Government Response to the Energy and Climate Change Committee Report on the Implementation of Electricity Market Reform

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

June 2015

Cm 9090

This publication is available at www.gov.uk/government/publications

Any enquiries regarding this publication should be sent to us at correspondence@decc.gsi.gov.uk

Print ISBN 9781474120890
Web ISBN 9781474120906

ID P002734097 06/15 50105 19585

Printed on paper containing 75% recycled fibre content minimum

Printed in the UK by the Williams Lea Group on behalf of the Controller of Her Majesty's Stationery Office

GOVERNMENT RESPONSE TO THE ENERGY AND CLIMATE CHANGE COMMITTEE REPORT ON THE IMPLEMENTATION OF ELECTRICITY MARKET REFORM

INTRODUCTION

DECC welcomes the Energy and Climate Change Committee's Report on the Implementation of Electricity Market Reform. As highlighted in the report the Electricity Market Reform programme (EMR) delivered on time, with the completion of the final policy design, the passage of secondary legislation and development of a strong institutional framework, enabling the delivery of the first Capacity Market (CM) and Contracts of Difference (CFD) auction. This has resulted in the Government delivering secure supplies and renewable electricity while ensuring value for money for the consumer.

In December 2014, the first Capacity Auction successfully procured 49.3GW of capacity for delivery in 2018/19 at a clearing price of £19.40/kW. The technology neutral auction ensured consumers received value for money as fierce competition drove down costs of reliable capacity well below our estimates.

In February 2015, the first competitively allocated Contracts for Difference (CFDs), worth over £315m per year (managed under the Levy Control Framework), were offered to renewable developers. In March 2015, 25 contracts were signed by a range of developers, including independent and smaller-scale companies, across the UK. These projects could power the equivalent of 1.4 million homes and could lead to the UK emitting 4 million fewer tonnes of CO_2 per year, supporting the delivery of decarbonisation and renewable targets. The early move to competitive auctions has driven down the costs to consumers, resulting in the capacity delivered costing up to £105m per year less than it would have in the absence of competition.

RESPONSE

Set out below are the Government's responses to the Committee's conclusions and recommendations. Where it makes sense to do so, some recommendations have been grouped together.

Reviewing the first year of EMR

Recommendation 1

> ***We recommend that DECC ensure its review of the first round of CFD allocation and first Capacity Market auction is concluded by the end of August 2015.***

The Government is committed to monitoring and evaluating the EMR programme. This will ensure its benefits are being realised. It will also enable lessons from the initial stages of the programme to be acted on.

We have appointed independent evaluators to evaluate the first CFD and Capacity Market auction, as well as the Final Investment Decision (FID) Enabling for Renewables process. A wide range of stakeholders have been involved in the evaluation research. The independent evaluation will be completed this summer.

The review should detail lessons learned from each step of the CFD allocation and Capacity Market auction outlined by DECC, and assess the extent to which the 2014 rounds contribute to the objectives of EMR

The evaluation report will examine the extent to which the process and outcomes of the first CFD and CM auction have supported delivery of policy objectives. Evaluators have interviewed a range of stakeholders including developers, sector associations, investors and consumer groups in order gain a representative qualitative perspective, supplemented by quantitative analysis of the available evidence. However, the conclusions that can be drawn on the basis of one round only may be limited. We are also implementing a monitoring and benefits realisation plan to assess progress against objectives in the longer term.

In conducting the review, DECC should particularly look at how engagement with small players can be improved

EMR has been designed to reduce risk and to help smaller companies to participate in the market.

For example: a wide range of smaller companies were successful in the auctions for the Capacity Market and the Contract for Difference - including at least one community level project winning a Contract for Difference. The introduction of the Offtaker of Last Resort (OLR) provides renewable generators with a guaranteed, 'backstop' route-to-market thereby securing payments under their CFD. It is designed to give comfort to lenders/finance providers over the worst-case revenues that a project will receive, enabling developers to reduce costs of raising finance and secure lower-cost debt finance without needing a long-term PPA. This opens up a wider range of contracting strategies for developers and reduces pressure on the long-term PPA market, and increases competition and new entry in the PPA.

The department has been proactive in engaging to smaller companies and ensuring they have access to the new instruments – both by involving them in policy design, and ensuring extensive engagement through the implementation process.

In addition, the evaluation process will assess whether there are issues in enabling smaller players to participate in the CFD and Capacity Market (based on the evidence available), and if such issues arise we will consider how to address these for future rounds. However, conclusions may be limited based on one round.

> ***The review should also include an assessment of the pros and cons of running more frequent CFD auctions***

Work on assessing any comments raised regarding the frequency of rounds as part of the evaluation is currently underway and we will consider any such points raised in the final report.

The role of National Grid

Recommendation 2

> ***We recommend that DECC's upcoming review of EMR should include a point-by-point response to the issues raised by the PTE.***

The Government commissioned, in February 2013, an independent Panel of Technical Experts (PTE) to impartially scrutinise and quality assure the analysis carried out by National Grid (in its role as EMR Delivery Body). The Panel (and interim Panel) have provided scrutiny on the methodology available to National Grid when conducting the analysis for the EMR Delivery Plan (published in December 2013) and National Grid's Electricity Capacity Report (published in June 2014).

The recommendations made by the Panel both during the analysis and in their reports have been considered both by DECC and National Grid.

Given the nature of the EMR evaluation, a point-by-point response to the issues raised by the PTE is not expected to be included in the evaluation report.

As the PTE scrutiny focuses on National Grid's analysis in their 2014 Electricity Capacity Report, National Grid will be responding directly to the issues raised by the PTE in their 2015 Electricity Capacity Report due to be published at the end of June. Furthermore, the PTE's own report on National Grid's ECR for 2015, due to be published on the same day, will also provide their view on how National Grid has progressed their recommendations from last year.

> ***The review should look again at how conflicts of interest are dealt with. We also expect DECC to set out what steps will be taken to ensure that National Grid does not have an unfair commercial advantage when interconnectors participate in future Capacity Market auctions.***

The active management of conflicts of interest has been central to the design of institutional arrangements for EMR and a number of steps have been taken to manage this risk:

- There is a clear separation between policy and advisory/delivery roles. Policy decisions are made by Government.
- The EMR Delivery Body is situated within the System Operator function of National Grid and the Government believes it is best placed to produce the analysis which informs the Electricity Capacity Report.
- The Government consulted twice specifically on National Grid potential conflicts of interest and modified National Grid's transmission licence to address the concerns expressed
- Ofgem is responsible for annually verifying compliance with the National Grid licence and publishing their findings.
- The independent Panel of Technical Experts was asked to look at the issue of conflicts of interest in its report on National Grid's Electricity Capacity Report in summer 2014. The Panel's report clearly states that the Panel 'have no evidence (of conflicts of interest) that should give cause for concern'.

With regard to interconnectors, the Secretary of State is responsible for deciding the de-rating factors for interconnectors bidding into the Capacity Market. This decision will be based on underlying analysis from National Grid, advice from the Panel of Technical Experts and other sources, thereby mitigating potential conflicts.

DECC will continue to ensure that changes to the CM design do not give rise to additional potential conflicts of interest that are not already mitigated through the licence modifications.

Demand-side response

Recommendation 3

> ***We recommend that the definition of demand-side response should exclude consumers turning on their own generation assets such as diesel generators. This agreed definition should be consistently and immediately applied by DECC, Ofgem and National Grid***

National Grid is currently undertaking a stakeholder process to review the definition of demand side response (DSR), and Government will consider whether this has any implications for EMR in the future.

The Capacity Market is technology neutral, i.e. it does not seek to procure specific volumes of capacity from different types of technology. Instead, it is designed to secure capacity at the lowest price to bill payers. All participants are required to meet relevant environmental regulations. As part of the review of the Capacity Market we will be considering its environmental impact.

It is not the case that all new small generation procured in the first auction (1GW) will be diesel powered. We expect a majority will be small gas generation. Flexible backup generation can play an important role in helping balance the grid, and rarely-used backup generation running for short periods – including both gas and diesel - can have a lower carbon impact than other alternatives that require time to ramp up. The large majority of existing demand side response in the UK is achieved via the use of backup generation; to exclude such capacity from the Capacity Market could significantly reduce the overall level of DSR participating in the Capacity Market over the short term.

Recommendation 4

> ***We recommend that DECC's review of EMR makes it easier for DSR to have a much bigger role in future Capacity Market auctions***

The evaluation report will assess the role of DSR and scope for removing any barriers to its participation in future Capacity Market auctions.

In consultation with the DSR sector, Government developed the 'Transitional Arrangements' to help DSR grow before the first one-year ahead Capacity Market auction in 2017. We have also taken steps (such as including a low de-minimis threshold of 2MW) to encourage smaller providers, an option of three metering configuration solutions to widen DSR participation and gave DSR units "price-maker" status to enable providers to bid up to the overall auction price cap.

As stated in response to recommendation 3, a large proportion of DSR currently participating in the GB market is delivered via the use of backup generation, which is likely to offer the most significant pipeline of further DSR in the near future. However, with developments including the roll out of smart meters in the domestic and SME sector, and industrial and commercial sites moving to half-hourly settlement, the availability of other forms of DSR (e.g. load shifting) may increase, providing an opportunity for greater involvement in the Capacity Market.

DECC is gathering further evidence about DSR capability and its potential future role in the Capacity Market through a specific research project, which will inform policy choices around the Transitional Arrangements Auctions.

> ***DECC should consider increasing the contract length of DSR capacity agreements in the next Capacity Market auction***

We will continue to work closely with stakeholders and use the best available evidence to ensure that proposals represent the best value for money for consumers, whilst meeting our required security of supply standards.

One-year capacity agreements are the default positon in the Capacity Market, and will be awarded to the majority of participants, including existing generation and DSR. This avoids locking consumers into committing to pay for longer agreements, where evidence suggests this is unjustified on value for money grounds.

15-year capacity agreements are only available to new build generation which require a high up-front capital investment of at least £250/kW, or 3-year agreements for generation that will be carrying out refurbishment at an investment of at least £125/kW.

Analysis of currently-available evidence indicates that DSR and existing generation do not require such significant up-front capital investment, which would potentially necessitate access to long-term capacity agreements. In fact, current evidence suggests that DSR is a relatively low-cost solution and should therefore be able to compete effectively on the basis of one-year agreements.

> ***We also recommend that DECC set out a more detailed strategy on how to help the DSR market grow to reach its full potential, in line with its proclaimed approach of supporting early stage technologies***

In addition to the participation of DSR in the Transitional Arrangements and the Capacity Market, Government is committed to rolling out smart meters by 2020, which will enable suppliers and consumers to play a more active part in the electricity market through smart tariffs (such as ‘time of use’ tariffs). Additionally, Ofgem has launched the ‘flexibility project’ to develop their strategy to enable and enhance the efficient provision and use of flexibility sources across the supply chain in the electricity system.

EMR: A cohesive package?

Recommendation 5

> ***We recommend that the Government clarifies its ambitions for the future of coal-fired power stations in the Capacity Market and its expectations for both new plant and DSR in the second four-year-ahead Capacity Market auction in 2015***

The Capacity Market allows new and existing plant, supply- and demand-side and different generation technologies to compete against each other on price; whilst it is important that we enable all technologies to participate, we do not target a particular auction outcome. Some existing unabated coal plants are expected to continue to offer their capacity up to the early/mid 2020s, although these plants will increasingly play a back-up role as their generation is displaced by lower-carbon capacity. Since 2012 a number of coal plants have closed and we expect this trend to continue due to a number of factors, including the ageing nature of the remaining GB coal fleet, strengthening environmental legislation and impacts of our Electricity Market Reforms. Our projections show unabated coal accounting for around just 1% of total generation by 2025.

Representatives from the UK Demand Response Association (UKDRA) who sat on the Capacity Market's Expert Group made clear that four year ahead auctions would take place too early for aggregators to sign up providers and suggested that the T-1 auction was better suited for them. We will run the first Transitional Arrangements auction later this year, which is designed to help build DSR capacity ahead of the first year-ahead auction in 2017.

We want to see all types of technologies competing with one another to deliver security of supply at the lowest cost to consumers.

> ***The Government's review of EMR should include a cost-benefit analysis of the 2014 Capacity Market auction in terms of balancing low clearing prices with long-term objectives to provide secure, affordable low-carbon energy.***

Cost-benefit analysis of the Capacity Market as an instrument for delivering security of supply, balancing the objectives of affordability to consumers with adequate security of electricity supply, is set out in a series of Capacity Market Impact Assessments that accompanied both primary and secondary legislation supporting its implementation.

Cost-benefit analysis for how much capacity to procure each year using that instrument is provided by National Grid through its annual Electricity Capacity Report and accompanying recommendation to the Secretary of State, scrutinised by the independent Panel of Technical Experts.

An updated modelling analysis, incorporating the outcome of last year's Capacity Market auction, will be encompassed in the forthcoming publication of DECC's updated Energy and Emission Projections, scheduled for release later this year.

Greater visibility for investors

Recommendation 6

> ***We recommend that DECC sets out what its intentions are across a range of potential future wholesale prices***

In support of advice/decisions around future CFD budget allocation and strike prices, analysis will be undertaken across a range of potential fossil fuel/wholesale price scenarios, to ensure their robustness to various future states of the world. These scenarios are updated annually and subject to a rigorous peer review process.

> ***DECC should commit to publishing more frequent updates of the funds left in the current LCF envelope and clarify rapidly what the timetable and budget of future CFD allocation rounds will be***

DECC published a report on the costs of consumer funded policies last November which was welcomed by the Committee. This Government will review the timetable for future LCF updates and CFD allocation rounds and communicate these in due course.

Recommendation 7

> ***We recommend that the Government clarifies the future of the LCF beyond 2020-21 as soon as possible after the General Election. Rolling forward projections of LCF funds should be published annually thereafter, so that investors are always able to look at least seven years ahead to make their investment decisions***

The Government recognises the importance of long term budget visibility for industry and will be setting out its plans for delivering a new generation of cost effective, secure, electricity supplies in the near future.

> ***The Government should also clarify its intentions in the event that the Levy Control Framework total is exceeded because gas prices remain much lower than previously anticipated***

The modelling DECC uses to predict potential spending under the Levy Control Framework takes into account a wide range of factors such as future electricity demand, fossil fuel prices, load factors and uptake of schemes like small-scale Feed in Tariffs and the Renewables Obligation. The Levy Control Framework is kept under regular review, updating our modelling and assumptions as things change, reflecting the challenges in making long-term forecasts in a changing and very active energy market.

<u>Conclusion</u>

This Command Paper forms the Government’s response to the recommendations set out in the Committee’s report: The Implementation of Electricity Market Reform (for the period 2014-2015).

ISBN 978-1-4741-2089-0