving disputes, particularly if a supplier did not pay; and
- uncertainty about the relationships between public and private law within the model.

The Government has worked over the summer to assess the viability of an alternative model that would mitigate investors concerns.

In the Energy Bill introduced to Parliament, the framework has been revised to include the following:

- a private law contract between a generator and a single, newly established counterparty body;
- the single counterparty body will be a newly established Government-owned company;
- it would be a specific institution for generators to interact with over the lifetime of the contract; and
- a levy raising power which will enable the counterparty to collect the funds from suppliers to meet payments to generators. This will be enforceable by Ofgem as a relevant requirement of suppliers' licenses.

19. The main purpose of the reforms was to reduce the cost of capital for investors. The nature of the counterparty will affect the cost of capital (see paragraph 97). In our view, a counterparty model that is underwritten by Government would be the best way to instil investor confidence and reduce financing costs. (Paragraph 95)

We propose that the single counterparty is a Government-owned company. Whilst the counterparty will be owned by Government, payments will always come from suppliers to match payments to generators. The obligation on suppliers to pay will be a requirement of their licences, regulated by Ofgem. The risk of supplier default impacting on payment flows will be mitigated by a series of backstops including the advance posting of credit and collateral to cover any payment period and the mutualisation of any losses across suppliers. In the event of an insolvency, the supplier of last resort regime (which effectively moves customers to a new supplier), and the Energy Company Administration Scheme (whereby an administrator continues to supply and meet obligations), would be in place to ensure that payments would continue. We believe these measures are sufficient.

20. DECC must fully assess the implications of a single counterparty without government underwriting on suppliers' balance sheets and on the cost of capital before adoption of this model. This should include an assessment of what impact this model would have on smaller suppliers to ensure that this counterparty model would not threaten the viability of these businesses. (Paragraph 96)

The Government cannot mandate how independent accountants will treat CfDs when they audit their clients' books in the future. This consideration will be made by looking at the detail of the individual arrangements, and different companies may legitimately account for CfDs in different ways given the subjectivity of accounting standards. However, from the analysis we have conducted we believe that the new payment model is very likely to remove the significant concern suppliers had raised regarding the original model - that they would have to value the total liabilities for CfDs on their own balance sheets.

In the documents we have published, we propose that the supplier obligation (the mandatory obligation through which monies will be raised to pay generators) will apply to all licensed suppliers, including small suppliers. We wish to understand

the impacts of what we are proposing on suppliers and whether significant impacts that are identified can be mitigated. We have therefore issued a call for evidence within the CfD operational framework that accompanies the Energy Bill. The detail of the supplier obligation will subsequently be set out in secondary legislation, on which we will consult during 2013.

21. We believe that the nature of the counterparty will have an impact on the cost of capital. DECC's claim that the nature of the counterparty would not affect the outcome of the Impact Assessment (IA) merely reflects the lack of sophistication in the original assessment, rather than the likely real-world impact on the cost of capital. (Paragraph 99)

22. DECC must update its methodology as well as the figures when revising the Impact Assessment (IA). The model needs to reflect real world approaches to capital pricing and should incorporate the impact of new risks on the cost of capital (including counterparty risk, development risk, risks to credit ratings and basis risk). The IA should specifically address the issue of how Government-underwriting (or lack thereof) of the CfD counterparty affects investor risks and costs. (Paragraph 102)

The Impact Assessment published alongside the EMR White Paper and the modelling underpinning it assumed that contracts would be bankable, to ensure that the necessary certainty to industry would be provided. Both the model published in May and the revised model based on a single counterparty would have been supported by a robust legal framework established by Government in legislation. Concerns were raised regarding the original payment model, and this has been replaced with a simpler bilateral contract model which has been welcomed by industry and investors. Since what we are proposing in the Energy Bill and Operational Framework is a credible counterparty, we do not consider that the Impact Assessment needs full revision.

Generators need to manage a range of risks in order to operate effectively in the wholesale market. The CFD specifically addresses the price risks faced by low carbon generation (subject to receiving the reference price), and this forms the basis of the costs of capital assessment. The Government has not included any revision on the cost of capital methodology due to the proposed change in counterparty. However, as part of the Impact Assessment alongside the Bill, we are publishing further details on the institutional model and the associated reasons behind our final choice of model, including any specific implications for investor certainty.

It is not possible to model the precise impact of counterparty risk on the cost of capital. This is primarily due to the absence of a quantified assessment of the different forms of project risks faced by developers, how the choice of counterparty is likely to affect those risks and how these in turn would impact the cost of capital or hurdle rates. Our discussions with stakeholders show that industry will invest only if the counterparty body is perceived to be bankable and creditworthy. We believe the measures set out in the response to Recommendation 19 (above) address the risk. The single counterparty model is perceived to have lower counterparty risks than the multiparty model. Hence, this

suggests that a CfD payment model with a single counterparty is more likely to be perceived as a credible counterparty and is therefore more likely to realise the full cost of capital benefits as modelled.

The Committee was concerned about whether the assessment was sufficiently detailed. DECC's modelling on the costs of capital were based on two sources of analysis: quantitative analysis undertaken using a dynamic model of the GB electricity market developed by Redpoint Energy, which simulates investment and generation behaviour; and qualitative analysis by Cambridge Economic Policy Associates (CEPA) on cost of capital effects. This was used to test the Redpoint figures, and to test a range of cost of capital figures in the model. The CEPA analysis was based on an alternative methodology taking explicitly into account the need for views from investors and how financing decisions are made in the real world, and led to results which were broadly consistent with the Redpoint figures.

23. Rationing the number of CfDs under the levy cap increases development risk. We recommend that DECC introduces a two-step or pre-registration process to give developers greater confidence that they will be able to obtain a CfD before reaching Final Investment Decision. (Paragraph 109)

We warmly welcome the Committee's and industry's input into the development of the CfD allocation process. In the draft Operational Framework we set out our preference for a one-stage allocation process which required developers to have reached Financial Close or equivalent before being able to receive a CfD. Our preference for this route was based on the desire to reduce the risk that projects reserve CfDs but then fail to complete development, as this would increase risks to the achievement of Government decarbonisation and renewable targets.

Since the publication of the draft Operational Framework, we have worked closely with industry to examine alternative mechanisms which allow Government to mitigate the risk of non-delivery by allowing contracts to be withdrawn and capacity reallocated to new projects in the event a project is unable to deliver. We have therefore set out in the Operational Framework our intention to develop a two-stage process in which projects are able to apply for a CfD once they have cleared lower, but still meaningful hurdles such as planning permission and a grid connection agreement, and then have to complete a small number of further hurdles post CfD-award in order to retain the contract. This will allow industry greater confidence to incur project development costs whilst protecting Government from allocating support to projects that fail to complete.

27. Auctions may be useful but they are not the only means to secure cost reduction. We recommend that DECC should learn from experiences overseas and consider setting out a planned reduction pathway for strike prices. This would guarantee a reduction in the level of subsidy paid by consumers over time. (Paragraph 117)

We agree with the Committee that it is important to provide industry with clarity on strike prices or the process for setting strike prices in good time to support

development decisions. Government has clearly stated its intention to move to a competitive price discovery process for all low carbon technologies as soon as practicable. Introducing competition through tenders or auctions should enable strike prices to be set more efficiently and reduce the costs of achieving our decarbonisation objectives. The Government anticipates that the conditions for moving to technology-specific competitions for some renewables could be present as early as 2017, and it is possible that it could move to technology-neutral processes in the 2020s.

The Administrative Price Setting process builds on the Renewables Obligation (RO) Banding Review, which already includes depression in support levels, and on the Government's wider determination to capture the savings that can be realised as technology costs reduce. Government has been working with each low carbon technology to understand the cost base and likely improvements, including close work with the offshore wind sector to develop a shared vision for reducing offshore costs from their current levels of approximately £140/MWh to £100/MWh by 2020. In the longer term we believe that a competitive price setting process can reveal better price data and therefore lower the cost of decarbonisation.

32. Government should provide clarity on the strike price level beyond 2017 as soon as possible in order to provide certainty and help secure investment for emerging technologies, such as wave and tidal power. (Paragraph 139)

Strike prices beyond 2017 may be set in a number of ways: administratively, through competitive processes, or through Final Investment Decision (FID) processes.

In the near term, Government will set the strike prices for renewables generation administratively, as with the Renewables Obligation (RO). Consulting in the summer of next year, strike prices for the first five years of the CfD scheme will be published in the 2013 Delivery Plan, by the end of 2013, subject to Royal Assent. The process for price-setting has already begun with the publication of National Grid's call for evidence on 8 October. We will provide strike prices for renewables for the period beyond 2018/19 through the annual update to the delivery plan, giving sufficient time for developers and investors to make investment decisions about future projects. Given the potential for significant changes in costs (particularly for innovative technologies where there may be learning effects) Government does not believe it is appropriate to offer prices for more than five years ahead.

It is our intention to move to a competitive process as soon as practicable. Introducing competition through tenders or auctions should enable strike prices to be set more efficiently and reduce the costs of achieving our decarbonisation objectives. The Government anticipates that the conditions for moving to technology-specific competitions for some renewables could be present as early as 2017, and our aim is to move to technology-neutral auctions in the 2020s.

For some projects, for example, the first nuclear projects, and early Carbon Capture and Storage projects, it will be necessary to set prices through the Final Investment Decision process. These contract strike prices could be established through negotiation or some form of competition depending on the particular circumstances of the projects.

47. In order to prevent this from happening, it may be necessary to consider pushing back the closing date for the RO (currently planned for 2017), for example to 2020, to reflect any slippage in the EMR programme. We note that an extension of the RO to enable slippage to be accommodated would not compromise the government's intention to combine underwriting for all low carbon technologies, since the date of 2018 as the year in which new nuclear power comes on stream has already slipped substantially. (Paragraph 211)

49. We do not believe that a backup plan is necessary at this stage. However, if DECC does not resolve the outstanding questions regarding the CfD payment model, allocation of CfDs and routes to market before the autumn, it may be necessary to consider keeping open the option to extend the RO and/or convert it into a PFiT. (Paragraph 216)

Government is on track to meet its stated timetable of starting to let CfD contracts in 2014; and has today introduced the Bill and published the Operational Framework setting out further detail on how the CfD mechanism works. The Government does not, therefore, believe it is appropriate or necessary to extend the Renewables Obligation (RO) to new projects beyond 2017 as this would not represent value for money for consumers. Government has chosen to introduce CfDs which improve long-term revenue certainty, lowering the cost of capital for low carbon generators whilst retaining short-term market signals for efficient operation of low carbon plant; and, as a result, are more cost effective than other options for support. This will reduce the cost to consumers compared to other potential support mechanisms, including the RO.

50. Some investors are concerned that there may not be sufficient acceptance among members of the public for the EMR proposals to be delivered successfully. There is therefore a fear that a future Government may renege on commitments as a result of political pressure from the electorate. This is driven by the perception in some quarters that the Government is failing to warn consumers about likely increases in electricity prices. In order to increase confidence, DECC should spell out the provisions for recompense should the CfD be dismantled as the result of circumstances beyond its control. (Paragraph 220)

The Government is adamant about maintaining the integrity of the UK as an attractive and internationally competitive location for business investment. The Government remains fully committed to the principle of grandfathering existing investments under the CfD and has articulated this consistently throughout the policy development. This reflects Government's recognition of the damage that can be done to general investment sentiment through retrospective policy

change. CfD contracts are private law contracts which bind the CfD counterparty as would any other contract.

Once the first set of CfD regulations have been made the Secretary of State is under a continuing duty (under the Energy Bill) to secure that the Supplier Obligation enables the CfD counterparty to meet its obligations under the CfD contracts. If the Secretary of State attempted to make regulations removing that ability he could be challenged under public law on the basis that to do so is unlawful.

CfD contracts could only be taken away through primary legislation; as would the duty on the Secretary of State to make provision for CfD contracts to be funded through the supplier obligation. As the Energy Bill does not provide for such powers; new primary legislation would be required. If such steps were taken by primary legislation, such legislation could also negate any recompense provisions within the contract itself. Such provisions would therefore offer little protection beyond the existence of the contract itself.

The Government would need to consider whether any new law that negated CfDs would allow the UK to continue to meet legally binding climate change, renewable and decarbonisation commitments. It would also have to consider the likely damage to the UK's reputation as a place to make long-term business commitments across all sectors.

In the very unlikely event that a future Government disregarded the contractual obligations, any proposed legislation would still be subject to detailed consultation, parliamentary scrutiny and legislative process.

Government is also bound by the European Convention on Human Rights and this is likely to afford protection for the rights of those CfD parties affected by any such future dismantling of the CfD regime (including Article 1 of the 1st Protocol which provides for property rights).

Levy Control Framework (LCF)

3. We welcome the Secretary of State's clarification that if faced with a choice between meeting legal climate change obligations and sticking within the levy cap, the Government would give primacy to statutory climate obligations. The investment community would have been further reassured had HM Treasury been able to confirm this. Because HM Treasury have told us that DECC spoke for all of Government in its evidence, we consider this a cast iron commitment to the primacy of statutory obligations over the Levy Control Framework. We would welcome an explanation from HM Treasury about how the working of the levy cap over the forthcoming funding period will be amended to make it compatible with the requirement to meet legal climate change obligations.

24. The Government should clarify what will be defined as falling within the Levy Control Framework at an early date. (Paragraph 112) We recommend that in order to provide greater confidence to developers, Government should set out:

- a) the level of the funding that will be available under the Levy Control Framework until 2020,**
- b) whether the present rules on headroom will remain as they are or will be amended to provide more flexibility for levy allocation over the next spending period; and**
- c) whether the present mechanism of capping expenditure annually and longitudinally by line will be maintained or relaxed during the next spending period.**

26. We note the Committee on Climate Change's suggestion that funding available under the Levy Control Framework until 2020 should be around £8 billion in 2020. (Paragraph 115)

Low carbon electricity spending under the Levy Control Framework This will be set at £7.6 billion (real 2012 prices) in 2020. This is fully consistent with meeting HMG's legally binding renewable energy and decarbonisation targets including nuclear and CCS generation.

Decarbonisation of the electricity supply

4. It is right to prioritise the decarbonisation of the electricity system because this is likely to deliver the most cost effective route to meeting our 2050 climate change targets. Although statutory carbon reduction targets are set out in the Climate Change Act 2008, these are economy wide, rather than sector specific. We conclude that providing greater clarity about the contribution that the power sector is expected to make towards meeting these targets would help to provide certainty to investors. The Government should set a 2030 carbon intensity target for the electricity sector in secondary legislation based on the recommendation of the Committee on Climate Change. (Paragraph 37)

8. We recommend that Clause 8, subsection (2) be amended to add "[...] (d) a 2030 target for carbon intensity of the electricity sector compatible with meeting statutory carbon budgets and the 2050 target (e) a reliability standard". We believe that setting a decarbonisation target should be a duty on the Secretary of State. However, the current wording of Clause 8 (the Secretary of State "may" by order provide for [...]) suggests that the introduction of "other targets" would be at the Secretary of State's discretion. Therefore we recommend that the Bill be amended to make this a statutory obligation within a fixed timeframe, possibly by way of further amendment to Clause 8. We note that a carbon intensity of the order of around 50gCO₂/kWh by 2030 is compatible with legally binding carbon budgets. (Paragraph 44)

The Government agrees with the broad thrust of the recommendation in that there are clear advantages to a stable investment climate for the power sector.

The Government is committed to the decarbonisation of the economy, and already has a number of binding commitments to ensure that this takes place. In particular, the Government is committed to meeting a legally binding target to reduce the UK's emissions of greenhouse gases (GHGs) to at least 80% below 1990 base levels by 2050 as set out in the 2008 Climate Change Act.

The Government is agreed on the need to encourage a least cost pathway to the UK's binding 2050 carbon target which is consistent with the Climate Change Act and carbon budgets. The Government will therefore bring forward an amendment to the Energy Bill to take a power to set a range in secondary legislation. The power will provide for flexibility in the setting or reviewing of the range by consideration of wider economic factors. A decision to exercise this power will be taken once the Government has received advice from the Committee on Climate Change (CCC) on the Fifth Carbon Budget which covers the corresponding period (i.e. to 2030).

The power will not be exercised until the Government has set the Fifth Carbon Budget. In addition the Government in 2013 will give (non-binding) guidance to National Grid setting out an indicative range for emissions/decarbonisation for the power sector in 2030 consistent with encouraging a least cost pathway to the UK's binding 2050 target. This guidance will also reflect sensitivity analysis covering different scenarios, including one where the Fourth Carbon Budget is revised upwards.

The introduction of the EMR overview document published in parallel this document explores this issue in more detail.

5. We recommend that the Committee on Climate Change should be made a statutory consultee to the EMR delivery plan in order to assess whether the proposals are in line with legally binding carbon budgets. (Paragraph 38)

6. We further recommend that the Committee on Climate Change should be given a role in advising whoever is the Transmission System Operator in the development of the delivery plan to ensure that it is in line with legally binding carbon budgets. (Paragraph 39)

The Government agrees that the Committee on Climate Change (CCC) should be appropriately involved in the EMR delivery plan process, consistent with its existing remit. Indeed, in May the Government committed to involve the CCC as early as appropriate in the process. The Government does not, however, believe that the CCC should be given a formal role on the face of the Bill. The CCC is already able to comment on the Government's progress towards its carbon reduction goals. Moreover, it is outside the remit of the CCC, set out in the Climate Change Act, to provide advice to bodies other than National Authorities, and that the System Operator is not classified as a National Authority.

9. We recommend that Clause 9, subsection (1) be amended to add “[...] (e) the Committee on Climate Change [...]” and that Clause 44, subsection (4) be amended to add “(d) the Committee on Climate Change”. (Paragraph 45)

While the Government is keen to involve the Committee on Climate Change (CCC) in the development of CfD secondary legislation under clause 14 (clause 9 in the draft Energy Bill) the Government does not agree that formal, statutory consultation falls within the CCC’s remit. As noted above, the CCC will be appropriately involved consistent with its existing remit, in the process that will inform decisions on CfD strike prices being set through the delivery plan process.

The Government’s view is that the CCC already has the ability and opportunity to feed into the Government’s considerations on the Strategy and Policy Statement under clause 116 and will have opportunity to respond to the planned public consultation.

43. We do not believe that it is appropriate for a private company—which is ultimately motivated by profit making—to act as the EMR delivery body. DECC’s proposals for the System Operator to take on this role will result in considerable conflicts of interest for National Grid and could result in unnecessary additional costs to consumers. We recommend that National Grid should be removed from this role and replaced by establishing a new independent, not for profit company. (Paragraph 198)

The Government considers that there are strong reasons why the System Operator within National Grid should take on the role of delivering EMR. As we set out in the EMR White Paper – *Planning our electric future: a White Paper for secure, affordable and low carbon electricity* and the subsequent Technical Update³ in December 2011, the Government is committed to putting in place a transparent, stable, robust and credible institutional framework to deliver the reforms. This is critical if we are to give confidence to industry and investors and successfully deliver the Government’s objectives of secure, low carbon, affordable electricity supplies.

The Government outlined in the Technical Update our conclusion that the System Operator (National Grid) best met these criteria for the implementation of both the CfD and the Capacity Market. In particular, the Government remains of the view that there are considerable synergies between the EMR delivery functions and the technical, commercial and financial expertise that National Grid possesses in its role as System Operator.

However, the Government does recognise the view of some industry players and the ECC Committee that in conferring the EMR functions upon National Grid, there is a potential for conflicts of interest to arise. DECC has been working jointly with Ofgem, which administers National Grid’s licenses, to assess the scale and extent of these possible conflicts, and issued an open letter to industry

³http://www.decc.gov.uk/en/content/cms/legislation/white_papers/emr_wp_2011/tech_update/tech_update.aspx

in March 2012 as part of the process of this analysis. Work has continued over the summer and alongside the Energy Bill, DECC and Ofgem have published a public consultation⁴ exploring possible appropriate mitigating actions. The consultation sets out further details on the delivery role which will help to assure stakeholders that the System Operator will have limited discretion, which will minimise the risk of conflicts arising. The consultation sets out that potential conflicts of interest could be addressed by transparency around National Grid's analysis, limits on its discretion and potentially some business separation measures.

Stakeholder responses to this consultation and further analysis of the issue will inform the final joint report expected in early 2013.

We are seeking powers in the Bill that will allow us to mitigate any conflicts of interest that come to light while still retaining the synergies identified above. These will allow us to put in place business separation measures within National Grid including geographical, employee and information restrictions. Ofgem will continue to have the ability to implement unbundling measures through its existing powers. We are also seeking powers in the Bill to be able to transfer the EMR delivery functions to another body should this ever be deemed necessary or desirable.

A robust governance and accountability framework will be put in place to manage the System Operator as delivery body. It is important to note that through existing legislation and licensing arrangements, National Grid is already subject to strict controls to ensure appropriate separation between its businesses through a robust licence and code regime enforced by Ofgem. Further, National Grid and DECC signed a Memorandum of Understanding⁵ in May 2012, and a legally binding agreement dealing with the Management of Information (Mol). Together, these documents are designed to reduce the potential for conflicts of interest and to ensure appropriate governance frameworks are in place between DECC and National Grid for EMR delivery in advance of legislation.

Final Investment Decision (FID) enabling and nuclear

25. It is essential that the Government makes clear how choices will be made by the agent allocating contracts, in particular in allocation between technologies. We recommend that reporting against the delivery plan should include details of commitments already entered into at FIDs or during FID-enabling discussions, and is transparent to other players in order to assist long term planning (Paragraph 113)

The Government will publish details of any investment contracts agreed as a result of Final Investment Decision (FID) enabling discussions, and any such contracts will be factored into analysis supporting the EMR delivery plan and

⁴ <http://www.decc.gov.uk/assets/decc/11/consultation/4562-joint-decc-ofgem-letter-seeking-views-on-potential.pdf>

⁵ http://www.decc.gov.uk/en/content/cms/news/nat_grid_mou/nat_grid_mou.aspx

annual updates. This analysis will include the projected impacts of CfD strike prices for renewables on Government's objectives and, for example, the electricity generation mix. The annual updates will report on the amount of CfDs let to different technology types. The EMR delivery plan and annual updates are also intended to set out and give clarity over Government's forthcoming decisions, if timings align, for example, on moves to CfD auctions for all technologies.

Initially, the Secretary of State will be the counterparty to any early CfDs (referred to as 'investment contracts'), that he judges should be entered into. To enable contracts to take effect from enactment (rather than being dependent on subsequent secondary legislation and the counterparty body being set up), the Bill, as introduced, provides the Secretary of State with a spending power and a power to raise a levy on suppliers to fund such contracts in the very unlikely event that they are not transferred to the counterparty body.

30. We are concerned that the proposed process for setting the nuclear strike price lacks sufficient transparency. The perception that decisions are being made “behind closed doors” could be highly damaging to the low-carbon agenda and may further undermine consumer trust in energy companies. It is essential that the negotiations deliver, and are perceived to deliver, value for money to consumers. We recommend that an independent panel of experts should be appointed to oversee the negotiations and to report to Parliament on the adequacy of the outcome and value for money for consumers. (Paragraph 134)

35. We share the concerns of many witnesses about the transparency of the FID enabling process. Hinkley C is the first project to be considered under the process. We recommend that DECC ensures that any contract terms agreed are published as soon as possible. We also recommend that, as with setting strike prices under the CfD mechanism, an independent panel of experts should be appointed to oversee the investment instrument negotiations, and should report to Parliament on value for money for consumers (see paragraph 134). (Paragraph 153)

The Government agrees that it is essential that the process for agreeing early CfDs (called investment contracts in the revised Bill) with developers through the FID enabling process, including for new nuclear plants, is robust, transparent, and subject to appropriate scrutiny.

On Hinkley Point C in particular, the Government is currently in discussion with New Nuclear Generation Company Limited over a possible investment contract that may be offered through the FID enabling process. The Government has put in place a number of measures to ensure that it obtains the best possible deal for consumers, including:

- Commissioning expert external technical and financial advisers to provide reports to the Secretary of State on the detailed costs of the project and the likely returns to the developer. This includes 'open book' scrutiny of the developer's internal project documentation, financial model, cost of capital,

and risk premium, and will include sensitivity analysis of the impact on consumers and the developer of a variety of different scenarios.

- Appraising the value for money of any contract, drawing on these reports, through:
 - (i) a 'fair price assessment', to consider whether the returns to the developer and levels of risk-sharing are appropriate;
 - (ii) a 'comparator assessment', which assesses the costs of the project against other technologies on a comparable basis; and
 - (iii) an 'affordability assessment' of the expected impact of any contract on consumers' energy bills.
- Commissioning a 'fairness opinion' from financial advisers assessing whether any proposed contract represents fair value to all parties.

The Government also recognises the importance of demonstrating to Parliament and the public that any investment contract agreed for Hinkley Point C represents value for money. We will therefore, in addition to laying in Parliament and publishing details of any contract agreed, publish summaries of the reports from our external advisers, our value for money assessment, and the fairness opinion. When publishing this information we will be mindful of the need to be as transparent as possible while not risking breaches of confidentiality or damaging commercial interests. These reports, prepared by experts external to Government, will demonstrate the extensive scrutiny and challenge that any contract agreed has been subject to, and the basis on which the Government has made its decision.

31. Since there is little competitive pressure or prospect of moving to auctions for new nuclear, we are concerned that the strike price for nuclear could be driven upwards. We hope that industry claims that the cost of nuclear is competitive with other forms of low-carbon energy will be reflected in the offers they put forward during strike price negotiations. We do not believe that a nuclear strike price higher than that given to offshore wind would represent good value for money to the consumer. The Secretary of State should not agree to contracts of this nature. (Paragraph 136)

We agree that it is essential that any CfD or investment contract offered for a new nuclear power station demonstrates value for money, including when assessed against the costs of other technologies on a comparable basis. This will be one of the key elements of our value for money assessment of the outcome of any negotiations (see response to Recommendations 30 & 35).

33. We conclude that state aid as well as political considerations have influenced the design of the CfD package, and have caused policy and financial support for nuclear to be rolled up with that for renewables. Logic suggests that the Government should differentiate nuclear from other low-carbon technologies within an overall FiT regime. The Committee will consider further the building of new nuclear and its associated challenges later in the year. (Paragraph 145)

Government's long-term aim is to drive effective competition between all low carbon technologies to deliver cost-effective low carbon generation. In order to realise this goal it is important that low carbon technologies (nuclear, CCS and renewables) operate within the same support structure so that we can make effective comparison between technologies and move toward competition.

The CfD has been designed to give appropriate support to all forms of low carbon generation, including renewables such as offshore wind, as well as nuclear and CCS. This is consistent with the clear Coalition policy that there will be no public subsidy for new nuclear power unless similar support is also made available more widely to other types of low carbon generation.

Capacity Market

36. The deferral of a firm decision to implement a capacity market creates uncertainty and risks a hiatus in investment. The Energy Bill should be based on a clear Government position on the circumstances in which a market will be introduced, and how this will be reviewed and updated over time. The Government should set out an enduring reliability standard, which, along with a decarbonisation target for electricity, would provide a clear framework for the System Operator to work within when operating a capacity market. (Paragraph 164)

The Government is minded to run the first auction in 2014, for delivery of capacity in the year beginning in the winter of 2018/19. A final decision will be taken subject to evidence of need. This will be informed by updated advice from Ofgem and National Grid which will consider economic growth, recent investment decisions, the role of interconnection and energy efficiency, as well as consideration of the outcome of the review of the fourth Carbon Budget.

The Government believes this strikes the right balance between the need to provide industry certainty, the need for a Capacity Market to address security of electricity supply concerns, and the need to ensure a competitive capacity auction by having long enough between the auction date and the delivery year to enable the participation of new market entrants.

The Government recognises the challenges that investors in new plant face in making final investment decisions, given the detailed design of the Capacity Market is still being developed. As such, we are continuing to make rapid progress on Capacity Market design and final proposals will be published by May 2013.

The Government agrees with the need to establish an enduring reliability standard and we intend to consult on this as part of the draft EMR delivery plan to be published in July 2013.

37. We are extremely concerned that the capacity market proposals are based upon outdated assumptions and an insufficient analysis of the

future risks to reliability. We recommend that the Government undertakes much clearer analysis of the problem that the capacity market is trying to solve, particularly the integration of the large volume of intermittent generation that is likely to be required to decarbonise our electricity supplies, and of the role capacity payments can play in furthering demand side response and reduction measures. The enabling legislation in the Energy Bill must be able to meet our future reliability challenges. (Paragraph 171)

The need for a Capacity Market, and the problem it is designed to address, have been identified in qualitative analysis as well as quantitative modelling of the power sector. This includes DECC analysis and the recent Capacity Assessment produced by Ofgem⁶. The most recent DECC analysis has been published in an updated Impact Assessment alongside the EMR policy update. This sets out the full economic analysis, and suggests that there are significant risks to future security of electricity supplies given expected changes to generation and demand.

Our analysis suggests that a Capacity Market would provide security of electricity supply to consumers, would have, at worst, only a modest impact on bills, and could potentially save consumers money, therefore justifying intervention in the market.

The Government has also made clear that non-generation technologies such as Demand Side Response (DSR) and storage will be able to participate alongside generation in the Capacity Market in the near term. This includes direct participation in the primary capacity auctions. In addition, there will also be transitional arrangements for DSR and storage, designed to address any initial barriers to their participation given their different characteristics to generation. This includes running three preparatory auctions: alongside the first primary auction, if initiated, in 2014; in 2015; and 2016. These auctions would be restricted to DSR and small scale storage and would assist those industries in building their capacity and capability.

The Government is also consulting later this year on possible policy approaches that can best unlock the potential for electricity demand reduction. This includes the inclusion of demand reduction within the Capacity Market.

38. We recognise that a more thorough assessment of cost-effectiveness must await the publication of detailed capacity market proposals. DECC should conduct further analysis on the costs of the capacity market to ensure it is not significantly higher than alternative options such as a strategic reserve. The Government should clarify how the Energy Bill will ensure that the capacity delivered by auctions will have the appropriate characteristics, such as flexibility, and how this relates to the System Operator's existing system balancing role, in order to ensure that costs are minimised. (Paragraph 175)

⁶ <http://www.ofgem.gov.uk/Markets/WhlMkts/monitoring-energy-security/elec-capacity-assessment/Documents1/Electricity%20Capacity%20Assessment%202012.pdf>

The analysis set out in the December 2011 Capacity Mechanism Impact Assessment⁷ indicated that a Strategic Reserve is not as robust as a Capacity Market to a range of security of electricity supply scenarios. This is principally because of the risk of ‘slippery slope’ associated with the Strategic Reserve. This is where the size of the Strategic Reserve grows significantly as a result of plant seeking to join the Reserve, undermining effective market operation and increasing costs to consumers. This effect could occur because the reserve would need to be held outside the market and only deployed in emergencies to minimise distortions to the energy market. This increases risk for plant in the market because at times of high prices investors would fear that the reserve would be deployed, which would have a dampening effect on prices and increase uncertainty of revenues.

These issues mean that a Strategic Reserve would be a risky intervention in the market and less suitable to addressing a long-term capacity problem. In addition, the design parameters of the Strategic Reserve make it difficult for Demand Side Response to participate given that it would be held back from dispatch until prices had risen to very high levels.

With regards to flexibility, the Capacity Market will be designed to ensure the electricity market provides the right incentives for delivery of the right mix of flexible capacity, and the intention is not to pick specific generating types for participation in the Capacity Market. However, there will be pre-qualification criteria for participation in the capacity auction to ensure sufficient total reliable capacity is available. The Capacity Market will ensure reliable capacity is in place for the long term, but the System Operator will continue to have a role in balancing the system in real time to address sudden, short-term shortages in electricity. That is the role of Balancing Services such as Frequency Response and Short Term Operating Reserve (STOR), which will continue to be used alongside the Capacity Market.

42. The Government should clarify how the capacity market will be made compatible with increased interconnection and the move to a more integrated European electricity market. (Paragraph 193)

There are a number of potential benefits of enabling capacity located outside the GB market but connected to GB via interconnectors (interconnected capacity) to participate directly in the Capacity Market. However, there are also a number of challenges to doing so – in particular, whether it is possible to ensure that interconnected plants are delivering energy to the GB market at system stress.

Our work with the Capacity Market Expert Group, and discussions with the European Commission and other EU Member States, has identified a number of difficulties with allowing interconnected capacity to participate on equal terms to GB capacity.

⁷http://www.decc.gov.uk/en/content/cms/legislation/white_papers/emr_wp_2011/tech_update/tech_update.aspx

We will look to establish principles which, if met, would enable interconnected capacity to participate within the GB Capacity Market. We will take into account the contribution that current and planned interconnected capacity can make to GB capacity at times of system stress when setting how much capacity to contract for through the Capacity Market

The Government recognises that ideally foreign capacity would be able to participate on the same terms as domestic capacity. As such, we are working closely with our European neighbours as we design the Capacity Market. We will keep the design of the Capacity Market under review as the domestic and European energy markets develop, and will consider opportunities for including foreign capacity in future.

Electricity Demand Reduction (EDR) and Demand Side Response (DSR)

12. The draft Bill and its associated documents are fundamentally flawed by the lack of consideration given to demand-side measures, which are potentially the cheapest methods of decarbonising our electricity system. Responsive demand features only to a limited extent in the proposed capacity market, a subject we discuss in Chapter 5. Reducing overall demand, meanwhile, is entirely absent from the Bill. Indeed, the Secretary of State admitted to us that “there is a lot of work we should be doing and are doing on that”. We recommended, over a year ago, that “demand reduction should be placed at the heart of EMR”. It is completely unsatisfactory that DECC’s work was not completed in time to be published alongside the draft Bill. This suggests that DECC is still failing to give enough priority to ensuring that demand side measures contribute to our energy policy goals. We are concerned that adding last-minute measures to an already pre-determined structure of a Bill may severely limit what can be achieved on demand reduction and management through EMR.

13. We note that DECC’s draft report on capturing the full electricity efficiency potential of the UK identified approximately 155TWh of demand reduction potential in 2030 (which represents around 40% of total demand). Of this potential, current policy is estimated to capture only around 35%. We recommend that permanent end-use reduction in electricity demand should feature much more prominently in the Bill in order to realise some of the remaining 65% savings. (Paragraph 51)

14. We note the publication of DECC’s draft report on capturing the full electricity efficiency potential of the UK and recommend that measures to encourage permanent end-use reduction in electricity demand are included in the Bill. We recommend an amendment to the draft Bill to provide the Secretary of State with powers to introduce a Feed In Tariff for energy efficiency, if this cannot be achieved through existing legislation. The Bill should also include stronger measures to encourage flexible, responsive demand, as we discuss in more detail in later recommendations. (Paragraph 58)

In the EMR White Paper, we recognised that reducing demand for electricity is likely to be more cost-effective than building additional generation capacity. In response to comments from the ECC Committee and other stakeholders, in July 2011 the Government set up a project to consider the opportunities for Electricity Demand Reduction in the context of EMR. The assessment we published in July 2012, “Capturing the full electricity efficiency potential in the UK” concluded that there is significant potential to use electricity more efficiently in the UK, and that current trends and policies will capture only part of this potential. We therefore committed to consult later this year on potential policy approaches that can best unlock this potential, taking into account existing policies, the opportunities of Electricity Market Reform and the Government’s wider Energy Efficiency Strategy. We have considered a wide range of policies in advance of this consultation – including policies which could be implemented within the Electricity Market Reform programme, and approaches outside of EMR.

A Feed in Tariff for Electricity Efficiency is among the options under consideration – the next step is to develop and evaluate a range of policy approaches. We believe this timeframe to be consistent with inserting clauses into the Energy Bill by amendment in the spring, should the final preferred options(s) require this. However, we have made no commitment to taking action in the Bill as this may not be the most appropriate way to take forward all the options under consideration. In order to explore the potential options, a Consultation has now been published⁸ to seek the views of stakeholders.

41. As innovative technologies, demand-side response and storage technologies should be recognised and defined explicitly in the Energy Bill. Support for innovation is given to the supply-side, for example by the banding of the Renewables Obligation, and the Bill should provide similar support to demand-side and storage technologies. DECC should investigate the legislative and other barriers to storage identified by our witnesses, and remove any that prevent it from competing fairly in the market. (Paragraph 191)

The Government investigated the need to take action to promote the deployment of key balancing technologies (including Demand Side Response (DSR) and storage) as part of its work on system balancing. There is no evidence to suggest that legislation is required to ensure storage and DSR can compete fairly in the market. The Government will however be taking forward a series of non-legislative actions to identify any barriers that may exist and ascertain what incentives, if any, may be required. In any event we are committed to work to ensure that DSR and electricity storage can play a fair and equivalent role in the Capacity Market. More generally we will seek to ensure that EMR is implemented in a way that allows the development of flexible solutions to generation challenges. Further to this, the Government is developing a proposal to put in place transitional arrangements for DSR and storage that is intended to ensure

⁸http://www.decc.gov.uk/en/content/cms/consultations/edr_cons/edr_cons.aspx

that they are not disadvantaged through the design of the primary auction process and that the market for both of these technologies develops.

Liquidity

15. The EMR provisions as they stand are likely to undermine Ofgem's efforts to increase competition in the wholesale markets. We therefore recommend that the Government amend its current proposals to avoid the likelihood that they will lead to more- not less- vertical integration and consolidation in the market. (See Chapter 3). (Paragraph 64)

The Government understands that low levels of liquidity in the wholesale power market present challenges to independent market participants, i.e. those that are not significantly vertically integrated. Improved liquidity will support independent market participants by providing trading and risk management opportunities, thereby allowing them to compete on a more even footing with other business models. We therefore support the objectives set out by Ofgem to increase competition in the wholesale market by addressing low liquidity. Industry has responded to some degree to these concerns, including through significantly increased trading on the day ahead exchanges, but there is more that industry can do especially in relation to improved forward market liquidity. In the absence of adequate progress regulatory intervention may be justified. Ofgem are currently developing their proposals and are expected to be able to set out their position and next steps this winter.

The Government believes that improved liquidity is essential to supporting independent market participants and the widest possible range of investment in our electricity market as well as ensuring that CfD reference prices are robust and reflect market fundamentals. The Government is therefore seeking powers in the Energy Bill to improve wholesale market liquidity if necessary.

The Government is also responding to concerns raised by independent generators about their ability to secure long-term contracts for their power. The Government response on this issue is covered under responses to Recommendations 28 and 29.

Small suppliers and independent generators

17. We consider that suggestions that small suppliers might be exempted partially or wholly from obligations to post collateral have merit and recommend that the Government takes steps to ensure that small suppliers are not disadvantaged. (Paragraph 87)

The Government believes that competition is key to keeping energy bills as low as possible. That is why we have been working to reduce barriers to entry and growth for small suppliers and independent generators. We have been working to improve competition in the retail energy market. We have cut red tape for

small suppliers to help them compete on a level playing field with the larger suppliers.

At the same time, the posting of credit and collateral for a future CfD payment period is an important part of ensuring certainty of payment for generators and an established method within existing market arrangements.

It is important that the Government understands the impacts of the supplier obligation on all suppliers including small suppliers, and whether or how those impacts can be mitigated.

For this reason, we set out more detail on our proposed approach to the supplier obligation and have published a call for evidence⁹ for suppliers to respond to on impacts of the proposed obligation, including collateral arrangements, on their businesses. It is intended that this exercise will highlight the extent of any issues suppliers may face in delivering the obligation for the Government to consider steps in which to mitigate adverse impacts. Further detail on the supplier obligation will be published in spring 2013.

Independent generators

28. Access to market for independent generators under the CfD arrangements is an extremely serious issue that must be resolved before a Bill can be introduced. We recommend that DECC expedites its review of evidence on access to the electricity market for renewable generators to ensure that a solution to this issue is identified before the Bill is introduced to Parliament in the “autumn”. (Paragraph 124)

Independent renewable developers have raised concerns about their ability to secure bankable Power Purchase Agreements (PPAs) in the current market. In response to these concerns the Government published a call for evidence on 5 July 2012, seeking to build the evidence base for policy development in this area. The call for evidence closed on 16 August. The evidence that we received broadly supports the views of the independent generators that the market has shifted in recent years and that generators are finding it difficult to secure PPAs on terms that are as beneficial as they used to be.

The drivers for the issues in the current market include the extent to which the large suppliers can meet their renewable obligation from their own generation and existing PPAs, the accounting treatment of PPAs (especially where they include floor prices) and uncertainties around imbalance pricing. There is no evidence that projects have failed because developers could not secure a PPA.

Independent gas developers also raised concerns about their ability to secure PPAs, both now and in the future. Cited reasons included the currently low market price due to a relatively high capacity margin, and the large energy companies focusing on developing their own generation.

⁹ http://www.decc.gov.uk/en/content/cms/meeting_energy/markets/electricity/electricity.aspx

29. We recommend that as part of its review of access to market for independent generators, DECC should examine the following options: introducing a buyer of last resort; introducing an incentive for suppliers to source energy from low-carbon generation; extending the micro-gen FiT to projects up to 50MW in size; and holding open the RO for new entrants in the event that the PPA market disappears. (Paragraph 128)

The Government's view is that the CfD offers a number of improvements over the current system that should improve conditions in the Power Purchase Agreements (PPAs) market. Most notably, the structure of PPAs is likely to be simpler and more transparent because there is no longer a need to market the ROC. In the longer term this is likely to contribute to additional competition in the PPA market. However, there may be a period of transition as market participants respond to the new support mechanism and consider the appropriate response to pricing and risk transfer.

Taken with the lower risk profile of the CfD and the removal of a number of temporary factors, a competitive PPA market is likely to develop. These temporary factors include uncertainties associated with end of the RO (which may mean suppliers do not want long-term contracts for ROCs) and wider regulatory uncertainty. We will focus on the efficient delivery of the EMR programme and we are working with market participants to explore a process from December 2012 to prepare for the introduction of the CfD and identify the changes to the PPA market that may be required to ensure a speedy transition.

If it becomes clear that the implementation of EMR and associated market-led approaches have not led to the development of an efficient market for PPAs then we will consider the need to regulate. The Government is, therefore, seeking powers in the Energy Bill that would enable Government to make modifications to electricity supply licences for the purpose of reducing barriers to entry associated with the PPA market. If necessary, these powers will be available if the PPA market does not develop as anticipated.

We are also seeking powers in the Energy Bill which ensure that the Government is able to act to improve market liquidity in order to improve trading opportunities for independent market participants (including aggregators) if necessary.

The Committee suggests that the Government considers the option of increasing the small-scale Feed in Tariffs (FITs) to support projects up to 50 MW in scale. This would be a significant change to the purpose of the FITs scheme – which is to incentivise the deployment of small scale distributed generation. There are no indications that the individuals, communities and small businesses for which the FITs scheme is designed are seeking to install generation of this scale. In relation to the RO, we do not intend to extend it as this does not represent value for money for consumers.

39. As we recommend in paragraph 223, it is vital to have an understanding of the likely impact of EMR on the future role for gas generation. DECC should conduct modelling work to assess the combined impact of the

Capacity Market and the EPS on emissions and security outcomes under different scenarios. This should include both a “dash for gas before 2015” scenario and a “no new gas before 2015” scenario (Paragraph 183)

51. It is vital to have a clearer understanding of the likely impact of the EMR proposals on the future role for gas. We hope that the Government’s forthcoming Gas Strategy will provide clarity about both the Government’s vision for the role of gas in the electricity system, and how the EMR proposals will deliver this in practice. There would be merit in assessing the combined impact of the Capacity Market and Emissions Performance Standard on energy security and climate change objectives. We recommend that DECC conducts modelling work before introducing the Bill to investigate the combined impact of the capacity market and EPS on emissions and security outcomes under different scenarios. This should include “dash for gas before 2015” scenario and a “no new gas before 2015” scenario. (Paragraph 223)

The Government’s Gas Generation Strategy will set out the potential role of gas in a future low-carbon electricity system, and how the EMR proposals will deliver this in practice. The Government expects that gas will continue to play a major role in our electricity mix over the coming decades, alongside low-carbon technologies as we decarbonise our electricity system. This is consistent with our security of supply goals and the least cost pathway to our legally binding commitment to cutting emissions by 80% by 2050.

The supporting analysis for the Gas Generation Strategy will model the impact of the EMR proposals on the future role of gas-fired capacity, with a range of scenarios considered including the impacts of the, as proposed, EPS and Capacity Market policies on the amount and role of new gas-fired capacity that might be deployed by 2030.

The Gas Generation Strategy will be published shortly and we are confident that that the EPS and Capacity Market policies as currently proposed together with our strategy for new gas are consistent with the delivery of our energy and climate change objectives.

40. We recommend that the Government, in its forthcoming Gas Strategy, considers the interrelationship between electricity market reform and the capabilities of the gas infrastructure, in particular the potential need for more gas storage. (Paragraph 184)

We agree that the interrelationship between changes in the electricity sector and gas infrastructure is important. A part of this will be the likely need for additional storage facilities as we become more reliant on imports, and as gas plays a larger role backing up intermittent renewables. Four fast-cycling storage facilities are currently under construction which will increase current capacity by around 20%, and almost double daily deliverability rates. There are also ten storage projects with planning consent for more than double the current storage capacity. However gas storage, while important, provides only part of the picture in ensuring security of supply. UK gas demand is met through a diverse and varied

range of sources: from domestic production (which currently meets around half of annual demand); imports via pipeline from stable sources such as Norway; and imports of LNG from a growing global LNG market.

In addition, Demand Side Response through interruptible contracts with large users ensures domestic consumers are prioritised in the case of an emergency. Independent reports published by DECC in July 2010 suggested that the GB gas market was operating well, the outlook for security of supply was broadly benign, and that major changes to our market framework were not required. However, we take seriously the gas security of supply risks around the changing use of gas for power generation. Ofgem's Significant Code Review (SCR) aims to sharpen incentives on gas market players to consider security of supply. We also asked Ofgem to report to us on the merits of possible further interventions in the gas market, and in light of this the Government will be considering further whether there is a case for providing support for gas storage, and will publish our findings in Spring 2013.

45. CCS is a special case and it is important not to risk delaying or undermining the development of the technology. But DECC should ensure that the Bill provides sufficient safeguards so as to avoid the unintended consequence of undermining decarbonisation. There may be merit in the inclusion of a minimum proportion of emissions to be captured by CCS plants in clause 37. (Paragraph 207)

The Government acknowledges the point made by the Committee in respect of the application of exceptions to the EPS for CCS demonstration projects and the concerns to which the clause gives rise.

The Committee quite rightly points out that CCS is a special case, and recognises that the policy intent behind the option to provide exceptions to the EPS for CCS demonstration projects is to assist the swift development and early deployment of CCS. However, the Committee also points to the risk that effectively taking all, or part of, a new-coal fired power station outside of the EPS regime could potentially undermine both the safeguards that the EPS is intended to provide and our decarbonisation objectives.

Given the current stage of the CCS Commercialisation Programme and the range of CCS projects that are competing for funding support (both in terms of maturity and design), it is, at present, difficult to be precise about the impact that the EPS may have on the ongoing commercial viability of a CCS project in the event that the CCS performs poorly or fails outright. In these circumstances there could be a number of things which impact on a project, for example the carbon price, and each potentially to a greater or lesser degree than the EPS.

The Government has therefore considered carefully the Committee's recommendation and the evidence provided to the Committee and decided, on balance, that the most appropriate way to manage any EPS related risk is through the CCS project contract. This provides greater flexibility to manage any

EPS related risk, along with other project risks, on a case-by-case basis, while leaving projects within the EPS regime and the safeguards it provides.

The Government will not now legislate for CCS exceptions to the EPS as part of the Energy Bill.

46. We believe that any decision to exempt plant from the EPS on energy security grounds should be subject to Parliamentary scrutiny, even if this scrutiny has to be retrospective. (Paragraph 209)

The EPS provisions contain a power enabling the Secretary of State to make provision in secondary legislation to suspend the EPS where he believes that doing so will reduce a potential shortfall of electricity.

The intent behind this provision is to provide a degree of flexibility to the EPS that would allow the Government to deal with any potential threat to security of supply that arose as a consequence of, or in part, due to the restriction that the EPS will place on a generators operating hours. We wish to avoid such unintended consequences, so the ability to suspend the EPS in circumstances such as a short-term supply emergency is necessary.

The Committee accepts that this is a sensible provision to take, albeit that it would only be applied under exceptional circumstances, the likelihood of which are remote. The Government accepts the Committee's recommendation that any such decision to suspend the EPS should be subject to Parliamentary scrutiny and we have therefore amended the Bill to include a requirement that the Secretary of State lay a Statement before the House in the event of a decision being taken to exercise the power to suspend the EPS.

Conclusion

There is an urgent need to reform our electricity market. Reform is needed to meet our climate change commitments; to ensure we continue to benefit from secure electricity supplies; and to diversify our energy mix so that consumers are not exposed to price shocks in the price of gas.

Our programme of Electricity Market Reform will deliver on this challenge, as well as open up huge opportunities for growth by attracting private sector investment in low carbon energy now, while spreading the cost to households over the operational lifetime of the schemes.

We are extremely grateful for the work undertaken by both the ECC Select Committee and Lords Informal Scrutiny Group, in scrutinising the draft Energy Bill and making a number of recommendations on ways it can be improved. We agree with many of these and have made changes as a result.

Concerns were raised on the counterparty arrangements for CfDs. We have changed the draft Bill accordingly and will establish a new body, owned by

Government, to act as a single counterparty to the CfDs. This move has been welcomed by both generators and suppliers.

It was asked that investors be given more certainty around access to CfDs – an important step if we are to secure the investment we need. We have responded by enabling generators to apply for a CfD earlier in the process, so long as they deliver on their commitments too.

Greater clarity was sought on how the Capacity Market would work. Alongside the Bill we have published further design details and will be consulting on further detail next year, alongside the Bill's passage through Parliament.

We look forward to working closely with Members of both Houses, as well as wider stakeholders, as we now take these reforms through Parliament. We hope all stakeholders will support our long-term vision for a diverse energy mix, where low carbon generation can compete fairly on cost.

EMR is a flexible toolkit that will take us through this transition, working with the existing market and maintaining a market-based approach while addressing market failures. It has been designed to meet the investment challenge we face and deliver this at lowest cost. It will keep the lights on and help us meet our climate change commitments, while minimising costs to consumers.



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