**Department of Energy and Climate Change**

**Supplementary Memorandum to the Delegated Powers and Regulatory Reform Committee**

**on Part 2 (electricity market reform) of the Energy Bill**

## INTRODUCTION

1. This supplementary memorandum responds to the request of the Delegated Powers and Regulatory Reform Committee ("the Committee") for further detail about the delegated powers in Part 2 of the Energy Bill.

2. Part 2 of the Bill encompasses provisions dealing with electricity market reform and comprises chapters dealing with contracts for difference, the Capacity Market, investment contracts, provisions relating to managing conflicts of interest, access to the market, transitional provisions for the renewable obligation and the emissions performance standard.

3. This supplementary memorandum focuses on the key delegated powers in chapter 2 (contracts for difference) and chapter 3 (Capacity Market) and also provides further detail on the delegated powers that will be used to implement investment contracts in chapter 4. The supplementary memorandum also discusses the rationale for the powers being taken in chapter 5 to manage any conflicts of interest which might arise through the implementation of the Electricity Market Reform ("EMR") policy which underpins the provisions in Part 2.

4. This supplementary memorandum is structured so that the delegated powers in each chapter of Part 2 are discussed as follows:

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| Section I | chapter 2 (contracts for difference); |
| Section II | chapter 3 (Capacity Market); |
| Section III | chapter 4 (investment contracts); |
| Section IV | chapter 5 (conflicts of interest); |
| Annex | summary of further policy detail available to the Committee. |

5. In Parts A, B and C the Department has been mindful of the Committee's strong desire to see more detail about what is to appear in the regulations. In providing this additional detail the Department has sought to structure Part A around some questions which it helpfully received from the Committee's Legal Adviser. We have tried to answer equivalent questions as part of providing further detail for the delegated powers in chapter 3 (Capacity Market).

6. The further detail provided is complemented by the information contained in the Annex which sets out the practical context in which the powers in Part 2[1] will be exercised.

[1] In addition to further information supporting the discussion in Sections I and II the Annex contains a general description of the powers in chapters 6 (access to markets), 7 (renewables obligation: transitional arrangements) and 8 (emissions performance standard) and their intended use. Further detail on the powers in chapters 6-8 help to provide a complete picture of the EMR policy.

**Section I – delegated powers in chapter 2 (contracts for difference)**

7. Clause 6 provides that the Secretary of State,

"*... may, for the purpose of encouraging low carbon electricity generation, make regulations about contracts for difference between a CFD counterparty and an eligible generator*."

and accordingly sets out the purposes for which the Secretary of State may make regulations under this provision. The essential components of this power are: (i) a contract for difference; (ii) a CFD counterparty body; and (iii) an eligible generator.

8. A contract for difference is defined in clause 6(2) whilst a "CFD counterparty" is an eligible person who is designated by order under the power in clause 7[2]. It is intended that the person designated will be a company set up by government for the purpose. The company we intend to designate is in the process of being set up, and we anticipate its incorporation towards the end of 2013 or in early 2014.

9. Designation can only take place with the consent of that person (as they will be accepting significant liability under the contracts which they will be required to enter). That consent can be withdrawn (with notice) and the Secretary of State can revoke a designation. This may be because the counterparty in place is not performing well, or because it is at risk of insolvency. In those circumstances it is critical that the CFD scheme can continue, so the Secretary of State retains a power to designate a new counterparty and transfer the contracts to that person.

10. The third component within the power in clause 6 to make regulations relates to an "eligible generator". Under clause 10(3), the Secretary of State has the power to define an "eligible generator".

11. In exercising the power in clause 10(3) to define an "eligible generator" the Department will be looking to catch a person responsible for a generating plant which is to be supported by the CFD scheme. The power here is limited by clause 6(1) and (3) such that the plant to be covered must be capable of producing "low carbon electricity".

12. In our view, at its widest "low carbon electricity" will catch nuclear power, carbon capture and storage ("CCS") and renewables generation which could have been supported under the renewables obligation.

13. A plant capable of being supported by the renewables obligation is identified in section 32M of the Electricity Act 1989 where "renewable sources" is defined as "sources of energy other than fossil fuel or nuclear fuel, but includes waste of which not more than a specified proportion is waste which is, or is derived from, fossil fuel". It would not be appropriate to have relied on the definition in section 32M because the definition would exclude type of generation which we wish to support under the CFD regime; nuclear generators will be powered by nuclear fuel and CCS plant may be fuelled by fossil fuels.

14. Conversely a definition without the restrictions in section 32M would have covered generation plant of any nature and therefore would be too wide. Therefore, for "low carbon

[2] Subsection (3) of clause 7 sets out the requirements of an "eligible person".

generation" we have adopted a definition of which is based upon provision in section 82(7)(j) of the Energy Act 2004 which is about the identification of energy sources which would reduce greenhouse gas emissions.

15. By adopting a definition based on section 82(7)(j) the Department feels an appropriate balance is achieved to maintain flexibility for the purposes of defining an "eligible generator" and ensuring an effective constraint is applied to the power. The Secretary of State must specify the generation that he believes will contribute to a reduction in emissions of greenhouse gases (and therefore which plant may be supported) is at the time of the making of the regulations.

16. Turning to the issue of who is a "generator" for the purposes of the power to define "eligible generator", in the Department's view the "generator" at its widest means someone concerned with the generation of electricity. It was considered whether this might be defined as a person who holds a generation licence under section 6(1)(a) of the Electricity Act 1989. However, since the CFD contract is intended to be awarded to a plant before it has been built it was thought unlikely that a direct link to the licensing system could work. In addition as contracts may be provided at an early stage of their development the eventual operator of the plant may not be the same as the developer applying for the CFD. Energy projects are likely to have complicated financing structures so it is important that the definition recognises and applies to the actual entity which is in the best position to ensure the CFD is executed and that any project complies with the contract's terms.

17. The Committee may wish to note that in Schedule 2 paragraph 1(3) provides a definition of "electricity generator". This concept is analogous to "eligible generator", but the definition of electricity generator is more precise as to the nature of the person covered. The Department feels it is appropriate for that more precise definition to be included there only because the provisions in Schedule 2 are transitional (indeed a trigger for the end of the transition period is the coming into force of a definition of eligible generator under clause 10(3).

18. However, this would not be appropriate for the enduring regime envisaged in chapter 2. Given the complexity of energy projects mentioned above it is likely that over the period of the different project and corporate structures may need to be catered for which cannot be envisioned now. Further, if the scheme is eventually extended to jurisdictions outside the UK (as it might where the electricity itself is to be supplied to UK consumers) the scheme may have to take account of different types of corporate structure recognised in those jurisdictions. In those circumstances extensive provision may be necessary covering the position in relation to multiple jurisdictions.

**Directions to Offer to Contract: what are the circumstances in which they may be given?**

19. The policy intention is for the Secretary of State or the national system operator, in accordance with any provision made by regulations, to direct the CFD body to offer a contract with a person specified in the direction, see clause 10(1).

20. Directions will be given following a process the Department calls "allocation". The Department expects that the great majority of projects which wish to benefit from a CFD will submit an application to the national system operator. The national system operator must issue

a direction if such a project a) meets the criteria which will be set out in the regulations and b) there is sufficient budget (which will be determined in accordance with the maximum costs order under clause 17).

21. There will, however, be projects for which the "allocation" process will not be suitable and it is for this reason that the Department has taken a power enabling the Secretary of State to direct the CFD counterparty to offer a contract on specified terms. Before exercising the power to issue a direction the Secretary of State will enter into bilateral negotiations with a developer, where the generic terms are unsuited. Bilateral negotiations will be appropriate when a project is sufficiently expensive or important. Where such bilateral negotiations are held it may be appropriate to introduce bespoke terms in relation to, for example, the sharing of refinancing gains. Where the largest generators are able to later negotiate cheaper financing following construction, bespoke contract terms may enable suppliers (and therefore consumers) to share the benefits of lower financing costs. It may also be necessary to introduce bespoke terms in relation to novel projects such as CCS where one project may vary significantly from another and a generic approach could lead to overcompensation of some projects.

22. It is in order to deal with the type of situation described here that the Department feels it is necessary to retain the flexibility to deal with particular projects on an individual basis and has, accordingly, sought the power in clause 10(1).

**Directions to Offer a Contract: what are the terms?**

23. Whether the Secretary of State or the national system operator makes a direction, that direction must specify the terms of the contract to be offered by the counterparty to the eligible generator. The terms specified will amount to the commercial terms of the contract between the generator and the counterparty that will exist following the generators acceptance of the offer.

24. At its core a CFD is a payment contract so the most important terms will be those about strike price and the reference price which determine the amount and direction of payments. However as the contracts are designed to cover a long period of time (normally 15 years) other "specified terms" are likely to include those which ensure that the contract can continue to work over that period. As the heads of terms document published by the Department in November 2012 indicated, there will be terms about, for example, termination, metering arrangements, change in law, dispute resolution and force majeure.

25. The Department expects that standard terms will substantially be provided for by the regulations (either by referring to terms contained in another document or by including terms in a schedule to the regulations). This will form the basis for the terms which the national system operator will have to include in a direction as "specified terms". Directions by the Secretary of State following a negotiation can be expected to be substantially similar to those given by the national system operator but subject to any negotiated variation.

**Decisions during allocation**

26. In the first few years CFDs will be allocated on an administrative basis. However, the intention is to move to a process by which the national system operator may hold auctions or use some other competitive process to allocate CFDs and determine the strike prices for those contracts. It is for this reason that the Department has sought the power in clause 10(4) and (5)(a) to enable it to quickly and efficiently move to a competitive process in order to secure best value for consumers.

27. Whilst it will be for the Secretary of State or the national system operator to decide whether they must exercise their function of making directions they may need to have regard to the existence of facts or information which they are not best placed to appraise by themselves. Clause 10(5)(b) enables provision to be included in the regulations for the determination or calculation of certain specific matters (which must be specified in the regulations) by specified persons in order assist the national system operator in establishing whether or not contracts should be offered. Without the provision it might be impossible for the Secretary of State or the national system operator to rely on determinations or calculations made by others as it could constitute unlawful sub-delegation. It is based upon provision in section 32K(1)(c) of the Electricity Act 1989. Matters to be dealt with in this way include those that would rely on independent expertise to determine whether particular facts are true. For example, we may include provision about that requires the national system operator to estimate the value of the contracts in order to determine whether issuing a direction would breach the budget. In order to do that we may require it to rely on estimates of long term electricity prices from a particular source (in which case the entity providing those numbers would be determining something). Calculations may also be necessary which make use of particular (electricity or general) market indices.

**Appeals against allocation decisions**

28. The Department recognises that a decision not to exercise the power in clause 10 (to direct a CFD is offered) may result in a person wishing to challenge that decision and the Department is currently actively considering the best mechanisms for an appeal. The Department fully expects to include provision, using the power in clause 10(6), for applicants for a CFD to be able to appeal against a Delivery Body's decision not to allocate a CfD. However, the Department is currently carefully considering the precise design of that appeal mechanism.

29. The Department's current view is that an applicant could ask the national system operator, National Grid, to review their decision to ensure no procedural error had occurred. If National Grid remained satisfied that no procedural error has occurred in the decision making process, the applicant might apply to a third party to check that the decision had been properly made. The Department is currently in discussion with Ofgem to determine whether it could provide this appeal service. This appeals process would be built into the application timetable ensuring that in the event of a mistake the issue could be rectified without the applicant losing out of an allocation, or other applicants being disadvantaged by retrospective correction of errors. For example, if the limit of the budget was near, a successful challenge by an applicant against a refusal to issue a direction in respect of that applicant might cast doubt on successful applicants who applied after the first applicant but before the settlement of the appeal.

Detailed provision is therefore being developed to ensure that the correct balance can be struck between early certainty for projects and the right to have matters reconsidered. The balance may change over time depending on whether projects are being allocated administratively or following competitive process.

30. In the event that the applicant was still not satisfied they would then be able to apply for judicial review of the decision. The Department expects the grounds upon which an applicant might appeal will relate to the determination of their eligibility, and on the allocation itself.

**The Supplier Obligation**

31. In opening Part A reference is made to the counterparty, see paragraph 5. The counterparty will be exposed to the liabilities under CFD contracts and will need a means to pay for them. As with previous electricity market support schemes, we have decided that the costs of the scheme will be borne by suppliers. This is because suppliers are the electricity market's only interface with consumers who are the ultimate beneficiary the transition to a low carbon electricity system (through reduced exposure to fossil fuel prices). Clause 9(1) therefore requires that the regulations make provision for suppliers to make payments to meet the liabilities of the counterparty under CFD contracts. The principal liability arising will be the payments that must be made to generators under CFD contracts. It will be up to electricity suppliers as to whether and the extent to which they pass those costs onto consumers, although we would anticipate that (subject to competitive pressures) that they will do so.

32. The "levy control framework" is designed to limit the exposure of suppliers (and ultimately consumers) to costs arising from schemes such as these. It already applies to the Renewables Obligation and will apply to CFDs. The levy control framework limit will be reflected in the order made under clause 17.

33. The greatest proportion of costs which a counterparty is likely to be exposed to will relate to the support offered to generators under the CFD contracts; this support will come in the form of top-up payments made by the counterparty body so that the generator is able (if it can sell its electricity for the average market price) to achieve a minimum revenue for its electricity (the strike price). Whilst it is imperative that the counterparty is funded sufficiently in order to make the payments required of it, it is also important that the requirements on suppliers can be imposed on suppliers in a manner that does not cause them excessive burden. To achieve both aims sophisticated provision is likely to be needed in regulations. That is likely to include the operation of reserve funds (see clause 9(2)(b)), mutualisation of losses between suppliers (clause 9(2)(c)) and extensive forecasting provisions. In addition provision will be needed to fairly distribute the obligations between suppliers in accordance with their comparative abilities to pay.

34. Aside from the top up payments which the counterparty needs to be funded to make the Department expects the running costs of the counterparty to also be paid (staff, accommodation, external advice etc.). The Department expects those costs to be approximately £15 million per annum for the first few years of the scheme (though it should be stressed this is only indicative and we will publish further and refined estimates in due course). If the counterparty incurs costs which are not connected with CFD contracts or the

operation of the supplier obligation[3] or any other requirements imposed upon it under chapter 2 of the Bill (such as any reporting requirements under clause 13) these will not be recoverable. The amendment made to clause 9 at Commons report (in what is now Clause 9(3)) makes this clear.

35. Having described the purpose of the power in clause 9(1) it is instructive to look at the specific power in clause 9(6). Clause 9(6)(a) deals with collateral. It is important to bear in mind that it is essential that suppliers provide collateral in order to safeguard the counterparty's ability to make payments to generators. The collateral will act to insure against the risk of suppliers defaulting on their obligations to pay the counterparty body.

36. Determining the amount of collateral for a particular supplier or a class of suppliers will require technical rules and so it is, in the Department's view, appropriate to set this sort of detail out in regulations.

37. There are many forms of collateral and it can be difficult to determine in advance whether a particular form of collateral, or collateral on particular terms presented would be sufficient. In all circumstances suppliers will be able to meet their collateral requirements with the payment of cash. However regulations may also allow them to provide letters of credit from financial institutions, which may be more cost effective for them. Clause 9(6)(a) will therefore allow the counterparty to make the decision about whether the collateral provided actually meets the requirement for collateral which will be set out in the regulations.

38. Clause 9(6)(b) is designed to enable the counterparty to calculate in accordance with calculations set out in the regulations what money is to be recovered from suppliers and how it is to be divided between them. The calculations will be based upon the amounts of money that the counterparty will have to pay under the contracts – which is, as yet, unknown. The division of the payments between suppliers will be based upon the amount of electricity they supply in a particular period.

39. The principal means of enforcement (clause 9(6)(d)) is now set out on the face of the Bill in clause 9(9). The counterparty will be able to recover sums owing as if they were debts to it. This is important to ensure that the counterparty can quickly pursue money owing to it to ensure that it can comply with its contract. In addition Ofgem will be able to carry out enforcement of persistent non-compliance as they currently do in relation to licence breaches with the obligations treated as relevant requirements within the meaning of section 25 of the Electricity Act 1989. There is a penalty regime in relation to such breaches found in sections 25 to 28 of that Act which would therefore apply.

**Determinations and Calculations under the Supplier Obligation**

40. Whilst the counterparty will be ultimately responsible for the imposition of the supplier obligation in accordance with the regulations, there may be need to be others involved. The counterparty will need to make calculations about the amount of money to be recovered. In order to do this (as with clause 10(5)) it may need to rely on calculations about future electricity prices to determine how much money it will need so there may be a reference to

[3] The obligation imposed on suppliers to make payments to the counterparty by virtue of the power in clause 9.

specified sources for that information to provide that aspect of the calculation. Clause 9(7) is designed to allow such sources to be specified. As we have mentioned above, the division of the obligation between suppliers will be on the basis of the amounts of electricity supplied in particular periods. In order to assist determining and calculating what those amounts are we are likely to ask the counterparty (and indeed suppliers) to rely on Elexon. Elexon are the company responsible for administering the balancing and settlement system. This system is used by all electricity market participants to ensure that the electricity system is balanced (i.e. supply is equal to demand – the electricity system will break down if there is significant deviation between the two). In order to administer the system Elexon has access to data about all supply and demand from the system and so is uniquely placed to calculate how much electricity suppliers have supplied in a period.

41. No entity will be exercising extensive discretion in relation to the determinations and calculations they make. They will be principally applying formula for calculations and methodologies set out in the regulations or using data from industry mechanisms to which suppliers are party.

42. To the extent any person can be said to be exercising a discretion under provision made by virtue of 9(7) it is only a limited discretion to calculate or determine. The provision is about determining matters of fact on the basis of judgement or opinion rather than conferring a discretion to decide how things should be.

**Payments back to suppliers**

43. In principle, suppliers can expect to be paid all sums which the counterparty has not used to meet liabilities under the contracts, sums held in reserve for the purpose of doing so, or to pay for its costs. The situation where the counterparty holds money which is not being used for these purposes may arise for two reasons. Firstly, the counterparty may have collected too much (as the calculations will be based upon *expectations* of what the counterparty needs), in which case it will need to repay it at some point. Secondly, because the CFD is a two way contract sometimes generators will be making payments to the counterparty. This will be the case when the market reference price exceeds the strike price. The support offered by the CFD protects generators from low market prices, but in exchange they do not get to benefit from high electricity prices. The design of the supplier obligation is still under development, and will be the subject of a consultation in the autumn. However, our thinking at this stage is that excess sums will be credited to suppliers by way of offsetting of forthcoming obligations and actual payments made.

44. Payments to a supplier would be in proportion to electricity supplied and therefore clause 11(2) is required to enable calculation and determination of electricity supply. At present the Department thinks that the company called Elexon is best placed to do this although in the event market arrangements change this may need to refer to different persons and sources in the future.

**Avoiding insolvency of the counterparty**

45. It is critical to the success of the scheme that the insolvency of the counterparty is avoided. The provision in clause 12(1) is therefore designed to assist in avoiding the insolvency of the

counterparty. It is intended that CFD contracts will contain a provision that limits the liability of the counterparty to money actually received from suppliers so that the default of a supplier does not cause the regime to collapse. Part of the complexity of the supplier obligation will arise from mechanisms to ensure that the counterparty always has the money to meet its liabilities (such as the collateral requirement mentioned above). However, it is always possible that an extreme event could cause the counterparty to be temporarily without sufficient funds.

46. The provision in the contracts limiting liability will work in concert with provision made under this clause to ensure that whatever money is available at a particular moment to the counterparty is distributed fairly between all generators (the contracts cannot do that themselves as bilateral instruments). The government introduced an amendment to the Bill at Commons Report to make it clear that such distribution would be done on a pro rata basis. The situation will occur whenever the money collected and held by the counterparty is insufficient to meet immediate demands. It is not entirely analogous to insolvency since the continued existence of the supplier obligation means that any such situation is temporary.

47. Given the duty of the Secretary of State in Clause 15(3) to include in regulations such provision as is necessary to ensure that a CFD counterparty can meet its liabilities under CFDs, it might seem unlikely that the provision made by virtue of clause 12(1) would ever be needed. To explore this issue, it is necessary to consider the effect of clause 15(3).

48. Clause 15(3) is intended to be a duty that requires the Secretary of State to make provision under the other provisions of this part to achieve the result that he has ensured that liabilities will be met. Clause 9(1) contains a duty to include provision for payments to be made by suppliers which will enable the counterparty to make payments under CFDs so it is possible that such provision may go some way to meeting the duty in clause 15(3). However, clauses 9(2), (4) and (6) give the Secretary of State a discretion to make provision about, for example reserves and collateral. The duty in clause 15(3) frames that discretion such that in the circumstances the Secretary of State may have to make provision by virtue of those clauses because it is necessary to ensure that liabilities will be actually be met. This combination of discretions under an overriding duty should give the Secretary of State the ability to set the right combination of measures that on the one hand ensures that liabilities are met whilst also seeking to reduce the costs to suppliers and consumers (having regard to his duty under clause 5(1) and 5(2)(d)).

49. It does therefore follow that if the Secretary of State is compliant with his duty under clause 15(3), the provision under clause 12(1) should in most circumstances not be called upon because the right measures under clause 9 will have ensured liabilities are always met.

50. However, it is important that generators will have continued certainty as to what would happen, even in the unlikely event that the measures in the regulations did not in a particular instance ensure that funds were available to the counterparty to meet its immediate liabilities. Clause 12(1) accepts that exceptional circumstances may occur, and the Department believes it is right to provide for them.

**Counterparty controls**

51. The counterparty is likely to be prevented from carrying out activities which are not related to CFDs. There may also be restrictions designed to limit discretion which it might otherwise have as a party to a CFD. Clause 15(1) and (2) are designed to enable such restrictions to be imposed if appropriate.

52. Restrictions may be imposed under clause 15(1)(c) prohibiting the counterparty from varying CFD contracts (which would in all cases require the agreement of a generator) without the consent of the Secretary of State. This is to ensure that the support that was agreed through allocation is not varied. At the same time, long term contracts may well need agreed variation to take account of unexpected situations.

53. However, as the counterparty will be wholly owned by the Secretary of State he will have ultimate control over the company (although the directors will be exercising day to day control). Therefore we are still considering the extent to which statutory controls should supplement any shareholder control. Even if we considered that statutory control were inappropriate in relation to the current counterparty, if in the future the counterparty had to be changed (as envisioned by clause 7(6) and (7)) it may become necessary to introduce controls. As the scheme is likely to last for at least 20 years we judge it prudent to ensure that such possibilities are catered for. As the counterparty is central to these arrangements effective continuity must be capable of being provided.

**Functions of Ofgem**

54. Ofgem e-serve currently provide fuel measurement and biomass sustainability checks for the Renewables Obligation. Fuel measurement and biomass sustainability checks are also likely to be conditions for support under CFD contracts. In order to ensure consistency of approach between the two support schemes and avoid duplication of expertise we felt it would be appropriate to allow Ofgem to act on behalf of the Counterparty in determining whether these have been met in order to allow payments to flow. The functions are necessarily limited to determinations of matters under the contract. It will allow Ofgem to provide expert determination under the contract which is a common mechanism for the settlement of commercial disputes. The only reason this provision is necessary is because Ofgem is a statutory body. There will be other examples of expert determination under the contract which will lead to the appointment of other experts, but who do not need a statutory basis to perform those functions.

**Section II – delegated powers in chapter 3 (Capacity Market)**

55. In this Part we have sought to anticipate, and provide answers to, questions which the Committee or its legal advisers may have on the delegated powers in Part 2, Chapter 4 of the Bill. So far as possible we have sought to answer equivalent questions to those around which we structured our answers in Part A.

**What provision will be made in regulations about the meaning of:**

**(i) "providing electricity" (cl. 21(3));**

**(ii) "reducing demand for electricity" (cl. 21(3));**

**(iii) "electricity supplier" (cl. 22(3))?**

56. "Providing electricity" is intended to include the provision of electricity by generation or storage. The power to make further provision in regulations about the meaning of the expression is included primarily to enable it to be made clear, if necessary, that it includes the provision of stored electricity.

57. The power to make further provision about the meaning of "reducing demand for electricity" is intended to be used to provide that it includes both temporary actions by electricity consumers to reduce their demand at times of system stress (known as 'demand side response' or 'DSR') and projects by which electricity consumers permanently reduce their consumption (known as 'electricity demand reduction' or 'EDR'). The policy intention is to enable DSR providers to participate in capacity auctions from their inception, and to put some transitional arrangements in place for the first few years to encourage their participation. The Government also intends in the future to make projects that deliver permanent reductions in electricity demand eligible, informed by evidence from an EDR pilot as envisaged by clause 37.

58. The purpose of the power to make provision about the meaning of "electricity supplier" is to make it possible, should the Department so decide, to exclude small electricity suppliers from obligations relating to the Capacity Market. Small suppliers are currently exempted from burdens under some other legislation[4]. It is not currently intended to exclude them from the obligation to make capacity payments, but the Department wishes to have *vires* to do so, should it be minded to change its policy on this following consultation.

**What provision will be made about the persons who may be capacity providers (cl. 22(4)(c))?**

59. This power will be used to specify:

- who may hold a capacity agreement in respect of a particular unit, e.g. requirements as to ownership or control of the unit (references to a 'unit' are intended to encompass generating or storage plant, or a demand response unit);

- requirements about the unit(s) that a person must own or operate in order to qualify to be a capacity provider, for example:

[4] For example see the Electricity and Gas (Energy Company Obligation ) Order 2012 (S.I. 2012/3018). Article 4 defines a supplier as one having a specified number of customers and supplying a specified amount of electricity or gas.

- to exclude units below a minimum size,
- requirements as to geographical location (it is currently intended to restrict the Capacity Market to units located in Great Britain, but this is subject to further consideration),
- to exclude units in respect of which financial support is being claimed under other schemes such as Contracts for Difference or the Renewables Obligation;

- additional requirements which must be met by persons seeking a capacity agreement for a proposed new plant, for example as to consents which must have been obtained.

**What will be the arrangements by which electricity suppliers are required to make payments (cl. 22(2)(b) and (4)(f) and (g))?**

60. It is intended that the settlement body will collect capacity payments from electricity suppliers and distribute them to capacity providers monthly during each delivery year (that is, each period from 1st October to 30th September in respect of which capacity agreements have been issued).

61. The total amount which suppliers are collectively required to pay will be calculated by the settlement body or Elexon (see below), principally by reference to the information recorded on a register about the capacity agreements issued for that period, i.e. the total amount of capacity for which capacity agreements have been issued and the price per MW of capacity specified in the agreements.

62. The regulations will contain provision specifying how each supplier's share of the total amount is to be calculated. It is proposed that suppliers' liabilities should be proportionate to the total amounts of electricity consumed by their customers in Great Britain during periods of peak system demand.

63. In certain circumstances payments may be calculated on the basis of forecasts or incomplete data; in such cases, once final data is available the settlement body will carry out further calculations ('reconciliations') and collect adjustment payments from, or make adjustment payments to, each supplier.

64. In the event that a supplier fails to make a payment, the settlement body will in the first place draw down on the collateral which it holds pursuant to clause 24(3) (see below). It is also proposed that the obligation on suppliers to make capacity payments will be made a relevant requirement, so that breach of the obligation will be subject to enforcement action by the Authority under its powers in sections 25-28 of the Electricity Act 1989, in the same manner as breach of a licence condition.

65. As with supplier payments under the CFD, it will be up to suppliers whether or not, and to what extent, they pass those costs on to consumers, although we anticipate that subject to commercial pressures they would do so.

**In what circumstances will capacity providers be required to pay capacity incentives (cl. 22(2)(c) and (4)(f) and (g))?**

66. Capacity market rules will contain detailed provision about the obligation on capacity providers, including the circumstances in which they are liable to provide capacity or be required to pay a capacity incentive, and the determination of the amount of capacity that must be provided (which will be a 'load-following' obligation – it will vary according to total demand on the system, so that the obligation on each capacity provider will be less in summer when total system demand is lower than in winter when total system demand is higher).

67. Liability will arise in respect of any period in which a system stress event occurs on the electricity transmission system which is caused by insufficient capacity, and the system operator has issued a prior warning to capacity providers. A system stress event occurs if disconnections or voltage reductions take place, or National Grid is required to take emergency actions to avert either of them. The amount of capacity incentive payable will be calculated by reference to the difference between the amount of capacity provided and the amount which the capacity provider was required to provide.

68. It is also proposed to give the system operator power to test generating units, i.e. to require capacity providers to demonstrate that they are capable of generating the amount of electricity, or reducing their demand, as specified in their capacity agreement, and to make capacity incentives payable in the event that a test is failed.

69. It is proposed to cap the total liability of capacity providers to pay capacity incentives, both in respect of individual system stress periods and a delivery year as a whole.

70. As with payments by electricity suppliers, it is proposed to make the obligation to pay capacity incentives enforceable by the Authority as if it was a relevant requirement on a regulated person. In addition, the settlement body will be able to set off any unpaid amounts against the capacity provider's future entitlement to capacity payments.

**What calculations and determinations are envisaged by clauses 22(6) and 24(5) and who will make these?**

71. As part of the payment and settlement process, calculations will need to be made of: the amounts of capacity payments, and payments in respect of the settlement body's costs, which electricity suppliers are liable to pay; the amounts of collateral which electricity suppliers are required to provide; the amounts to be distributed by the settlement body to each capacity provider; and the amounts of capacity incentives which capacity providers are liable to pay; the amounts to be distributed by the settlement body to each electricity supplier.

72. In order to make these calculations, determinations will need to be made about, for example: suppliers' shares of peak demand; whether a system stress event has occurred, and the timing and duration of the event; and the amount of capacity provided by a capacity provider during a system stress period.

73. Each calculation and determination will be made by one of the settlement body, Elexon, or the system operator, with the regulations or rules specifying who is to make it in each case. We consider that Elexon is the body best placed to make many of them, because of its existing role in administering the balancing and settlement system, and its access to data about supply and demand from the system. None of these entities will be exercising extensive discretion; they will principally be applying formulae set out in the secondary legislation or using data from established industry mechanisms.

74. Clauses 22(6)(b) and 24(5), similarly to clause 10(5)(b) in Chapter 2, is designed to avoid determinations or calculations by a person other than the settlement body constituting unlawful sub-delegation.

**What kinds of costs will electricity suppliers or capacity providers be expected to pay under clause 24(1)(a)?**

75. It is intended to require electricity suppliers to pay the costs associated with calculation, determination and settlement of payments, including the settlement body's running costs attributable to its performance of this function. These costs will be divided between suppliers in the same proportions as capacity payments. It is not currently intended to require capacity providers to contribute to settlement costs, but the Department wishes to retain the *vires* to do this, in case it should decide to change its proposals in the light of consultation.

**What provision will be made about appeals (cl. 23(2)(g) and 30(4)(d))?**

76. We expect there to be provision for parties seeking to obtain a capacity agreement to appeal against the system operator's decisions relating to their eligibility to participate in a capacity auction, or the basis on which they may participate (e.g. the length of capacity agreement for which, or amount of capacity in respect of which, they are eligible to bid).

77. We are currently considering the best mechanism for such appeals, and our current thinking is along similar lines as for CFD allocation appeals. The applicant would be able to ask the system operator to review its decision, following which it could apply to a third party to check that the decision had been taken correctly. We are currently in discussion with Ofgem to determine whether they could provide this service. Our aim is to ensure that these steps can be taken before the capacity auction is held, so that in the event of a mistake the issue could be rectified and the applicant allowed to participate in the capacity auction on the correct basis. We are also considering whether to make provision for a statutory appeal to the court in the event that the applicant is still not satisfied; if such provision is not made, the applicant would be able to apply for judicial review of the decision.

78. We are also currently considering what provision to make for appeals against determinations of electricity suppliers' and capacity providers' liabilities to make, or entitlements to receive, payments. We are minded as a minimum to give the settlement body a function of determining disputes about calculations and determinations made by Elexon. We are also considering providing for a statutory appeal to the court against the settlement body's decisions; although again, as the settlement body will be a public body, in the absence of such provision parties would be able to apply for judicial review of its decisions.

**Why does Chapter 4 include power to make capacity market rules (cl. 28) as well as electricity capacity regulations (cl. 21)?**

79. The power to make capacity market rules has been included because we consider it appropriate for the Authority rather than the Secretary of State to be responsible for future amendments to most of the detailed provisions governing the operation of the Capacity Market, once it has initially been established. We also consider it appropriate for those detailed provisions not to be contained in a statutory instrument, because they will need to use complex definitions and concepts drawn from existing industry licences and codes which are not drafted as statutory instruments.

80. Our intention is that the Secretary of State will make the first electricity capacity regulations and capacity market rules at the same time, and the regulations will confer power on the Authority to amend, add to or remove provisions of the capacity market rules. Clause 28 enables regulations to confer power on the Authority to make rules, rather than the Bill conferring such power directly, in order to give us flexibility to limit the extent of the Authority's power. In particular, we might wish to use this flexibility to preclude the Authority from changing special provisions relating to DSR or EDR.

81. Annex D[5] includes a diagram showing our present thinking as to which provisions will be included in regulations and which will be in rules, although this remains subject to possible refinement. It is our view that the matters to be contained in regulations are those which will be of wider public and political interest, while the matters to be contained in capacity market rules will be more technical in nature and will primarily be of interest to capacity providers or prospective capacity providers and the delivery bodies.

82. We would note that much of the detailed provision governing the operation of the electricity market is contained in industry codes (described in legislation as documents maintained under licences) rather than in statutory instruments. We considered the alternative option of creating a new Capacity Market code, but decided that capacity market rules will be a more appropriate instrument because (a) the main purpose of existing codes is to govern licence holders but a significant number of Capacity Market participants, in particular DSR and EDR providers, will not be licensed entities; and (b) it would be inconsistent with existing practice to give the Authority general power to amend an industry code; existing codes provide for the establishment of an industry panel to be responsible for most changes.

[5] See page 50

**Part III – delegated powers in chapter 4 and Schedule 2 (investment contracts)**

83. Schedule 2 allows the Secretary of State to give effect to investment contracts which are an early form of CFD entered into between the Secretary of State and developers of low carbon electricity generating stations ahead of establishment of the CFD counterparty and implementation of the CFD regime. Investment contracts must be entered into before 31 December 2015, or earlier if certain CFD regulations are in force before then.

84. The Bill contains a power in paragraph 16(1) of Schedule 2 enabling the Secretary of State to make transfer schemes to transfer rights and liabilities under investment contracts to the CFD counterparty and a power in paragraph 16(2) to make regulations to treat investment contracts which have been transferred to the CFD counterparty as CFDs for the purpose of CFD regulations under Chapter 2.

85. It is intended that all investment contracts entered into by the Secretary of State will be transferred to the CFD counterparty and funded and administered in the same way as CFDs.

86. The power to make transfer schemes is necessary to ensure that contracts can be transferred to the CFD counterparty without the need to seek the explicit consent of the electricity generator or to re-open the terms of the contract. The regulation making power under paragraph 16(2) is necessary so that investment contracts can be managed in the same way as CFDs by the CFD counterparty – the contents of the regulations under paragraph 16(2) will depend largely on the detail of the Chapter 2 regulations relating to CFDs.

87. There is a duty on the Secretary of State (if it is appropriate to do so in all the circumstances of the case, see paragraph 16(5) to transfer investment contracts to the CFD counterparty once the period for entry into investment contracts has expired, the core CFD regulations are in place and the CFD counterparty is designated. When this duty applies to Secretary of State must also make regulations to treat the relevant investment contract as a CFD.

88. In order to give developers entering into investment contracts sufficient certainty that their rights under those contracts can be satisfied, the Bill also allows the Secretary of State (i) to directly fund investment contracts, (ii) to fund investment contracts through payments made by electricity suppliers, or (iii) to transfer the investment contracts to an entity designated by the Secretary of State (an investment contract counterparty) which funds the investment contracts through payments made by electricity suppliers.

89. The majority of the remaining delegated powers in relation to investment contracts are intended to make provision for circumstances described in (ii) and (iii) above and mirror very closely those delegated powers contained in Chapter 2 in relation to CFDs and the CFD Counterparty, as described in detail above.

90. It is intended that these powers would only be called upon in the event that investment contracts cannot be transferred, for example because no CFD counterparty is designated. In the event that the powers were to be exercised, the descriptions of the clauses provided in relation to Chapter 2 above would apply also to the respective investment contract provisions.

**Section IV – delegated powers in chapter 5 (conflicts of interest and contingency arrangements)**

91. Building on what is said in the Department's Delegated Powers Memorandum in relation to chapter 5, clauses 39 is included in the Bill to ensure efficient and effective implementation of the Contracts for Difference and Capacity Market and policies.

92. National Grid, as the Great Britain Electricity System Operator, is uniquely suited to delivering EMR, sitting as it does at the heart of the electricity system. However, the new EMR functions may potentially give rise to conflicts of interest with its existing commercial activities. As part of ensuring the effective implementation and delivery of EMR policies it will be necessary to ensure that no conflicts of interest arise when National Grid, the System Operator, takes on the EMR delivery role.

93. Some of the risk of conflicts arising will be minimised at the design stage of the Capacity Market and CfD policies. However, some conflicts of interest may nevertheless arise and these will need to be successfully managed in the particular circumstances in which they arise. Clause 39 confers the necessary power that will enable any conflicts of interest which do arise to be properly managed. For example, the power in clause 39 enables the necessary business separation measures to be put in place to mitigate the risks created by any conflicts of interest.

94. Clause 40 confers a power on the Secretary of State to transfer EMR functions to an alternative delivery body in the unlikely event that someone other than National Grid needs to be appointed. The circumstances in which it may be necessary to appoint another delivery body are set out in clause 40(2) and include for example, National Grid, requesting another person be appointed, an administration order is made against National Grid or the performance of National Grid is said to be unsatisfactory.

*Clause 39 – further design of business separation measures*

95. Following work with Ofgem on the risks of conflicts arising, the Government has announced a list of business separation measures that are likely to be implemented using the power in clause 39. The measures are:

    a. creation of a data handling facility within National Grid to ensure that commercially sensitive data submitted to it for the delivery plan analysis (which will be used to inform Ministerial decisions on CfD strike prices and the amount of capacity to contract for) is protected;

    b. business separation of some of the EMR functions within National Grid from the rest of National Grid's businesses to reduce the risk of conflicts of interest arising between the EMR 'administrative' functions[6] and National Grid's other interests;

[6] Administrative functions refers to the Allocation process for CfDs, the pre-qualification, auction, and monitoring in the Capacity Market

c. a duty on the Director within National Grid responsible for the EMR analytical function to ensure that the EMR analysis it supplies for the delivery plan has not been unduly influenced for the benefit of National Grid's other interests.

d. Restrictions on EMR information leaving the System Operator part of National Grid – to ensure that information the System Operator has access to through carrying out the EMR delivery role does not pass to other National Grid staff.

e. managerial, information, physical, employee, and legal separation of certain National Grid 'competitive businesses' from that part of National Grid which may create a potential conflict of interest with the EMR delivery role.

96. The Department intends to consult on the licence modifications required to apply these business separation measures in the autumn. The measures will be implemented using the power in clause 39 to modify NGET's transmission licence.

*Clause 40 - contingency arrangements*

97. In addition to taking a power which will help the Secretary of State manage any conflicts of interest that may arise in particular circumstances, clause 40 provides the Secretary of State with a power to deal with a situation where National Grid are for one of the reasons listed below – listed in clause 40(2) – unable or unwilling to continue to perform their role as the EMR delivery body.

98. We do not expect to ever need to bring secondary legislation using this power as the System Operator is likely to successfully delivery EMR throughout the lifetime of the scheme. However, it is prudent to take a power to act quickly and appoint another delivery body in the following five circumstances.

a. Where the national system operator requests such a transfer.

b. Where the national system operator is subject to an energy administration order granted under the Energy Act 2004; energy administration orders may be made by the court under a special regime to ensure that energy network companies' distribution and transmission systems are maintained and developed efficiently and economically in insolvency situations.

c. Where the Secretary of State considers that the EMR delivery functions are not being performed efficiently and effectively.

d. Where there has been a change of control of the national system operator and the Secretary of State considers it necessary or desirable to transfer the functions as a result of that change.

e. If the Secretary of State considers it necessary or desirable in order to further the purposes of encouraging low carbon electricity generation, or providing capacity to meet the demands of consumers for the supply of electricity in Great Britain.

**Conclusions**

99. The Department hopes that the foregoing further information clearly explains the detail which will both influence the making of regulations under Part 2 of the Bill and is likely to be contained in the regulations. In this supplementary memorandum we have endeavoured to provide as much useful detail as is possible and in the Annex to distil from the considerable amount of information which has been published in recent weeks that which will provide useful context to the information contained in this supplementary memorandum.

100. The implementation of EMR will be facilitated by the delegated powers in Part 2 of the Bill. As the Committee will note the EMR policy is a complex one which has several strands to it. One of those strands is a commercial strand. In producing this supplementary memorandum it has been necessary to avoid the disclosure of any information which might prejudice the commercial interests of a third party or otherwise be damaging to investors and industry. With the exception of commercial information of this type we have sought to provide the Committee with as much detail of what will go in regulations and the circumstances in which the key delegated powers in Part 2 will be exercised.

101. In preparing this supplementary memorandum it has also been important to ensure that the Department does not pre-empt the consultation which will be necessary for many components of the EMR policies being implemented. This supplementary memorandum therefore reflects our current view and is intended to give the Committee as much on our latest thinking and current policy intentions as is possible, so as to inform its scrutiny of the Bill. The final form of the consultation and secondary legislation will continue to develop over the Summer, ahead of publication in October.

102. Whilst the Department has focused on the delegated powers in chapters 2 and 3 we hope the Committee finds the additional information relating to chapters 4 and 5 of assistance too in its further consideration of Part 2. The Department stands ready to provide any additional information which the Committee may find useful in its further consideration of Part 2.

## Annexes

This annex contains the following further information:

## Annex A - Table of key recent EMR Announcements on design development and planned future work

| Energy Bill Section | Policy element | Content / description | Recent announcements made on EMR design | Further design detail expected |
|---|---|---|---|---|
| EMR Overview | EMR | General EMR | 1. EMR – Delivering UK investment (key CfD terms and draft strike prices) – June 2013[7]<br>2. EMR – Capacity Market proposals – June 2013[8]<br>3. EMR – Update on Final Investment Decision Enabling for Renewables – June 2013[9]<br>4. Response to Call for Evidence on Renewable Energy Trading – June 2013[10] | 1. Draft EMR Delivery Plan – July 2013[11]<br>2. Details of CfD contract – August 2013<br>3. Collaborative design phase with industry – over Summer 2013<br>4. Consultation on secondary legislation – October 2013<br>5. Final EMR Delivery Plan – December 2013 (subject to Royal Assent)<br>6. Final CfD Contract – December 2013 (subject to Royal Assent) |

[7] https://www.gov.uk/government/publications/electricity-market-reform-delivering-uk-investment
[8] https://www.gov.uk/government/publications/electricity-market-reform-capacity-market-proposals
[9] https://www.gov.uk/government/publications/increasing-certainty-for-investors-in-renewable-electricity-final-investment-decision-enabling-for-renewables
[10] https://www.gov.uk/government/publications/response-to-call-for-evidence-on-renewable-energy-trading
[11] This publication will include detail on the methodology behind the CfD Strike Prices and the Reliability Standard for the Capacity Market

**Annex B - Summary of EMR provisions and further design developments**

| Energy Bill Section | Content / description | Announcements made to date on EMR design | Further EMR design detail (see annexes for more detailed design descriptions) |
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| Chapter 1: EMR Objectives | Sets out the objectives of EMR and requires the Secretary of State to have regard to them carrying out functions in relation to Contracts for Difference, the Capacity Market and related functions.<br><br>The Secretary of State must also provide an annual report to Parliament on delivery of Electricity Market Reform. | At Commons Introduction, we made a positive concession to the ECC Committee's PLS report by putting the EMR objectives on the face of the Bill.<br><br>Following discussions at Commons Committee stage, an amendment was made to cover the Secretary of State's duty to meet any decarbonisation target range (if and when the power is exercised) as one of the overarching EMR objectives to ensure that the Bill is coherent and fully aligned with the existing requirement to consider decarbonisation, as set out at clause 5(2) (b) of the Bill.<br><br>The Government also made a concessionary amendment (52) at Commons Report to introduce a statutory reporting requirement to this clause, which requires the Secretary of State to lay in Parliament and publish an | There are a number of different reviews and reports planned on decarbonisation and EMR, each with its own purpose.<br><br>The statutory annual report on EMR, within clause 5, will be a report of how the Government has carried out its powers across all of Part 2 of the Energy Bill.<br><br>The EMR Delivery Plan and its annual updates are the vehicle through which Government's decisions on CfDs and the Capacity Market will be announced. Their aim is to give certainty and clarity to industry on Government's decisions following a robust, evidenced-based and appropriately transparent decision-making process.<br><br>There will be a more substantive update after |

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| | | annual report on EMR, in a manner the Secretary of State deems fit. | five years, where another five year forward look for these mechanisms will be set – including proposed CfD strike prices or auction volumes.<br><br>The five year review at clause 50 goes wider than this and considers the extent to which the relevant objectives have been met, and whether they could have been achieved with less regulation. It will for instance also consider provisions on the Emissions Performance Standard, access to markets and transitional arrangements.<br><br>And, once a decarbonisation target range has been set under Part 1 of the Bill, the Secretary of State will be under a separate obligation to make annual reports to Parliament on the carbon intensity of electricity generation in Great Britain. |

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| Chapter 2: Contracts for Difference (see Annex C) | Powers for the Secretary of State to make regulations about Contracts for Difference, including provisions for:<br><br>CfD Contract Terms: Allowing for the provisions of the terms of the CfD contract;<br><br>Eligibility: To state which low-carbon generation will be eligible to receive an offer of a contracts;<br><br>Allocation: How such offers will be allocated by the System Operator and Secretary of State<br><br>CfD Counterparty: Designation of and giving directions to a | November 2012: Government published the CfD: Operational Framework[12]<br><br>November 2012: Government published the draft CfD Heads of Terms[13]<br><br>November 2012: Government launched a 12 week consultation on the design of the supplier obligation. We have been testing proposals with suppliers and generators and publishing developments on our website since then[14]. The precise design of the supplier obligation will influence the administrative burden placed on suppliers and therefore the costs of the regime to consumers. It is therefore important to continue to work on proposals in conjunction with suppliers. | Government will publish further detail on the methodology for these strike prices within the draft delivery plan, due to be published in July.<br><br>We will then publish the CfD contract in August, and will be engaging with stakeholders over the summer, before publishing a final contract in December 2013.<br><br>Government are currently designing the process for allocation of CfD contracts and more detail is provided within Annex B.<br><br>Alongside the CfD contract, further detail will be published on the form of the CfD Supplier Obligation, including Government's formal response to the call for evidence that |

[12] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/65635/7077-electricity-market-reform-annex-a.pdf
[13] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/65636/7078-electricity-market-refrorm-annex-b.pdf
[14] https://www.gov.uk/government/policy-advisory-groups/116

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| | CFD counterparty<br><br><u>Supplier Obligation</u>: Provisions for a supplier obligation to enable funding of CfDs from electricity suppliers via the CFD counterparty, and for the recovery of the CFD counterparty's operational costs<br><br><u>Payment through the CfD Counterparty</u>: The application of sums held by the CFD counterparty including the payment of CfD sums being passed to suppliers from the CFD counterparty | 27th June 2013: To help achieve Government's objectives on renewables and low-carbon generation – we published the draft CfD strike prices for renewables.[15]<br><br>We also released our approach to the key contract terms which will form a basis of the final CfD contracts. These have been developed through work with industry and developers on the design of CfDs – to ensure a robust legal framework against which to secure investment in the UK (see table 3 in Annex B). | closed in 15 January 2013[16].<br><br>Draft secondary legislation on the supplier obligation and operational cost recovery will be published for consultation in October. Within this consultation we will set out further detail on the governance framework for the CFD counterparty.<br><br>**See Annex C for more a detailed design position** |
| Chapter 3: Capacity Market | Provisions to allow the Secretary of State to establish a Capacity Market, a mechanism for the purpose of ensuring that | The EMR Policy Overview published in November 2012 contained Annex C: Capacity Market: Design and Implementation update[17]. | A draft reliability standard will be published for consultation as part of the first draft EMR delivery plan in July 2013. |

[15] https://www.gov.uk/government/publications/electricity-market-reform-delivering-uk-investment
[16] https://www.gov.uk/government/consultations/contracts-for-difference-cfd-supplier-obligation-call-for-evidence
[17] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/65637/7104-emr-annex-c-capacity-market-design-and-implementat.pdf

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| (see Annex D) | sufficient capacity is available to meet the demands of consumers for the supply of electricity in Great Britain.<br><br>The delegated powers include power for the Secretary of State to make:<br>• electricity capacity regulations (clauses 21-27, 28(3), 29-30 and 34(1));<br>• capacity market rules (clauses 28 and 36);<br>• modifications to electricity licences and industry codes ('documents maintained in accordance with the conditions of licences') (clause 31);<br>• regulations amending enactments (clause 32 | On June 27, Government published its final design proposals for the Capacity Market[18], setting out:<br>• How the Capacity Market is intended to work in practice and outlines our rationale for some of the more significant design choices.<br>• The Capacity Market 'Strawman' which provides an end-to-end description of the design of the Capacity Market.<br><br>Government also confirmed that the Capacity Market will be initiated in 2014 with capacity providers successful in the 2014 auction required to provide capacity from the winter of 2018-19. | DECC will continue to test the final design proposals (set out in the 27 June publication) with industry over the summer before consulting on them alongside the draft secondary legislation in October.<br><br>The secondary legislation that will be produced will largely be based on the policy included in the detailed design proposals.<br><br>**An outline of our detailed design position can be found within Annex D.** |

[18] https://www.gov.uk/government/publications/electricity-market-reform-capacity-market-proposals

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| | and 34(1)).<br><br>The power for the Secretary of State to make electricity capacity regulations includes power to make provision:<br>• conferring power on the Gas and Electricity Markets Authority to make capacity market rules (clause 28(3)); and<br>• requiring the national system operator to prepare and publish rules or guidance about capacity auctions (clause 23(3)). | | |
| Chapter 4: Investment Contracts (see Annex E) | This clause and associated schedule (Schedule 2) is aimed at addressing the risk of hiatus in investment in low-carbon electricity generation before | Government have published updates to the Final Investment Decision Enabling for Renewables.[19] | Government plans to send Investment Contracts to renewable electricity developer applicants whose projects meet the minimum threshold evaluation criteria in December |

[19] https://www.gov.uk/government/publications/increasing-certainty-for-investors-in-renewable-electricity-final-investment-decision-enabling-for-renewables

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| | the CfD regime is fully established.<br><br>Investment contracts are private law contracts with an electricity generator entered into by the Secretary of State, and are intended to be transferred to the main regime when that is in force.<br><br>The Bill includes provisions to fund investment contracts even if the main EMR regime does not come into force. | | 2013.<br><br>The intention is for the Secretary of State to enter into Investment Contracts with successful renewable electricity developer applicants and for Investment Contracts to be laid in Parliament (subject to Parliamentary timetable).<br><br>The Government is in negotiations about the potential terms of an investment contract that might enable EdF to take a final investment decision on their Hinkley Point C new nuclear power plant project. An investment contract will only be offered if it is fair, affordable, value for money, consistent with state aid, and in line with the Government's policy of no public subsidy for new nuclear.<br><br>**See Annex E for more detail.** |

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| Chapter 5: Conflict of Interest and contingency arrangements | Power allowing the Secretary of State to modify the conditions of electricity licenses and codes for the separation of the National System Operator's business functions and EMR functions. This is designed to address potential conflicts of interest between National Grid's new role under EMR and its existing interests in the energy market.<br><br>Powers to transfer the EMR functions from the System Operator to another body under specific circumstances. | Government set out on 22 April 2013 how we intend to use the business separation powers[20] in a joint report with Ofgem. This followed an assessment of potential conflicts of interest between National Gird's new EMR role and its existing interests in the energy market.<br><br>The report found that the risk of conflicts of interest arising was relatively small and could largely be managed through the design of EMR: transparency, scrutiny and limits on National Grid's (NGET's) discretion.<br><br>However the package also included certain business separation measures, which will be implemented by using the powers that we are proposing in the Energy Bill to modify NGET's transmission licence. | Government intends to consult on licence modifications in October 2013. |

[20] https://www.gov.uk/government/consultations/synergies-and-conflicts-of-interest-arising-from-the-system-operator-delivering-electricity-market-reform-emr

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| Chapter 6: Access to Markets – Liquidity<br><br>(see Annex F) | Provisions to allow the Secretary of State to modify generation and supply licences issued under section 6 of the Electricity Act 1989, and codes and agreements within such licenses. | Ofgem is consulting on proposals that would obligate the eight largest generators to offer "fair and reasonable" trading terms to all market participants.[21]<br><br>Subject to a final decision from the Gas and Electricity Markets Authority (GEMA) Ofgem expects the relevant licence conditions to come in to effect in early 2014. | It is important for Government to retain the ability to implement appropriate reforms in light of Ofgem actions and prevailing conditions.<br><br>If Ofgem's reforms are delayed or frustrated Government will consider a range of options similar to those which Ofgem has been considering. This would be subject to negative resolution.<br><br>**See Annex F for more information** |
| Chapter 6: Access to Route to Market (See Annex G) | Provision allowing Secretary of State to modify licenses and codes to facilitate investment in electricity generation by promoting arrangements (such as Power Purchase Agreements) for the sale of generation. | | Government have committed to providing further information on this issue during the Lord's stages of the Energy Bill.<br><br>**See Annex G for more information** |

[21] http://www.ofgem.gov.uk/Media/PressRel/Documents1/liquidity%20feb%202012.pdf

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| Chapter 7: The Renewables Obligation: Transitional Arrangements<br><br>(see Annex H) | Powers to enable to Secretary of State to make regulations for a fixed price certificate. | Government will publish its RO Transition consultation in July, which will include the most up to date information on our intentions for the fixed price certificate, and will re-check stakeholder views on our intention to introduce the fixed price certificate scheme in 2027, rather than at an earlier date. | Government will then publish the detailed arrangements for the fixed price certificate scheme within a consultation and secondary legislation next year.<br><br>**See Annex H for more detail on our current view of these arrangements** |
| Chapter 8: Emissions Performance Standard<br><br>(see Annex I) | The defining characteristics of the EPS regime are set out on the face of the Bill and so will be contained in primary legislation. | The EMR Policy Overview document published in May 2012 contained Annex D which provided an update on the EPS[22]<br><br>Detailed approach reflected within Clause 47(7) of the Bill. | Government intend to publish draft regulations in autumn 2013 for public consultation.<br><br>Powers required across four areas:<br><br>1. Interpretation of the emissions limit<br>2. Application to additional cases or modification of the duty<br>3. Suspension or modification in for reasons of security of supply<br>4. Regime for monitoring compliance with, |

[22] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/48375/5350-emr-annex-d--update-on-the-emissions-performance-s.pdf

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| | | | and enforcement of the EPS<br><br>**See Annex I for more detail** |
| Chapter 9: Miscellaneous | Clause 52 enables provision to be made, in CfD or Capacity Market regulations, to limit National Grid liability for damages in relation to its role as EMR Delivery Body.<br><br>Other provisions do not include provision for subordinate legislation:<br><br>Cl.53 – sets out procedural requirements relating to secondary legislation that make Code or Licence changes.<br><br>Cl 54 – ensures coherence of the Energy Bill with existing legislation.<br><br>Cl.55 – makes provision for a review of EMR, five years after Royal Assent. | No specific policy published in relation to clauses 52-54.<br><br>In relation to clause 55 – statements have been made in Parliament that affirm our commitment to this review (e.g. *Official Record*, 7 March 2013, col. 1122W), and amendments were also made at Commons Report to bring Chapter 8 (the Emissions Performance Standard) into scope of the review. | Clause 52 – we will be consulting on secondary legislation in the Autumn, to which the liability shield will be applied as appropriate.<br><br>No further announcements are currently planned in relation to clauses 53-55. |

## Annex B

## Further Detail on Intended Use of Provisions

## Part 2, Chapter 2: Contracts for Difference

**Description of Powers:**

The underlying purpose of the scheme is to encourage low carbon electricity generation. Contracts for Difference will provide investors with efficient and long-term support for low-carbon generation – reducing the risks currently faced by those generators by increasing price certainty through long term contracts.

The Energy Bill enables the Secretary of State to implement the Contract for Difference regime through a combination of regulations and a private law contract between generators and a designated counterparty that defines the level of support a generator is entitled to. The costs to that counterparty of meeting its obligations under those contracts will be met by electricity suppliers who will be required to make payments to that counterparty. The counterparty will be required to offer contracts to eligible generators in accordance with the scheme.

Although the precise nature of the regulations and the detailed legal drafting of the CFD contract will be determined over the summer, we can provide a high-level draft overview of the legal architecture which sets out the latest position (see next page).

This approach will enable Government to retain accountability for key aspects of the CFD regime, while ensuring that the CFD contracts themselves provide the legal certainty that investors in low-carbon generation projects lasting several decades require.

The Department has expressed its view that the definition of "low carbon electricity generation" in the Bill would permit renewables technologies currently supported by the Renewables Obligation, Fossil fuel plant which is fitted with carbon capture and storage and Nuclear. Plants powered primarily by fossil fuels which are unabated are not low carbon. The Department will continue to consider whether technologies continue to remain low carbon, or whether new technologies should also be included within the scheme.

# Contract for Difference's Legal Structure

## Proposed high-level structure

**Energy Act (currently Energy Bill)**

**Contract for Difference Regulations**

As set out in the Energy Bill Contract for Difference Regulations will contain the requirements in relation to the Contract for Difference and provision of some matters which the Secretary of State will retain accountability for. They must be made by statutory instrument. The Regulations are likely to cover:

- Definition of an Eligible Generator;
- Allocation by the Secretary of State;
- Normal allocation and restricted allocation by the System Operator;
- Appeals against allocation;
- Provision of advice by the System Operator;
- Obligations on the Settlement agent;
- Obligations on suppliers to pay CFD amounts and Counterparty costs, including: relevant requirements; calculation of obligation; notices to suppliers to pay; appeals; and information requirements.
- Obligation on the Counterparty to pay suppliers.
- Counterparty statutory controls, including powers to direct and enduring general requirements;
- Allocation or application of Counterparty funds.

**Contracts for Difference Orders**

As set out in the Energy Bill the Secretary of State may make the following orders:

- Counterparty Designation Order
- Cost / Targets Order

**CFD Contract**

The CFD Contract will be technical, covering the processes for how the CFD will operate. The CFD Contract will be written by the Secretary of State and is likely to cover:

- CFD Strike Prices;
- CFD Contract terms covering issues such as:
  - Contract length
  - Inflation indexation
  - Reference price
  - Refinancing
  - Change in law and other adjustments
  - Capacity adjustment
  - Conditions precedent etc.
  - Force Majeure
  - Dispute resolution
  - Termination
  - Metering arrangements
- Ofgem functions.

**Licences**

To consider whether consequential amendments to existing licences are required as a result of the CFD Contract.

**Industry Codes**

To consider whether consequential amendments to existing codes (e.g. BSC) are required as a result of the regulations on the Supplier Obligation and as a result of the CFD Contract.

1. *Strike Prices:*

To help achieve Government's objectives on renewables and low-carbon generation – we published the *draft CfD strike prices for renewables*. These were announced on 27th June, in order to provide industry with early sight of the likely levels of support under the CfD. Government will publish further detail on the methodology for these strike prices within the draft delivery plan, due to be published in July. This will be subject to consultation with final strike prices to be published in the final Delivery Plan by the end of the year, subject to Royal Assent. The strike prices will be given effect through the secondary legislation to be implemented for the start of the CfD scheme in July 2014.

2. *Contract Terms*

The CfDs will be detailed commercial contracts. Government has previously published the CfD heads of terms in November, providing significant indicative detail of the CfD contracts. We have recently released our approach to the key contract terms on 27th June and this will form a basis of the final CfD contracts (see table 3). These have been developed through work with industry, developers and consumer representatives on the design of CfDs – to ensure a robust legal framework against which to secure investment in the UK. We intend to publish a draft CfD contract, setting out full-length contract drafting of the main contract terms, in early August. This publication will set out significant detail on those terms which affect the overall balance of risk and reward under the contract, and thus which go to value. Over the summer we will be engaging with stakeholders on the draft contract terms, before publishing final contract terms in December 2013.

Summary of key contract terms:

The table below draws together the current position on all of the key contract terms, as they would apply to the generic allocation of CfDs. Bilateral negotiations could take different approaches, e.g. on risk allocation and contract length, where this provides better value for money.

Consequently, when read alongside the November 2013 Heads of Terms, Government has set out its policy on all of the key design features affecting the risk allocation under the CfD. It sets out how the difference payment will be calculated, by confirming the approach to both the adjustment of the strike price over time and the measurement of the reference price, as well as setting out the duration of payments under the contract. It also confirms the overall approach to risk allocation, through the change in law terms, and the ways in which the contract will be enforced and disputes resolved.

We would be happy to provide further detail on these if you are interested.

**Table: Key Contract terms (published on 27th June 2013)**

| CfD Term | Description | Decision |
|---|---|---|
| Contract term | Length of the contract from point project is commissioned (i.e. starts generating). | **Contract length standardised, but flexibility to adapt to technology requirements**<br>• Renewables projects (under the 'standard' allocation mechanism) – 15 years of payments.<br>• Biomass conversion – all contracts cease to pay in 2027 (regardless of start date), consistent with the approach under the Renewables Obligation and reflecting the transitional nature of the technology.<br>• Flexibility for the Secretary of State to adjust contract term for projects where technology justifies a different duration (e.g. nuclear, CCS, tidal range and potentially large hydro projects). |
| Inflation indexation | How strike prices are adjusted for inflation. | **Index-linked payments**<br>• Strike price fully indexed 100% to Consumer Price Index (CPI) throughout entire term. |
| Reference price | The difference payments are based on the difference between the reference price (a measure of the electricity market price) and the strike price. | **Payments based on a reliable measure of the market price**<br>• Intermittent technologies (e.g. wind) – hourly day-ahead price.<br>• Baseload technologies (e.g. nuclear) – season-ahead price, moving to year-ahead price when conditions allow. |

| | | |
|---|---|---|
| Refinancing | Whether to include any arrangements to recover higher returns from project refinancing. | **Developers free to recycle capital, consumers protected by price-setting process**<br>• No refinancing clause in the generic CfD contract.<br>• Bilaterally negotiated CfDs for large projects may have different approaches, including possible refinancing clauses. |
| Change in law and other adjustments | Protections given to developers against certain changes in law. | **Developers protected against changes in law that target a project, technology or the CfD**<br>• Compensation available for material and unforeseeable changes in law that uniquely target specific technologies, individual projects or CfD holders as a group.<br>• Protection also covers political decisions to shut down a generator, and general changes in law that have discriminatory effects without objective justification.<br>• Protection extends to such changes in law that limit a generator's ability to either deliver its output or to receive appropriate payment.<br>• Compensation will adjust strike prices to reflect 100% of operating costs, a proportion of capital costs (tapering over time) and for lost revenues, over the term of the CfD.<br>• Protection against certain changes in network charges, relating to the costs of the balancing system and transmission losses. |

| | | |
|---|---|---|
| Capacity adjustment | Amount by which a developer can reduce the project capacity (with and without penalty) between applying for a CfD and commencement of payment. | **Developers provided with flexibility to vary their plans**<br>• Developers may vary capacity to a certain limited degree above or below their original proposal, without penalty. Developers will be able to exercise part of this flexibility before and part after construction.<br>• Further flexibility provided to reduce capacity delivered beyond this level, but with a reduction to the strike price, to encourage accurate planning and prevent over-allocation of the available budget for CfDs. |
| Conditions precedent etc. | Parameters to ensure project delivery. | **Developer flexibility to deliver within a 'commissioning window'**<br>• Payments commence once specified standards are met relating to connection, metering, capacity instalment, and contract payment/collateral requirements.<br>• Satisfaction of conditions precedent outside of the target commissioning window leads to a reduction in the contract's payment term. Failure to satisfy by the long stop date could lead to termination. |
| Force Majeure | Criteria for when flexibility will be allowed on a developer's contractual obligations. | **Protection against events outside of the control of the developer**<br>• Force Majeure will allow relief for circumstances beyond a developer's control (which will include a 'reasonable and prudent operator test').<br>• Additional flexibility where connection delays are caused by network operator. |

| | | |
|---|---|---|
| Dispute resolution | Mechanism for resolving contractual disputes. | **Clear process to resolve disputes in a timely manner, including with binding arbitration**<br>• Developer and CfD Counterparty will seek to agree informal resolution of disputes, but with access to external, legally binding determination of disputes.<br>• Government has no contractual right to impose settlements. |
| Termination | Circumstances when contract can be terminated. | **A proportionate approach to contract enforcement**<br>• Includes material breaches of contract by generators – such as, non-payment, fraud and non-delivery of capacity (subject to Force Majeure or delay to grid connection).<br>• Measures that encourage generators to move back into compliance with the contract e.g. 'remediation plans' and payment suspension. |
| Metering arrangements | How low-carbon electricity generation is recorded for the purposes of billing. | **Arrangements to support a wide-range of project types, using existing processes where possible**<br>• Loss adjusted net metered energy.<br>• Making use of existing settlement arrangements, where possible.<br>• Arrangements will be developed for transmission, distribution and private wire generation. |

## 3. *Allocation Process*

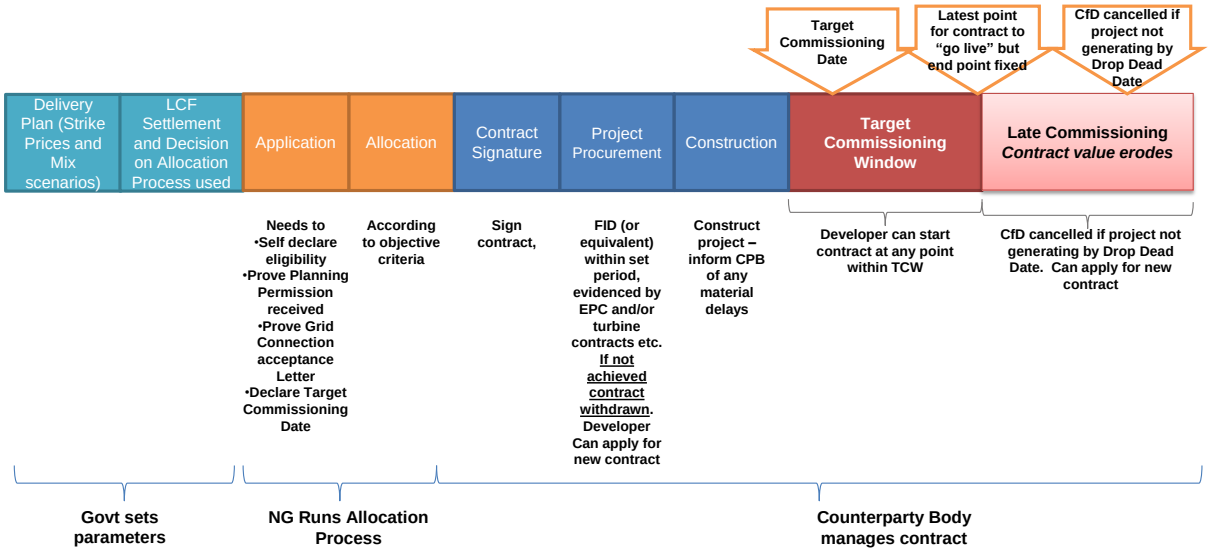
In early August we will be publishing further details of how CfDs will be allocated, building on the details originally published as part of the Final Operational Framework in November alongside the Bill introduction. It will set out those details as to how National Grid acting as the Delivery Body will assess applicants for CfDs under the generic CfD and what details applicants will need to provide. It will also set out detail on how progress to delivering generating capacity will be monitored through the procurement and contracting periods. (A summary of the process can be found below). These will be implemented through secondary legislation which is currently being drafted and will be consulted on in October

### Summary of Allocation Process

The section below sets out detail of how we intend to run the allocation process. This builds on details published on the Operational Framework in November 2012. The principles set out below will be implemented by secondary legislation and will also include detailed definitions of the eligible technologies and technology specific requirements to be monitored during the process of delivery.

Further detail will be published in August 2013.

The Diagram below shows the journey a project goes through from application through to operation:




### Application

The application process allows developers to submit projects to the Delivery Body (National Grid) who will then identify those projects that meet the Eligibility Criteria.

Developers that wish to apply for CfDs will be required to provide the CfD Delivery Body National Grid with evidence that the proposed project is eligible for support and sufficiently

advanced to have a realistic prospect of progressing through to commissioning. The Delivery Body will use this information to confirm that the eligibility criteria have been met so that it can instruct the CfD counterparty to offer a contract.

We have made a conscious decision to allow a relatively low threshold for projects applying, so that developers are able to apply for a CfD at an early stage of their project development, thereby reducing their risks and the overall cost to consumers. Government has set out its view that, for the majority of applicants, they will be eligible to apply when they have obtained a grid connection agreement and planning permission, and can confirm that their project will conform to the list of eligible technology types (which is based on the criteria established under the Renewables Obligation).

Allocation

The allocation process allows Developers to secure CfDs while ensuring that the budget available to support decarbonisation is managed in a way that preserves affordability and value for money.

The Government and the Delivery Body will provide timely information about the budget available for CfDs to enable investors to plan their projects and applications.

The degree of budgetary control applied needs to increase over time as the CfD budget available decreases. This is essential to maximise affordability and value for money as the UK gets closer to achieving the 2020 renewable target and decarbonisation objectives.

Government has indicated that its current policy is that ahead of the longer term transition to competitive allocation there will be 3 separate phases of Contract Allocation:

- The early years of CfD application when the investment need is greatest and the CfD budget is largely unspent will see the Delivery Body apply a First Come First Served process that awards a CfD to all eligible projects.

- When 50% of any annual CfD budget has been spent then Allocation Rounds will be introduced. Allocation Rounds are likely to be run twice a year and will enable groups of projects to be assessed in batches in order to provide greater oversight of the CfD Budget.

- In the event that the more projects come forward than can be supported by the budget available for a delivery year or specified maxima within that delivery year then a Constraint Mechanism will be applied to that Round and each of the subsequent constrained Allocation Rounds to ensure that the maximum amount of low carbon generation that is compatible with DECC's wider objectives can be built. It is likely that projects will be ranked on a criteria to reflect their overall cost effectiveness.

Contract Signature

If a project is successful in receiving an allocation of a CfD, the Delivery Body will instruct the CfD Counterparty to offer contract.

Monitoring Delivery and Non-Delivery

All CfDs will include milestones at a relatively early stage in project development that are intended to help identify projects that are not making adequate progress towards commissioning in time to honour their contract. Terminating the CfDs of those non-performing projects releases CfD Budget that will allow other viable projects to secure support, thereby increasing the Government's confidence in its ability to meet its renewables target and decarbonisation objectives.

The monitoring process will also enable developers to make reasonable adjustments to their projects and amend the capacity (MWs) of their development to reflect the more detailed site analysis and procurement processes that only take place after contract award.

Target Commissioning Windows

This is the window within which a project must commission a minimum level of capacity in order to enjoy the full value of the CfD for the full duration of the contract. The Target Commissioning Window is will be set around a project's nominated Target Commissioning date CD in a prescribed manner. The Length of the Target Commissioning Window reflects the technical challenges of constructing a generation project of that eligible generation type and allows government to more effectively manage its financial flows under the CfD.

This incentivises Projects to deliver broadly on time while recognising that it is seldom possible for projects to be able to be absolutely confident that they will deliver on a specified delivery date.

Late Commissioning

This aims to ensure that support under CfDs is not permanently tied up by projects which fail to commission. Termination rights arise if projects have failed to deliver a minimum amount of capacity before the longstop date, which gives the CfD Counterparty the right to withdraw the CfD from a project which has not delivered and this also gives the System Operator the opportunity to reallocate that relinquished support to other viable projects.

Amending Contract Capacity

As well as the measures set out above to avoid contracts which are never delivered holding up budget so preventing other projects from being awarded CfDs we are also including a certain degree of flexibility to developers to vary the contracted capacity without losing support under the CfD.

Government is likely to offer developers the opportunity to refine the amount of capacity they will deliver within certain pre-set bounds – reflecting the further information available to them through the project development process. This would mean that developers obtain a degree of flexibility whilst ensuring that the overall budget is only potentially tied up for a limited period (say, one year).

The project will then be expected to deliver a minimum amount or suffer a penalty, e.g. strike price reduction or termination. This manages the risk that projects under-deliver in ways that prevent Government from meeting its renewables and low-carbon objectives, with the available budget.

*4. CfD counterparty designation*

**Clause 7** enables the Secretary of State to designate the CfD counterparty, ensuring that CfDs can be managed. The power for the Secretary of State to designate a counterparty instead of naming a counterparty on the face of legislation is being sought to enable flexibility over the long term. It is essential that we make provision to be able to adapt to any circumstances that might arise.

The counterparty, including the settlement agent functions, is being set up by DECC and the Shareholder Executive (ShEx) in BIS, who have recent experience of setting up other Government-owned companies (e.g. Green Investment Bank). We expect the counterparty to be operational when legislation allows and are currently planning for the counterparty to be functioning by mid-2014. By this time the counterparty will be designated and able to sign contracts. We expect to recruit Board members between January and June 2014, with the Chair in place early in the year.

Payments will be ready to be made by the end of 2014 and we intend to designate Elexon to the role of settlement agent for EMR after Royal Assent.

We expect functions of the counterparty to include:

- Monitoring whether contract allocation milestones are met
- Managing payments between suppliers and generators including identifying when payments will start, data collection, calculating the value of payments to generators according to the formula within the contract and the Supplier Obligation rules;
- Collecting and holding collateral from suppliers and generators as appropriate;
- Providing information to the Delivery body [National Grid] and DECC as appropriate;
- Dealing with disputes;
- Monitoring whether the terms of the contract have been met and taking action accordingly.

*5. Supplier Obligation*

The making of regulations under **Clause 9** ensures that the CfD counterparty can meet its contractual obligations and provides certainty to generators that they will receive the amounts due to them under the CfDs. These regulations will also ensure that appropriate safeguards will be put in place to ensure certainty of payments to CfD generators in the event of supplier

non-payment, including the posting of collateral and the ability to mutualise unpaid debts across suppliers. We are currently considering the precise detailed operation of these mechanisms considering such questions as the order they will happen in, or the form of collateral that can be provided. Suppliers are clear that the design of the detail will affect them while it is also important to generators. With this in mind we issued a call for evidence asking for feedback from the industry on the form of the supplier obligation, which closed in January 2013.

We proposed that the obligation could take the form of a variable rate levy (whereby the precise amounts owed to the generators under the CfDs in a given period are collected by the CfD counterparty from suppliers as soon as possible after that period and passed to generators) or a fixed rate levy (whereby the costs of CfDs for the coming year would be forecast and from that a pence per kWh rate would be set for suppliers. Monies would then be collected from suppliers to pay to generators based on what was supplied in a given period). Responses showed concerns from the majority (but not all) suppliers about a variable rate levy as it would be hard to predict CfD payments as well as manage and hedge against the volatility of a variable rate obligation.

The detailed design of the supplier obligation will influence the administrative costs on the counterparty and on suppliers and therefore the costs of the regime to consumers. It is therefore important to continue to work on proposals in conjunction with suppliers.

In light of this we have conducted further analysis, have discussed issues with the EMR Institutions Expert Group, and will be publishing more details on our current thinking on the detailed design of the levy in August followed by a full consultation in the autumn.

Operational costs of the counterparty will be recovered from suppliers and this is enabled by Clause 9. Regulations will be subject to Parliamentary scrutiny as the Regulations will be laid under the Affirmative procedure.

We plan to set out in legislation the detail of the costs that can be recovered for the CFD counterparty's operational costs – this will be subject to Parliamentary scrutiny as the Regulations will be laid under the Affirmative procedure. We currently anticipate that the CFD counterparty will be required to publicly consult on their proposed budget for the forthcoming year with the final proposal being subject to scrutiny and approval by DECC's Secretary of State. This process will allow for thorough scrutiny of the proposed operational costs of the CFD counterparty to ensure that it has an appropriate level of budget. DECC will also closely monitor the counterparty's spending through regular reporting. The counterparty's costs will be consolidated into DECC's accounts and will therefore be subject to the usual scrutiny and auditing processes for Government Departments.

*6. <u>Direction to offer to contract</u>*

**Clause 10** sets out the power allowing the Secretary of State and the national system operator to issue a direction to the CfD counterparty to offer a CFD to eligible generators. Most projects will receive CFDs allocated by the national system operator and in strict accordance

with the terms set out in regulations made under clause 6. Where flexibility is needed to vary the terms for particular projects, the Secretary of State will allocate CFDs.

Regulations will specify the eligibility criteria for different plant, as well as being able to specify the details of when directions to offer contracts may or must be made and what terms may or must be set out in the contracts. It also allows for contract allocation to be done via a competitive process, such as an auction as well as providing for an appeals process against a decision by the Secretary of State or the system operator not to direct the CFD counterparty to offer a contract.

*7. Application of sums held by a CfD counterparty*

**Clause 12** enables the regulations to make provision about the allocation of sums between generators by the CFD Counterparty in circumstances where the supplier obligation is not large enough to meet all of its obligations in full – such as in the case of a supplier default. The CfD contract sets out that the obligation on the CFD Counterparty to make payment under the CfDs will be conditional on its having received payment under the supplier obligation. Its immediate liability will therefore not exceed the amount it has received under the supplier obligation in respect of the contract.

In the event of CFD Counterparty having received insufficient amounts under the supplier obligation - and assuming that unusually, there is insufficient supplier collateral which can be accessed to make up the shortfall - the CFD Counterparty would make payments to generators on a pro-rata basis to spread any shortfall evenly across CfD generators in proportion to what they are owed in the relevant payment period.

In subsequent periods, the CFD Counterparty would be obliged to recover and so make good any shortfall to generators accrued under the CfD contract.

A clear position on the method to apportion payments from suppliers to generators cannot be achieved merely through the Contract for Difference itself, as it involves the interests of more than one generator. Setting the rules out clearly in regulation will give generators certainty over how the pro-rating of payments will work, minimising the risk of dispute.

*8. Regulations: further provision*

**Clause 15** enables the making of further regulations to require a CfD counterparty to enter into a contract or arrangements for purposes connected to a contract. Regulations may include requirements to consult with, or seek consent of the Secretary of State in relation to enforcement of the CfD, variations of the contract, termination of a contract, claims made under a contract, legal proceedings related to a contract and the manner in which the CfD counterparty's rights under the contract are exercised. They may specify what the counterparty may or must do, and things the counterparty cannot do. Having such regulations would allow controls and constraints to be applied on its decision making to ensure that it works alongside Government and the national system operator (National Grid) to achieve the objectives of CfDs.

This clause does not provide for the Secretary of State to be able to vary the terms of the CfD by regulation.

## Annex D

## Further Detail on Intended Use of Provisions

## Part 2, Chapter 3: Capacity Market

### Description of Powers

Government is legislating for a Capacity Market to ensure security of electricity supply. This is because there is an increased risk to security of electricity supplies in the medium term as a large proportion of our existing capacity is set to close by the end of the decade and more intermittent and inflexible (e.g. wind and nuclear) generation will be built to replace it.

The Capacity Market is designed to cost effectively bring forward the amount of capacity needed to ensure security of electricity supply. It will do this by providing certain, regular payments to capacity providers, in return for which those providers must be available and produce electricity (or reduce demand) when the system is tight, or face penalties. The Capacity Market will be implemented and administered by a combination of Government, Ofgem, the System Operator (National Grid) and a Settlement Body.

The Capacity Market will be put in place by the Secretary of State under the powers included in the Energy Bill; specifically powers to allow the Secretary of State to make electricity capacity regulations (Clause 21) and capacity market rules (Clause 28), although clause 28(2) includes provisions for issues that must be included in the regulations rather than the rules, such as payment and settlement.

The System Operator will undertake the delivery role for the Capacity Market, including: providing advice to Minsters on the security of supply outlook and recommended amount of capacity to auction to meet the reliability standard; administering the capacity auction; and issuing capacity agreements. A Panel of Technical Experts will provide independent scrutiny of the System Operator's advice on the level of capacity to auction. It is intended that electricity capacity regulations will include provision for making Ofgem responsible for future amendments to the capacity market rules after the first auction has taken place and will continue to regulate the System Operator and enforce the rules and competition law within the Capacity Market.

The need for a Capacity Market will be reviewed every five years.

# Capacity Market's Legal Structure

## Proposed high-level structure

**Energy Act (currently Energy Bill)**

**Electricity Capacity Regulations**

As set out in the Energy Act [Bill] the Electricity Capacity Regulations will contain the high-level requirements in relation to the Capacity Market and detailed provision of some matters which the Secretary of State will retain accountability for (e.g. payment and settlement and determining the volume of capacity). They must be made by statutory instrument. The Regulations are likely to cover:

- Functions of the Secretary of State
- Functions of the Authority and National System Operator
- The circumstances in which, and amount of capacity for which, a capacity auction is to be held
- Eligibility to participate in capacity auctions
- Establishment of the Settlement Body
- Payments and settlement
- Information and advice
- Enforcement and dispute resolution
- Provision for the Authority to amend of add to Capacity Market rules
- Other requirements (e.g. appeals)

**Capacity Market Rules**

The Capacity Market rules will be technical, covering the processes for how the Capacity Market will operate. The first rules will be made by the Secretary of State. The regulations may confer power on the Authority to make further rules or amend existing rules and may limit the extent of, or impose conditions on, the exercise of such power. The rules are likely to cover:

- Pre-qualification, eligibility and de-rating
- Rules and procedures for a capacity auction
- Contents and effect, issuing, assignment and termination of capacity agreements
- Maintenance of a register of capacity agreements
- Circumstances in which capacity providers must make capacity available and provision for calculating the amount of capacity which must be made available
- Calculation of capacity incentives
- Testing of plant
- Enforcement and dispute resolution procedure

**Licences**

To consider whether consequential amendments to existing licences are required as a result of the Capacity Market and the regulations and rules.

**Industry Codes**

To consider whether consequential amendments to existing codes (e.g. Grid Code / BSC) are required as a result of the Capacity Market and the regulations and rules.

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## Further Capacity Market design detail

*Implementing the Capacity Market through electricity capacity regulations and capacity market rules*

The Energy Bill enables the Secretary of State to implement the Capacity Market through a combination of regulations and rules.

The regulations, which will be made and overseen by the Secretary of State, will include aspects covering the amount of capacity to auction, eligibility criteria and settlement of payments. The first regulations will be subject to the affirmative parliamentary procedure.

The capacity market rules, which will be first made by the Secretary of State with subsequent amendments being made by Ofgem, will contain provisions which will relate to the mechanics of operating the framework set out in the regulations, along with technical rules which will help the framework to operate efficiently. The first rules will be subject to the negative parliamentary procedure.

Although the precise split between the regulations and rules will be determined over the summer, we can provide a high-level draft overview of the legal architecture which sets out the latest position. (see previous page)

This approach will enable Government to retain accountability for key aspects of the Capacity Market, while Ofgem will be responsible for consulting on and implementing future changes to the rules to ensure they remain in line with the developing electricity market.

*Existing codes and licences*

Further work will be needed to examine the possible consequential amendments to existing licences and industry codes as a result of the Capacity Market being introduced. This work will commence in the summer as the draft regulations and rules are produced and will be subject to consultation later in 2013.

*Amount of capacity*

Ministers will decide the amount of capacity for which capacity agreements are to auctioned, based on analysis from the System Operator on the amount needed to meet an enduring reliability standard. The enduring reliability standard will be established in December 2013 in the first EMR delivery plan following consultation in July 2013.

The Secretary of State will also, in advance of the first auction in 2014, set out an enduring methodology for calculating a demand curve for the capacity auction.

*Eligibility*

All existing and new forms of capacity will be eligible to participate, expect for capacity supported by Contracts for Difference, small scale Feed in Tariffs or the Renewables Obligation and interconnected capacity (although further work on interconnected capacity will be undertaken).

Demand side response capacity will also be eligible (i.e. heavy users of electricity who commit to reducing their demand at times of system stress). The Government also intends in

future to make projects that deliver permanent reductions in electricity demand eligible, informed by evidence from an EDR pilot. *Pre-qualification*

A pre-qualification will take place around 7 months ahead of the auction and is designed to confirm the eligibility and bidding status of all potential capacity. This process will be run by the System Operator and participation in the pre-qualification stage will be mandatory for all eligible generation even if it does not intend to bid.

*Capacity auctions*

Pre-qualified capacity will enter competitive central pay as clear auctions also run by the System Operator. There will be an initial auction four years ahead of delivery, and a further year-ahead auction.

*Contract length*

Existing plants will by default have access to a one year capacity agreement.

Existing plants requiring major refurbishment may have access to agreements with a term of up to three years, and longer agreements are expected to be available for new plants.

*Penalties*

Where penalties are applied to capacity providers, the funds will flow from them, via the Settlement Body, to suppliers.

Penalties will be linked to the value of lost load (VoLL) minus the prevailing 'System Buy Price' imbalance price for each half hourly settlement period in which there was system stress.

A joint DECC/Ofgem study is presently underway to establish the appropriate level to use for VoLL. Once this study is complete, Government will set a VoLL in the penalty regime.

*Capacity agreements*

An individual capacity agreement will be an instrument setting out the particulars specific to each resource (e.g. plant successful in a capacity auction), including a description of the unit to which capacity obligations apply, the capacity of that unit, the period in which obligations apply, and the price determined in the capacity auction.

*Payment and settlement*

The overall responsibility for the efficient settlement of the Capacity Market will rest with a settlement body. Payment flows between suppliers and capacity providers will be the responsibility of a settlement body and some of its operational functions may be designated to a settlement agent (e.g. calculation of all amounts that are owed under the Capacity Market arrangements). The Secretary of State will appoint the settlement body; it has yet to be determined whether this will be an existing body or a new government-owned company. DECC has already announced its intention to designate Elexon Ltd as the settlement agent.

*Secondary trading*

From a year ahead of the start of the delivery year, and throughout the delivery year, participants will be able to hedge their position through secondary trading.

*Delivery*

Capacity providers will receive payment for capacity in the delivery year. In return they will be obliged to deliver energy in periods of system stress and will be financially penalised (following the publication of a Capacity Market warning) if they do not deliver in stress periods.

*Further detail being worked on*

While the 27 June publication confirmed many of the final design proposals for the Capacity Market, it also confirmed that further work was required ahead of the October consultation in the areas of:

- Contract length for new and refurbished plants and the eligibility criteria for existing plants to access different agreement lengths;
- Capacity auction process, specifically whether it is feasible and desirable to run an auction which would require new entrants to bid on the basis of a contract of around 10 years and one that is significantly longer;
- Enforcement and dispute resolution (e.g. on the issue of appeals);
- Which body will be the settlement body; and
- Interconnected capacity where prospective providers of interconnected capacity are prepared to face exposure to Capacity Market penalties, further work on assessing the level of certainty in physical delivery at times of system stress will be undertaken.

## Annex E

## Further Detail on Intended Use of Provisions

## Part 2, Chapter 4: Investment Contracts

### Description of Powers

Chapter 4 and Schedule 2 of the Energy Bill are aimed at addressing the risk of hiatus in investment in low-carbon electricity generation before the EMR CfD regime is fully established by enabling the Secretary of State to give effect to investment contracts with developers. Investment contracts are private law contracts with an electricity generator entered into by the Secretary of State. They are, in effect, an early form of CfD.

Investment contracts are a transitional measure and must be entered into on or before 31 December 2015 (or earlier if certain CfD regulations come into force before then). The Bill contains a power to transfer investment contracts to the CFD Counterparty, and a duty to do so in certain circumstances. The Bill also contains a regulation making power to treat investment contracts as CFDs, so that following the transfer they can be funded and administered in the same way as CFDs by the CFD Counterparty.

The Bill provisions authorise the Secretary of State to fund payments under investment contracts and includes regulation-making powers to require suppliers to fund investment contracts. The powers to require suppliers to fund investment contracts mirror to a large extent those in Chapter 2. It is envisaged that investment contract will be transferred to the CFD Counterparty as set out above, and that it will not be necessary to make regulations under these powers for investment contracts that have been transferred.

Any investment contracts that are agreed will be conditional on State Aid clearance from the European Commission as well as Royal Assent of the Energy Bill if entered in to before this. Investment contracts must be laid before Parliament and published. Confidential information may be withheld from publication, but the key commercial information – the strike price and the reference price- may not be withheld.

**Further design detail**

The Government is committed to helping investment in low carbon electricity come forward in advance of the Contract for Difference (CfD) regime being put in place as part of Electricity Market Reform (EMR).

*Nuclear*

The Government is in negotiations with NNB GenCo (a subsidiary of EdF) about the potential terms of an investment contract that might enable their final investment decision on their Hinkley Point C new nuclear power plant project. No commitment to NNB GenCo has been made by the UK Government. An investment contract will only be offered to NNB GenCo if the deal is fair, affordable and value for money, as well as consistent with state aid, and in line with the Government's policy of no public subsidy for new nuclear where similar support is not available to other forms of low carbon generation.

*Renewables*

The Final Investment Decision (FID) Enabling for Renewables process is intended to provide real value to eligible developers by offering investment certainty and support through early CfDs. It will enable successful applicants to take final investment decisions ahead of the implementation of the enduring CfD regime. There are two stages of FID Enabling for Renewables:

Phase 1: Qualification for participation and issue of status letters
Phase 2: Investment Contract allocation

DECC launched FID Enabling for Renewables on 14 March 2013 with the publication of "*Update 1: Invitation to Participate"*. This set out the process, qualification criteria and indicative timetable for renewable electricity developers to apply in Phase 1. Under Phase 1, applicants who meet the qualification criteria for participation will receive a letter notifying them of their successful qualification. In addition, qualifying applicants can also request a Status Letter. The window for Phase 1 applications closed on the 1 July 2013.

A second update document was published on 27 June 2013 "*Update 2: Investment Contract Allocation*". This sets out the process and indicative timetable for renewable electricity developers to apply for Investment Contracts in Phase 2, as well as details of the evaluation criteria which they will be assessed against. The window for Phase 2 applications closes at midday on 6 September.

In Phase 2 applicants who have qualified under Phase 1 can apply for an Investment Contract. Applications will be assessed on whether they continue to meet the Phase 1 qualification criteria and will be evaluated against the Phase 2 evaluation criteria. The evaluation criteria include Project Deliverability and Impact on Industry Development. Each application will be scored against the evaluation criteria and minimum thresholds will be applied.

DECC will then send draft Investment Contracts to applicants whose project meets the minimum threshold evaluation criteria in December 2013. Applicants will subsequently confirm to DECC their interest in an Investment Contract by way of a binding application for an Investment Contract. If, once affordability has been assessed, it is found to be constrained; a down-selection process will be carried out. It is intended that Investments Contracts will be signed and laid in Parliament in March 2014.

## Annex F

## Further Detail on Intended Use of Provisions

## Part 2, Chapter 6: Access to Markets – Liquidity

### Description of Powers

Wholesale market liquidity is an important feature of a competitive market and an important enabler of the Electricity Market Reform programme. Ofgem is currently taking forward reform proposals to improve liquidity in the wholesale market. The Government welcomes this and supports Ofgem's reform process. However due to the importance of a well-functioning wholesale market Government is seeking backstop powers in the Energy Bill to allow him to act should Ofgem's proposals be delayed or frustrated.

### Further design detail

Given the on-going nature of Ofgem's reform process it is not possible to predict exactly what is or will be required at this stage and set it out in primary legislation. It is important for Government to retain the ability to implement appropriate reforms in light of Ofgem actions and prevailing conditions. If Ofgem's reforms are delayed or frustrated Government will consider a range of options similar to those which Ofgem has been considering – this could include a reform package similar to that which Ofgem is consulting on. Any Government intervention would be subject to Parliamentary scrutiny through negative resolution. This has been used in equivalent situations and we judge would provide the appropriate level of Parliamentary scrutiny.

## Annex G

## Further Detail on Intended Use of Provisions

## Part 2, Chapter 6: Access to Markets – Route to Market

### Description of Powers

The Government expects that the framework introduced by this Bill will better support independent investment, but there are risks that the current problems in the Power Purchase Agreement (PPA) market will persist as we transition to the CfD support mechanism. We consider that the flexibility to make a targeted intervention if that proves necessary based on evidence of market development justifies the delegation of these powers.

### Further design detail

Government have been working to gain a better understanding of the complex PPA market and investment issues for independents. Since last year's call for evidence on access to markets, we have undertaken analysis on the issues and potential options for addressing these.

Government have committed to providing further information on this issue during the Lord's stages of the Energy Bill.

## Annex H

## Further Detail on Intended Use of Provisions

## Part 2, Chapter 7: Renewables Obligation: Transitional Arrangements

### Description of Powers

The Renewables Obligation (RO) will close to new generation on 31 March 2017. As the number of generators operating within the RO reduces, the RO could be vulnerable to price volatility. The fixed price certificate scheme is designed to fix the income generators receive during the final decade of the scheme, both to give generators and investors' confidence in a certain RO income, and to prevent overpayments by consumers.

### Further design detail

To enable this, powers within the Bill allow the Secretary of State to make regulations for a fixed price certificate scheme.

Table 4: This table outlines the provisions and our current view of design.

| **Powers within the Bill** | **Current view of design** |
|---|---|
| Replacing the RO with a Certificate Purchase Obligation on Ofgem (Northern Ireland Authority for Utility Regulation in Northern Ireland), the Secretary of State or the Contract for Difference (CfD) counterparty to purchase certificates at a fixed price; | There will no longer be a renewables obligation on suppliers. The obligation will instead be on the purchasing body to purchase certificates at a fixed price. |
| Setting the price of the certificates; | We will set the price of the certificate at the long term value of the Renewables Obligation Certificate (ROC). In 2027, this would be the 2027 buyout price, plus 10 per cent. |
| The issue of the fixed price certificates, in place of the current renewables obligation certificates; | With the obligation on suppliers being removed, ROCs is no longer an appropriate name and for this reason will be replaced with fixed price certificates. |
| The Certificate Purchase Obligation to be funded by a certificate purchase levy charged on the supply of electricity by electricity suppliers; | The levy is a substitute measure for the existing obligation on suppliers, to either submit ROCs or pay a buyout price (a financial alternative/penalty). As it replaces |

| | |
|---|---|
| Imposing penalties if a requirement in respect of the levy is breached; | the RO, it will not really be a new cost on suppliers. The certificates previously purchased by suppliers will instead be purchased directly by a purchasing body; the costs of which will continue to be recouped from suppliers. |
| Requiring electricity suppliers to make up shortfalls in the amounts due to be collected by the levy in cases of insolvency or missed payment; | |
| Imposing restrictions and conditions on the transfer of GB and NI certificates, e.g. to prevent fraud; | The clause replicates many of the existing powers for the RO, as our intention is to mirror wherever possible the secondary legislation for the RO as it exists just before the move to the fixed price certificate system. |
| Sums to be repaid if a certificate has been wrongly issued and subsequently purchased by the purchasing body, and if it is not possible to refuse the issue of another certificate in its place; | |
| Specifying the amount of electricity that has to be generated in order to receive a certificate, and for a banding review to be carried out before making a subsequent Order containing such provision; | |
| Making the operation of a banding provision conditional upon the repayment of a grant; | |
| Revoking the designation of a CfD counterparty as purchasing body or as the administrator of the levy; | We consider it prudent to provide the option for these functions to be transferred to the CfD counterparty if it would be beneficial to do so. It is appropriate to ensure that we are able to make a judgement on that based on circumstances closer to the time. |
| Making transitional provision in connection with a designation of a CfD counterparty as ceasing to have effect. | |

## Annex I

## Further Detail on Intended Use of Provisions

## Part 2, Chapter 8: Emissions Performance Standard

### Description of Powers

The Emissions Performance Standard (EPS) will act as a regulatory backstop on the amount of carbon dioxide emissions from new fossil fuel power stations. The EPS will support the planning policy requirement that any new coal-fired power station must have a proportion of its capacity equipped with Carbon Capture and Storage (CCS), sending a clear regulatory signal that any new coal-fired power station must be constructed and operated in a way consistent with our decarbonisation objectives.

The EPS is set at a level that will not impact on the new gas generation capacity needed to replace older, retiring capacity as we make the transition to a low carbon electricity system. 'Grandfathering' the level until 2045, will provide long-term regulatory certainty to investors in new gas generation.

### Further design detail

To enable effective implementation of the EPS there are regulation making powers across four areas:

1. interpretation of the emissions limit;
2. application to additional cases or modification of the duty;
3. suspension or modification in for reasons of security of supply;
4. regime for monitoring compliance with, and enforcement of the EPS.

The first of these is necessary because interpreting the emissions limit duty across a range of circumstances will need to contain technical details, for example how the EPS is to be applied in the case of a Combined Heat and Power plant or where fossil-fuel is used at a power plant for ancillary or safety purposes; for example as in a nuclear power plant.

Similarly, with reference to the second point, where major upgrades are undertaken that extend the technical lifetime of an existing coal plant for a period comparable to that of a new plant, it is likely that technical detail will be needed in regulation and to possibly cover a range of circumstances, including power plant types and configurations and approach for how any upgrade of this type would be assessed for the purposes of this provision.

Dealing with the third point, whilst the provisions in the Bill already provide clarity on the scope and limitation on the exercise of the power to suspend the EPS, there are additional requirements which are placed on the Secretary of State which will ensure that the exercise of this power is constrained and exercised subject to parliamentary scrutiny. For example, the Secretary of State must publish and consult on a 'Statement of Policy' in respect of

exercising the power to suspend or modify the EPS. The Statement of Policy will give those who might be affected by the exercise of the power an opportunity to understand the circumstances in which they might be affected and to comment on the design of the policy. There is also a requirement for any Direction by the Secretary of State to suspend or modify the EPS to be laid before Parliament together with a 'Statement of Reasons' for any suspension or modification. This will further ensure that the any use of this power is tightly prescribed and subject to Parliamentary scrutiny.

The drafting of the enforcement regulations should not involve significant policy choices. The expectation is that enforcement of the emissions limit duty will largely, but not necessarily exclusively, be based on administrative verification of emissions. Equally, the Department does not expect to exercise policy choices other than those set out in the monitoring and enforcement powers contained under Schedule 5 of the Bill. The focus here will be on designing an effective regime which minimises any regulatory burden.

Regulations made in respect of 1 and 2 above are subject to the affirmative procedure as they will contain complicated and technical detail, some of which will be controversial to some stakeholders because it will be determine whether a plant is caught by the emissions limit duty. Regulations made under 3 and 4 above are subject to the negative procedure except where they amend any provision in primary legislation.