



Department for
Business, Energy
& Industrial Strategy

**Department for Business, Energy &
Industrial Strategy**

3 Whitehall Place,
London SW1A 2AW

E: energy.security@beis.gov.uk.

www.gov.uk/beis

Our ref: Government response to Capacity Market consultation letter

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To whom it may concern,

Capacity Market: amendment to ensure fair competition in future capacity auctions relating to certain risk finance schemes

This is the Government's response to the recent consultation on selective over-compensation in the Capacity Market ("CM")¹. We are writing to you as you responded to this consultation or may in any case be interested in the Government's response on this issue. In summary, the Government has concluded that from the date the amended CM Rules come into force (21 November 2016), all capacity providers who in future secure a capacity agreement for a prospective CMU in any CM auction will need to take action in line with the enclosed amendments to the CM Rules.

Background to the consultation

The CM is designed to promote fair competition in order to discover the lowest sustainable price at which the necessary capacity can be brought forward to ensure security of electricity supply in Great Britain. To ensure fair competition, and value for money for consumers, a number of CM rules are already in place to ensure capacity providers are not over-compensated through receiving a double subsidy. The Government has reviewed the issue of potential for over-compensation in connection with certain risk finance schemes that have provided tax reliefs to incentivise investment in new capacity.

In March 2016, the Government consulted on an exclusion from future CM auctions of capacity that has used investment through risk finance schemes². In response to the March consultation, the Government committed to develop a revised proposal, which would involve making deductions from capacity payments rather than an exclusion, and to consult on this in the Autumn³. The more recent September 2016 consultation set out the detail of that approach, which was to offset investment received through risk finance schemes, and spent on prospective capacity, from capacity payments (secured from future CM auctions) so that the total investment from the risk

¹ <https://www.gov.uk/government/publications/selective-overcompensation-in-the-capacity-market>

² <https://www.gov.uk/government/consultations/consultation-on-reforms-to-the-capacity-market-march-2016>

³ In response to the March consultation, the Government stated its intention to develop a revised proposal to "require any new build CMU that has benefitted from EIS / VCT tax-advantaged investment for the same project within a period of ten years prior to the start of the delivery period, and that secures a capacity agreement in a capacity auction, to have their capacity payments deducted until the total State aid that has benefitted the CMU from EIS and/or VCT plus interest is repaid."
https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/521301/Govt_response_to_March_2016_consultation_FINAL.pdf

finance schemes plus CM payments received for that project is capped at the amount awarded in the CM auction.

Summary of responses

Thirteen responses were received, with seven respondents in broad support of the proposal or advocating further action and six respondents generally opposed to the proposal or promoting more limited action. Issues that were raised with the proposal and the Government's response to these are set out in the Annex to this letter.

The Government's response

The Government has considered the responses to the consultation and has concluded that the proposal set out in the consultation is the most proportionate approach to address this issue of potential over-compensation in the CM. The CM rules have been amended in line the consultation drafting but subject to some minor technical amendments. These amendments come into force on 21 November 2016.

The Government intends to make the relevant payment and secondary trading provisions before the start of the CM 2017/18 delivery year.

Yours faithfully,

Energy Security Team

Annex

Capacity Market: amendment to ensure fair competition in future capacity auctions relating to certain risk finance schemes – Summary of responses and the Government’s response

Consultation Question	
1.	Are there any aspects of this proposal that you think will not work in practice?
2.	When making the funding declaration, do you foresee any issues with declaring the total Capital Expenditure incurred, or expected to be incurred, with respect to the Prospective CMU from investment received under a risk finance scheme? Or any issues with submitting an updated declaration if necessary?

1. Quantifying the amount of over-compensation

- 1.1. Respondents to the consultation were divided in how to quantify the amount of over-compensation (or the “total State aid that has benefitted the CMU” as it was described in the Government response to the March consultation) that would need to be offset to ensure that those CM participants are able to compete fairly.
- 1.2. On the one hand, some respondents (3) stressed how the benefit of receiving investment through a risk finance scheme did not amount to the full investment spent on the CMU as ‘Capital Expenditure’ (as defined in the CM Rules). Rather they felt that the benefit to the CMU was limited to the tax relief granted, or should be assessed on a case-by-case basis by considering how much the investee company has benefitted. It was also argued that rather than removing an unfair advantage, the proposal would penalise smaller companies funded by risk finance schemes in comparison to larger investors.
- 1.3. Other respondents (2) contended that the benefit goes further than the amount of the investment spent on the CMU as Capital Expenditure and should include other benefits such as the ability for raising debt alongside equity when only the equity is proposed to be offset. Those respondents suggested that a more effective way to remove the unfair advantage would be by way of an exclusion.
- 1.4. The Government maintains that the most appropriate approach to quantify the amount of over-compensation will be to consider the value of the State aid received by the investee company through the risk finance schemes and used to fund Capital Expenditure for a prospective CMU that also has a capacity agreement. What constitutes State aid from the risk finance schemes, in accordance with their approvals by the Commission, is explained in the rules for these schemes; this is the full investment received. Please see HMRC website for further information on the risk finance schemes⁴.
 - 1.1. Such State aid would also need to be repaid under proposals to prevent cumulation of State aid with Contracts for Difference (“CFDs”)⁵; where support is similarly competitively allocated, ensuring that competition is fair. The Government response to the consultation on amendments to the CFD contract which will outline the Government’s final decisions on the proposals will be published in due course.

2. Impact on projects already in progress

⁴ <https://www.gov.uk/hmrc-internal-manuals/venture-capital-schemes-manual/vcm2050>

⁵ <https://www.gov.uk/government/consultations/consultation-on-amending-the-cfd-contract-and-regulations>

- 2.1. A key concern highlighted by many respondents (6) was the need to minimise the impact on projects that are already under construction or that have already met their Financial Commitment Milestone (“FCM”).
- 2.2. There was some explicit support (3) for the Government’s proposal to not apply the new requirement to capacity payments for capacity agreements already awarded in 2014 or 2015. Other respondents (3) disagreed that capacity agreements already secured should be out-of-scope arguing that the proposal did not go far enough to avoid over-compensation and the cumulation of State aid.
- 2.3. The Government is mindful of the need to minimise the impact on decisions already taken and it is partly for this reason that the Government previously discounted the option of excluding CMUs with risk finance scheme investment from participating in future CM auctions and proposed its preferred option of offsetting the relevant investment as a more proportionate approach. Furthermore, the Government has no intention to re-open CM auctions already concluded or to ‘unpick’ capacity agreements already awarded which is why 2014 and 2015 capacity agreements are to not fall within scope of the amended provisions.
- 2.4. However, to ensure fair competition in future auctions, the Government needs to ensure that capacity providers are not over-compensated through receiving a double subsidy. Therefore the Government does not intend to award further capacity agreements without ensuring that capacity payments under these agreements are not cumulated with State aid received under the risk finance schemes. As a result, with regards to any CMU projects that have made commitments but have not yet secured a capacity agreement in a CM auction, the amended rules will apply.
- 2.5. The proposal to submit a funding declaration alongside the FCM report was intended to be for administrative ease and simplicity as the FCM is a requirement for all prospective CMUs (and not for other CMUs). However, the Government does not intend to ‘reverse’ the FCM status for those CMUs intending to bid into the forthcoming CM auctions that have already completed this milestone. Therefore, the drafting included with the consultation has been amended so that the funding declaration will be an additional step for those CMUs that have completed their FCM ahead of the forthcoming CM auctions. For those prospective CMUs that are successful in future CM auctions, the funding declaration must be submitted to the delivery body no later than 16 months after the relevant Auction Results Day (or 3 months for the Early Capacity Auction). We have included transitional sanction provisions for CMUs that have met their FCM but fail to submit a funding declaration in line with the amended rules.

3. CMUs in scope

- 3.1. Respondents to the consultation were divided on whether prospective CMUs bidding into the Early Capacity Auction should be in scope of the proposed amendments. One respondent argued that the Early Capacity Auction should be entirely out-of-scope as only one-year capacity agreements are available, and therefore there are no multi-year capacity agreements for prospective CMUs to over-compensate. Alternatively, two respondents argued that prospective CMUs that already have a capacity agreement for a prospective CMU from a previous CM auction should be in scope as further State aid awarded through the Early Capacity Auction would be further cumulated aid.
- 3.2. Other points raised were that existing CMUs should also be in scope of the proposal, that Combined Heat and Power CMUs should not be in scope of the proposal and that the proposal should apply to the company rather than the CMU.
- 3.3. The Government has considered the scope of the proposal in light of comments received. The potential for over-compensation occurs when aid from both the risk finance schemes and the CM is used to incentivise investment in capacity, which for the CM occurs in new build and refurbishing projects. A capacity agreement awarded in respect of a new build or refurbishing project is partly intended to facilitate investment in Capital Expenditure for the

project. Therefore, if investment through a risk finance scheme is also used to fund Capital Expenditure for that project, then both types of aid would be incentivising the same project (and therefore the project, the CMU, has been over-compensated). This will only be an issue for new build or refurbishing projects (i.e. prospective CMUs), since capacity agreements awarded in respect of existing CMUs are not intended to facilitate investment in Capital Expenditure in the same way. Therefore the amendments will only apply to prospective CMUs. For prospective CMUs participating in the Early Capacity Auction, it will only be 'new' prospective CMUs that are in scope as these projects will not already hold a capacity agreement that has provided the incentive to facilitate the Capital Expenditure in the project. Furthermore, the CM is technology neutral and as such there are no exemptions in regards to double subsidy or over-compensation for any one type of technology.

4. Implementation issues

- 4.1. Several respondents (4) commented that the original proposal to exclude CMUs that have benefitted from risk finance scheme investment would be a simpler solution, less complex, less onerous for the Delivery Body and Electricity Settlements Company, and less at risk of unintended consequences or circumvention of the rules by participants. It was also felt that the pre-qualification results disprove the need to mitigate the risk to auction liquidity by not having an exclusion. Furthermore, other respondents (3) noted that the proposal to offset relevant investment from capacity payments was in effect an exclusion from the CM.
- 4.2. In relation to submitting a funding declaration, of those that commented, one respondent welcomed the requirement for director level sign-off without being over-burdensome. Another respondent felt it would be difficult to identify where Capital Expenditure was for the CMU rather than other parts of the business.
- 4.3. The Government previously considered an exclusion as an option to address this issue and consulted on this proposal in March 2016. In response to the March consultation, we noted the issues raised in relation to this proposal including risks to auction liquidity and the impact on investment decisions already taken. The approach of offsetting the relevant investment is a more proportionate approach as set out above and we cannot assume that all projects will choose to not proceed with the reduced capacity payment and therefore do not consider that it will necessarily have exclusionary effect. The CM is designed on the principle of fair competition and therefore we strive to maximise liquidity in the auction which is why we want to enable providers with risk finance investment to participate.
- 4.4. In regards to identifying Capital Expenditure, prospective CMUs are already required to identify Capital Expenditure for the specific CMU in order to comply with the 'Qualifying £/kW Capital Expenditure' requirements under CM Rules 3.7.2 and 3.8.1.

5. Assessment of impacts

Consultation Question

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| 3. | To help us understand the impact of the proposal, please indicate if you planning on bidding in capacity that would be affected by this proposal? If so, what volume of capacity may be affected? |
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- 5.1. Several respondents (3) highlighted that the impact of offsetting the relevant investment from future capacity payments may make projects unfeasible and therefore these CMUs may no longer be able to participate in the forthcoming CM auction.

- 5.2. Other respondents (4) highlighted concerns that without taking action, CMUs that have benefitted from risk finance investment would be in a position to bid below their real costs, thus leading to an inefficient outcome in the CM auction. Indeed some respondents felt that without a complete exclusion, there remained a risk of this based on arguments set out in section 1 that the benefit to the company is greater than the amount of risk finance investment offset.
- 5.3. From the information provided by respondents, approximately 500 MW of capacity would be affected by this proposal. It is unknown what bid CMUs would have targeted without the proposed change. However, as the affected amount of capacity is relatively small and the auctions remain liquid, impacts on the clearing price are expected to be small. The information provided does not cause us to change our approach.

6. Implications for the capacity payment and secondary trading mechanics

Consultation Question

4. **Is there anything that we should have particular regard to in relation to the payment and secondary trading mechanics when making the detailed technical amendments to implement these proposals?**

- 6.1. Most respondents who commented felt that the outline proposal for the payment and secondary trading mechanics appeared suitable. Two respondents noted the need to bring amendments to the payment mechanics into force before the start of the first relevant capacity payments (i.e. before October 2017) and to ensure that any excess capacity payments are distributed back to suppliers pro rata. One respondent explicitly supported the need to retain over-delivery payments and penalties to ensure capacity obligations continued to be met despite offset capacity payments. However, one respondent stated that transferring the offset requirement with the CMU would hinder secondary trading for these CMUs.
- 6.2. The Government confirms that the intention is to return excess capacity payments to suppliers pro rata and to lay amendments to the relevant CM Regulations in parliament in Spring 2017. The secondary trading approach has been designed to ensure that a prospective CMU that has used risk finance investment towards Capital Expenditure, and that has been awarded a capacity agreement, is not over-compensated with full capacity payments. As this applies to the CMU (rather than the company), the offset requirement will need to be attached to the relevant CMU and therefore transferred with it in secondary trading.