HM Revenue
& Customs

Local Compliance
Government Departments Team S0483
PO Box 29994
GLASGOW
G70 6AF

Phone

Email

Web www.hmrc.gov.uk

F.A.O. Mr Jim Wager
Department of Energy and Climate Change
3 Whitehall place Area 7D
LONDON
SW1A 2AW

Date 05-08-14
Our ref
Your ref
VAT number

Dear Mr Wager,

RE: Capacity Market Reform and VAT Treatment

I am writing to outline the HMRC view on the liability to VAT in relation to the main transactions undertaken as part of the operation of the DECC Capacity Market Reform. HMRC view is based on the facts as established to date.

Facts as outlined:

Purpose of Capacity Market Reform (CMR)

1. CMR was being introduced to tackle inefficiencies in the existing electricity generation market. On current projections DECC expects there to be a generating capacity shortfall of around 20% in the foreseeable future. This shortfall is expected to arise as the forecast market price of electricity is not sufficiently high enough to justify the investment case for building new generating capacity or refurbishing and bringing back online mothballed capacity.

2. CMR aims to impact the cost / benefit analysis undertaken by these companies to support investment in future capacity which will ensure that this future shortfall does not take place due to a lack of investment in the present.

3. At present the investment decisions taken by electricity generators will be based on forecast revenue from the relevant investment, i.e. to support the sunk costs in building a power plant the electricity company would expect a certain level of revenues from selling electricity in the future based on their current forecast of the electricity market. However if these expected revenues do not justify the investment they will not build the power plant / refurbish mothballed plant.

4. The CMR aims to change this equation by providing an additional source of revenue to the income that the electricity generator will receive from selling their electricity into the market. This is a fixed payment (or subsidy) to the electricity generator based on the price agreed at the auction process and dependant on the length of the agreement in place.

5. The auction process will ensure that electricity generators bid for this subsidy based on the additional funding they require to support a positive investment decision to bring capacity online in the future. The additional funding will depend on the type of investment required and therefore it is expected that those with lower marginal costs of providing capacity will submit lower bids to support their investment case.

6. For example the cost of bringing online a mothballed power plant may well be significantly less than building a brand new power plant and therefore the required additional funding (subsidy) will be significantly less.

7. This helps establish a clearing price that will be received by all successful participants for that auction process.

8. The aim is to ensure that existing generators maintain their existing generation capacity and also ensure building capacity for future demand. This should ensure that demand does not exceed supply in the future leading to a 'Stress Event' that could see the 'lights go out.' The CMR will ensure that the electricity generators get the income required to incentivize them to build the capacity to meet electricity demands in the future.

Roles and Responsibilities of DECC, CMSB, National Grid, OFGEM and Industry Participants

9. DECC had the responsibility for creating and maintaining the relevant Energy Act legislation and that OFGEM as the regulator would have responsibility for overseeing the rules that applies to this scheme.

10. National Grid as the system operator is responsible for forecasting / modelling future energy requirements and this informs how much capacity is required from the auction process.

11. National Grid will also be responsible for administering the auction process on behalf of DECC and the Capacity Market Settlement Body including ensuring that the relevant bidders were pre-qualified to take part in the process.

12. The Capacity Market Settlement Body (CMSB) will be a separately incorporated body set up by DECC to administer the raising of levies from electricity suppliers based on their market share of the electricity market during periods of high demand and making payments to successful bidders / electricity generators based on the capacity agreement process.

Auction Process & Capacity Agreements

13. No actual capacity agreements are signed between the electricity generators and the National Grid and no consideration passes between these two parties in respect of the capacity auction process. Successful bidders would be expected to build capacity as per their bids and be able to supply electricity in to the market in scenarios where potential demand could exceed supply.

14. The auction process was explained as follows;

15. The National Grid would run annual auctions for four years and one year ahead of each capacity market delivery year, to procure a target volume of capacity as

determined by the Secretary of state-this volume is informed by analysis and a recommendation provided by National Grid, which is also scrutinised by DECC's panel of technical experts.

16. These capacity auctions would specify the amount of additional capacity to come online within 1 year and 4 year delivery timescales. This would be a rolling process whereby each year additional capacity agreements would be put up for auction depending on the forecast requirements in the future.

17. The length of a capacity agreement will vary depending on the type of build; i.e. new plants will be able to access capacity agreements up to 15 years whereas plants undertaking significant refurbishment will be able to access capacity agreements of up to a maximum of 3 years.

18. In practice this would mean that a successful bidder in 2014 for a 4 year delivery timescale and 8 year capacity agreement would start to receive the auction cleared price agreed in 2014 from 2018. The annual payments would continue to be paid for the duration of the 8 year capacity agreement.

19. The capacity market has been notified to the European commission as state aid and has been approved as compatible with the EU guidelines for energy aid. It is intended that the Capacity Market is a transitory intervention to correct market failures rather than a permanent arrangement.

Main transactions in the Operation of the CMR

20. The Capacity Market Settlement Body will levy the Electricity Suppliers based on their market share of the electricity market during periods of high demand. There will be two levies, one to fund the Capacity Market agreements and one to fund the operating costs of CMSB.

21. If the operating costs of CSMB exceed the amount raised through the relevant levy DECC will meet the shortfall through Grant-in-Aid.

22. The CSMB will make payments to Electricity Generators as per the terms of the capacity agreements.

23. The CSMB will make additional payments to the Electricity Generators where they deliver over and above their capacity agreements (over-delivery) in a 'stress event'

24. The CSMB will charge penalties under statutory powers where Electricity Generators fail to provide the promised capacity during a stress event which will be payable to CSMB.

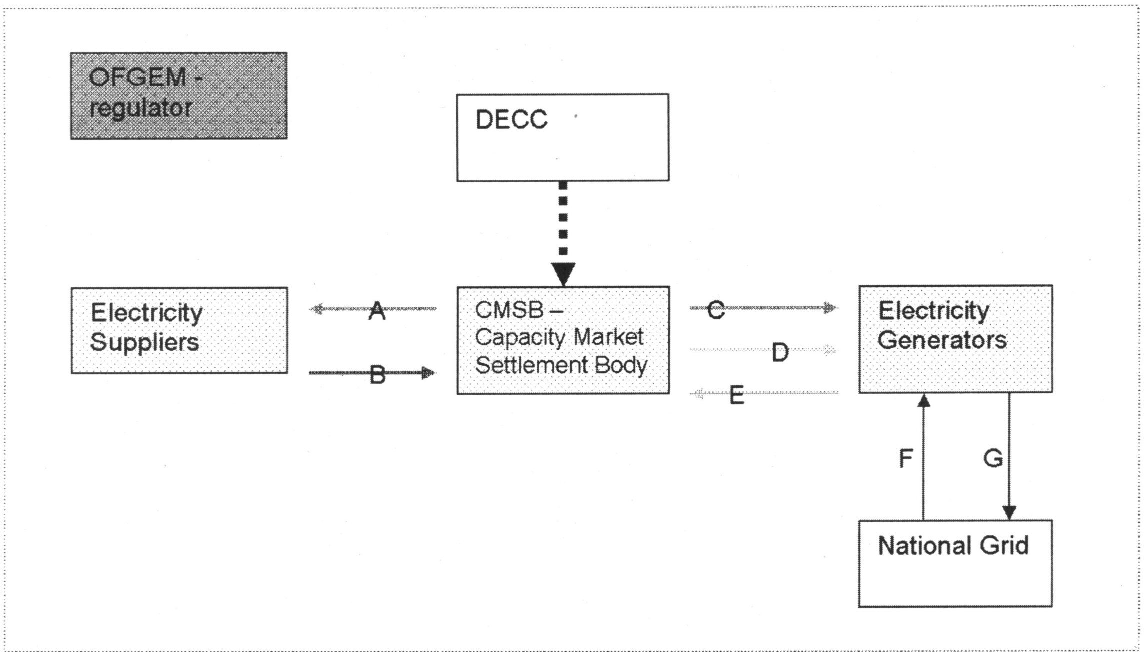
25. Any surplus from the annual operating cost levy or surplus arising from the balance of payments made and penalties charged will be refunded to the Electricity Suppliers.

26. These payments between the Electricity Suppliers and to / from Electricity Generators will be managed by a third party Settlement Agent, Elexon Ltd.

The HMRC view on the VAT treatment is outlined below:

HMRC View on VAT Treatment

PRIMARY MARKETS



KEY:

A: Refund of Surplus held by Settlement Body to Electricity Suppliers
B: Levies on Electricity Suppliers to fund capacity market and operational costs of CMSB
C: Payments as per Capacity Agreements with National Grid
D: Additional Payments for Over Delivery during 'Stress Events'
E: Penalties charged for failure to deliver during 'Stress Events'
F: Capacity Agreements between National Grid & Electricity Generators
G: Electricity supplied to Market during 'Stress Events'

HMRC VIEW ON THE VAT TREATMENT:

A: REFUND OF LEVIES ON ELECTRICITY SUPPLIERS BY CSMB:

Surplus funds (levies) held by the CSMB will be refunded to the electricity suppliers. These payments will be **Outside the Scope of VAT** as they do not represent consideration for a supply.

B: LEVIES ON ELECTRICITY SUPPLIERS BY CSMB:

The Levy is charged on the electricity suppliers under statute and is considered to be **outside the scope of VAT.** The levy does not represent consideration for a supply.

This levy will be classed as direct taxation by ONS and will be used to fund the operating costs of the settlement body.

C: PAYMENTS FROM THE ELECTRICITY SUPPLIERS TO THE ELECTRICITY GENERATORS:

These payments, *passing through the Capacity Market Settlement Body, as per Capacity Agreements with National Grid* will be **Outside the Scope of VAT** as there is no direct link between the payments to the generators by the settlement body and the final supply of electricity generation to the electricity market.

D: OVERPAYMENTS DURING STRESS EVENTS:

Overpayments will be made to the electricity generators by CSMB during stress events where they exceed delivery agreed per the capacity agreements. These payments will be **Outside the Scope of VAT** as there is no direct link between the payments to the generators by the settlement body and the final supply of electricity to the electricity market.

E: PENALTIES CHARGED FOR FAILURE TO DELIVER ELECTRICITY

Penalties will be charged under the capacity agreements, as per the statute. They do not represent 'consideration for any supply'. On that basis VAT will not apply to the penalties charged for defaulting capacity agreements.

F: CAPACITY AGREEMENTS

The capacity agreement is a function of the CMR administered by the National Grid. Capacity agreements will not be supplied for consideration and consequently the activity will be outside the scope of VAT.

G: SUPPLY OF ELECTRICITY:

The electricity generators will supply electricity to the market in the normal way and these supplies will be subject to VAT.

INPUT TAX RECOVERY BY THE SETTLEMENT BODY:

The settlement body will not be registered for VAT as it is not making any taxable supplies. The settlement body will not be in a position to recover any purchase VAT incurred.

SECONDARY MARKET:

Capacity Agreements are originated at auction and only awarded to those potential providers who have pre-qualified (A). Some potential providers may have pre-qualified but been unsuccessful at auction (B).

A may relinquish obligations in respect of its capacity agreements to a pre-qualified bidder B and consideration will pass between A & B.

Theses payments represent consideration for a supply and will be subject to VAT.

I trust this provides the certainty required in relation to the VAT treatment for Capacity Market Reform. Please let me know if anything is unclear or if we have misunderstood anything and I will be happy to review that information.

If I do not hear from you by 14 August 2014, I will close this query.

We have changed our address to help us deal with you more quickly. If you write to us but do not use the address shown in this letter then there may be a delay.

Yours sincerely

To learn more about your rights and obligations go to hmrc.gov.uk/charter