

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

Introduction

- 1.1. In March 2016, the UK Government consulted on reforms to the Capacity Market ("CM") including a set of questions on a proposal to avoid over-compensation in connection with certain risk finance schemes. Responses to this consultation revealed the complexity of the issues involved, and in response, the UK Government committed to revert with a more focused proposal in the Autumn. The proposal below sets out the Government's preferred approach to prevent cumulation of State aid and over-compensation in future CM auctions in respect of certain risk finance schemes.

Issue

- 1.2. The CM determines the amount of capacity payments by a competitive bidding process to discover the "lowest sustainable price at which the necessary capacity can be brought forward."¹
- 1.3. In principle, the use of investment through risk finance schemes (specifically the Enterprise Investment Scheme ("EIS"), the Seed Enterprise Investment Scheme ("SEIS") and Venture Capital Trusts ("VCT") – the "risk finance schemes") to finance prospective capacity that is also incentivised by securing a capacity agreement under the CM would go beyond the minimum amount of aid needed to incentivise the additional investment. To ensure the amount of aid under the CM is limited to the minimum needed and that there is no cumulation or over-compensation, the total amount of aid (i.e. the total aid received under the risk finance schemes and the total aid received under the CM) should not exceed the amount awarded in the CM auction.
- 1.4. Although amendments to the risk finance schemes through the Finance (No.2) Act 2015 added "making reserve electricity generating capacity available"² to the excluded activities list from 30 November 2015, investment raised before this amendment may have been used, or may continue to be used, to fund prospective capacity that also secures a capacity agreement in a future CM auction. Therefore in principle there is the potential for cumulation and over-compensation.

Proposal

- 1.5. In our previous consultation, the Government considered an exclusion from future CM auctions of capacity that has used investment through risk finance schemes. In the Government's response to this consultation, we noted the issues raised in relation to this proposal.³ An outright exclusion may create risks to auction liquidity and create a new barrier to companies and investors who have already taken investment decisions in good faith.
- 1.6. This consultation sets out details of an alternative proposal, on which we invite comments. We recognise that any proposal will impact upon relevant capacity. However, we consider that a more proportionate approach is to, rather than exclude capacity, offset investment received through risk finance schemes, and spent on prospective capacity, from capacity payments (secured from future CM auctions) so that the total support received for that project is capped at the CM auction price.
- 1.7. Indicative drafting for our proposed amendments to the CM Rules in relation to the provision of a funding declaration (as described in more detail in paragraphs 1.11 to 1.18 below) is enclosed. This is indicative of the amendments that we propose to bring into force before the December 2016 capacity auction. Further amendments to enact

¹ See recital 145 of the Commission's Approval Decision for case SA.35980 (2014/N-2):

http://ec.europa.eu/competition/state_aid/cases/253240/253240_1579271_165_2.pdf

² <http://www.legislation.gov.uk/ukpga/2015/33/introduction/enacted>. This exclusion was broadened to cover all energy generation from 6 April 2016 in the Finance Bill 2016.

³ https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/521301/Govt_response_to_March_2016_consultation_FINAL.pdf

proposals for capacity payments and secondary trading (as described in paragraphs 1.19 to 1.26 below) will be incorporated into amending legislation in 2017.

Scope of proposed solution

1.8. This cumulation issue occurs when aid from risk finance schemes and the CM are both used to incentivise new capacity. Under the CM, prospective capacity is eligible for longer-term capacity agreements to incentivise new investment; “new and refurbished capacity -which involves intensive investment capital costs- are eligible to longer capacity agreements to allow these investors secure the necessary financing.”⁴ The risk finance schemes likewise aim to support certain enterprises that “would otherwise struggle to have access to finance due to an insufficient track record and/or poor collaterals.”⁵

1.9. Therefore the proposal to prevent cumulation will only apply to prospective capacity⁶; capacity that has not been commissioned. Existing capacity and demand-side response capacity is not in scope. Capacity agreements awarded before these proposed changes come into force will not be in scope.

CMU Type	In scope	Out of scope
Existing generating CMU		X
Prospective new build generating CMU	X	
Prospective refurbishing generating CMU	X	
Existing interconnector CMU		X
Prospective interconnector CMU	X	
Demand-side response CMU		X
Capacity agreements awarded in 2014 and 2015 T-4 capacity auctions		X

Table 1: Example of CMU type in scope of the proposal to prevent cumulation in respect to risk finance schemes.

1.10. For the Early Capacity Auction (delivery in 2017/18), prospective capacity that already holds a new build or refurbishment capacity agreement previously awarded is not in scope. This is because, where the same prospective capacity secures a capacity agreement from the Early Capacity Auction, it is intended to incentivise acceleration of this new capacity rather than incentivise the new investment. However, new prospective capacity that does not hold a capacity agreement from a previous auction is in scope as a capacity agreement from the Early Capacity Auction is intended to incentivise new investment.

Declaration as part of Financial Commitment Milestone

1.11. All Prospective CMUs must, under existing CM rules, achieve their Financial Commitment Milestone (“FCM”) obligation no later than 16 months after the Auction Results Day for the CM auction in respect of which the capacity agreement was awarded (see Rule 6.6.1).⁷ At this stage all Prospective CMUs must submit a FCM

⁴ See recital 145 of the Commission’s Approval Decision for case SA.35980 (2014/N-2).

⁵ See recital 6 of the Commission’s Approval Decision for case SA.40991 (2015/N).

⁶ A Prospective CMU is either a New Build or Refurbishing generating CMU or an Interconnector CMU, including a Prospective CMU with multiple legal owners.

⁷ In the case of a capacity agreement awarded in respect of the Early Capacity Auction, the FCM must be achieved within 3 months.

report to the Delivery Body which confirms (by an independent technical expert) that the Capital Expenditure and financial commitment requirements have been met.

1.12. Under our proposal, all Capacity Providers of Prospective CMUs will in future also need to include declarations (a “funding declaration”) alongside the FCM report concerning any risk finance investment received. The funding declaration will cover (see indicative drafting for proposed wording):

- a) Whether the Prospective CMU has incurred, or expects to incur, Capital Expenditure (as defined under Rule 1.2.1) from investment received under a risk finance scheme (“relevant investment”). If the CMU has used relevant investment, or will use relevant investment, this will need to be offset from capacity payments to avoid cumulation and over-compensation.
- b) Permission for Ofgem to access relevant information from HMRC and for HMRC to disclose relevant taxpayer confidential information to Ofgem, if required. This will assist with any necessary enforcement action.
- c) Agreement to submit an updated declaration three months after the start of the first delivery year in respect of which the capacity agreement was awarded (this will be alongside the evidence of Total Project Spend for Prospective CMUs with a capacity agreement longer than one delivery year) if the total Capital Expenditure incurred in respect to relevant investment changes. If the total relevant investment changes from that indicated under (e)(i), the revised total will be offset from capacity payments.
- d) Confirmation that each of the confirmations and declarations are true and correct. If the CMU has not used, and will not use, any relevant investment, there is no further action required by the Capacity Provider.
- e) Where the CMU has used, or will use, relevant investment, the Capacity Provider must also confirm the following:
 - i. the total Capital Expenditure incurred, or expected to be incurred, with respect to the Prospective CMU from relevant investment (see below). This will indicate the amount to be offset from capacity payments;
 - ii. the date the relevant investment was made. This will assist with any necessary enforcement action;
 - iii. the name of the company that received the relevant investment (if different to the name of the Capacity Provider making the declaration, for example a holding company). And in the case of investment from a VCT, the name of the VCT. This will assist with any necessary enforcement action; and
 - iv. agreement for the total Capital Expenditure incurred with respect to the Prospective CMU from relevant investment to be offset from capacity payments in respect to the Prospective CMU.

Total relevant investment

1.13. The total Capital Expenditure incurred, or expected to be incurred, with respect to the Prospective CMU from relevant investment will need to be identified according to the amount that is reported to HMRC when complying with the existing risk finance scheme rules. Once the company has started to trade, under existing rules of the risk finance schemes, the money raised from the relevant investment must be spent within two years.

- 1.14. The investee is responsible for keeping records of what the investment was spent on, and when, in order to comply with the existing rules of the risk finance schemes. Where the relevant investment has been spent on costs counting as Capital Expenditure for the CM, it is proposed that the total amount must be declared by the Capacity Provider to the Delivery Body as part of the declarations that are to be provided alongside the FCM report⁸.
- 1.15. If, at the time of making these declarations, the relevant investment has not been fully spent, it is proposed that the final spend from the relevant investment will need to be updated to the Delivery Body three months after the start of the first delivery year. Under the current CM rules, certain Prospective CMUs must provide confirmation of the total project spend no later than three months after the start of the first delivery year; "Evidence of Total Project Spend" (see Rule 8.3.6). It is proposed that an updated funding declaration must be made at the same time if the total Capital Expenditure incurred differs from the original funding declaration. This will be a requirement for all Prospective CMUs, but only if the total amount of relevant investment differs from that stated in the original funding declaration.

Enforcement

- 1.16. Under this proposal, Prospective CMUs will not achieve their FCM until the funding declaration has been received, making the funding declaration an essential step for Prospective CMUs before delivery. Existing rules in relation to delays in achieving the FCM or failure to achieve the FCM will continue to apply; along with existing termination provisions.
- 1.17. If the information provided in the funding declaration is suspected to be false or misleading, Ofgem may investigate the matter and take enforcement action under its existing enforcement powers. Under this proposal, we have included a new termination event for providing false or incorrect information with associated repayment of any capacity payments made to date, and are also considering any further information gathering requirements to support this role.
- 1.18. We have included a further new termination event for failure to provide an updated funding declaration three months after the start of the first delivery year where the total amount of relevant investment differs from that stated in the original funding declaration.

Capacity Payments

- 1.19. The Delivery Body will have received all funding declarations alongside the FCM report (with an updated declaration following this if required). The Delivery Body will then notify the Electricity Settlements Company (ESC) which capacity agreements received relevant investment and the total amount to be offset from payments in respect of each capacity agreement (this being the final total Capital Expenditure incurred with respect to the Prospective CMU from investment received under a risk finance scheme).
- 1.20. The ESC will deduct the amount of relevant investment from CM monthly payments and so will not make any CM monthly payments in respect of the relevant capacity agreement until the total amount of relevant investment is offset. This will include any update to the total amount of relevant investment that the ESC is notified of by the Delivery Body.
- 1.21. We propose that the Capacity Provider holding the relevant capacity agreement will be able to access over-delivery payments and be liable for non-delivery penalties under existing rules whilst capacity payments are being withheld. If a capacity payment is forfeited due to failure to demonstrate relevant satisfactory performance days under

⁸ We have not proposed to require interest to be added on to the relevant investment used for Capital Expenditure.

existing rules, the forfeited payment will be in addition to the amount of relevant investment to be offset; i.e. it will not count towards the amount to be offset.

1.22. These proposed changes will apply to capacity payments made from October 2017 in respect to relevant capacity agreements under the Early Capacity Auction and from October 2020 onwards in respect to relevant capacity agreements under T-4 auctions.

1.23. The Supplier Levy will be adjusted to take account of the offset relevant investment. Any excess resulting from deducted capacity payments will be returned to suppliers on a pro-rata basis via the existing reconciliation process.

Secondary trading

1.24. If the relevant CMU is transferred to another party, we propose that capacity payments will continue to be offset in respect of that CMU until the total amount of relevant investment has been offset. As above, over-delivery payments and non-delivery penalties will continue to apply.

1.25. If the relevant capacity agreement holder temporarily trades their capacity obligation to another CMU, all rights and obligations are traded with the capacity obligation and therefore the transferee will continue to be liable for offsetting the relevant investment. As such no CM monthly payments will be made in respect of that capacity agreement until the full amount of relevant investment has been offset. The transferee will however be responsible for delivering at times of system stress and liable for any penalties resulting from any such non-delivery. Volume reallocation is not affected.

1.26. If the relevant CMU has multiple legal owners and wishes to transfer, sell or dispose of a Generating Unit comprised in the relevant CMU, the aggregator will retain despatch control over that Generating Unit as set out in Rule 9.2.10A and will continue to be liable for offsetting the relevant investment.

Consultation Question	
1.	Are there any aspects of this proposal that you think will not work in practice?
2.	When making the funding declaration, do you foresee any issues with declaring the total Capital Expenditure incurred, or expected to be incurred, with respect to the Prospective CMU from investment received under a risk finance scheme? Or any issues with submitting an updated declaration if necessary?
3.	To help us understand the impact of the proposal, please indicate if you planning on bidding in capacity that would be affected by this proposal? If so, what volume of capacity may be affected?
4.	Is there anything that we should have particular regard to in relation to the payment and secondary trading mechanics when making the detailed technical amendments to implement these proposals?

Information on this consultation:

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

Territorial extent: Great Britain

How to respond: Your response will be most useful if it is framed in direct response to the questions posed, though further comments and evidence are also welcome.

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Confidentiality and data protection: Information provided in response to this consultation, including personal information, may be subject to publication or disclosure in accordance with the access to information legislation (primarily the Freedom of Information Act 2000, the Data Protection Act 1998 and the Environmental Information Regulations 2004).

If you want information that you provide to be treated as confidential please say so clearly in writing when you send your response to the consultation. It would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded by us as a confidentiality request.

We will summarise all responses and place this summary on the [GOV.UK website](#). This summary will include a list of names or organisations that responded but not people's personal names, addresses or other contact details.

Quality assurance: This consultation has been carried out in accordance with the [Government's Consultation Principles](#).

If you have any complaints about the consultation process (as opposed to comments about the issues which are the subject of the consultation) please address them to:

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