



Department
of Energy &
Climate Change

Capacity Market

Government Response to the March 2016 consultation
on further reforms to the Capacity Market

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Contents

Executive summary 4

Chapter 1 – Investment..... 9

Chapter 2 - Clarification / Simplification 26

Chapter 3 – Security of Electricity Supply in 2017/18 36

Chapter 4 – Other issues 42

Executive summary

The March Consultation sought views on further reforms to the Capacity Market and proposed changes to the Electricity Capacity Regulations 2014 (“the Regulations”), and the Capacity Market Rules 2014 (“the Rules”). In addition, the consultation outlined the Government’s position on a range of wider issues relating to the future of the Capacity Market.

Analysis of consultation responses

In total, one hundred and sixty one responses were received from a wide range of stakeholders, including energy suppliers, generators, consultants, interconnectors, renewables companies, environmental groups, UK trade associations, private investors and others.

This Government Response provides a representative overview of the feedback received in relation to each of the twenty four consultation questions, and explains what final decisions have been taken. All responses received as part of the consultation were considered in developing the final policy positions in the areas covered.

We would like to thank all those who engaged with the consultation and submitted a response.

Next Steps

Draft Regulations, implementing the decisions outlined in this Government Response, will be laid before Parliament shortly. We intend that the changes to the Capacity Market Rules required to complete the implementation of the decisions in this document will be made in time for prequalification.

Introduction

Security of supply - the context

1. Delivering energy security is the number one priority for DECC. Maintaining the secure electricity supplies that hard-working families and businesses across the country can rely on is our primary objective. We face a legacy of years of underinvestment which has left us more open to the risk of any quickening in the pace of plant closures. To address this we need to ensure the right incentives are in place to bring on new capacity as it is needed, largely expected to be gas, to guarantee our energy security in the 2020s.

2. Our principal security of supply tool is the Capacity Market (CM). Two CM auctions have been held to date, for delivery in 2018/19 and 2019/20 respectively. Whilst the auctions procured relatively little new capacity, due to existing capacity being able to meet the target levels that were set, both auctions went smoothly and secured capacity at very low prices for consumers. A Transitional Arrangements (TA) auction has also been held, for delivery in 2016/17, to provide targeted support for Demand Side Response (DSR), encourage enterprise, build DSR capability and improve its ability to participate in the main CM auctions in future.

Capacity Market Review

3. The Government reviewed the CM mechanism earlier this year, in light of the experience gained in the first auctions, to ensure it remains fit for purpose and is capable of bringing forward the new capacity we need, expected to primarily be gas plant, as older plant such as coal come off the system.

4. The March Consultation outlined the outcome of this review, the key messages fed back from industry, our plans for reforming the CM, and steps planned by Defra and Ofgem to consider concerns related to emissions from diesel engines and embedded benefits respectively. To ensure this Government Response is viewed in the appropriate context, the key outcomes of the review are laid out here.

5. The clear message from industry and investors that we heard as part of the review was that the CM mechanism retains their confidence; is the best available approach to our long-term security of supply; that regulatory stability is of crucial importance; and that the Government should remove distortions and interventions, such as the Contingency Balancing Reserve (CBR), from the market. At the same time, we heard concerns that we must do more to protect against delivery risks; that we need to tighten the incentives on those with agreements to honour those agreements; ensure that the full range of delivery risks are accounted for in our procurement decisions; and that we must avoid the risk of under-buying, or buying too late – which would mean that new plant had insufficient incentive to come forward and get built in time. The overarching message was that the volume of capacity targeted needs to rise, noting

the clearing price will increase as a result, if the CM is to provide the appropriate incentives for the market to bring forward new capacity.

6. Around the same time as our review of the CM, it was becoming increasingly apparent that decisive and additional action was needed to ensure energy security in 2017/18. The huge movement in global commodities prices in 2015 was putting significant amounts of thermal generating capacity at risk of closure, with a number of plants announcing plans for early closure during 2016.

7. We reflected on these messages, and the worsening market conditions for thermal generation, and proposed, in the March Consultation, a plan of reform for the CM in three important respects:

- Holding an ‘early’ auction to bring forward the first CM delivery year to 2017/18;
- Tightening delivery incentives on those who have agreements to deliver against them and to penalise those who renege more severely; and
- Buying more capacity, and buying it earlier.

8. The outcome of the CM review, and planned reform, as outlined in the March Consultation, was widely welcomed by industry and organisations representing electricity users – for example, the EEF commented “Collectively, these proposals represent a decisive and coherent response that will be welcomed by industrial consumers.”

Holding a new auction to bring forward the first CM delivery year to 2017/18

9. To address the emerging risks to energy security, the March Consultation set out proposals to bring forward the start of the CM delivery period by a year, by holding an auction this coming winter (January 2017) for delivery one year ahead, in 2017/18.

10. These proposals attracted a significant amount of responses, with the great majority of respondents highly supportive. In light of this feedback, the Government intends to proceed with the early auction to ensure energy security for 2017/18. A summary of the consultation responses and final policy design decisions is provided in Chapter 3.

11. This Government has promised to remove distortion and interventions from the market. We recognise that although CBR has safeguarded our energy security, in the light of recent market movements, it increasingly risks doing so at the cost of distorting investment and actually encouraging plant closure decisions, by giving plants the impression they can opt out of the market and get a better deal direct with the CBR. By introducing the CM early, we allow the market to operate better earlier with less price volatility, lower uncertainty and, hence, lower consumer bills than would otherwise have been the case – a more efficient way of delivering energy security.

12. Ofgem has said that it would expect the early auction to procure enough capacity to meet the government’s reliability standard in 2017/18 and, therefore, the CBR services would not be needed for that year.

13. The Government has published a technical Impact Assessment alongside this Government Response which uses economic modelling to stress test the benefits, costs and consumer bill implications of the early auction.

Tightening delivery incentives

14. The March Consultation outlined the need for a robust system of checks (both on new build projects, to ensure that they are on track to deliver by the delivery year, and on existing plant to ensure that they honour their agreements), whilst recognising the importance of ensuring that the system is not so punitive that legitimate projects are dissuaded from participating in the first place. It noted the Government was already implementing a number of new requirements to tighten the assurance regime around new build projects, following consultation in October 2015.

15. We have evidence that, despite the termination fees already in place, there have been instances wherein capacity providers have viewed their obligations as low-cost options and contemplated reneging on their commitments. The Government therefore needs to act to ensure the CM is effective at ensuring security of supply. We therefore outlined a suite of additional proposals for tightening up arrangements for termination fees, payable where a capacity provider abandons its CM agreement, and related assurance measures designed to lock companies more firmly into their agreements and ensure that they are penalised appropriately where they fail.

16. In light of the feedback received, the Government intends to proceed with its core proposals – raising termination fees, disqualifying failed units from two years' of future capacity auctions, and increasing credit cover for most applicants already required to lodge credit cover – but does not plan to pursue a number of others at this time. Chapter 1 provides a summary of the responses and an explanation of the policy decisions taken since consultation.

Buying more capacity, and buying it earlier

17. In the March Consultation, we set out our intention to buy more capacity, and buy it earlier, in order to manage the increased risks we face in the next decade, given the changes in market forces and as older plant reaches the end of its natural life and closes. Although the precise target for the next (December 2016) four-year ahead CM auction will not be set until summer, we set out an expectation in the consultation that the next auction could target significantly more capacity – perhaps over 3GW more – than would otherwise have been the case. We indicated around 1GW of this increase in the target volume could come from the introduction of new sensitivities to cover a more extreme cold winter scenario and/or increased non-delivery risks, and the remainder could come from bringing forward to the four year ahead auction a significant proportion of the 2.5GW that might otherwise be set aside for the one-year ahead auction.

18. Although this element of our planned reform of the CM was not subject to the consultation exercise, many stakeholders took the opportunity to submit their views on this as part of their broader response. The overwhelming majority of respondents were in support of the proposal. Full details are provided in Chapter 4. Final decisions on the target capacity will be taken when the Secretary of State determines the auction parameters in June.

Diesel emissions & embedded benefits

19. The March Consultation drew attention to the steps that are being taken by Ofgem to consider concerns relating to potential unfair advantage gained as a result of 'embedded benefits' and by Defra in response to concerns regarding the impact on local air quality from diesel engines. Both are important issues irrespective of the CM but, if not addressed, there is a risk that they distort investment signals within the capacity market as well as damaging air quality, in the case of the diesel engines.

20. The Government recognises the benefits to the system offered by small, flexible engines (especially gas ones), but it is nevertheless right that any environmental impact or issues of potential over-reward – related to any type of generation – are properly considered and addressed in the appropriate way so that any market failures external to (but which impact upon) the CM are corrected swiftly.

21. Although this area of activity was not subject to the consultation exercise, and is not being led by DECC, many stakeholders took the opportunity to submit their views on this as part of their broader response. A summary of the feedback is provided in Chapter 4 together with a brief update on the Ofgem and Defra proposals.

Chapter 1 – Investment

1.1 New Build Assurance – further reforms

Consultation Question

Q1 Do you agree that we should increase requirements on the level of credit cover (and termination fee liability for not lodging increased credit cover if required as a result of not achieving the Financial Commitment Milestone at the 11-month point) for new build projects at the pre-auction stage?

Summary of Responses

1.1.1 There were forty-eight responses to this question, of which the majority expressed a clear preference for increasing the level of pre-auction credit cover for new build units. The primary reasons cited by those in favour of the proposal included increased delivery assurance and enhanced deterrence of speculative projects. Representations also suggested that any increase is unlikely to deter any serious market participants on account of the relatively short period for which credit cover is required to be maintained.

1.1.2 The main reason quoted by those not in favour was the belief that bidders consider the credit cover as an ‘option fee’ and that increasing the collateral requirements would simply increase the cost of offering new build capacity into the auction, and the level they are willing to commit to, rather than deterring any speculative offers. Respondents also suggested it may present additional barriers to entry, thereby reducing auction liquidity, as well as leading to upward pressure on investors’ cost of capital at a time when the market’s appetite for merchant risk is reduced due to weak wholesale prices. Whilst some respondents cited a barrier to entry, no evidence was received as to why it would affect their *ability* to bid as opposed to influencing the *price* of their bid. Some respondents questioned whether an increase in pre-auction credit cover was required in addition to the post-auction increase in credit cover and termination fee detailed in the Government’s response to the October 2015 consultation.

1.1.3 Others proposed that the Government should focus on ensuring the auction brings forward offers which reflect the true cost of capacity and which can be relied upon to deliver capacity. One suggestion proposed the concept of a sliding scale of credit cover based on capacity.

1.1.4 Several respondents questioned the applicability of the proposals to unproven DSR capacity, citing concerns that any additional requirements would have to be met from equity

rather than bank finance (on account of their relatively limited assets). Representations suggested this would cost the sector proportionately more than larger companies able to access lines of credit at more preferable rates.

Consultation Question

Q2 Do you have views on the appropriate level for requirements on credit cover for new build projects at the pre-auction stage? Does £10k/MW strike an acceptable balance?

Summary of Responses

1.1.5 There were forty-six responses to this question, of which around half thought that either the pre-auction credit cover of £10k/MW was appropriate, or that a higher figure should apply. Representation from those in favour of the £10k/MW figure focused on enhanced delivery assurance.

1.1.6 Other respondents thought the proposed £10k/MW figure was too low, effectively representing an inexpensive speculative option for developers, where it represents approximately 2 per cent of the market estimated capital costs of £500/kW for a CCGT project. Suggestions were received to increase the collateral requirement to a 'considerably higher' level to bring it into line with investment options in other sectors; to £25k/MW, or to 5 per cent of the minimum capital expenditure threshold (£255/kW in the 2015 capacity Market auction) £12,750/MW, in order to make it more proportionate.

1.1.7 Other respondents requested extending the window for submitting credit cover and further flexibility in the types of acceptable credit cover.

1.1.8 Representation from those not in favour of increasing the credit cover requirements mirrored that provided for question one, primarily that an increase to the credit cover requirements is not necessary and would only serve to increase the cost of any capacity offer, without any additional delivery assurance.

1.1.9 Several respondents also questioned the applicability of the proposal to unproven DSR capacity, and suggested that the current £5k/MW requirement is already difficult for DSR providers which are mostly small players.

Decision taken since consultation – questions 1 and 2

1.1.10 The Government welcomes the extensive and detailed stakeholder feedback on the proposal to increase pre-auction credit cover for new build CMUs, from £5k per MW to £10k per MW of de-rated capacity, to deter speculative new build applications **and** secure exposure against increased Termination Fees.

1.1.11 The Government confirmed its intention to increase termination fees for new build units failing to demonstrate achievement of their Financial Commitment Milestone in its response to the October 2015 consultation. The Government also maintains there is now a need to increase the levels of termination fees across the board, as discussed later in the response to question

five. As such the Government intends to implement this proposal to raise new build pre-auction credit cover to £10k per MW of de-rated capacity. This will help to fully secure exposure to termination fee liability for failing to lodge increased credit cover if necessary post auction, as well as helping to deter speculative applications by requiring a greater level of pre-auction commitment. The Government believes the figure of £10k/MW presents an appropriate balance between deterring speculative projects and inflating the risk premia priced into auction bids.

1.1.12 In addition, the Government also intends to increase the pre-auction credit cover requirements to £10k/MW of de-rated capacity for existing generating CMUs which have made a declaration in respect of a Distribution Connection Agreement (rule 3.7.3(c) refers). This will ensure that a higher proportion of their enhanced termination fee liability (£15k/MW, response to question five refers) is secured than would otherwise have been the case.

1.1.13 The increased credit cover requirements will apply in respect of all applicants for new build or existing generating / interconnector CMUs notified of the need to lodge applicant credit cover after these amendments come into force; this includes applicants for the early auction for 2017/18. Under these proposals, the Government does not intend extending the scope of those CMUs which would be subject to the applicant credit cover requirement. Additionally the Government does not intend applying the increase in pre-auction credit cover requirements to unproven DSR capacity at this time. However, the Government will consider the equity of this position alongside the broader increase in termination fees and may bring forward proposals later this year.

1.1.14 The Government acknowledges the challenge as to whether the increase in credit cover is strictly necessary to deter speculative bids given the increase in termination fee liability. The Government maintains, however, that retaining credit cover at its current level would increase the unsecured liability for new build units and present a greater risk of joint venture arrangements collapsing to avoid paying their higher termination fee liability.

Consultation Question

Q3 Do you have views on whether the proposed increase in credit cover should apply to all new build units, irrespective of their size or broader corporate structure, or only to those meeting a 100MW threshold applied at a unit and broader portfolio level?

Summary of Responses

1.1.15 There were forty-three responses to this question, of which a sizeable majority thought any increase in pre-auction credit cover requirements should apply to any new build CMU, irrespective of size.

1.1.16 Representations from those opposed to a threshold focused on avoiding unnecessary market distortions which favour or penalise particular categories of participant, which could deliver less efficient auction outcomes for consumers. Feedback also suggested a threshold

may create a perverse incentive to structure projects and companies into blocks which fall below the threshold.

1.1.17 Concerns were also highlighted about projects below the threshold being considered lower cost options by developers, and potentially incentivising more speculative applications whilst undermining larger, more assured projects should they fail to deliver. Challenges were raised about whether project risk is actually a function of unit or portfolio size, suggesting that smaller projects are just as likely to default as larger ones. Others suggested not having a threshold but applying the increased credit cover requirements only where an applicant cannot demonstrate a minimum credit rating.

1.1.18 Those in favour of a threshold suggested a more targeted approach, mainly at 100MW to focus on new build transmission connected capacity. Others suggested setting the threshold at a level that does not stifle innovation from smaller-scale plant / technologies, especially in the renewable energy sector. A range of threshold limits were also proposed, from individual CMU sizes of 30MW, 50MW, 100MW and 400MW, to portfolio thresholds between 50MW and 250MW.

Consultation Question

Q4 Should the package of new build delivery assurance measures (increased credit cover as described here and the new build measures described in chapter 1 of the accompanying Government Response document) apply to all new build units or only those in excess of a 100MW threshold applied at a unit and broader portfolio level?

Summary of Responses

1.1.19 There were forty-three responses to this question, of which a large majority thought the package of new build delivery assurance measures, including any increase in pre-auction credit cover, should apply equally to all new build CMUs irrespective of size.

1.1.20 Representations from those against applying a threshold were similar to those provided for the previous question; lack of correlation between unit/portfolio size and delivery risk, and desire to avoid market distortion and its associated perverse incentives and unintended consequences. Several respondents also challenged how any threshold could be implemented and policed, especially if applied at a portfolio or group level.

1.1.21 Feedback from those respondents in favour of applying a threshold was also similar to that provided in respect of the previous question; primarily the threshold enabling the costs to be targeted at the materially riskier projects. As previously, a range of thresholds were proposed, from individual CMU sizes between 50MW and 100MW, to a portfolio threshold of 250MWs.

1.1.22 Those in favour of a threshold suggested a more targeted approach, mainly at 100MW to focus on new build transmission connected capacity. Others suggested setting the threshold at

a level that does not stifle innovation from smaller-scale plant/technologies, especially in the renewable energy sector.

1.1.23 Several respondents also queried the application of the additional new build progress reporting requirements to smaller new build developments, given differences in the construction lead-times between larger and small-scale developments (earlier notice of delivery failure with larger-scale projects). They argued that changing the reporting requirements for small-scale developments would be more effective than changing credit cover levels.

Decision taken since consultation – questions 3 and 4

1.1.24 The Government notes the representations made regarding market distortion, potential perverse incentives and unintended consequences, complexity, the impact on smaller participants and progress reporting timescales. As such, the Government does not intend to introduce a threshold for either the increase in pre-auction credit cover requirements or broader new build delivery assurance proposals; both will apply in full to any new build CMU going forwards.

1.2 Termination Fees – all CMU types

Consultation Question

Q5 Would there be a benefit in increasing termination fees for all participants with Capacity Agreements? Do you consider the current level of termination fee 2 (£25k/MW) for new build generating units failing to achieve operational status is sufficient? Please provide evidence to support your response.

Summary of Responses

1.2.1 There were forty-eight responses to this question, in which the majority of respondents, including most of the big six and many independent generators, disagreed that there would be benefits to increasing the level of termination fees; those in favour of the thrust of the proposals included some large and smaller generators as well as consumer interest bodies. Respondents in favour of such an increase proposed a range of permutations as to how this could be achieved. These ranged from increasing Termination Fee 2 (TF2) from its current £25k/MW, but retaining the distinction from Termination Fee one (TF1), through to retaining TF2 at its current level but increasing TF1 to £25k/MW (so that all termination events with a termination fee liability would have the same £25k/MW consequence).

1.2.2 Respondents in favour of increasing termination fees cited recent market activity, where bidders would rather consider paying a termination fee than fulfil their capacity obligations, as evidence of the current levels being insufficient. Some respondents also cited that the auction clearing price would be expected to increase in future auctions in recognition of the need for new build capacity, and as such bidders should be expected to take on additional risk in exchange for their additional returns. Others suggested that termination fees should be of a

greater magnitude than the development budget for a new site, which can typically be comfortably written off should the project not progress for any reason.

1.2.3 Several respondents suggested that increasing the level of TF2 to £50k/MW, representing approximately 10 per cent of the typical CCGT new build development costs (£500/kW), would be a reasonable adjustment.

1.2.4 Representations from those respondents not in favour of increasing the level of termination fees primarily focused on the enhanced market risk, and therefore increased risk premia and auction costs to consumers, associated with any increase. Respondents also suggested that the current levels of termination fees are already a substantial incentive not to trigger the termination of agreements, and that any increase may present a barrier to entry, especially for smaller, independent generators (who may be less likely to absorb higher termination fees than large, incumbent generators).

1.2.5 A sizeable number of respondents highlighted the 'unusual and extreme market conditions' currently facing thermal, especially coal, generation and that any failures (actual or perceived) to honour capacity obligations should be viewed in this context. They argue that the fact that 'surprisingly few plants have reneged' on their capacity obligations, despite these challenging conditions, suggests the termination fees are broadly the right order of magnitude and cautioned against making significant changes to the termination regime in response to poor underlying coal economics. In addition, they highlighted that the risks for generators are particularly acute in the intervening period before they start receiving capacity payments, which has been partially addressed by the proposals to bring forward the first delivery year.

1.2.6 Several responses suggested any increase in termination fees should be addressed during the first full review of the Capacity Market in 2019 rather than in the current context.

1.2.7 A couple of respondents identified the broad equivalence between the level of TF2 and the price taker threshold, suggesting that any increase in TF2 should be accompanied by a comparable rise in this threshold.

1.2.8 Several respondents suggested raising termination fee exposure would be unlikely to influence the economics of whether or not to progress a new build project, and that within-year penalties should be strengthened in preference. This would create much stronger incentives for providers to secondary trade and secure replacement capacity themselves. Suggestions were also received that some termination events do not reflect true terminations of the capacity (e.g. metering test failure), only their capacity agreement, and as such should be fined but their agreement should be allowed to continue once the underlying issue is rectified.

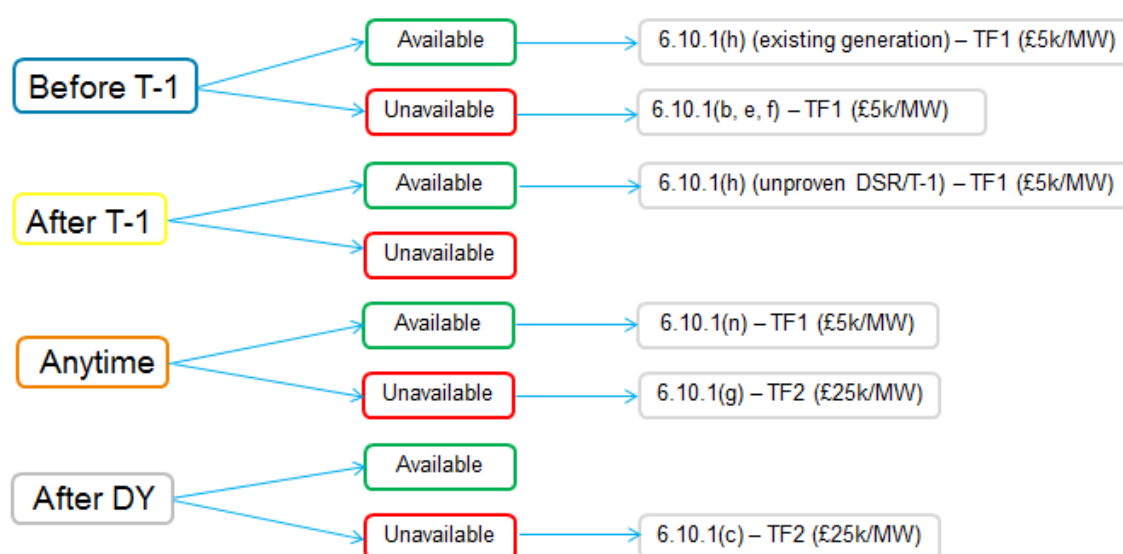
Decision taken since consultation

1.2.9 Under the current design there are seven types of termination event, referenced in rule 6.10.1, which i) terminate a capacity agreement and ii) incur a termination fee. These events are associated with one of two levels of termination fee (TF1 - £5,000/MW or TF2 - £25,000/MW), with the applicability of each being determined by the blunt 'severity' of the triggering termination event. Some of the termination fee liabilities are secured by credit cover lodged pre-auction, others are not.

1.2.10 There are another seven types of termination events which terminate an agreement but do not incur a termination fee.

1.2.11 The Government has undertaken an internal review of the termination fee levels, in which the ‘severity’ of each of the termination events with a contingent termination fee has been categorised. This severity is based on both a) the potential timing of the event – i.e. whether the event could occur i) before the T-1 auction (enabling the terminated capacity to be rebought), ii) after the T-1 auction but before the start of the delivery year, iii) at any time between the auction and end of the delivery year and iv) after the delivery year has finished – and b) the likelihood of the capacity being available in the delivery year despite the termination of their agreement. The categorisation of the current provisions is shown in figure 1 below.

Figure 1 – categorisation of current termination fee liabilities



Key to types of termination events under rule 6.10.1 referenced above:

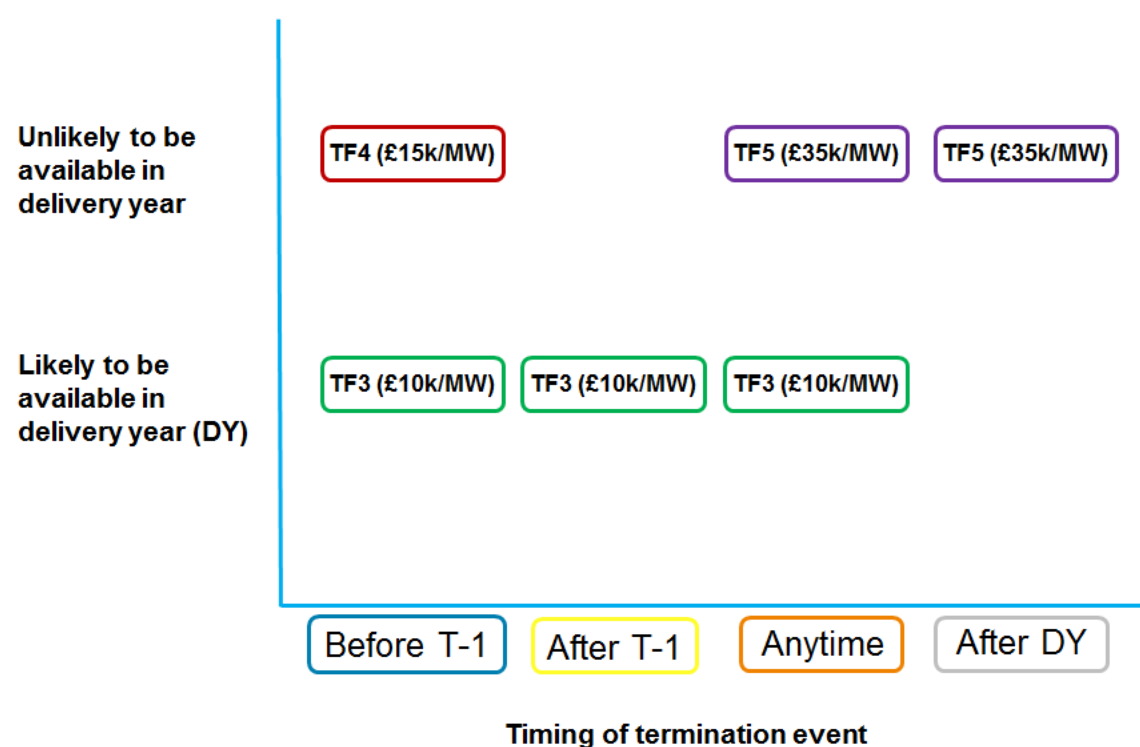
Rule 6.10.1 ref	Description of termination event
B	Failure of new build CMU to achieve Financial Commitment Milestone
C	Failure of new build CMU to achieve Minimum Completion Requirement
E	Failure of new build CMU to provide copy of distribution connection offer
F	Failure of existing generating CMU to evidence TEC by 18 months ahead of delivery year
G	Generating or interconnector CMU ceases to have TEC
H	Failure of existing generating CMU or DSR CMU to provide metering test certificate
N	Unauthorised transfer, sale or disposal of generating CMU

1.2.12 Based on the categorisation, the Government intends to increase both the level and number of termination fees (TFs) to reinforce delivery assurance whilst enabling the tailoring of the termination liability to the severity of the event. Two new termination levels (TF3 - £10k/MW

and TF4 – £15k/MW) are being introduced as a result of the new build delivery assurance amendments from the October 2015 consultation. The Government intends to add a new termination fee level of £35k/MW (TF5) to this list. The current levels of TF1 and TF2 will be reserved for the grandfathered provisions of agreements awarded prior to these amendments coming into force.

1.2.13 Figure 2 shows how the three new termination fee levels will apply based on this combination of when the termination event could occur and the broad likelihood of units being terminated under this type of event being able to provide capacity in the delivery year. It should be noted the timing of the termination event is based on when it could occur, rather than when it does actually occur. For example, an agreement can be terminated for reducing Transmission Entry Capacity (TEC)¹ at any time between the award of the agreement and the end of the relevant delivery year. In contrast, termination of an agreement from a T-4 auction for failing to achieve a Financial Commitment Milestone can only occur ahead of the T-1 auction. In addition, the likelihood of a unit being able to provide capacity in the delivery year is based on generic units, rather than considering the specific circumstances of individual units.

Figure 2 – categorisation of new termination fee levels



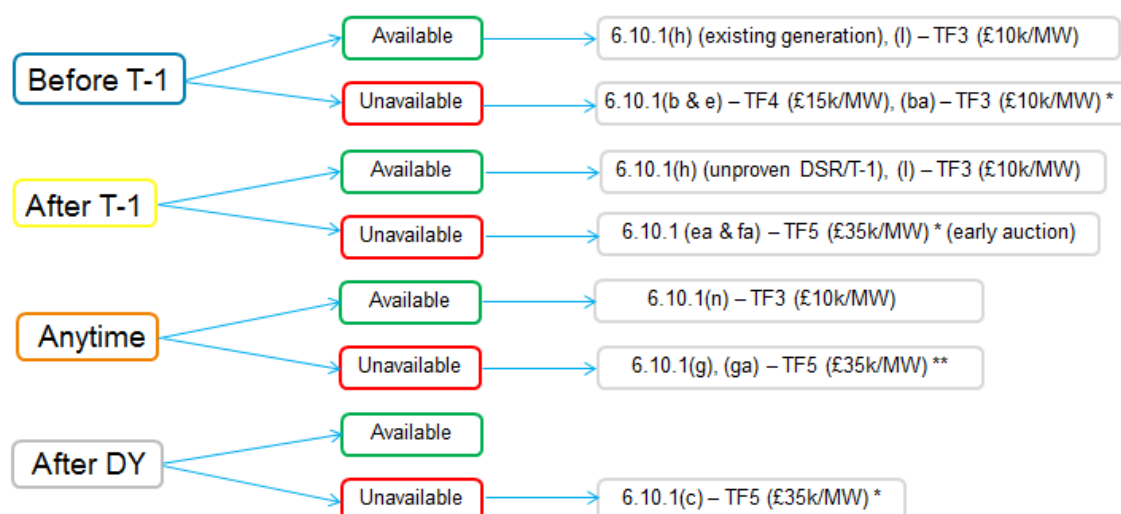
1.2.14 Applying this categorisation to specific termination events results in the following termination fee liabilities as shown in Figure 3 below.

¹ Transmission Entry Capacity (TEC) - represents the maximum level of transmission access at which a Power Station owner wishes to purchase and use for a given financial year.

Figure 3 – new termination fee liabilities

* Disqualification from 2yrs auctions as new build (N/A if sold outside provider's Group)

** Disqualification from 2yrs auctions in any form, restriction on secondary trading.



1.2.15 The asterixed (*) coding on figure 3 indicates which of the termination events will be subject to either of the disqualification provisions discussed in response to question 9.

1.2.16 The timings of some of the termination events may differ under the early auction for 2017/18 from that shown in Figure 3, but the level of termination fee applied will be as shown above.

Key to types of termination events under rule 6.10.1 referenced above:

Rule 6.10.1. ref	Description of termination event
B	Failure of new build CMU to achieve Financial Commitment Milestone (FCM)
Ba	Failure of new build CMU to lodge increased levels of credit cover when required to do so after not having met FCM by 11 months post auction (new provision)
C	Failure of new build CMU to achieve Minimum Completion Requirement
E	Failure of new build CMU to provide copy of distribution connection offer
EA	Failure of existing or new build CMU to provide copy of distribution offer (new provision for early auction)
FA	Failure of existing or new build CMU to evidence TEC (new provision for early auction)
G	Generating or interconnector CMU ceases to have TEC
Ga	Generating or interconnector CMU reduces TEC below level of aggregate capacity obligations (new provision)
H	Failure of existing generating CMU or DSR CMU to provide metering test certificate
L	Invalidation of metering test certificate by a generating CMU
N	Unauthorised transfer, sale or disposal of generating CMU

1.2.17 NB – termination event (F), referenced in Figure 1, is not referenced on Figure 3 as the derogation was only applicable to the first and second full capacity auction (and the termination fee liability is therefore grandfathered).

1.2.18 Under this approach the termination fee (TF) liability of two termination events (rule 6.10.1(h) and (n)) with a current £5k/MW exposure will increase to £10k/MW. The TF liability of two with a current £5k/MW exposure will increase to £15k/MW (6.10.1 (b & e)). The TF liability of the two termination events with a current £25k/MW TF exposure (rule 6.10.1(c) and (g)) will increase to £35k/MW.

1.2.19 In addition, the Government will be introducing four new termination events (6.10.1 (Ba), (Ea), (Fa) and (Ga)), with TF liabilities of £10k/MW for 'Ba' and £35k/MW for the other three. The Government also intends to introduce a TF of £10k/MW for termination event 6.10.1(l) – whereby a provider invalidates their metering test certificate – in order to close off this potential no cost option.

1.2.20 The increased termination fees will apply in respect of all agreements awarded post the amendments coming into force; this includes agreements awarded in respect of the early auction for 2017/18.

1.2.21 The non-completion fee for a new build interconnector CMU will also be increased from the current £5k/MW to £15k/MW in line with the failure of a new build generating CMU to achieve its Financial Commitment Milestone.

1.2.22 The Government notes the representations not in favour of increasing termination fees and the contextual comments regarding current market conditions. However, the Government proposes the introduction of a more graduated, and therefore targeted, approach to termination fees as described above, along with the magnitude of termination fee increases, should help to reinforce delivery incentives and assurance without significantly raising auction risk premia.

1.2.23 Finally, we have become aware of specific situations which would enable capacity providers who have triggered a termination event under Rule 6.10.1 (h) and Rule 6.10.1 (i), prior to the start of the delivery year, to receive capacity payments until their capacity agreement has been terminated, although they are not participating in the delivery year and contributing to security of supply. The Government intends to address this so that any capacity payments received will be repaid by the capacity provider so that the Rules enforce Government's original intentions.

Consultation Question

Q6 Is there a case for increasing the termination fees for those CMUs that were the subject of a termination event for a previous agreement? Do you have any views on the relative merits and downsides to the alternative options outlined above?

Summary of Responses

1.2.24 There were forty-eight responses to this question, of which a sizeable minority agreed there was merit in increasing the termination fees for those CMUs that were the subject of a termination event for a previous agreement.

1.2.25 Representations from parties supporting this proposal primarily focused on incentivising companies to learn from their mistakes with previous agreements and targeting more serious termination consequences on those subject to a previous termination event, which, for example, have a history of repeatedly failing to meet financial or project completion milestones. Others suggested that such an approach would help to disincentivise speculative bids by addressing potential 'free options'. Widespread representation from both those in favour of the proposal, and those not, highlighted difficulties around changes in ownership and preventing providers re-applying under different guises. Feedback suggested this could lead to providers structuring their corporate arrangements in novel ways to avoid the risk of increased termination fees.

1.2.26 Representations from those opposed to the proposal primarily focused on the potential increased costs and risk premia associated with the uncertainty of termination fee liability, especially where the triggering termination event was outside of the provider's control. Some respondents also questioned whether the risk of a CMU triggering a second termination event is actually any higher than for any other CMU triggering its first event, but is likely to result in a higher auction bid to cover the risk of the enhanced termination fee.

1.2.27 Some respondents also challenged the justification, if applied at a portfolio level, of penalising a provider's wider portfolio for failing to deliver on a single, unrelated CMU. They also stated the proposal could have a disproportionate impact on providers with numerous CMUs within their portfolios.

1.2.28 Relatively few responses discussed the alternative proposals referenced in the question. Those representations were generally not in favour of differentiating termination fee exposure on the basis of circumstances, primarily due to the gaming potential and the difficulty distinguishing between causal arrangements (for example the grey area between mechanical breakdown versus commercial abandonment).

1.2.29 Some respondents considered the issue of applying termination fees to individual delivery years rather than the number of agreements terminated. All the responses recognised the need to cap any increased liability if applied to multi-year agreements. A couple of suggestions were received to apply a multiplier based on the number of opportunities to rebuy the terminated capacity that has passed since the award of the original (now terminated) agreement.

Decision taken since consultation

1.2.30 The Government acknowledges the strength of representation to both questions five and six. In light of its intention to graduate and increase basic termination fee exposure, as described under its response to question five, the Government does not intend to implement any form of multiplier for termination fee liability based on previous termination exposure. Units will be liable for the termination fees as described in the previous section, irrespective of the number of termination events triggered at their CMU or broader portfolio level. The Government considers the combination of such proposals could lead to some unintended consequences regarding uncertainty, auction risk premia and liquidity.

1.2.31 Furthermore, the Government does not intend to progress proposals to apply multiple termination fees for multi-year agreements or introduce graduated termination fees based on the causation of a termination event.

Consultation Question

Q7 Do you agree that we should impose credit cover for existing CMUs to cover for the termination fee? Are there any unintended consequences of such a proposal?

Summary of Responses

1.2.32 There were forty-four responses to this question, of which a small minority supported the proposal to require credit cover in respect of existing CMUs (refers to non-new build CMUs, rather than those in possession of an agreement awarded in December 2014 or 2015 auctions) in order to secure their termination fee liability.

1.2.33 Representations from those in favour of the proposal focused on ensuring equivalence with new build units, to avoid favouring incumbents over newcomers, and encouraging applicants to include the cost of maintaining their connection in the pre-delivery years in their auction bids. One response supported the proposal but only if applied to a minimum 50MW threshold.

1.2.34 Representations from those against the proposal primarily focused on the cumulative cost of credit liabilities; given existing CMUs already have significant credit liability in order to participate in the energy market, and with the consequential impact of increased auction bids. Responses cited that the cost of this proposal could be unsustainable, and disproportionate to the problem, particularly if the credit requirements were additive year-on-year; figures of approximately £1.2billion of credit cover being lodged indefinitely, or approximately £5billion for around 50GW of existing capacity for 4 years until the delivery period, were cited.

1.2.35 Responses also questioned the rationale for the proposal and what issue it was trying to address, given existing CMUs are, by definition, proven assets with an associated value – in contrast to new build projects where there is no physical asset prior to the auction.

1.2.36 Several respondents also highlighted that the proposal would remove funds from the sector and tie up capital available for further investment, just at a time when investment in new

capacity is required. Others suggested that whilst it would secure any termination fee liability, it is unlikely to influence any decision to renege on a capacity agreement, which would be based on prevailing market conditions.

1.2.37 A few respondents suggested that if the Government was minded to introduce this measure, applicants would need to be given the option to use appropriate Letters of Credit or parent company guarantees based on set criteria – such as credit rating/financial strength of parent entity.

Decision taken since consultation

1.2.38 The Government notes the representation against this proposal, especially the challenges around the impact on the sector's investment in new build capacity and the potential costs and disproportionality to the issue being addressed. As such the Government does not intend to progress this proposal. The scope of those CMUs subject to the provision of applicant credit cover will not be expanded from its current scope.

Consultation Question

Q8 Should we redefine “termination event” to focus on penalties rather than on ‘delivery incentives’? Should we amend the Regulations and Rules to make clear that sanctions are in place for non-delivery?

Summary of Responses

1.2.39 Thirty-seven responses commented on this question, the majority of which did not support redefining “termination event” to focus on ‘penalties’ rather than ‘delivery incentives’.

1.2.40 Representations from those not in favour of this proposal primarily focused on its probable ineffectual nature. Respondents argued it would have limited impact as CM participants already focus on delivery incentives as if they were penalties. A significant number of responses also commented that the level of payments in the event of non-delivery is more important than the nomenclature.

1.2.41 Representations from those in favour felt that a change in language was justified by recent defaults on capacity agreements, would improve clarity and would help emphasise the costs and distortions created by non-delivery of capacity.

Decision taken since consultation

1.2.42 The Government notes the potentially ineffectual nature of this proposal and does not intend to progress it at this stage.

Consultation Question

Q9 Do you agree that we should disqualify CMUs who have had an agreement terminated from future auctions?

Summary of Responses

1.2.43 Forty-six responses commented on this question, the majority of which were opposed to disqualifying from future auctions those CMUs who have had an agreement terminated.

1.2.44 A large number of respondents opposed to the proposal were concerned that the disqualification of CMUs could lead to the sterilisation of potential and existing generation assets which would undermine security of supply and increase consumer costs. A number of respondents felt that robust penalties and the existing two-year disqualification should provide adequate incentive.

1.2.45 Of those respondents in favour, a significant proportion suggested that the disqualification should be limited in some way to avoid sterilisation of sites and risks to security of supply. Suggestions included limiting the disqualification to three years for new CMUs and one year for existing CMUs. A number of respondents also suggested that the disqualification should be lifted if the CMU was purchased and under different ownership.

1.2.46 A significant number of respondents also felt any disqualification should not apply to capacity providers as this would be grossly disproportionate (especially as non-delivery is sometimes beyond the direct control of the provider) and represents a huge risk to security of supply if the provider has a large portfolio of generation assets.

1.2.47 Some respondents suggested alternatives such as disqualifying directors or introducing higher penalties for those providers triggering a second termination event.

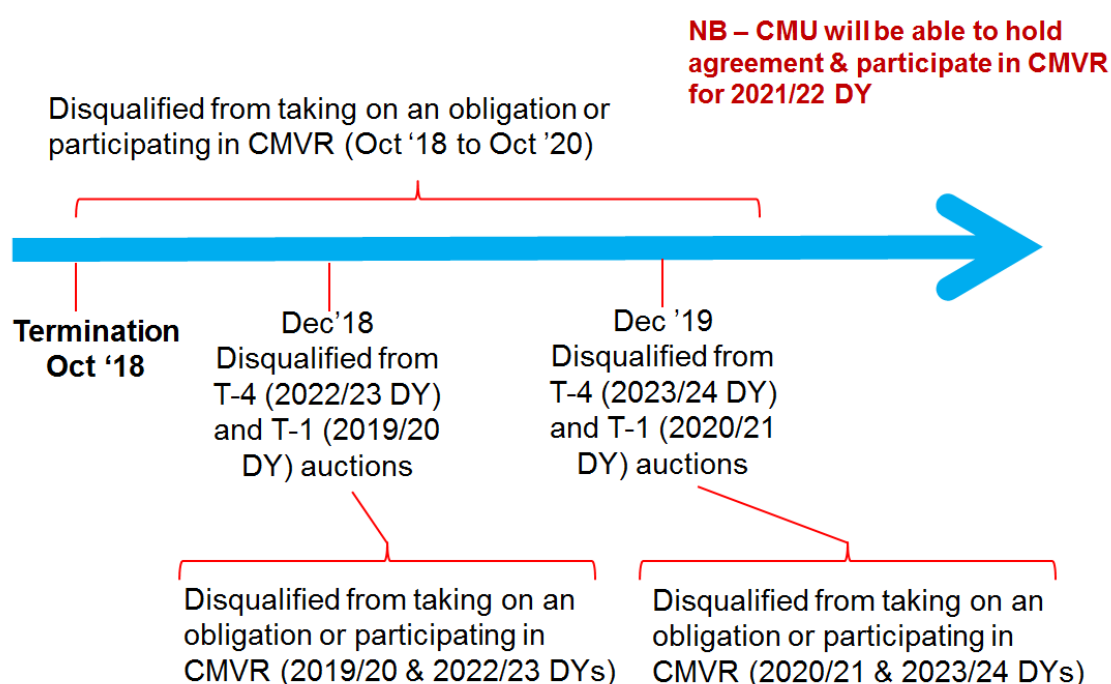
Decision taken since consultation

1.2.48 The Government welcomes feedback on the disqualification proposals, especially regarding concerns over implementation and the sterilisation of sites which could otherwise meaningfully contribute towards security of supply under different ownership.

1.2.49 In the Government Response to the October 2015 consultation, the Government confirmed its intention to progress disqualification provisions for new build CMUs where their agreements have been terminated for failing either their Financial Commitment Milestone or their Minimum Completion Requirement. This disqualification, expanded to include related failures to confirm a distribution connection agreement (where relevant) or lodge increased credit cover 12 months post auction (where relevant), will apply in respect of an application in respect of a new build CMU, from an applicant, or a member of their group, which was the capacity provider for that new build CMU at the time their agreement was terminated. Whilst this does not prevent the CMU being the subject of an application as an existing CMU, it effectively sterilises the new build site whilst owned by the provider or a member of their group. It does not sterilise the site where it is sold outside of the provider's group.

1.2.50 The Government intends to progress disqualification provisions for units which have been subject to a termination event for reducing their TEC, that prevent the unit from being the subject of an application, in any form and under any ownership arrangement, for a two year period. This disqualification would also prevent the CMU from taking on a transferred obligation for the four relevant delivery years covered by their disqualified auctions, or participating in volume reallocation in this period. In addition the CMU would not be eligible to take on a transferred agreement or participate in volume reallocation for the two years immediately following their TEC-related termination. This is shown below in Figure 4.

Figure 4 – disqualification proposal for TEC-related termination events



1.2.51 The asterixed (*) coding on figure 3 indicates which of the termination events will be subject to either of the disqualification provisions.

1.2.52 The Government proposes that such disqualification provisions reinforce the delivery incentives without significantly altering the balance between assurance and increases in auction risk premia. The Government does not intend to progress any form of additional disqualification in respect of other termination events at this stage.

Consultation Question

Q10 Do you agree that we should introduce a wider discretionary ability for the Secretary of State to penalise (or increase the penalty otherwise falling on) those who have failed to take reasonable steps to comply with the terms of their capacity agreement?

Summary of Responses

1.2.53 There were fifty-one responses to this question, the majority of which were opposed to the introduction of a wider discretionary ability for the Secretary of State to increase the penalty faced by those who fail to meet the terms of their capacity agreement.

1.2.54 Representations from those opposed noted that a new discretionary power for the Secretary of State of this nature would introduce an unquantifiable risk which could undermine investor confidence, deter participation in the CM and lead to more expensive bids (particularly amongst independents and in relation to new build capacity). A number of respondents also commented that robust penalties, set down in the rules and regulations, should provide sufficient incentive and facilitate clarity and certainty. Several respondents noted that Ofgem's existing enforcement role is sufficient and the proposal potentially introduces a level of duplication. And several noted that it was unclear what was meant by "reasonable steps".

1.2.55 Even amongst those respondents in favour, there was a view that any new discretionary power should be used sparingly and be subject to an overall limit on the level of penalty that could be applied.

Decision taken since consultation

1.2.56 The Government notes the representation regarding the impact of such a proposal on risk exposure and potential auction liquidity and new build investment. As such it does not intend to introduce such discretionary powers at this stage.

Consultation Question

Q11 Do you think separate de-rating factors should be considered in respect of new and existing CCGT units? Should this be restricted to CCGT units or expanded further?

Summary of Responses

1.2.57 There were thirty-seven responses to this question, the majority of which were not in favour of separate de-rating factors in respect of new and existing CCGTs.

1.2.58 Representations from those against the proposal questioned the evidence for differentiating between old and new CCGTs, whilst others noted that new CCGTs are often less reliable in the first several years of operation.

1.2.59 A significant number of respondents (including some of those in favour) highlighted the complexity of the issue and the need for more detailed proposals. Issues to consider would include: how to account for differences in reliability between turbine technologies, and how to define 'new' and 'existing' recognising that the reliability of a new CCGT will tail off over its fifteen year agreement. Others thought that any changes should be applied to the full range of technologies, in part to preserve the technology-neutrality of the CM.

1.2.60 A number of responses did not comment on the proposal but instead took the opportunity to either criticise the concept of de-rating or express a preference for plant operators to choose their own de-rating levels given plant specific factors, such as maintenance regime, are likely to have more of an impact on reliability than age alone.

Decision taken since consultation

1.2.61 The Government does not intend to progress any amendments to the de-rating methodologies at this stage, noting the statutory duties on the Delivery Body to periodically review the appropriateness of the existing methodologies.

Chapter 2 – Value for money

2.1 Avoiding cumulation of State aid

Consultation Question

Q12 How likely is it that your company has benefitted or will benefit from aid under the EIS or VCT schemes? Do you have any other comments on the proposed change to the eligibility criteria?

Summary of Responses

2.1.1 There were one hundred and eleven responses to this question, a large proportion of which were from private investors who have invested in companies that have benefitted from the Enterprise Investment Scheme (EIS) or Venture Capital Trusts (VCT) schemes.

2.1.2 A small minority of respondents supported the Government proposals to restrict eligibility for participants that have raised finances under the EIS or VCT to ensure they are not receiving benefits from these schemes and Capacity Market payments.

2.1.3 However, the large majority were opposed to the proposal, in many cases strongly so, and believe that participants with EIS and VCT support should continue to be eligible in the CM. A small number of respondents did not agree that this represented cumulation. And a sizeable number of respondents asserted that HMT's removal of 'reserve generating activities' from eligible tax relief was sufficient to address any issue of cumulation. Representations from those opposed to the proposal also argued that action which would affect existing agreements would be unfair and undermine investor confidence.

2.1.4 A number of respondents suggested that Government should implement a transition period; an approach used for the exclusion of renewable energy activity under EIS and VCT, where companies were informed of a change taking place in eligibility in April 2014 with a deadline of July 2014 – companies that raised EIS funding up to the deadline were permitted to enter into energy contracts.

2.1.5 Several respondents opposed to the changes suggested that the shareholders of the Company, the original EIS/VCT investors, only remain shareholders until the start of the CM delivery year removing the additional benefit of receiving both CM payments and EIS/VCT tax relief.

2.1.6 Other responses requested further clarification in relation to the level (Company, SPV or CMU) from which the dual benefit will be excluded.

Consultation Question

Q13 Are you aware of any other State aid which Capacity Market recipients could benefit from?

Summary of Responses

2.1.7 There were thirty-seven responses to this question, the large majority of which simply stated they were not aware of any other sources of State aid from which capacity providers could benefit.

2.1.8 The remainder of the respondents identified the following as potential sources of aid: Enhanced Capital Allowances, tax allowances for shale gas exploration used onsite, National Innovation Competition, Low Carbon Network Funding, and Enterprise Zones. It was also mentioned that Energy Intensive Industries also do not need to pay for the cost of carbon and that state funding via Innovate UK and other grant bodies may also constitute State aid.

Consultation Question

Q14 Would it be appropriate for a capacity provider that has benefitted under the EIS or VCT schemes and received capacity payments to have their capacity agreement terminated, capacity payments recovered and/or the imposition of a termination fee? If not, are there any other penalties that should be considered?

Summary of Responses

2.1.9 There were one hundred and seven responses to this question, the large majority of which were opposed to any form of penalty. Representations from many of those opposed were of the opinion that the proposal effectively introduced retrospective penalties for CMUs with existing CM agreements that have received EIS/VCT funding in the past. These respondents expressed strong concerns in this regard, arguing that this would be unfair and would deter future investment in the sector.

2.1.10 A small minority of respondents agreed that some form of proportional penalty should be considered (no specific suggestions were given); although some further added that no penalties should be applied retrospectively for CMUs that already have an existing CM agreement.

Decision taken since consultation – questions 12 to 14

2.1.11 The Government welcomes the feedback received in relation to questions 12 – 14. We note that many of these responses want us to do nothing. However, the Government has an obligation to comply with the law. Benefitting from both CM payments and tax advantaged investment under the EIS and VCT scheme together may result in cumulation of State aid.

2.1.12 That said, the consultation responses do reveal the complexity of the issues involved: for example, whether the benefit should be considered at the level of the company or of the individual CMU; whether the benefit we should be concerned about is in relation to all CMUs or only new build CMUs where the funding is used for the same project costs; whether we should disallow only simultaneous cumulation, or also cover benefits received through EIS or VCT for the same project costs in the past.

2.1.13 The Government therefore intends to reflect on the consultation responses and revert with a more focused consultation proposal in the Autumn. We expect to consult on a 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.”*

2.2 Eligibility for Transitional Arrangements

Consultation Question

Q15 Do you agree that the eligibility for the TAs should be refined to support load reduction DSR?

Summary of Responses

2.2.1 There were forty-three responses to this question, the majority of which agreed with our proposal to refine eligibility for the Transitional Arrangements (TAs) to target support to genuine load reduction DSR only.

2.2.2 Representations in support of the proposal pointed to generation-derived DSR (both small-scale distributed generation and back-up generation) crowding out turn-down DSR from the first TA auction, the higher barriers and cost bases for turn-down DSR, the availability of existing embedded benefits for generation-derived DSR, and the existence of an alternative route to market for generation-derived DSR following the introduction of an early CM auction for delivery in 2017/18. A number of respondents went further and questioned the need for the second TA auction given the introduction of the early auction (question twenty-three refers).

2.2.3 However, a significant number of respondents felt the eligibility should not be changed, or changed only to exclude small-scale embedded generation which exports electricity. Representations from these respondents argued that it was unhelpful to distinguish between ‘back-up generation’ DSR and ‘turn-down’ DSR as participation in the CM is, for many in the sector, a learning experience which starts with on-site generation but moves into more advanced load management with time. They also argued that, although back-up generation is a mature technology it is an immature market, and the proposed changes to the TA auction risk discouraging potential DSR resource providers taking the first step and ultimately involvement

at all. A small number of responses also argued that battery storage should be allowed to continue participating.

2.2.4 There were a number of complaints that this proposal, together with our proposal to reduce the portion of capacity that we set aside from future T-4 auctions to buy at T-1 auctions, acts to undermine confidence in the Government's overall commitment to DSR and may impact on market confidence, affecting both delivery of DSR for the first TA delivery year and interest in the second TA auction. Related to this, a number of respondents highlighted that the DSR sector's route-to-market for 2020/21 is highly uncertain because (a) there is an existing 'exclusivity' provision which prohibits components of an unproven DSR CMU with a TA agreement from bidding into the 2016 T-4 auction as an unproven DSR CMU for delivery in 2020/21, and (b) the proposal to reduce the portion of capacity that we set-aside from T-4 auctions to buy at T-1 auctions also starts with the 2020/21 delivery year. These respondents requested reconsideration of the T-1 auction set-aside or removal of the exclusivity provision.

2.2.5 Several respondents raised concerns that holding the second TA auction in March would only allow 6 months to sign up new DSR resources and carry out the necessary testing procedures ahead of the delivery year.

Decision taken since consultation

2.2.6 The Government believes that DSR can play an important role in delivering a smart, flexible energy system in the UK, which could help us achieve numerous benefits including deferring / avoiding investment in network reinforcement, meeting climate change targets with less low carbon generation, making the best use of our low carbon generation and optimising balancing of our energy system on a minute-by-minute basis. We are planning to publish a call for evidence shortly, to build our evidence base and to consider how Government and the regulator could better enable the development of a smarter energy system. A Government Response will be published later in 2016, which will outline a route map to a smart energy system.

2.2.7 The Government recognises that the introduction of the early CM auction for delivery in 2017/18 may, to some extent, reduce the need for a second TA auction. However, we continue to be of the view that parts of the DSR sector are not yet sufficiently mature to compete in the main auctions and still require targeted support. The Government therefore intends to proceed with a second TA auction.

2.2.8 At the same time, the Government believes it is important that we better distinguish between the different 'types' of DSR, particularly in the context of providing ring-fenced support via the TAs to develop a nascent sector, but equally with a view to the longer term.

2.2.9 The Government is therefore keen to ensure that (a) funding through the next TA auction is targeted to those types of DSR resource that need it most, and (b) those DSR resources that are mature enough to participate in the main auctions are encouraged to do so. The results from the first CM and TA auctions, and information regarding the nature of participants in balancing services, clearly suggest that generation-derived DSR, both small-scale embedded generation and back-up generation, is well-established relative to turn-down DSR. And whilst we do recognise that back up generation is a different proposition/business model to small-scale generation that exports electricity, this does not detract from the fact that DSR sourced

from running back-up generators is easier, the barriers lower, and the behaviour change needed smaller, than turn-down DSR.

2.2.10 Therefore, we believe generation-derived DSR does not need ring-fenced support through the next TA auction (and continuing to allow this would represent poor value for money for consumers who ultimately pay for the TAs) and is mature enough to participate in the main CM auctions, most notably the early auction for delivery in 2017/18. The Government therefore intends to progress with its proposal to refine eligibility to better support turn-down DSR in the second TA auction. In terms of the participation of generation-derived DSR in the main CM auctions, it is worth noting again the steps being taken by Ofgem to consider concerns relating to potential unfair advantage gained as a result of 'embedded benefits' and by Defra in response to concerns regarding the impact on local air quality from diesel engines (see Chapter 4).

2.2.11 We will also amend the CM rules to allow Unproven DSR capacity with an agreement from the first TA auction to participate in the main CM auctions taking place in winter 2016/17 – this should resolve the concerns raised in relation to a route-to-market for the delivery year 2020/21 and help improve the liquidity of the early auction.

2.2.12 We accept that turn-down DSR is more challenging to recruit and that aggregators may struggle to attract clients within the short time available between the proposed auction in March and the start of the delivery year in October. That is one of the reasons why we are progressing with our proposal to lower the minimum capacity threshold for entry into the TA auction from 2MW to 500kW (question seventeen refers). This will enable a wider range of resources to enter the auction and make it easier to recruit turn-down DSR.

Consultation Question

Q16 Which option: a) excluding all generation assets or b) requiring a minimum threshold for load reduction with a CMU would better support load reduction DSR?

Summary of Responses

2.2.13 There were thirty-eight responses to this question. Amongst the majority of respondents there was a preference for option (a) – the exclusion of all generation assets – as this was felt to be the best option for encouraging the growth of load reduction DSR. A number of respondents also highlighted that option (a) would be simpler to implement, as a minimum threshold would be difficult to define and measure and so make it more difficult to enter Unproven DSR.

2.2.14 Those respondents which, in response to question fifteen, were opposed to changes to the eligibility criteria, or favoured allowing back-up generation to continue participating in the TA auctions, tended to prefer option (b) – establishing a minimum threshold for load reduction – to outright exclusion. These representations cited similar arguments to those noted under question fifteen.

Decision taken since consultation

2.2.15 The Government notes the broad support for option (a) and intends to proceed with its implementation. We note that the alternative – option (b) – would add to complexity during implementation and would only partly deliver on our ambition to target support where it is most needed and in so doing maximise value for money.

Consultation Question

Q17 Do you agree that the government should lower the minimum capacity threshold for entry into the Transitional Arrangements auction for delivery in 2017/18? Would 500kW be the appropriate threshold level for eligibility?

Summary of Responses

2.2.16 Thirty-eight responses commented on question seventeen, the majority of which were in favour of the proposal to lower the capacity threshold.

2.2.17 Representations in favour noted a lower threshold would help lower the cost of entry (no need for participants to go through an aggregator) and allow a wider range of resources to participate, boosting competition in the next TA auction.

2.2.18 Whilst the majority also supported a new threshold of 500kW, several responses suggested alternatives; one suggested lowering the threshold to 1MW in the first instance and another pointed to the PJM Capacity Market in the United States which has a threshold of 100kW.

2.2.19 Those respondents opposed to the change felt the administrative effort would be too great for this size of participant. They also argued that the ability to aggregate small components to meet the existing 2MW threshold meant a lower threshold was not necessary. Several respondents objected on the grounds that there should be a level-playing field between all types of capacity participating in the CM.

Decision taken since consultation

2.2.20 The Government welcomes the feedback received and confirms its intention to proceed with the proposal on the basis that it will enable a wider range of load reduction DSR resources to enter the next TA auction. As noted in response to question fifteen, this will help address concerns about the difficulty and time needed for providers to recruit turn-down DSR. We believe a threshold of 500kW strikes a balance between opening up the TA auction to smaller resources and increasing administrative complexity.

2.2.21 Whilst some respondents noted that the complexity and administrative burden associated with participation in the CM could mean, in practice, that these smaller resources do not participate, we do not see that as a sufficient justification to exclude these resources from the TA.

Consultation Question

Q18 Do you have any suggestions on how market power risks can be mitigated by the Government?

Summary of Responses

2.2.22 Twenty-nine responses commented on this question, although only a limited number made suggestions on how market power risks could be mitigated. A number of respondents felt the risk should be limited and possible to manage through the auction parameters (i.e. limiting the amount of capacity procured, setting a price cap at an appropriate level) and the use of regulatory powers similar to those available in the main auctions. The proposal to lower the capacity threshold for entry into the TA was also highlighted as useful in minimising risks.

2.2.23 Other respondents pointed to market power risks in support of their earlier arguments that eligibility for the TA auctions should remain unchanged / specific types of DSR (e.g. battery storage) should remain eligible for the next TA auction / the second TA auction should be scrapped.

Decision taken since consultation

2.2.24 In light of the feedback received, the Government does not propose to introduce any new measures and will rely on the existing powers to address excessive market power. We will propose and adjust the auction parameters to ensure the auction is competitive.

2.3 Prequalification timing and processes

Consultation Question

Q19 Do you have any comments on the proposed changes to prequalification timings in the Regulations?

Summary of Responses

2.3.1 Twenty-eight responses commented on this question, all of which indicated support for the proposed changes to prequalification timings as set out in the consultation paper.

2.3.2 Almost half the responses expressed support with no further comment. Others expressed support on the basis that the changes would result in increased accuracy of information communicated to the industry, as well as to the Secretary of State, regarding recommended adjustments to the auction parameters. A number noted these changes would have no adverse effect on participation at auctions.

2.3.3 Several respondents qualified their support with a request that no further changes should be made to the duration for which the Secretary of State is expected to make a decision on any adjustments to the auction parameters.

Consultation Question

Q20 The Government wishes to implement these changes with minimal amendments to the current regime. Do you agree with this approach? How will these changes work operationally for participants?

Summary of Responses

2.3.4 There were thirty-four responses to this question, almost all of which agreed with the approach outlined in the consultation paper.

2.3.5 A number of respondents noted that there would be little or no adverse operational impact. Others requested that changes be communicated to CM participants at the earliest possible opportunity to provide increased clarity. One respondent requested that DECC ensure its approach is aligned with any relevant changes made by Ofgem and another requested that any existing agreements for capacity arrangements be 'grandfathered'.

Decision taken since consultation – questions 19 and 20

2.3.6 In light of feedback received, the Government has decided to go ahead with the proposed changes to prequalification timings.

2.3.7 The Government will amend the Regulations regarding the requirement for the Delivery Body to advise the Secretary of State whether the demand curve for the capacity auction should be adjusted following the prequalification period.

2.3.8 The Delivery Body will now await the results of Tier 1 appeals following the prequalification period before making recommendations to the Secretary of State for adjustments to the auction parameters. The Tier 1 appeals process takes ten working days to complete meaning that recommendations for adjustments to the Secretary of State will be made as soon as reasonably practicable after the results of prequalification are finalised.

2.3.9 Following this recommendation by the Delivery Body, the Secretary of State will have a further ten working days to decide whether to adjust the aforementioned auction parameters prior to the auction.

2.3.10 The CM register will now be published once the Tier 1 appeals process has concluded rather than after the results of prequalification are finalised.

2.3.11 This process applies to the T-4 auction, the early auction and TA auction in 2016/17 and will apply to all subsequent T-4 and T-1 auctions.

2.3.12 In addition the Government will introduce a provision to the Regulations which means that as soon as reasonably practicable after the T-4 auction and early auction the Delivery Body will notify the Secretary of State of the aggregate prequalified capacity that remains eligible to participate in the TA auction. In other words, those that were unsuccessful in or withdrew from both the preceding T-4 auction and early auction and therefore remain eligible to participate in the TA auction. The Secretary of State will then have five working days to decide whether to adjust the auction parameters for the TA auction. A provision will be introduced to allow TA auction participants to withdraw ten working days before the first bidding window of the TA auction.

2.3.13. This process applies to the 2016/17 TA auction.

2.4 Review of Capacity Market Rules

Consultation Question

Q21 Do you agree that Ofgem's duty to review the Rules should be contained in the Rules themselves, rather than in the Regulations?

Summary of Responses

2.4.1 There were twenty three responses to this question, with a split between those supporting alignment with the Small Business, Enterprise and Employment Act 2015 (SBEEA) and those who thought Ofgem's duty to review the Rules should be in the Regulations. Representations from this latter group were made on the basis that Ofgem have the power to amend the Rules and therefore could also amend this duty.

2.4.2 One respondent commented on the clarification to regulation 77(3) in support of this amendment.

Decision taken since consultation

2.4.3 The Government believes that it is good practice to align the Capacity Market review provisions with those of SBEEA and will therefore proceed with these amendments. Concerns raised regarding Ofgem's ability to amend the Rules in relation to this duty are addressed through regulation 77(3) and the greater clarity proposed – this expressly prevents Ofgem from making, amending or revoking any provision in the Rules which confers functions on the Authority except with the approval of the Secretary of State.

Consultation Question

Q22 Do you have any other comments on the indicative drafting for the amendments to Regulations 81 and 82, and for the new Chapter 15 of the Rules, and the amendment to Regulation 77(3)?

2.4.4 This question should have been withdrawn from the consultation before publication as the indicative drafting for amendments to regulations 81 and 82, and for the new Chapter 15 of the Rules, and the amendment to regulation 77(3), were not available for the consultation period.

Chapter 3 – Security of Electricity Supply in 2017/18

3.1 Early capacity auction for delivery in 2017/18

Consultation Question

Q23 Do you agree with the proposal to run an early capacity auction for delivery from October 2017 to September 2018?

Summary of Responses

3.1.1 Fifty two responses were received to this question, which overwhelmingly supported the Government's proposal to bring forward the start of the CM delivery year to 2017/18 by running an early auction.

3.1.2 Respondents recognised the need to respond to market developments since the CM was established, and agreed that an early auction is the appropriate response in order to ensure security of supply over winter 2017/18. Many respondents took the view that bringing forward the capacity market was preferable to extending National Grid's Contingency Balancing Reserve (CBR), due to concern about potential market distortions associated with the CBR. A number of respondents also noted that the benefits of the early auction will continue to be realised in subsequent years, as some capacity that may gain an agreement for 2017/18 but is not already holding an agreement for 2018/19 will be available to compete in the first T-1 auction, thereby increasing liquidity and supporting security of supply in that year also.

3.1.3 A small number of respondents offered the opposing view that, instead of an extra CM auction, National Grid should extend the use of the CBR. These representations argued this would be a less interventionist, better targeted approach, and in their view would be likely to cost less. It was also suggested that an early auction would impact retrospectively on commercial decisions that have been taken previously, e.g. bidding strategies in previous auctions. Respondents requested further information on the cost/benefit analysis that has been carried out in support of holding an early auction.

3.1.4 Several respondents – many of whom supported the case for an early auction – nevertheless expressed concern regarding the relatively short timescale between Government announcing the auction, and the point at which the costs of this will be collected from suppliers. It was noted this could create challenges for suppliers and/or customers in managing the unexpected bill impact. Larger customers in particular purchase their electricity several years in advance. Where suppliers have locked in contracts with customers, this may make it difficult to

pass on the increased costs to these customers – although one respondent noted that whilst not optimal, change-of-law clauses can be used to address this. Where costs cannot be recovered from particular customers, these would need to be absorbed by the supplier or passed on to other customers. However, few respondents cited these concerns as grounds for not proceeding with the auction, rather they emphasised the importance of clarity from Government on timelines for providing key information on e.g. auction parameters, finalised rules etc. to aid participants in managing their planning and management of costs impacts. One respondent suggested that the costs of the 2017/18 delivery year should instead be collected in the subsequent two delivery years to make it easier for suppliers to manage.

3.1.5 One respondent suggested the early auction should be brought forward to November, in advance of the third T-4 auction, to allow participants to minimise costs associated with closure decisions.

Decision taken since consultation

3.1.6 The Government welcomes the broad support amongst respondents and confirms it will proceed with the implementation of an early auction for delivery in 2017/18, and will immediately begin the process of making the necessary regulatory and rule changes in order to enable this.

3.1.7 In agreement with the majority of respondents, the Government remains of the view set out in the consultation that bringing forward delivery of the capacity market by a year will have a less distortive impact and offer greater transparency than extending the use of CBR for a further year. Whether or not earlier knowledge of an auction could have informed commercial decisions that have been taken is a moot argument. It should not prevent the Government from taking the appropriate action now in response to market developments and new risks to security of supply. The Government is publishing an Impact Assessment alongside this consultation response – this sets out our analysis for why this approach represents better value for money for consumers than extending CBR and our analysis of the potential impact on wholesale prices.

3.1.8 The Government acknowledges the operational challenges faced by suppliers in managing the previously unexpected costs associated with an early auction, and recognises that it is optimal to give suppliers as much notice as possible of policies that will have a bill impact. However, as has been acknowledged by many of the respondents – including suppliers – who raised this issue, an early auction is a necessary step in order to ensure the security of our electricity supply in response to previously unforeseen market developments – to the ultimate benefit of customers and suppliers. This will mean it is necessary to recover from suppliers the costs associated with the auction in the 2017/18 delivery year. It is not possible to delay recovery of these costs until subsequent delivery years as the settlement body operates on a ‘pay-when-paid’ basis, and therefore requires payments from suppliers in order to make payments to capacity providers for the same period.

3.1.9 The auction will proceed according to the timeline set out in the consultation document. Key milestones, summarised from National Grid’s Operational Plan, also published today, are:

June 2016	National Grid publishes its 2016 Electricity Capacity Report – including target volume for 17/18
By July 2016	Secretary of State confirms auction parameters – including target capacity and price cap - for the early auction
August 2016	Prequalification for all auctions to open
December 2016	The third T-4 auction (for 2020/21 delivery) takes place
January 2017	The early capacity auction (for 2017/18 delivery) takes place
March 2017	The second TA auction (for 2017/18 delivery) takes place

Consultation Question

Q24 Are there any further issues or interactions that DECC should consider without which the early capacity auction could not be implemented?

Summary of Responses

3.1.10 Respondents did not raise any significant regulatory or operational issues that could have implications for the implementation of the early capacity auction, other than the minor changes to existing T-1 processes set out in the consultation document.

3.1.11 A few respondents sought further clarification regarding the ability to obtain Transmission Entry Capacity (TEC), and TEC interactions for those currently participating in the Supplementary Balancing Reserve. One respondent suggested that a deadline for securing TEC six months ahead of delivery was too early, and also proposed that participants should be offered a guarantee from National Grid that they will receive TEC, be waived from termination fees if they are unable to obtain TEC, or be permitted to drop TEC without charge. Conversely other respondents felt that six months was appropriate, and another believed participants should be required to secure TEC before participating in the auction.

3.1.12 Several respondents asked for greater clarity regarding the ability of capacity that is associated with an agreement won in the first TA auction to participate in the new auction. Respondents also queried whether capacity that has previously participated in the TA and enters the early auction would need to post higher credit cover than in the TA. If so, respondents queried why this was necessary, taking the view that it could act as a disincentive to participate.

3.1.13 Several respondents questioned why interconnectors are allowed to participate in the early auction, expressing the view that interconnectors would be expected to deliver anyway regardless, so there is no benefit to consumers for paying them to deliver in the capacity market.

3.1.14 One respondent proposed that CMUs that participated in the first three T-4s should be automatically prequalified in the early auction, and another proposed that the early auction should offer 15 year agreements.

Decision taken since consultation

3.1.15 As proposed in the consultation, the Government will proceed with an early auction which follows the T-1 capacity auction design, making only those amendments necessary to regulations and rules to accommodate the circumstances and timing of the auction. Key design elements of the early auction are as follows:

- **Target capacity** - As no T-4 auction was held for 2017/18, the early auction will procure the entire CM requirement for that year. National Grid will provide a recommendation on the volume to procure in an Annex to its 2016 Electricity Capacity Report.
- **Eligibility** - As with the existing T-1 auction design, all types of capacity will be able to participate – including existing and new build generation, storage, DSR and interconnectors.
- **Agreement length** - Also reflecting the current T-1 structure, only 1-year agreements will be available. This is necessary to avoid the risk of over-procurement for delivery years where the majority of capacity has already been secured (i.e. 18/19, 19/20 and 20/21).
- **Existing CMUs and TEC** - Transmission-connected generators will be able to prequalify without TEC, provided they secure the required TEC by 6 months prior to the start of the Delivery Year. Any capacity that is successful in the auction but fails to obtain TEC by this date will be subject to a Termination Fee (TF5) of £35k/MW as detailed in Chapter 1. The same TF of £35k/MW will be applied where a provider fails to demonstrate their distribution connection agreement by the same date.
- **Prospective CMUs** will be able to participate in the new auction – including those that have already obtained agreements in any of the first three T-4 auctions. To ensure this capacity is ready to deliver on time the existing delivery milestones will be brought forward and condensed, as set out in the consultation document.
- **Secondary trading** - Volume reallocation trading will be permitted for delivery year 2017/18 as per the existing rules and regulations. Obligation trading will also be permitted, but will only be available 4 months ahead of the start of the delivery year.
- **Bidding round information** - Excess capacity announced at the start of each bidding round of the early capacity auction will be rounded to the nearest 1GW.

3.1.16 Participants in the early auction will be required to hold TEC by 6 months ahead of the start of the delivery year (e.g. 1st April 2017). The Government believes the proposal to allow TEC to be secured after the auction offers participants sufficient flexibility to avoid locking in costs, and that a requirement to secure TEC by six months ahead is an achievable timescale, particularly where participants submit TEC applications in advance of the auction. It is ultimately the responsibility of auction participants to satisfy themselves that they will be able to secure TEC by this date where they have not done so in advance of the auction, and to assess the risk of failing to achieve this. National Grid will be in communication with any prospective auction

participants for whom TEC could be an issue in order to ensure there is a clear understanding of TEC positions and requirements.

3.1.17 The Government also wishes to confirm that the derogation from demonstrating TEC at prequalification for the first two full (T-4) auctions (under rule 3.6.3(b)) will not be extended for any subsequent T-4 auctions. As such, for December 2016's T-4 auction, applicants in respect of existing Transmission CMUs, will be required to demonstrate they have secured a relevant volume of TEC for the delivery year as a pre-requisite for prequalifying in the T-4 auction.

3.1.18 Applicants for the early auction for 2017/18, where notified of the need to lodge applicant credit cover, will be required to lodge the increased amount of £10k/MW of de-rated capacity, rather than the current level of £5k/MW – as detailed in Chapter 1. This increased requirement will not, however, apply in respect of Unproven DSR capacity, which will continue to be subject to the £5k/MW level. In addition all agreements awarded in respect of the early auction will be subject to the increased termination fee liabilities – TF3 (£10k/MW), TF4 (£15k/MW) or TF5 (£35k/MW) depending on the termination event as detailed in Chapter 1.

3.1.19 As noted in relation to question fifteen, the Government intends to amend the CM Rules to allow Unproven DSR capacity with an agreement from the first TA auction to participate in the early auction (and the 2016 T-4 auction).

3.1.20 The TA auctions were designed and implemented as a ring-fenced pilot to support, develop and build capacity in the DSR sector. As such, reduced barriers to entry were put in place to facilitate participation – which included lower requirements for credit cover. The new auction for delivery in 17/18 is aimed at securing supply for that year. Therefore, to provide assurance that capacity participating is dependable and reliable the full credit cover requirements will apply for all relevant participants – as is the case for T-1 and T-4 auctions. This means that any Unproven DSR wishing to participate in the new auction will need to post credit cover at the full amount, and not the lower amount permitted in the TA.

3.1.21 CMUs that prequalified for the first three T-4 auctions will not be automatically prequalified for the early auction, as it is important that participants should make an active decision to participate, and take the necessary steps to achieve this, including provision of necessary certificates and declarations. Automatic prequalification could result in prequalified capacity that cannot / does not intend to participate. However, to reduce the burden on participants, the application system allows information from previous applications to be carried over to applications for subsequent auctions.

3.1.22 As set out in the consultation document, fifteen-year agreements will not be available, mirroring the T-1 auctions; fifteen-year agreements would offer an unfair competitive advantage as they would only be available to those types of capacity able to build to this timeline, whilst excluding others. They would also lock consumers in to buying capacity for subsequent delivery years, for which capacity has already been purchased – thereby risking over-procurement in these years.

3.1.23 The Government has committed to allowing interconnectors to be able to participate fully as soon as the relevant methodology is in place; the only exception to this was the 2018/19 delivery year, as at the time of the T-4 auction for this period the rules and regulations governing the participation of interconnectors had not been established. The contribution of interconnectors was therefore included within the baseline assumptions for this delivery year.

There is no rationale for excluding interconnectors from the early auction now that the methodology for enabling their participation has been determined. As such, regulations will be amended to permit the participation of interconnectors.

Chapter 4 – Other issues

Summary of Responses

4.1 A number of responses to the consultation raised issues that did not specifically relate to any of the consultation proposals upon which comments were sought.

4.2 The steps being taken by Defra in response to concerns about **emissions from diesel engines**, as outlined in the March Consultation, attracted most attention from respondents many of whom were supportive of the proposed action – some even provided evidence to support the concerns expressed. A number of respondents in favour of action voiced scepticism that the review would lead to sufficiently robust controls on diesel or proposed that controls on diesel should be established within the CM itself.

4.3 Other respondents, however, raised objections to any such controls. Representations from these respondents tended to stress the benefits of diesel engines in terms of its flexibility, reliability, low capex costs and contribution to a resilient energy network. Some respondents submitted that the efficiency of the auctions would be undermined if the participation of diesel was to be constrained.

4.4 Some respondents felt that the negative impacts were being overstated, with diesel only securing two per cent of the capacity procured in the last auction. A number of respondents also argued that emissions from diesel may be lower than expected given their limited run hours, their small scale, the potential to use 'green' diesel and deploy catalytic converters, and the planning controls already in place. Others were concerned that Defra's intent may be to introduce tighter environmental controls than those established by the recent Medium Combustion Plant Directive, stressing this would introduce distortions between the UK and the rest of the EU. Several respondents underlined the need to exempt 'emergency plant' from any new environmental controls.

4.5 Ofgem's review of the **charging arrangements for distribution-connected generators**, such as diesel engines, also attracted a significant number of comments. Again, there was significant support for the review, with many respondents sharing the concerns outlined in the March Consultation regarding the potential for over-reward. One response cited a report by National Grid which estimated the cost of avoided investment in transmission infrastructure at just £1.60/kW and contrasted this with the increasing level of revenues received from embedded benefits.

4.6 Others disputed whether there was any over-reward, describing the benefits provided by embedded generation to the system. A number of respondents stressed that some industrial plants are highly reliant on the embedded benefits generated by their CHPs – if Ofgem's review led to a reduction in these revenues, it could undermine the viability of the associated industrial plants. A number of responses also suggested that the review is likely to lead to a hiatus in investment until it is complete, noting this may be the Government's intention.

4.7 Several respondents highlighted that the manner in which the **CM supplier obligation** is currently calculated creates another distortion in the market, giving embedded generation a further advantage over transmission-connected plants.

4.8 The Government's plan to **buy more and buy earlier** also attracted significant attention. Again, a significant proportion of respondents commenting on this issue indicated their support. Some respondents, however, voiced concern about the impacts of this move on the DSR sector, as they are better suited to compete in the T-1 auctions, and others stressed that the Government should avoid procuring above the Loss of Load Expectation (LoLE) requirements.

4.9 Related to this, some respondents questioned the Government's focus on **encouraging new gas**. Some queried whether the system needs large-scale new gas that is better suited for baseload generation versus more flexible, low capex small-scale generation. Others also expressed concern about the potential impact on carbon emissions, particularly in light of the Government's decision to cancel the CCS Competition. Conversely, some respondents thought new gas would be needed in future but were not convinced that procuring more capacity in the T-4 auction would bring this forward, instead suggesting that a separate auction should be held for CCGTs or high efficiency plant.

4.10 A significant number of respondents had a **favoured technology** and took the opportunity to outline its benefits and argue for changes to the CM design so it would be better supported in future (this was particularly the case for DSR and battery storage, but also gas and coal generation).

Other issues raised included:

- Contracts for Difference (CfD) transfer notices – should ensure that a generator with a CM agreement is able to retrofit CCS and transfer into an alternative scheme (e.g. CfD) within the terms of its CM agreement.
- De-rating factors – should allow parties to select their own de-rating factors.
- Pre-qualification process – should introduce an *initial* pre-qualification round and subsequent *additional information* round to deal with the high failure rates and volume of appeals.
- Carbon Price Floor – several responses were critical of the CPF and blamed it for the premature closure of coal-fired power stations.
- Scope of the CM – should consider broadening the scope to allow renewables coupled with battery storage, or baseload renewables, to participate in the CM.
- Consolidated version of the CM Rules – should publish a consolidated version of the Rules as far in advance of pre-qualification as possible.

Decision taken since consultation

Emissions from diesel engines

4.11 The Government welcomes the feedback on the steps being taken by Defra in response to concerns regarding the impact on local air quality from Diesel engines. Defra will take these

representations into account as part of their review and we encourage direct engagement, as appropriate.

4.12 Defra has hosted workshops with industry and regulators to explore options to tackle emissions from diesel generators ahead of its consultation on proposals, which will be published later in the year. To limit the increase in numbers of polluting generators in the near term, Defra expects the timeline for introducing measures to control emissions will run ahead of the deadlines for implementation of limits set out in the Medium Combustion Plant Directive (MCPD). Defra has also indicated that its proposals are unlikely to include the blanket running hour exemptions permitted by the MCPD. If you are interested in updates on this work please email [Control.Pollution@defra.gsi.gov.uk]. As set out in our consultation document, the Government believes the steps being taken by Defra sends a clear signal regarding the long-term viability of investing in generation that may be leading to localised pollution.

4.13 In relation to the call for controls on diesel to be established within the CM itself, the Government notes the importance of maintaining the principle of technology neutrality.

Embedded benefits

4.14 The Government welcomes Ofgem's review of embedded benefits and the feedback received on this issue through the consultation. It is clear from consultation responses that this is a complex issue, with a wide range of views held by stakeholders. It is therefore necessary and appropriate that these benefits are properly scrutinized.

4.15 As noted in the March Consultation, Ofgem will set out their conclusions and a proposed way forward on embedded benefits, potentially including initiating changes to the charging regime, in the summer. Ofgem will need to consider carefully how and when any changes should be implemented, including whether any transitional arrangements are required, and will aim to provide clarity on their direction of travel before prequalification for the next CM auction. Any further queries on this review should be directed to Ofgem.

CM supplier levy

4.16 In response to the concerns raised regarding the Capacity Market supplier levy (specifically, the concern that the use of 'net demand' to calculate each supplier's share of the levy is creating an unfair double benefit), the Government believes there is merit in this looking at this issue. Whilst the use of net demand was designed to encourage generation over peak periods, it is now apparent that this benefit may unfairly distort competition (as well as potentially having an indirect impact on local emissions). As such there is a clear case to address this. Whilst we will not be making changes to the supplier levy as an immediate outcome of this consultation, we will consult as part of our next package of changes on a proposal to change the supplier levy so that it is calculated based on gross, instead of net demand. This consultation will be carried out in time for any consequential regulatory changes to be made in advance of the levy being collected for the new capacity market auction in October 2017, and would apply for CM revenues recovered in respect of all delivery years from that point forward.

Buy more, buy earlier

4.17 The Government welcomes the broad support in this regard, and we reiterate our intention to proceed with our plans to buy more and buy earlier.

4.18 We note the concerns expressed by the DSR sector. However, it is always the case that the procurement requirements for any particular T-1 auction may vary from year to year for a variety of reasons.

4.19 The precise target will be set in the light of all the evidence available at the time, including crucially an updated value for money analysis. There could for example be trade-offs in purchasing capacity early, which may hedge against risk and allow new resources to compete, but which brings with it some risk of over-procurement if demand subsequently shifts. And, of course, if it becomes clear that plant which already have capacity agreements for the 2020/21 delivery year will fail to make good on their agreements, then we would expect to re-buy that capacity from other sources. **Nonetheless, we remain of the view that the next T-4 auction can be expected to purchase significantly more capacity – perhaps over 3GW more – than would otherwise have been the case.**

4.20 We are confident that a healthy pipeline of robust baseload and peaking gas projects stands ready to take advantage of the opportunities we are creating, and that the revised CM will deliver the new plant we need. Discussions with industry suggests that, provided the CM is reformed in the way described, there are few if any other barriers to these projects coming through to fruition – but the Government will continue discussions with developers and investors to ensure that no unnecessary barriers exist to bringing forward an appropriate mix of plant.

Other issues

4.21 In relation to the request for a consolidated version of the CM Rules, we are working with Ofgem to make sure there will be an informal consolidated version of the Rules available in the summer.

4.22 In relation to CfD transfer notices, we stated in our response to the October 2015 consultation that we would not progress either of the previous consultation options at this stage and that we will bring forward amended proposals within the next 12 months.

4.23 We note the issues raised around de-rating factors but are not planning to amend the methodology for calculating de-rating factors at this stage.

4.24 The Government will reflect on the range of other issues raised and, if appropriate, come forward with proposals for consultation in due course.

Catalogue of consultation questions

Chapter 1 – Investment

Q1	Do you agree that we should increase requirements on the level of credit cover (and termination fee liability for not lodging increased credit cover if required as a result of not achieving the FCM at the 11-month point) for new build projects at the pre-auction stage?
Q2	Do you have views on the appropriate level for requirements on credit cover for new build projects at the pre-auction stage? Does £10k/MW strike an acceptable balance?
Q3	Do you have views on whether the proposed increase in credit cover should apply to all new build units, irrespective of their size or broader corporate structure, or only to those meeting the 100MW threshold applied at a unit and broader portfolio level?
Q4	Should the package of new build delivery assurance measures (increased credit cover as described here and the new build measures described in chapter 1 of the accompanying Government Response document) apply to all new build units or only those in excess of a 100MW threshold applied at a unit and broader portfolio level?
Q5	Would there be a benefit in increasing termination fees for all participants with Capacity Agreements? Do you consider the current level of termination fee 2 (£25k/MW) for new build generating units failing to achieve operational status is sufficient?
Q6	Is there a case for increasing the termination fees for those CMUs that were the subject of a termination event for a previous agreement? Do you have any views on the relative merits and downsides to the alternative options outlined above?
Q7	Do you agree that we should impose credit cover for existing CMUs to cover for the termination fee? Are there any unintended consequences of such a proposal?
Q8	Should we redefine “termination event” to focus on penalties rather than on ‘delivery incentives’? Should we amend the Regulations and Rules to make clear that sanctions are in place for non-delivery?
Q9	Do you agree that we should disqualify capacity providers or CMUs who have had an agreement terminated from future auctions?
Q10	Do you agree that we should introduce a wider discretionary ability for the Secretary of State to penalise (or increase the penalty otherwise falling on) those who have failed to take reasonable steps to comply with the terms of their capacity agreement?

Q11	Do you think separate de-rating factors should be considered in respect of new and existing CCGT units? Should this be restricted to CCGT units or expanded further?
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Chapter 2 – Clarification / Simplification

Q12	How likely is it that your company has benefitted or will benefit from aid under the EIS or VCT schemes? Do you have any other comments on the proposed change to the eligibility criteria?
Q13	Are you aware of any other State aid which Capacity Market recipients could benefit from?
Q14	Would it be appropriate for a capacity provider that has benefitted under the EIS or VCT schemes and received capacity payments to have their capacity agreement terminated, capacity payments recovered and/or the imposition of a termination fee? If not, are there any other penalties that should be considered?
Q15	Do you agree that the eligibility for the TAs should be refined to support load reduction DSR?
Q16	Which option: a) excluding all generation assets or b) requiring a minimum threshold for load reduction with a CMU would better support load reduction DSR?
Q17	Do you agree that the government should lower the minimum capacity threshold for entry into the Transitional Arrangements auction for delivery in 2017/18? Would 500kW be the appropriate threshold level for eligibility?
Q18	Do you have any suggestions on how market power risks can be mitigated by the Government?
Q19	Do you have any comments on the proposed changes to prequalification timings in the Regulations?
Q20	The Government wishes to implement these changes with minimal amendments to the current regime. Do you agree with this approach? How will these changes work operationally for participants?
Q21	Do you agree that Ofgem's duty to review the Rules should be contained in the Rules themselves, rather than in the Regulations?
Q22	Do you have any other comments on the indicative drafting for the amendments to Regulations 81 and 82, and for the new Chapter 15 of the Rules, and the amendment to Regulation 77(3)?

Chapter 3 – Security of Electricity Supply in 2017/18

Q23	Do you agree with the proposal to run an early capacity auction for delivery from October 2017 to September 2018?
Q24	Are there any further issues or interactions that DECC should consider without which the early capacity auction could not be implemented?

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