



Department  
of Energy &  
Climate Change

# CAPACITY MARKET

## Consultation on reforms to the Capacity Market

15D/457 15 October 2015



The consultation can be found on DECC's website:

<https://www.gov.uk/government/collections/electricity-market-reform-capacity-market>

Published by the Department of Energy and Climate Change

# Ministerial Foreword



Ensuring that hardworking families and businesses across the country have secure, affordable energy supplies they can rely on is our top priority. That is why we already have firm mechanisms in place, working closely with National Grid and Ofgem, to maintain comfortable margins on the system over the next couple of winters.

Beyond that, it is essential that generators have confidence they will receive the revenues they need to maintain, upgrade and refurbish their existing plant; and can finance and build *new* plant to come on stream as and when existing assets retire. Equally,

we want to make sure that those who are able - without detriment to themselves and the wider economy – to shift demand for electricity away from periods of greatest scarcity are incentivised to do so.

That is why we have the Capacity Market. The first auction held in December 2014 saw a good outcome for consumers, as fierce competition between participants meant that we obtained the capacity we will need in 2018/19 at prices below the levels many had expected. And that translates to lower costs on consumer bills.

We want to ensure that the mechanism continues to provide the capacity we need in a way that is cost-effective for industry and consumers alike. The formal evaluation we commissioned, also published today, suggests that the Capacity Market is broadly fit for purpose, but nonetheless recommends a number of areas for reform. And the extensive feedback we have received from industry, while suggesting an overriding desire for regulatory stability and predictability, has also identified a number of areas where detailed simplifications and improvements may be possible. This consultation reflects that evaluation and that feedback.

Throughout the development and implementation of the Capacity Market we have been immeasurably assisted by the active participation of industry and other stakeholders. I see this consultation as another important step in that process of engagement. I look forward to all responses which can help increase the efficiency of the Capacity Market in delivering the security we need at costs we can all afford.

A handwritten signature in black ink, appearing to read "John R. Smith". The signature is written in a cursive, flowing style with a large initial 'J' and 'S'.

# Contents

Ministerial Foreword .....	4
Contents.....	6
General Information .....	8
Executive Summary .....	10
Chapter 1 - Investment.....	14
Chapter 2 - Regulatory Stability and Simplification .....	34
Chapter 3 - Looking Ahead .....	51
Annex 1 - Types of secondary trading.....	55
Annex 2 - Detailed explanation of Monthly Penalty Cap and Annual Penalty Cap recommendations.....	57
Annex 3 - Obligation trading.....	62
Annex 4 - Examples of termination events.....	64
Catalogue of consultation questions .....	67

## List of Figures

Figure 1: Summary of new declarations and evidence.....	21
Figure 2: Reallocation trading and over delivery payment scenarios .....	30
Figure 3: Adjusting MPC according to the proposed option .....	57
Figure 4: Apportioning penalties to obligations.....	58
Figure 5: Comparison of penalty exposure for two stress settlement periods in a month (350MW agreement priced at £19.40/kW) .....	60
Figure 6: Obligation trading timeline window 1 .....	62
Figure 7: Obligation trading timeline window 2.....	63
Figure 8: Obligation window 2 additional capacity.....	63
Figure 9: Examples of termination events 1 and 2 .....	64
Figure 10: Examples of termination events 3 and 4 .....	65
Figure 11: Examples of termination events 5 and 6 .....	65



# General Information

## **Purpose of this consultation:**

This consultation seeks views on proposed changes to the Electricity Capacity Regulations 2014, the Electricity Capacity (Supplier Payment etc) Regulations 2014 and the Capacity Market Rules 2014. In addition, this consultation poses questions on wider issues of interest to stakeholders of the Capacity Market.

**Issued:** 15 October 2015

**Respond by:** 10 December 2015

## **Enquiries to:**

Security of Electricity Supply team  
Department of Energy & Climate Change  
4th Floor  
3 Whitehall Place  
London, SW1A 2AW

Consultation reference: URN 15D/457 Consultation on reforms to the Capacity Market.

## **Territorial extent:**

This consultation mainly applies to Great Britain as the Capacity Market is a GB-wide mechanism.

## **How to respond:**

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

Please use the e-consultation link: <https://econsultation.decc.gov.uk/decc-policy/reformstothecapacitymarket>

## **Additional copies:**

You may make copies of this document without seeking permission. An electronic version can be found at <https://www.gov.uk/government/collections/electricity-market-reform-capacity-market>

Other versions of the document in Braille, large print or audio-cassette are available on request. This includes a Welsh version. Please contact us using the above details to request alternative versions.

## **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:

DECC Consultation Co-ordinator  
3 Whitehall Place  
London SW1A 2AW  
Email: [consultation.coordinator@decc.gsi.gov.uk](mailto:consultation.coordinator@decc.gsi.gov.uk)

# Executive Summary

1. This consultation seeks views on proposed changes to the Electricity Capacity Regulations 2014 (“the Regulations”), the Electricity Capacity (Supplier Payment etc) Regulations 2014 (“the Payment Regulations”) and the Capacity Market Rules 2014 (“the Rules”). In addition, this consultation poses questions on wider issues of interest to stakeholders on the future of the Capacity Market.

2. The Government is also publishing illustrative drafting (unless indicated otherwise) for each of the proposals alongside the consultation to help explain the proposed changes, and would welcome comments on this as well.

3. Responses are invited from all interested parties by 5pm on 10 December 2015 to

Security of Electricity Supply Team  
Department of Energy & Climate Change  
4th Floor  
3 Whitehall Place  
London  
SW1A 2AW

E- Consultation link: <https://econsultation.decc.gov.uk/decc-policy/reformstothecapacitymarket>

## Changes proposed

4. This consultation, reflecting evaluation evidence and feedback from stakeholders on the importance of regulatory stability, focuses on a limited number of reforms designed to enhance investment support, and make detailed adjustments to the framework in the interests of simplicity and transparency.

5. The most significant change proposed will ensure that new-build generating plant which win agreements in the Capacity Market auction face the right incentives and penalties to ensure that they deliver fully and according to their agreements. This is intended to ensure that the mechanism operates as intended to maintain high levels of security of electricity supply. In detail this will include:

- A prequalification finance test, with larger new build projects needing to state the lowest clearing price they could accept, and provide evidence in principle that, at that clearing price, they will have bank and/or equity finance secured, before they are allowed to compete for a capacity agreement;
- A post-agreement test at around five months after the auction, and again at 11 months, where such projects will be required to show evidence that they have obtained finance;
- Disqualification provisions whereby not only is an unsuccessful new build project barred from competing again in the next two annual auctions, but a director who was previously nominated as a responsible director for the project that failed is also prevented from being associated with any other new build project for the next three years (with similar provisions in relation to other projects terminated for lack of a sufficient grid connection agreement);
- A progressive increase in the level of credit cover which larger new build projects must lodge, to incentivise them, if they are going to fail, to fail early, and enhanced reporting requirements, so that the Government receive earlier and clearer notice of any problems or delays.

6. Other changes are generally simplifications or minor, incremental improvements to the process, reflecting stakeholder suggestions and formal evaluation following the first auction last year. They include:

- Consent Mechanism – The Government proposes to introduce a provision allowing the Government to give notice to Ofgem, in respect of changes to the Rules which they are considering, that the proposals will require approval by the Secretary of State before implementation; in effect allowing the Secretary of State to call in proposed provisions where they raise questions of policy that need to be considered by Government;
- Three-Year Refurbishing Agreements – Evaluation, and initial stakeholder feedback, has suggested that there may be no continuing need for the three-year agreement category and the Government is consulting on whether the category is necessary or appropriate in future;
- Unproven Demand Side Response (DSR): Credit Cover and Termination Fees – The Government proposes to amend the Regulations so that in calculating the termination fees for an unproven DSR Capacity Market Unit (CMU) prior to the start of the delivery year, the Government will take into account any previously drawn down collateral;

- **Aggregation of Prospective Generating Units** – The Government is proposing to amend Rule 3.2.6 and 3.2.7 and associated declarations Exhibit F and G to enable the aggregation of all Generating Unit types that have multiple legal owners under 50MW and to clarify that the Aggregator must be the Applicant. The Government is also proposing to extend Rule 9.2.10A and associated declarations Exhibit H and I to all Generating Units to enable individual units within a Prospective CMU to be able to be transferred, sold or disposed, but only where Despatch Control for the CMU remains with the aggregator;
- **Price Duration Equivalence** – The Government commissioned work over the summer to investigate whether there were options for introducing price duration equivalence between agreements of different length in the auction. In light of the consultants' report which has concluded firmly that no robust methodology is possible, the Government is consulting on the basis that we will not attempt to put in place such a methodology;
- **Payments and Credit Cover** – The Government is proposing to make a number of minor amendments to the Regulations in relation to payments and credit cover, with the intention of simplifying processes for suppliers and capacity providers, and reducing administrative burdens for the Settlement Body (SB);
- **Appeals** – In the Electricity Capacity (Amendment) 2015 Regulations, the Government extended the derogation to the 2015 T-4 auction (and both Transitional Arrangements ("TA") auctions) which allowed appellants to provide additional information at a Tier 1 appeal. The Government is now seeking views on whether this provision should be made permanent or extended for a further year (i.e. for the 2016 T-4 auction);
- **Enforcement of Penalties on Companies with Zero Turnover** – During the last auction there was an issue around misinformation being submitted, which lead to Ofgem using enforcement powers and some CMUs being disqualified from the auction and the next two auctions. However the CMU in question did not receive any financial penalties as it had zero turnover, and Ofgem's current ability to impose fines relates to turnover. The Government is now seeking views on how to resolve this;
- **Adjusting Auction Parameters** – After prequalification and following National Grid's auction liquidity report, the Secretary of State has five working days to make any adjustments necessary to the auction parameters. In order to allow a greater period of time to carry out the analysis required the Government is consulting on extending this period to ten working days;

- Interactions with other support schemes – Under the current drafting of the Regulations, capacity receiving financial support under specified mechanisms are excluded from participation in the Capacity Market. Stakeholder views are welcomed on whether there is any evidence to suggest the current arrangements for eligibility as between the Capacity Market and other Government support schemes create any difficulties or uncertainty;
- Capacity Market and Contract for Difference (CfD) Interaction – The current drafting of the Regulations have tensions with the Contracts for Difference (Allocation) Regulations 2014 over the ability of a Unit to terminate its capacity agreement and enter a CfD. The Government is taking the opportunity presented by this consultation to consider how this interaction could be refined;
- Clarify the amount of DSR Credit Cover to be maintained in the TA auctions – The Government proposes to amend Regulation 60(2) of the Regulations to make clear that for the TA auctions where an Unproven DSR CMU has nominated a lower bidding capacity the level of credit cover to be maintained is in an amount equal to £500/MW;
- Termination Event for Misleading Information – The Government proposes a new termination event for applicants who are found to have provided false or misleading information in their prequalification application and who were later awarded a capacity agreement;
- Table of Minor and Technical Changes – A table of minor corrections to specific rules and regulations.

7. The Government is also seeking views on longer term issues including the timing and methodology for determining the target capacity in the T-1 auction and how Great Britain should approach cross- border participation with other EU Member States.

## Next Steps

8. Following the consultation, the Government will be looking to amend the regulations and the Rules in time for the opening of the 2016 Capacity Market prequalification.

9. The European Commission granted State aid approval for the Capacity Market on 23 July 2014. Changes to the design need to fall within the scope of our current State aid approval. If the changes as a result of this consultation ultimately go beyond our current approval, they will need to be notified to the Commission and this will have an impact on the timing and final outcome of implementing these changes.

# Chapter 1 - Investment

## 1.1 Introduction

1.1.1 The Capacity Market can provide support to all eligible forms of capacity, irrespective of their technology type, or of whether they are an existing or a new resource. But within this context, it is particularly crucial that it is and remains a robust and credible mechanism for supporting new-build projects. A key objective for the capacity market is to incentivise sufficient investment in capacity; to provide “missing money” – the shortfall between predicted energy market revenues and what is needed to justify investment in new plant.

1.1.2 There are two key issues facing the Capacity Market in respect of major new build plant:

- ensuring that the design is, and remains, an adequate mechanism for incentivising sufficient investment in new build projects that will be needed to ensure security of supply in future years;
- ensuring that those new build projects that do succeed are robust and reliable, and do not carry unacceptable non-delivery risks which would compromise security.

## 1.2 Supporting new build delivery

1.2.1 In respect of the first of the above challenges, feedback from stakeholders suggests that the overriding concern is to see regulatory stability, and that this can in itself be an important driver of investment; allowing projects to assess in advance the future regulatory regime and plan their development options around it. At the same time it is essential that the Government continues to review and scrutinise all aspects of the design to ensure there are no inadvertent barriers to robust new projects coming through, and the Government continues to welcome any suggestions for ways in which the framework can be improved.

1.2.2 As an example, some stakeholders have suggested that there may be more the Government can do to ensure that Capacity Market prequalification timings align with the planning consent cycle, and that the Government do not require evidence at an earlier stage in the pre-qualification process than it can realistically be provided, thus causing problems to new build development proposals.

#### Consultation Question

Q1 - Do you have any suggestions for ways in which the Capacity Market requirements for evidence of planning consent can be better aligned with project development cycles?

#### Consultation Question

Q2 - Do you have other suggestions for modifications or improvements which, within the overall framework, would help meet the legitimate needs of new build projects?

## 1.3 Securing new build delivery

1.3.1 The current assurance regime, prequalification requirements, level of credit cover, reporting requirements and termination provisions attempt to balance the tensions between the twin challenges of enabling support for new build projects whilst having confidence that they are robust and deliverable. The year-ahead (“T-1”) auction provides additional assurance via the flexibility to annul non-performing agreements and re-procure capacity in time to maintain security of supply.

1.3.2 Informal stakeholder representation and an internal review of the current arrangements have identified the requirement for greater delivery assurance, especially around new build projects bidding in the auction at a level where they can realistically be financed. The remainder of this section therefore proposes a package of additional assurance measures; primarily for larger new build projects which will have a material individual impact on capacity volume should they fail, for stakeholder consideration. The package attempts to balance the benefit of such greater assurance with the risk of disproportionately increasing barriers to entry. Stakeholder views on the detail of the proposals and whether this balance has been



achieved is welcomed. It should be noted, however, that this will be an area which the Government will keep under review and may consider strengthening further (than what is proposed in this section).

1.3.3 The proposals detailed in this chapter will not apply in respect of any capacity agreement awarded prior to the amendments coming into force, with the exception of the enhanced reporting requirements detailed below.

#### Pre-auction financeability test – applicable to new build CMUs over a 400MW threshold

1.3.4 From a policy perspective it is desirable to award capacity agreements only to those new build CMUs (both prospective CMUs and prospective interconnector CMUs) which have a high degree of certainty of being able to achieve financial closure at the auction's clearing price. It is of course important to ensure that the detailed requirements which implement this policy objective do not create inadvertent or disproportionate burdens for all, or certain types of, applicants, imposing unnecessary costs which could affect their participation in the auction.

1.3.5 The starting policy position in this regard is to have full assurance that a new build unit has fully-committed finance in place prior to participation in an auction. This would be comparable to the bidder committed finance requirements for many Public Finance Initiative (PFI) contracts, which are targeted on those bidders reaching the Invitation to Tender (ITT) stage. It is recognised, however, that a capacity auction is a different proposition to a PFI award process, where the market is willing to bear the additional upfront costs associated with finance-raising in return for being part of a select bidding pool. From the Capacity Market's perspective the level of financing commitment should be considered in light of the probability of each bidder succeeding. A requirement for fully committed finance pre-auction, which would prove redundant for losing bidders, could act as a barrier to entry for some independent project financed developments and increase auction bids across the board for new build CMUs.

1.3.6 The Government is therefore considering whether some additional requirements for new build CMUs, short of a full financial test, should be implemented pre-auction. Focusing these new requirements on new build CMUs with a connection capacity in excess of 400MW will target the additional requirements on those developments above a critical materiality threshold.

1.3.7 It is proposed to include a new auction-specific financial declaration to be made alongside the bidding confirmation that prequalified new build CMUs make circa ten working days before the auction. The new requirement will be for directors to declare:

- the minimum price at which they would be willing to commit the bidding capacity for that unit (termed 'Minimum Acceptable Auction Bid' "MAAB");

- whether they are reliant on debt finance (and if so the declaration must be accompanied by an evidenced commitment from lenders (meeting the definition of ‘qualifying banks’ in Regulation 53 of the Regulations) for at least 50 per cent of a declared debt level. Such commitment stated to be valid down to and including the MAAB); and
- they have equity available in principle from their own or Group resources or from alternative equity providers for the residual project cost (such in principle commitment valid down to and including the MAAB).

1.3.8 The Government proposes that the threshold requirement to evidence debt commitment is set at 50 per cent of the stated debt level. This is set to provide an in principle indication that the project is financeable down to the minimum auction bid, but reflecting that discussions with lenders will still be at a relatively early stage. An alternative proposal would be to test the market’s capacity for debt financing of the prospective projects by requiring evidence of in principle commitment for the entire stated debt level. This would effectively require applicants to have a fully funded financial plan prior to participation in the auction. Stakeholders’ views are welcomed on the merits and disadvantages of both approaches, question four refers to it.

1.3.9 A failure to provide such a declaration, and evidence of committed debt finance where appropriate, in respect of a new build CMU would result in the CMU not being eligible to participate in the auction.

1.3.10 The Government is mindful of potential stakeholder concern regarding the disclosure of a new build unit’s MAAB in advance of the auction’s first bidding round. The potential interaction of the MAAB disclosure on the principle of a descending clock auction and impact on resultant bidding behaviour at the margins is noted, for which stakeholder views are welcomed. The Government also notes that the MAAB will be subject to the provisions on the protection of information contained in Regulation 65 of the Regulations, which should be sufficient to ensure stakeholder confidence in the handling of this market sensitive information.

### Consultation Question

Q3 - Is 400MW an appropriate threshold for the new pre- and post-auction financeability tests? If not, please explain your reasoning.

### Consultation Question

Q4 - For the pre-auction financeability test, is the requirement for the directors to certify and evidence support for at least 50 per cent of debt level appropriate? Would a higher percentage up to 100 per cent be more appropriate, and if so, why?

**Consultation Question**

Q5 - Are the pre-auction financeability test requirements for evidencing commitments from debt providers appropriate?

**Consultation Question**

Q6 - Do you agree with the proposal for the directors' certification in the pre-auction financeability test that equity is available for the balance of funding? If not, please suggest alternative/additional ways of evidencing the availability of equity funding pre-auction (for example letters confirming a willingness to provide equity on a first refusal basis from the third party equity provider). Views are especially welcomed (where equity is to be corporately funded) as to the potential inclusion of a net worth statement (for example to the effect that the equity requirement will not exceed a defined percentage of a metric such as the enterprise value of the applicant or Group) and the appropriate level of any such test in order to help mitigate a potential gaming risk of directors inaccurately certifying that equity is available.

**Consultation Question**

Q7 - Do you agree that the pre-auction financeability test should be applied at the bidding confirmation point (10-15 working days before the auction) rather than as part of the prequalification application? If not, please explain your reasoning.

**Post-auction financing tests and increased credit cover – applicable to new build CMU over a 400MW threshold**

1.3.11 Under the current design, various categories of applicants are required to lodge credit cover where their applications are conditionally prequalified by the Delivery Body. Industry representation has suggested the potential to increase the levels of credit cover for new build CMUs in order to provide additional delivery assurance.

1.3.12 The Government proposes introducing targeted stepped increases in credit cover for those new build CMU, over the 400MW threshold, which are unable to demonstrate committed

finance in two new post-auction financing tests. This would incentivise a project to achieve financial closure as soon as possible, to give early notice if it cannot proceed and help discourage speculative projects in the first instance.

1.3.13 The two new financing tests will apply five months and eleven months after the auction results day. The Government has considered what the appropriate level of financial commitment is for a project to have achieved, and to be able to demonstrate, by these points in their development timeline in order to be ready for the start of their first delivery year. For the five month test providers will need to submit evidence of a financial commitment for at least 100 per cent of the stated debt level and/or 100 per cent of the required equity level, as appropriate.

1.3.14 The evidence for the debt commitment should include confirmation from the qualifying banks that they have reassessed the business case at the auction clearing price; taken into account normal lending criteria and ratios, the proposed equity level and are actively taking forward discussions to conclude the financing of the project.

1.3.15 The evidence for equity commitment could include declarations of support from equity providers (taking into account the auction clearing price and the proposed debt level) and which similarly confirm they are actively taking forward discussions to conclude the financing of the project. Alternatively, directors could confirm that the required equity will be available from the capacity provider's own or Group resources with evidence that resources have been, or how they would be, made available. Stakeholder views are welcomed on what the evidence for equity availability could consist of.

1.3.16 In addition, stakeholder views are welcomed as to whether it would be appropriate to test project financial closure at this five month point, rather than apply a test of the nature outlined above.

1.3.17 New build CMUs failing to satisfy the requirements of the five month financing test will be required to increase their credit cover from £5,000/MW to £10,000/MW, with effect from six months after the auction results day. Providers failing to lodge this increased credit cover within the requisite timescales will have their agreements terminated and a £5,000/MW termination fee applied.

1.3.18 For the eleven month test providers will have to evidence signed, credit committee or investment committee approved, offer letters and term sheets for the project accounting for 100 per cent of the stated debt level and 100 per cent of the required equity level.

1.3.19 New build CMUs failing to satisfy the requirements of the 11 month financing test will be required to increase their credit cover to £15,000/MW 12 months after the auction results day; from either £5,000/MW for those which passed the five month test or £10,000 for those which failed the five month test. Providers failing to lodge the increased credit cover will have their agreements terminated and a termination fee applied equal to their pre-increase level of credit cover (i.e. either £5,000/MW or £10,000/MW).

1.3.20 The level of the termination fee applied for failing to meet the financial commitment milestone will also be amended to equal the level of credit cover being maintained by the capacity provider; a provider failing their five month and eleven month financing tests and their financial commitment milestone would have their agreement terminated and a £15,000/MW termination fee applied.

1.3.21 Hence providers would not have their agreements terminated for solely failing either or both their five month and eleven month financing tests; the two ramifications being an increase in credit cover requirements and associated termination fee for those failing either or both tests, albeit that a failure to then post a required increase in credit cover would lead to termination.

1.3.22 It is proposed to expand the criteria that a provider has to meet in order to have their credit cover returned after meeting their financial commitment milestone. A provider meeting the milestone by virtue of entering into a major contract for at least 20 per cent of their total project spend will have to maintain credit cover of the requisite level minus any capital expenditure incurred, and receipted, post achievement of the milestone. As they incur capital expenditure post the milestone, their credit cover requirements decrease, reaching zero only when their reported incurred capital expenditure exceeds the required amount of credit cover.

1.3.23 A provider achieving their financial commitment milestone through the alternative 10 per cent incurred expenditure route would be able to include their capital expenditure incurred in the achievement of the milestone in the amount netted off from their credit cover (meaning that in most cases the incurred capital expenditure would be in excess of the credit cover requirements, and that the credit cover is returned in accordance with current timeframes upon achievement of the milestone).

1.3.24 In addition, the date of the financial commitment milestone will be brought forward from eighteen months to sixteen months after the auction results day for all new build CMUs. This will provide additional time in which to adjust the volume to procure decision for the T-4 auction two years after the original auction without materially affecting the period in which providers have to achieve the milestone.

**Figure 1: Summary of new declarations and evidence**

	Debt financed	Third-party equity	Balance sheet funded equity
Pre-auction requirements	Indicative commitment declaration for at least 50 per cent of stated debt level	Directors' declaration as to in principle availability of 100 per cent of equity	Directors' declaration as to availability of resources
5 months post auction test	Indicative commitment declaration for at least 100 per cent of stated debt level – subject to due diligence	Indicative commitment declarations for at least 100 per cent of equity level – subject to due diligence	Directors' declaration as to availability of resources
11 months post auction test	Signed offer letters and detailed term sheets for at least 100 per cent of stated debt level – subject only to legal documentation	Signed offer letters and detailed term sheets for at least 100 per cent of equity level – subject only to legal documentation	Directors' declaration as to availability of resources

### Consultation Question

Q8 - Should applicants/capacity providers have the flexibility to change the declared debt/equity ratio of their new build projects between their pre-auction declarations and their five month post-auction financing tests? Are there gaming risks associated with increased flexibility and how could these best be mitigated?

### Consultation Question

Q9 - Should the financial commitment referenced in the five month post-auction financing tests refer to the project's financial closure?

### Consultation Question

Q10 - Are the post-auction financing test requirements for evidencing commitments

from debt providers appropriate? Would the submission of a summary term sheet (i.e. non-binding and subject to due diligence) with a prescribed set of headings, be preferable to the proposed debt-provider's declaration for the five month test?

#### **Consultation Question**

Q11 - Do you have views on what post-auction financing test requirements for evidencing availability of equity should consist of for project financed and balance sheet funded projects? Should a form of net worth test (as outlined in Q6) be re-applied at these post-auction stages? Would the submission of a summary term sheet (i.e. non-binding and subject to due diligence) with a prescribed set of headings, be preferable to the proposed approach for third-party equity declarations for the five month test?

#### **Consultation Question**

Q12 - Should the pass/fail status of a new build unit in the five and eleven month financing tests be published on the Capacity Market Register? Please explain your reasoning.

#### **Consultation Question**

Q13 - Do you agree with the proposal to focus increased credit cover, and an increased termination fee potential, on those new build projects unable to demonstrate committed finance in the post-auction financing tests? If not, please suggest alternatives.

#### **Consultation Question**

Q14 - Should the requirements for new build CMU to meet their financial commitment milestone be strengthened in light of the proposed post-auction financing tests? Should the requirement to have achieved financial closure be explicitly introduced into the financial commitment milestone?

#### **Progress reporting – applicable to all new build CMUs**

1.3.25 Providers in respect of new build CMUs are currently required to submit independently verified six monthly reports detailing their progress against four key milestones, and where



necessary remedial plans to recover any delays. The Government are proposing to increase the frequency in which progress reports for all new build CMUs are to be submitted, from every six months to every three months, up until the project achieves its financial commitment milestone. In practice this will equate to additional reports at the three month and nine month points. After achievement of the financial commitment milestone, the reporting requirement will revert to the existing six monthly basis.

1.3.26 This increased frequency, is focused on the periods of greatest risk and will enable us to factor in a timely assessment of delivery risk into decisions about target capacities for subsequent auctions. However, to minimise the administrative requirements the Government does not propose to require verification from an Independent Technical Expert for these additional reports.

1.3.27 In addition, the Government proposes expanding the number of milestones providers are required to report progress against, from the current four to fifteen. Rather than specifying the new milestones, the Government proposes the milestones are identified by the provider in their prequalification application, based on the specifics of their project, with at least seven of their self-declared milestones referring to the construction phase.

1.3.28 The Government also proposes tightening up the specification of the progress reports, to improve the consistency and standards of the reports submitted. These amendments include a non-technical summary, identification of a most likely achievement date for each milestone and details of the Independent Technical Expert's experience and technical expertise.

### Consultation Question

Q15 - Are there core milestones, additional to the existing four milestones, which are sufficiently generic to all new build projects which should be specified in the Rules to provide consistency between progress reports? If so, please provide details.

### Disqualification provisions – applicable to all new build CMUs and board directors

1.3.29 Currently, new build CMUs may default on either their financial commitment milestone or their Minimum Completion Requirement and reapply for a subsequent delivery year as a new build unit, and potentially access another fifteen year agreement. The Government is proposing to disqualify terminated new build CMUs from reapplying as a new build CMU within

the following two year period in a manner similar to the existing disqualification provisions for engagement in prohibited activities (for example market manipulation or unreasonable business methods) or failure of its refurbishment milestones.

1.3.30 The amendment would introduce a disqualification requirement on any CMU being terminated as a result of failing either of their two termination-backed milestones. This would apply in respect of the specific unit, irrespective of whether the applicants were the same legal identity as those which bid the unit into the original auction, thereby preventing the re-branding of the project under a different legal identity. It would not, however, prevent an application from the CMU as an existing CMU, in order to preserve incentives to gain operational status.

1.3.31 In addition, the Government proposes personally disqualifying board directors from being associated with any future new build applications for a three year period, where they had directorial responsibility for a new build unit whose capacity agreement had been terminated. Applicants in respect of new build CMUs will be required to declare the name of their board director with responsibility for the successful delivery of the project. This individual would be the subject of the targeted disqualification, should the capacity agreement for the new build unit be terminated for failure of their financial commitment milestone, or their Minimum Completion Requirement. The nominations of named directors can be amended by the applicant/capacity provider as necessary over time, and the disqualification would apply in respect of the nominated director at the time of the termination event.

1.3.32 Applicants in respect of new build CMUs would be required to declare in their prequalification application, that they are not employing any individuals in a managerial role in relation to the Capacity Market who were subject to the personal disqualification at any time in the preceding three years.

1.3.33 The Government also proposes to apply the two year unit disqualification and three year director disqualification in respect of existing or prospective generating or interconnector CMUs which have had their capacity agreements terminated as a result of not maintaining the requisite level of Transmission Entry Capacity (TEC). To facilitate this, applicants would have to declare in their application their board director with responsibility for maintaining TEC, where relevant.

### Consultation Question

Q16 - Are there any unintended consequences associated with the disqualification

proposals?

#### Consultation Question

Q17 - Should the disqualification proposals also apply in respect of new build agreements terminated for failing to provide increased credit cover?

#### Consultation Question

Q18 - Are the draft amendments pertaining to this chapter aligned with the policy proposals contained in this document? Are there any unintended consequences associated with the draft amendments?

#### Consultation Question

Q19 - Do you think the package of amendments detailed in this chapter effectively balances greater delivery assurance and incentives against the risk of imposing unnecessary or disproportionate additional burdens?

## 1.4 In-year delivery incentives

1.4.1 Recent stakeholder representation has indicated concern over the delivery incentives for small-scale embedded generating CMU which are not directly exposed to energy market price signals and whose business case is predicated on capacity payments accounting for a high percentage of their revenues. Concern exists as to whether their incentives at times of system stress are of sufficient magnitude to drive the desired behaviour (for example efficient maintenance regimes and warming protocols), especially when compared to the incentives for their peers in the energy market; for whom the costs/opportunity costs associated with reformed imbalance cash out signals would comprise the bulk of their delivery incentives at such times.

1.4.2 A proposal to address this issue by applying different penalty rates to CMUs subject to their balancing mechanism participation status was consulted on in October 2013 (question

CM37<sup>1</sup> refers), prior to the finalisation of the legislative drafting. Respondents to the question were generally not in favour of such a proposal, primarily on the grounds of complexity, inequity between larger generation and embedded generation/DSR capacity and the impact on secondary trading liquidity. Additional representation suggested that all participants would be subject to similar imbalance price signals, either directly or indirectly through a consumption account and the price which demand pays their supplier. The proposal from the October 2013 consultation was not taken forward in the implemented version of the Regulations; however the Government is seeking views from stakeholders about whether the comparability of delivery incentives is still an issue.

To note: There is no illustrative drafting for this section.

### Consultation Question

Q20 - Are you aware of any class of participants for whom the Capacity Market incentives under the implemented design, when considered alongside their other incentives to deliver at times of system stress, could be considered insufficient to drive the desired behaviour? If so, please suggest how this could be addressed.

## 1.5 Secondary trading

1.5.1 An important element in ensuring that Capacity Market agreements support underlying investment is that there should be an appropriate secondary trading market which, in its entirety, allows the management of risk relating to non-delivery and penalty exposure during periods of planned and unplanned outages whilst compensating for any uncertainty regarding over delivery rates. The Government is seeking views on a number of proposals relating to secondary trading to ensure a fully functional and inclusive Capacity Market.

1.5.2 The current regulatory framework needs additional provisions to deal with the interaction between transfers of agreements and the penalty regime. Liquidity and competition concerns

---

1

[https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/324170/Government\\_Response\\_to\\_EMR\\_implementation\\_consultation.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/324170/Government_Response_to_EMR_implementation_consultation.pdf)

have also been raised by stakeholders regarding the level of additional capacity available within obligation trading and also the lack of consistency regarding who qualifies for reallocation trading. Following feedback from stakeholders the Government have outlined a number of proposals, the full drafting of which can be found published alongside this consultation. An explanation of the different types of secondary trading which incorporates the proposals set out below can be found in [Annex 1](#).

### Monthly and annual penalty caps, penalty rates and capacity payments

1.5.3 The current regulatory framework does not include provisions to calculate penalty rates, penalty caps or capacity payments when trading occurs for obligation periods of less than a full year. The policy intent was to allow the transfer of obligations between parties ensuring that all parties are subject to the same level of incentives and these incentives should be adequate to ensure CMUs take sufficient steps to deliver or be available to deliver during a stress event.

1.5.4 The treatment of obligation trading, penalties, capacity payments and over delivery rate have been considered previously and the findings are detailed in the January 2015 government response<sup>2</sup>. The current Monthly Penalty Cap (MPC) calculation creates an uneven playing field where CMUs hold similar obligations in a period of stress if obligations are held for different lengths of time. A CMU which holds an obligation for a single day, for example, would have an MPC equal to twice the value of their actual monthly capacity payments, the equivalent of two days of capacity payments, whereas a CMU which holds the same obligation for a month would have an MPC equivalent of up to sixty two days (i.e. twice their full monthly capacity payment).

1.5.5 The Government proposes to calculate the MPC for each CMU so that when penalties occur and an obligation is held for less than a month, the monthly cap is set as if they had held the obligation for the entire month. The MPC calculation applies in respect of each stress settlement period and only applies to those obligations held in this period plus any penalty liabilities incurred earlier in the month against obligations no longer held.

1.5.6 The current Annual Penalty Cap (APC) calculation creates very different incentives based on the duration an obligation is held for despite both calculations exposing 100 per cent of payments. Using the same example as the MPC where a CMU holds an obligation for a single day, their APC exposure would be equivalent to just a single day of capacity payment, compared to an APC equivalent to three hundred and sixty five days of capacity payments.

---

2

[https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/396505/Government\\_Response\\_to\\_CM\\_Supplementary\\_Design\\_Consultation\\_v.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/396505/Government_Response_to_CM_Supplementary_Design_Consultation_v.pdf)

1.5.7 The proposal is therefore to dis-apply the APC until a CMU has received forty eight periods of penalties across at least six months, with a minimum of four periods of penalties in each month; effectively the point at which a CMU holding an auction acquired obligation would reach their APC. This would ensure that the same penalties were incurred for a CMU holding an obligation for a single day as though it were holding that obligation for a year, although in such circumstances its MPC would be invoked. Once applied, a CMU's APC would continue to be based on their scheduled capacity payments (as determined by the size of their obligations, capacity prices and durations held), rather than their actual payments received.

1.5.8 The Government recognises that both recommendations for MPC and APC will make it harder for obligations to be traded between CMUs for very short periods due to the proportional increase in penalty exposure. The Government therefore foresees obligation trading only being used to cover longer periods of unavailability. However, as a package the Government considers that volume reallocation and financial trading offer adequate cover against shorter periods of unavailability. A more detailed explanation of these recommendations can be found in [Annex 2](#).

### Competition and liquidity

1.5.9 The Government is proposing amendments to the scope of obligation trading, reallocation trading and over delivery payments to address stakeholder concerns over competition and liquidity. These amendments will broaden the potential to trade the capacity available to those unable to deliver in periods of stress.

1.5.10 Obligation trading is available to any prequalified CMU and is most likely to be used for longer term outages. Obligation trading will rely heavily on prequalified plant without auction acquired agreements remaining open and/or new build coming online early, neither of which can be guaranteed. Stakeholders are therefore concerned that the pool of potential transferees could be very small, essentially making obligation trading obsolete.

1.5.11 The Government therefore proposes expanding the pool of potential transferees by allowing transfers above de-rated capacity for all CMUs, other than interconnectors, in a period ("window 2") closer to real time. Transmission connected CMUs will be able to take on obligations up to the lower of their TEC or connection capacity, the connection capacity for distribution connected CMUs or the proven DSR capacity for DSR CMUs. Interconnectors would be excluded from this as flow direction would not be known during the "window 2" trading window.

1.5.12 Transfers are proposed to be up to a maximum of five weeks, to allow full months to be transferred, and to be notified between five and ten business days ahead of the first transfer day. This will enable obligation holders to take into account near term opportunities where there is known additional capacity above de-rated capacity. An example of the timetable for obligation trading “window 2” can be found in [Annex 3](#).

1.5.13 The ability to reallocate excess delivery (volume reallocation) or access over-delivery payments is currently available to any CMU holding an obligation and delivering in excess of its obligation at times of stress. The Government proposes to expand the scope of reallocation trading and eligibility for over delivery payments to include any acceptable transferee (i.e. any party eligible to participate in obligation trading) who has pre-registered with the delivery body for the purposes of participating in volume reallocation. This would be irrespective of whether they hold an obligation for that period or not.

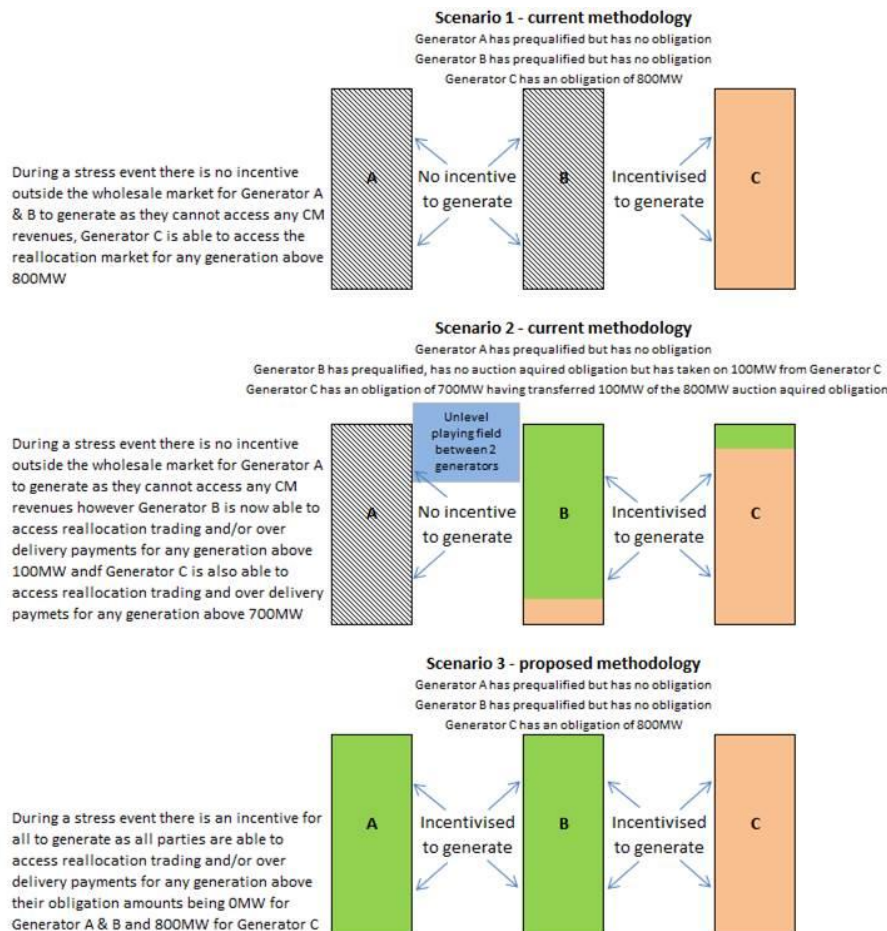
1.5.14 The over delivery rate will be set at the T-4 auction clearing price for those without obligations who access over delivery payments. To access over delivery rates and reallocation trading an acceptable transferee must meet the existing criteria as per Rule 9.2.6, with the following additions:

- new build CMU must have met the substantial completion milestone;
- a copy of the distribution connection agreement have been provided, where relevant; and
- DSR CMU must have a DSR test certificate with a proven capacity at least equal to the volume of obligations they wish to take on.

Figure 2 below shows the incentives offered under the existing and proposed methodologies for CMUs.



**Figure 2: Reallocation trading and over delivery payment scenarios**



1.5.15 The proposals in this section are estimated to bring an additional 7GW of capacity into the scope of the secondary market. Access already exists for this 7GW to access reallocation trading and over delivery payments through taking on small obligations. These changes allow all acceptable transferees access to these opportunities.

### Satisfactory Performance Days and Termination Events

1.5.16 There are a number of other areas impacted by the proposals discussed in the previous sections, including Satisfactory Performance Days and Termination Events. The Government has also considered ways to simplify requirements and also apply consistency where it currently differs. A DSR CMU must currently nominate (ex-ante) three, and no more than six, separate days that it expects to be a Satisfactory Performance Day (i.e. testing days). This is in contrast to generators who select three separate Satisfactory Performance Days that have occurred (ex-post) by the end of winter (end of April). The rationale for treating DSR differently

was in recognition of their inability to access market funding for their nominated days and to address potential gaming considerations. However, an ex-post approach allows providers to select days where they reduced to meet balancing service requests/triad avoidance. In addition, the gaming considerations are no longer valid with the establishment of the metering test.

1.5.17 In addition to this the number of Satisfactory Performance Days required is dependent on how long obligations are held and the current drafting does not take into account what happens when different values are held on different days.

1.5.18 The proposal is for all generating and DSR CMUs to:

- undertake three Satisfactory Performance Days over the winter period if an obligation is held at any point over the winter and for any length of time;
- for all three days prove the highest level of obligations held over the winter period; and
- provide details of the Satisfactory Performance Days ex post.

1.5.19 Termination events may be triggered under the existing drafting if additional obligations are taken on under “window 2”. In addition, the opportunity exists to provide further clarity regarding what happens to transferred obligations if an obligation is terminated.

1.5.20 The proposal is to:

- amend the definition of termination events to ensure TEC must be held to cover obligations acquired through “window 2”;
- expand the termination events to include terminating a transferee’s obligation if taking on such an obligation takes them above their TEC;
- amend the termination provisions to ensure that the termination of a transferred part of an obligation does not entail the termination of the entire obligation, enabling it to revert to the holder at the end of the transfer period; and
- ensure that the termination of an auction acquired obligation will also nullify any future transfers.

1.5.21 Examples of termination events can be found in [Annex 4](#).

### Consultation Question

Q21 - Do you agree with the recommendations and proposed Regulation and Rule amendments?

### Consultation Question

Q22 - Do you agree that DSR CMUs should be able to nominate Satisfactory Performance Days ex-post (as with Generation)? If not, what other steps could be taken to ensure that providers are robustly demonstrating what they can realistically contribute during a system stress event.

### Consultation Question

Q23 - Are there are other areas of the Capacity Market regime that need amending to deal with secondary trading?

### Consultation Question

Q24 - Are there alternative ways to encourage participation, liquidity and competition in secondary trading?

## Financial Trading

1.5.22 Financial trading is intended to fill any gaps not covered by reallocation and obligation trading, and also to be used in combination with these products to facilitate a fully functioning secondary market. It is not subject to any of the Capacity Market's legislative provisions, being a private, bilateral arrangement between two parties. However the Government wants to ensure there are no unintended consequences on the liquidity of such a market.

1.5.23 Stakeholder feedback indicated that most CMUs are likely to use financial trading, but more as an origination route to market using products such as ex ante bilateral agreements. Such agreements would re-allocate any over delivery from one party to another with shortfalls incurring penalties at pre agreed rates providing both cover and a route to market during stress events. These bilateral agreements are more suited to the structure of the Capacity Market rather than the churn of agreements through financial trading, which has gone out of favour in the industry in recent years due to liquidity and high credit costs. There was little appetite for

Government intervention within this market and stakeholders will likely assess the need for financial trading and develop products within industry closer to the first delivery year.

#### **Consultation Question**

Q25 - Do you agree that no Government intervention is required to facilitate a secondary financial trading market?

#### **Consultation Question**

Q26 - Do you think the contents of the (publicly-visible) Capacity Market Register could be expanded to include other items of information which would be useful to those looking to undertake secondary trading? If so what extra detail should be included?

# Chapter 2 - Regulatory Stability and Simplification

## 2.1 Regulatory stability

2.1.1. The Government is committed to establishing a stable and predictable cycle for running the Capacity Market auctions. The Government aims to work with industry and interested parties to improve the process; reviewing and making incremental improvements, whilst providing the certainty and clarity required in advance of each auction. Amendments are intended to clarify or resolve issues in the first instance. Due to the parliamentary process required to make changes to regulations and the lead time to implement systems changes, the Government envisages that this will be a two-yearly cycle. The regulatory changes consulted on in this document, if agreed, are therefore generally intended to come into force before the 2016 auction (except where indicated), and regulatory amendments proposed following the 2015 auction will be consulted on in the autumn of 2016 and any resulting regulatory changes to be in force prior to the opening of prequalification for the 2017 auction.

2.1.2 In addition to this cycle of regulatory changes, Ofgem are responsible for maintaining and amending the Rules, which generally set out the administrative and operational arrangements. Ofgem conducted an exercise, including stakeholder and public consultation, earlier this year, to make some changes to the Rules, and it is envisaged that a similar process will be followed after the next auction. Government believes it is right that Ofgem should have this responsibility, and welcomes the active involvement of Ofgem in helping shape the Capacity Market framework. Indeed, over time, it may well be right for Ofgem to take a still larger role in this area.

2.1.3 Therefore, while changes to regulations are for Government to make (together with any changes to the Rules that are consequential upon those amendments), changes to the Rules are essentially made by Ofgem. These processes are intended to be sequential and complementary, but it is the distinction between policy (regulations) and operational and administrative process (Rules) that is not always clear, and stakeholders have been concerned in some instances that there is potential for Ofgem and DECC to reach differing policy views on some issues, leading to inconsistency or uncertainty in the overall regulatory framework.

2.1.4 In the interests of full transparency the Government proposes to introduce a provision allowing Government to give notice to Ofgem, in respect of changes to the Rules which they are considering, that the proposals will require approval by the Secretary of State before implementation; in effect allowing the Secretary of State to call in proposed provisions where they raise questions of policy that need to be considered by Government. The Government intends this provision to be used very sparingly. This will also provide external reassurance that there is ultimately only one policy owner of the framework, and is in line with the Competition and Market Authority's<sup>3</sup> comments about the importance of transparent mechanisms where there is a risk of regulatory overlap between DECC and Ofgem.

### Consultation Question

Q27 - Do you agree with the proposal for DECC to give notice to Ofgem on proposed changes to the Rules which would require approval by the Secretary of State?

## 2.2 Refurbishment agreements

2.2.1 As noted elsewhere in this document, trading agreements of different length as part of the same auction brings with it some potential inefficiencies and cost-risks. Where there is a strong case for the different agreement lengths, the Government has no intention of making any changes. The Government notes, for example, the evidence that developers of new build generating plant have provided that they need the certainty of fifteen year agreements to support their investment decisions, and the Government is not consulting on any changes in this respect. The Government does however believe there are legitimate questions to ask about the continuing need into the future of the three-year refurbishment category of agreement.

2.2.2 The policy intent behind longer agreements for Refurbishing CMUs was to help facilitate refurbishment and plant improvement which would not otherwise be brought forward, which would effectively enable applicants to provide capacity which would otherwise not be the case,

---

<sup>3</sup> See CMA's Energy market investigation, Summary of provisional findings report, [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/442500/EMI\\_PFs\\_Summary.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/442500/EMI_PFs_Summary.pdf)

and which would not be possible without the security and certainty of an agreement longer than one year. The category was not intended to support routine maintenance, or reward plant in respect of work for which a three year agreement is not required. It is therefore important to identify if there is a continuing need for such agreements and, if so, what capacity and programmes are reliant on these agreements. This will facilitate an assessment of the value of these agreements for security of supply.

2.2.3 Much of the evidence that the Government originally received suggested that this category was particularly important for coal plant, who may have been facing refurbishment challenges when looking to comply with the provisions of the IED (Industrial Emissions Directive). Recent evidence suggests no technology has a need for these agreements, the Government is therefore seeking views on whether this category of agreement is needed or appropriate in future, and if not, when it should be withdrawn.

2.2.4 If the category is maintained, the Government is keen to ensure that definitions of eligibility remain accurate, and in particular that they do not inadvertently allow any expenditure which is not genuine refurbishment to qualify. The Government is therefore seeking views on the specific eligibility criteria in respect of a Refurbishing CMU, in particular the definition of an improvements programme and maintenance works ensuring the best value for consumers whilst maintaining a fair and simple Capacity Market mechanism.

2.2.5 “Refurbishing CMU” is defined in the Rules to mean “...an existing Generating CMU which is the subject of an Application as a Prospective Generating CMU by virtue of an improvements programme.” A prospective generating CMU is defined in Regulation 4 of the Regulations. In Regulation 4(8) a prospective generating unit is defined as “...a generating unit or proposed generating unit that (a) has not been commissioned; or (b) is to be subject to an improvements programme and has not been re-commissioned following that improvements programme;...”.

2.2.6 The February 2015 Capacity Market consultation resulted in a new requirement for company directors to confirm that “a Capacity Agreement greater than one year in duration is required to facilitate the improvements programme at the Refurbishing CMU”.

2.2.7 There remains a concern that “improvements programme” within these definitions may be construed to include maintenance works and at present what constitutes an improvement programme is not clear. A CMU which is operational and, for example, undertaking any maintenance work should not be able to satisfy the definition of prospective generating CMU above.



To note: There is no illustrative drafting for this section.

### Consultation Question

Q28 - Do you have views on whether there is a continuing need for three year refurbishment agreements? If not, when would it be appropriate to withdraw this option? Please provide evidence, for example of any planned refurbishment programmes that would not take place without three year agreements (you may mark your reply as confidential if sensitive information is provided)

### Consultation Question

Q29 - How could the eligibility requirements and definitions be further defined? For example, could the Government outline specific qualifying improvement programmes for each technology or identify what is deemed routine maintenance and therefore should not qualify?

## 2.3 Unproven DSR – credit cover and termination fees

2.3.1 Currently under Regulation 59, Unproven DSR CMUs are required to lodge credit cover of £5000/MW for the enduring regime or £500/MW for TA auctions. Under Regulation 61(1)(a)(ii), credit cover can be drawn down by the Settlement Body if a CMU's DSR Test Certificate evidences capacity less than 90 per cent of their unproven DSR capacity.

2.3.2 It may be possible for an Unproven DSR CMU to have its credit cover drawn down and subsequently face a termination fee. For example, an Unproven DSR undertakes a DSR Test and the capacity evidenced is less than 89 per cent of its unproven capacity, but above 2MW *de-minimis* threshold and therefore has 100 per cent of its credit cover drawn down. The CMU then takes its Metering Test and fails and is terminated under Rule 6.10.1(h) with an invoice of £5000/MW for termination fees.

2.3.3 Another scenario is where the CMU obtains a DSR Test certificate evidencing 95 per cent of its capacity obligation amount. Even though the CMU will receive 95 per cent of its collateral back under Regulation 60(5), if on failing a subsequent metering test, the remaining 5 per cent that was drawn down would not be taken into consideration when calculating termination fees.

2.3.4 The policy intention was to incentivise achievable DSR bids entering the auction and CMUs being operationally ready for the delivery year to ensure security of supply. The Government proposes to amend the Regulations so that in calculating the termination fees for an unproven DSR CMU prior to the start of the delivery year, any previously drawn down collateral is subtracted from any termination fees. This amendment is also proposed for the TA auctions.

### Consultation Question

Q30 - Do you agree that Unproven DSR providers should not incur the loss of their credit cover and also a termination fee prior to the start of the delivery year?

## 2.4 Aggregation of prospective generating CMUs

2.4.1 Following the Capacity Market consultations in October 2014 and in February 2015, the Government amended Regulation 4(3) to disapply the provision that generating CMU in a CMU (under 50MW) must have the same legal owner. Rules were amended to implement aggregation of Existing Generating CMUs with different legal owners. In addition the Government also amended Rule 9.2.10 to allow an individual generating unit in a CMU to be transferred, sold or otherwise disposed, but only where Despatch Control for the CMU as a whole is unaffected and remains with the aggregator.

2.4.2 In the February 2015 Capacity Market consultation, the Government also asked stakeholders how they envisaged extending aggregation of Prospective CMUs (under 50MW) with multiple legal owners. The responses outlined that Prospective Generating CMU should be able to aggregate and the aggregator should take on the responsibilities and penalties of a CMU. It is for the aggregator and legal owners to decide through their contractual relationship how responsibilities and penalties are shared.

2.4.3 Government is therefore proposing to enable the aggregation of Prospective Generating CMU (under 50MW) with different legal owners that have not yet been commissioned. Rule 3.2.6 and 3.2.7 and associated declarations in Exhibits F and G would be amended to include all Generating Unit types under 50MW and to provide that the Despatch Controller with respect to the Generating CMU must be the Applicant for a Capacity Agreement.

2.4.4 The Government is also proposing to extend Rule 9.2.10A and associated declarations in Exhibits H and I to include Prospective Generating CMU to enable individual CMU within a Prospective CMU to be able to be transferred, sold or disposed, but only where Despatch Control for the CMU remains with the aggregator.

### Consultation Question

Q31 - Do you agree with the proposed approach to enable Prospective CMUs under 50MW with different legal owners to aggregate and that the individual CMU in the aggregated Prospective CMU can be sold, transferred or disposed of?

## 2.5 Price Duration Equivalence

2.5.1 The Government has consulted on the issue of “Price Duration Equivalence” (PDE) before. PDE is the umbrella term used for methodologies that seek to take account of agreement length in defining prices for multi-year agreements with the aim to make agreements more comparable. Driven by responses to the October 2014 consultation, the Government decided not to implement its proposed methodology, involving the use of modelled forecast clearing prices from the Dynamic Dispatch Model, for the 2015 T-4 auction. However, the Government committed to looking further at the option of using a PDE methodology for future auctions.

2.5.2 In June 2015, DECC commissioned research to explore potential PDE methodologies, using auction theory, evidence from other capacity markets and other existing auction frameworks. The Government has published these findings alongside this consultation.

2.5.3 The research considered a wide range of options that would implement price duration equivalence, within the current regulatory framework, namely “price duration curves”<sup>4</sup>. PDE curves that were evaluated in the study were found to have a number of fundamental problems, which would not lead to an improved Capacity Market design:

- In most cases, the overall Capacity Market cost to consumers would increase;

---

<sup>4</sup> A “price duration curve” involves the adjustment of a bid, within the same auction, that would ensure prices fully reflect differences in contract duration.

- The use of PDE curves would complicate the Capacity Market design;
- Results were sensitive to the forecast accuracy of future clearing prices, which was already one of the major criticisms of the previous methodology<sup>5</sup>; and
- There is a risk of circularity in the use of price duration curves; where expectations of future clearing prices are made an input to defining the price duration equivalence mechanism, bidding behaviour and thus Capacity Market outcomes may be influenced.

2.5.4 Due to these reasons, the Government has decided to continue not to apply price duration curves to the Capacity Market for next year's auction; and, subject to the views of consultees, are not minded to pursue the proposal further for any auctions beyond that, as the Government has no evidence that a robust solution can be found.

To note: There is no illustrative drafting for this section.

### Consultation Question

Q32 - Do you agree that there is no robust basis for applying a price duration equivalence methodology not just for the next, but for any subsequent, auction? If not, please provide evidence.

## 2.6 Payments and credit cover

2.6.1 The Government is proposing to make a number of minor amendments to the Regulations and Rules, in relation to payments and credit cover, with the intention of simplifying processes for suppliers and capacity providers, and reducing administrative burdens for the Settlement Body (SB) (the role performed by the Electricity Settlements Company) which is responsible for processing these transactions. The proposed amendments are outlined below.

- Where payments are required to be made to or by the SB, it is proposed to make the cut-off time for payment the end of the day (i.e. midnight). As banks do not

---

<sup>5</sup> Detailed information on these methodologies and the evaluation of them can be found alongside this consultation: <https://www.gov.uk/government/collections/electricity-market-reform-capacity-market>

record time of transfer, this change reduces administrative burden by allowing the SB to run a single report at the end of the day to check payments have been made. It also avoids the possibility that an otherwise accurate payment transferred shortly after the 5pm cut-off is treated as late, which would have no negative implications for payment flows but could lead to unnecessary additional administrative burden on behalf of the payer and the SB to remedy the error. The cut-off time for other activities will not be changed.

- Amendments to timings for payments to allow for a five working day payment term across all invoices and credit notes. Also, a short extension to the time-frame in which the Settlement Body must issue credit notes. These changes are aimed at reducing the burden on stakeholders and the SB, and to reduce the risk that payments are not received on time due unforeseeable reasons such as an administrative error.
- Simplification of “late payment interest” in the Payment Regulations, so that the definition of “late payment interest” in Regulation 11(3) of those regulations applies to Regulation 7(5) of those Regulations.
- The period permitted for providing replacement credit cover after the giving of notice (in the event that the bank issuing the initial credit cover ceases to be a qualifying bank) in Regulation 57 of the Regulations to be amended to ten working days. This will ensure participants have sufficient time to comply.
- Regulation 56 of the Regulations to be updated so that if credit cover is not maintained in accordance with Regulation 56(3), the SB has the ability to draw down on the letter of credit and convert it into cash (to be held as credit cover). This will reduce the risk that the SB does not hold the necessary amount of credit cover.
- Regulation 30 of the Payment Regulations to be updated so that an entry no longer needs to be made on the credit default register in relation to credit cover draw-downs under Regulations 12 and 23. An entry will be made on the non-payment register in relation to the circumstances under Regulations 12 and 23. It seems unnecessary and an administrative burden to name suppliers on both the credit default register and the non-payment register. A minor clarification will also be made to ensure the entries on the credit default register are removed as soon as reasonably practicable, and if none of the other sub-paragraphs in Regulation 30(3) apply, after the last annual reconciliation run under Part 5 for the delivery year in respect of which the entry was made.

- Amendments to ensure that scheme participants are not unintentionally penalised for failing to pay late payment interest for which they have not yet been invoiced. (Draft amendments not provided alongside the consultation).
- A couple of minor typos, in Regulations 6(5)(a) and 15(5) of the Regulations (identified in the process of working through the above amendments) to be corrected.

### Consultation Question

Q33 - Do you have any comments on any of the above payments and credit cover proposals?

## 2.7 Appeals

2.7.1 In the Electricity Capacity (Amendment) 2015 Regulations, the Government extended the derogation to the 2015 T-4 auction (and both TA auctions) which allowed appellants to provide additional information at a Tier 1 appeal. This appears to have worked well with many applicants who initially failed to pre-qualify, going on to successfully pre-qualify following a Tier 1 appeal. In general, this derogation appears to be a welcome change for stakeholders. However, we would like to gather views on whether there are negative implications of this derogation and, in light of this, whether this provision should be made permanent or extended for a further year (i.e. the 2016 T-4 auction).

To note: There is no illustrative drafting for this section.

### Consultation Question

Q34 - Should the Government extend or make permanent the derogation which allowed appellants to provide additional information at a Tier 1 appeal?

## 2.8 Enforcement of penalties on companies with zero turnover

2.8.1 During the last auction there was an issue with a company submitting misinformation. Ofgem were able to use enforcement powers and disqualify the relevant units from the auction and, in addition, bar them from participating in the next two auctions. In terms of financial penalties, while Ofgem are in principle able to impose a fine of up to 10 per cent of turnover, in this instance as the company was new and effectively had zero turnover, it was not practically possible to impose a fine. This may represent a potential loophole as certain types of company (for example start-ups or certain types of subsidiary) may be able to escape the penalties that other companies would face for breaches of Capacity Market requirements.

2.8.2 Enforcement of Capacity Market requirements essentially relies on Ofgem's general enforcement powers, and there is an argument that any changes are best addressed in the context of those general powers. Government will bear the Capacity Market in mind in its consideration of, and in any future consultation on, the general enforcement regime. However, we would be interested in whether consultees feel there is a problem about companies which over little or no turnover operating in the Capacity Market that requires tackling for the Capacity Market specifically. If so, we would be interested to hear from consultees on options for what could be done.

2.8.3 One option to deal with companies with zero turnover could be to insert a new section on enforcement into the Capacity Market Rules, allowing Ofgem to impose a financial penalty. This could be a fixed penalty (or a set of fixed penalties according to the nature the breach) or a more flexible power for Ofgem to impose a penalty that is reasonable in all circumstances, for example, a percentage of the value to an applicant of the agreement it could have obtained if it had not breached the Rules. If there were concerns about the potentially open-ended nature of such fines, a penalty cap could be set.

2.8.4 Alongside this, it would be possible to include, as part of the application process, a requirement for a financial guarantee of a fixed figure to offset any penalty that may be imposed by Ofgem as a result of a contravention. This could be in terms of an approved letter of credit or cash deposit similar in nature to credit cover, or a financial guarantee from a parent company or group from which Ofgem could draw down automatically on a finding of contravention. These arrangements could be useful if there were concerns over the ability of companies of this sort (with little or no turnover) to meet any penalty liabilities when called upon. However, such arrangements could also introduce additional complexity to the overall

process, and create disproportionate extra costs for smaller bidders who might find it more difficult to access funds or credit up-front.

To note: There is no illustrative drafting for this section.

#### Consultation Question

Q35 - Do you believe there is an issue with companies who have breached the Rules and have zero or little turnover? If so, do you feel that it requires addressing in the context of the Capacity Market specifically?

#### Consultation Question

Q36 - If this were to be addressed, would the preference be for a new section on enforcement to be inserted into the Capacity Market Rules, allowing Ofgem to impose a financial penalty?

#### Consultation Question

Q37 - Do you think the disadvantages of a financial guarantee of a fixed figure to offset any penalty outweigh the advantages?

## 2.9 Auction parameters adjustment

2.9.1 After prequalification and following the Delivery Body's auction liquidity report, the Secretary of State has five working days to make any adjustments necessary to the auction parameters. The Secretary of State may wish to adjust parameters following new information gained at prequalification to ensure value for money for consumers and to ensure the capacity target is adequate. For example, if a plant has opted out of the auction but has notified the Delivery Body that they will still be operational in the delivery year, then following an assessment of whether this is credible, the Secretary of State may wish to remove the associated capacity from the demand curve to ensure the market does not secure more capacity than necessary.



2.9.2 A short period of time for the Secretary of State to make this decision is needed to minimise industry uncertainty of auction parameters but to achieve this within five days is challenging. In order to carry out the analysis required without compromising the robustness of any decisions to adjust auction parameters, the Government is consulting on extending this period to ten working days.

### Consultation Question

Q38 - Do you agree with extending the period of time in which the Secretary of State can decide to adjust any of the auction parameters to ten working days?

## 2.10 Interactions with other support schemes

2.10.1 Under the current drafting of the Regulations capacity receiving financial support under specified mechanisms is excluded from participation in the Capacity Market. The specified mechanisms are i) Feed in Tariffs (FITs) ii) Renewable Heat Incentives (RHI) iii) Renewables Obligation (RO) iv) Contracts For Difference (CfDs) v) New Entrance Reserve (NER) 300 and vi) Carbon Capture Storage (CCS) demonstration project funding. Capacity subject to a long-term Short Term Operating Reserve (STOR) contract with National Grid is also excluded.

2.10.2 The primary rationale for these exclusions is to provide clarity and avoid overlap between schemes and overpaying capacity, given their level of existing support under the aforementioned mechanisms had been set at the minimum level to bring forward the low-carbon/flexible capacity. Providing additional support through the Capacity Market creates the potential for overpayment, overcompensation or overinvestment in particular technologies. From a policy perspective all capacity types (public and private sector, existing and new, generation and DSR) should be in scope for participation in the Capacity Market, save for where a definitive case has been made for their exclusion on the grounds of overpayment. This is principally determined with reference to whether the level of support under the alternative mechanism takes account of the full system costs of the resource and was determined in a competitive process where participants can take full account of their potential capacity revenue. Government believes current arrangements effectively ensure that there is clarity on which scheme provides the appropriate support mechanism for particular resources in which circumstances, but stakeholders are welcome to provide evidence if they consider there is any

doubt or ambiguity. The range of excluded mechanisms will be re-considered as part of the review cycle.

To note: There is no illustrative drafting for this section.

### Consultation Question

Q39 - Do you have any evidence to suggest the current arrangements for eligibility as between the Capacity Market and other Government support schemes create any difficulties or uncertainty?

## 2.11 Capacity Market / Contract for Difference interaction

2.11.1 The current drafting of the Regulations confirms the policy position that CMUs which are subject to a CFD for any of the delivery period are not eligible for participation in the Capacity Market. The Delivery Body will therefore not prequalify any such CMU.

2.11.2 The Government intends that capacity providers can withdraw from their capacity agreement, via a ROO Conversion notice or a CfD Transfer Notice, in order to transfer to receiving support under the RO or CfD respectively; the latter where it has been successful with its CfD application and the CfD Counterparty 'intends to grant a CfD'. Such withdrawal must be made prior to the year-ahead auction for the delivery year for which their capacity agreement is held. This provision was intended to relate to circumstances where the provider wished to fully convert their plant or unit to biomass utilising support from one of the two aforementioned mechanisms.

2.11.3 There is, however, tension between the legislative drafting referenced in the previous two paragraphs and the Contract for Difference (Allocation) Regulations. Regulation 14(10) of the CfD Regulations prevents an application being made for a CfD by a provider in respect of a unit which is already subject to a capacity agreement. In addition, in March 2015 the Government consulted on an amendment to also prevent an application being made in respect of a unit which is subject to a pending application for a capacity agreement. The drafting of Regulation 14(10) is at odds with Regulation 34 of the Electricity Capacity Regulations 2014; effectively preventing the circumstances envisaged under Regulation 34 from occurring (as unable to reach the stage in the process where the CfD Counterparty 'intends to grant').

2.11.4 Stakeholders have requested clarification as to both the original policy intent and how the interaction between the contradicting Regulations should be interpreted. Whilst this latter point is clear, in that the drafting precludes such a Capacity Market to CfD transfer, the Government is taking the opportunity presented by this consultation to consider the notional interaction between the two schemes and corresponding Regulations. This includes further consideration of any material allocation design questions that may arise from a transfer. Concerns, amongst others, may include advantages for those using the transfer and appropriate incentives that avoid non-delivery. The Government is not consulting on circumstances which would be required to exercise the CfD transfer notice.

2.11.5 Stakeholder views are requested on the following two options:

- i. delete the concept of a CfD Transfer Notice from Regulation 34 of the Regulations (thereby aligning the Regulations with the current drafting of the CfD Allocation Regulations); or
- ii. amend Regulation 34 of the Regulations to restrict the circumstances in which such a CfD transfer can be affected to full unit or station biomass conversions. In addition, the scope of the CfD Transfer Notice would be amended so that it contains a director's declaration that they wish to terminate their capacity agreement for the sole purpose of being able to enter a CfD allocation round. The amendments would effectively move the point of transfer to a point where they are considered eligible to submit an application (assuming all other eligibility criteria are met). The transfer would be a one-off move out of the Capacity Market and a transferred unit which had been unsuccessful with their CfD application would not be able to revert to their previous capacity agreement, which would have been terminated upon the point of transfer.

To note: There is no illustrative drafting for this section.

#### Consultation Question

Q40 - Which option do you favour and why? Are there other options which should be considered?

#### Consultation Question

Q41 - Do you believe applicants that enter via a CfD transfer notice, as described in option two, would have an advantage over other applicants in the CfD allocation process?

#### Consultation Question

Q42 - Which, if any, sanctions should be considered for applicants that enter the CfD allocation process via a CfD transfer notice and, for example, are awarded a CfD but do not subsequently sign, or fail to deliver, the project as required under the CfD terms?

## 2.12 New termination event

2.12.1 The Government is looking to make an addition to the termination events and fees and circumstances in which capacity payments are repayable (Rule 6.10 and Regulation 43B) to deal with applicants who make false or misleading declarations in their prequalification application and are then awarded a capacity agreement. This proposal will complement the amendment made in March 2015 which addressed the issue of such false or misleading declarations coming to light pre-auction.

2.12.2 The Government proposes that a termination fee of £25k/MW will be payable as a consequence of this new termination event. Additionally capacity payments will have to be repaid in respect of the period beginning with the date on which capacity payments began under the relevant capacity agreement and ending with the date of termination of the relevant capacity agreement.

#### Consultation Question

Q43 - Do you agree that capacity providers found to have made false or misleading declarations should have their capacity agreements terminated, a termination fee of £25k/MW applied and be required to repay their capacity payments?

### 3.13 Table of minor and technical changes

Rule/Regulation to be amended	Reason for amendment
<b>Schedule 7 – section F: Bespoke Technical Requirements</b>	Amendment to clarify that for Metering Systems using a Half Hourly Meter in a Type 1, 2 and 3 situation, a Main and Check Meter should be supplied for each circuit.
<b>Regulation 39: DSR and volume reallocation “net output”</b>	<p>Include a definition of “net output” in regulation 39 to enable DSR to participate in volume reallocation as set out in regulation 39(1)(b).</p> <p>Government proposes to insert the following definition of net output in regulation 39: ““net output” ‘in relation to a demand side response CMU, means DSR volume (as defined in Capacity Market Rules)’”.</p>
<b>Rule 1.2.1: Definition of Metering Assessment</b>	Extending the existing definition of Metering Assessment to include Prospective and Interconnectors CMUs. The Rules were amended in June 2015 to include Prospective and Interconnectors CMUs undertaking a Metering Assessment, however the definition of Metering Assessment was not updated to reflect these resources.
<b>Regulation 50 (4) &amp; Rule 13.4.1(c): Interaction between satisfactory performance days and repayment of capacity payments</b>	<p>The Government intends for capacity providers that have failed to demonstrate the requisite number of satisfactory performance days by the end of the delivery year, to be liable to repay all their capacity payments received in respect of the specific CMU in that delivery year, minus any penalties paid for delivery failure at times of system stress. Regulation 50(4) of the Regulations does not, however, require the netting off of such penalty exposure. This could theoretically expose providers to 200 per cent of their annual capacity payments. The Government therefore proposes amending Regulation 50(4) of the Regulations to provide for netting off of any capacity provider penalty charges to address this issue. The Government also intends to amend rule 13.4.1(c) to reference</p>

Rule/Regulation to be amended	Reason for amendment
	capacity provider penalty charges, as opposed to Settlement Period Penalties – which was an undefined term.
<b>Regulation 60(2): Credit cover for TA auctions</b>	Correction to Regulation 60(2) to clarify that for the TA auctions an applicant for an unproven DSR CMU must maintain credit cover in an amount equal to £500/MW, if it nominates a lower bidding capacity ahead of the auction. This amendment is to reflect the policy intent that the amount of credit cover for DSR CMUs participating in the TA auctions should be maintained at the original level of £500/MW, in accordance with Regulation 59(2)(b).
<b>Regulation 7 &amp; Rule 2.3: Clarification of ECR requirements</b>	There is an inconsistency between Regulation 7, which requires the Delivery Body to include recommendations as to de-rating factors in the annual Electricity Capacity Report, and Rule 2.3, which imposes an obligation on the Delivery Body to calculate de-rating factors according to a specified methodology for the first Delivery Year (and in accordance with a revised methodology following the consultation and Ofgem approval process set out in that Rule). We intend to amend Regulation 7 to remove this inconsistency.
<b>Regulation 59/ Rules 4.5A to 4.5C Credit Cover for Interconnectors</b>	Alignment of credit cover requirements for New Build Interconnectors and Unproven DSR, so that similar procedures will apply in the two cases.

## Consultation Question

Q44 - Do you have any comments on the table of minor and technical changes?

# Chapter 3 - Looking Ahead

## 3.1 Introduction

3.1.1 The Government is committed to establishing a stable and predictable cycle for running the Capacity Market auctions and the regulatory changes consulted on in this document, if agreed, are generally intended to come into force before the 2016 auction.

3.1.2 There are however two areas where the Government is aware that action may perhaps be needed in future. The Government do not as yet have concrete proposals for amendments, and may conclude that none are needed, but the Government is keen to open a debate with stakeholders and gather evidence that can inform any future decisions. Please note there is no illustrative drafting for this chapter.

## 3.2 T-1 auction

3.2.1 The Government is seeking initial views on the timing and structure of the T-1 auction, and within the current framework, how to ensure that the policy design offers the optimal balance in terms of security of supply, market access, and value-for-money for bill payers. Government currently has no specific plans to make any alterations to the capacity market design in this respect, but the Government is keen to seek initial views on whether there could be scope for future changes to improve the policy design in this area. In particular, the Government are considering whether the current policy approach of holding a single T-1 auction, held around one year ahead of delivery, is appropriate in order to maximise liquidity by ensuring participation of all capacity types. The Government are also considering whether greater clarity is needed regarding the process for 'setting aside' capacity from T-4 for the T-1 auction.

3.2.2 The purpose of the T-1 auction is to enable Government to 'true-up' the capacity based on updated analysis of supply and demand closer to the delivery year. In this way, consumers

face a reduced risk of paying for capacity that may ultimately not be required. The target capacity at the T-1 auction will be decided by Government, but will be informed by an updated assessment of demand from National Grid's Electricity Capacity Report (ECR), which is provided by June each year, and is based on analysis carried out for the annual Future Energy Scenarios Report.

### Determining the set-aside amount

3.2.3 A portion of the target capacity set for each T-4 auction will be set aside, to be purchased at the T-1 auction if needed. Government determines the amount of capacity to set aside, informed by advice from National Grid. In the first two T-4 auctions (for 18/19 and 19/20 delivery) this amount was set at 2.5GW, and was informed by estimates of the amount of DSR that could come forward by that time. This is not because the T-1 auctions are aimed specifically at DSR (they are open to all forms of capacity), it is because the T-1 auction is expected to be particularly suitable to the DSR sector, and so Government agreed with National Grid that this provides a useful benchmark for determining how much to set aside. The Government would welcome views on whether there are other considerations that should be taken into account when making this determination, and whether there would be advantages to developing a more transparent approach for doing this.

### T-1 auction timing

3.2.4 The current policy intent is to hold each T-1 auction twelve months ahead of delivery. The Regulations allow for a later auction (i.e. closer to the delivery year) but do not allow an auction to be held more than thirteen months ahead. Twelve months fits the timeline for producing the ECR and enables Government to determine the target capacity approximately sixteen months ahead of delivery with a reasonable degree of confidence. Twelve months is also intended to provide a suitable lead time for a range of capacity to be able to participate; including plants returning from mothball, plus smaller new plants and DSR. This should increase the likelihood of a liquid, competitive auction.

3.2.5 The Government would like to refine our analysis of the specific timing of the auction, to understand whether there would be advantages in having extra flexibility in regards to the timing of the T-1 auction in order to ensure that our security of supply objectives are met. For example, this could mean allowing the auction to be held earlier than September in the year before the start of the delivery year (that is, more than thirteen months ahead - the earliest currently permitted by the Regulations). The Government is interested in views as to whether an auction further ahead of delivery (for example eighteen months) might improve or reduce the ability of certain types of capacity to participate.



3.2.6 Equally, the Government would welcome views on whether there are arguments in favour of retaining an ability to secure capacity closer to the delivery year than the current approach of twelve months ahead, particularly as this could allow greater responsiveness to changing demand estimates or other unforeseen market developments closer to real time. Of course, stakeholders may feel that the current policy intent of holding a single auction following T-4, held approximately twelve months ahead of the delivery year, is appropriate and, for the sake of stability, should be retained as is.

#### Consultation Question

Q45 - Is more clarity needed on the process and responsibility for determining the T-1 'set aside' amount at the point that T-4 auction parameters are announced? Do you have any views on the factors that should be considered to determine this in order to achieve the best balance of security of supply, market access, and value for money for bill payers?

#### Consultation Question

Q46 - Does a T-1 auction held 12 months ahead of delivery represent an appropriate balance in terms of being able to access suitably accurate/up-to-date analysis of requirements whilst allowing a broad range of capacity to participate? Are there any arguments for allowing greater flexibility in the Regulations to run the T-1 auction earlier than this?

### 3.3 Cross border participation – other Member State interim solutions

3.3.1 The European Commission launched a consultation last July on Market Design. Among other topics, it covers Capacity Remuneration Mechanisms (CRMs) and cross-border participation. Great Britain has already enabled cross border participation by including interconnectors in the capacity auction from December 2015 and, in line with our State aid approval the Government will transition to an EU solution once one has been developed. In the meantime, other Member States are also introducing capacity markets in line with the State aid guidelines. The importance of cross-border flows to capacity adequacy is widely acknowledged and consequently some Member States are consulting on cross-border participation in their CRMs. Within the EU framework of the third package, the State aid guidelines, network codes and the energy market design consultation, it may be that different approaches to cross-border

participation are considered and implemented by Member States before a common approach is agreed.

### Consultation Question

Q47 - Until an EU solution has been agreed, do you have any views on how Great Britain should approach cross-border participation with other Member States, in particular with Member States whose electricity grid is connected to GB?

# Annex 1 - Types of secondary trading

	Financial trading	Volume reallocation	Obligation trading (window 1)	Obligation trading (window 2)
<b>Eligibility</b>	Parties can trade with whomever they choose (e.g. each other or insurers).	Parties can reallocate excess output to another CMU.	Parties can only move obligations up to the level of a prequalified unit's de-rated capacity where the unit does not have obligations for the relevant delivery year up to the level of their de-rated capacity.	Parties can move obligations to pre-qualified generating CMUs up to the lower of their TEC figure or connection capacity if transmission CMU, their connection capacity if distribution CMU or their Proven DSR capacity if DSR CMU.  I/C CMUs are not able to take on additional obligations in excess of their de-rated capacity.
<b>Payment for holding capacity obligation</b>	Unaffected.	Unaffected.	Payment goes directly to whoever holds the obligation.	As per obligation trading (window 1).
<b>Timing</b>	As privately negotiated.	Volume reallocation can only happen ex post in 11 to 19 working days following months in which there have been stress events.	Obligation trading can take place following the T-1 auction up to near real time – with at least five working days' notice of the intended transfer.	Trading can take place from two weeks ahead of real time – with at least five working days' notice of the intended transfer.
<b>Size of trading blocks</b>	As privately negotiated.	No restrictions on size; renominations made on settlement	Same de minimis threshold as prequalification criteria,	As per obligation trading (window 1) but with a maximum period of five

		period basis.	minimum trading blocks of a calendar day.	weeks per notification.
<b>Expected use</b>	To provide ex-ante short to medium-term cover.	To provide ex-post cover for a specific system stress event (although likely to be agreed bilaterally ex-ante).	To provide ex-ante medium to longer-term cover.	To provide ex-ante short-term cover.
<b>Agreement</b>	For a fixed fee, A agrees to pay B an amount if B becomes liable for a penalty.	Agreement made after stress event.	B transfers the capacity obligation to A. B has no obligation.  A has the same obligation B once held.	As per obligation trading (window 1).
<b>B under-delivers; A over-delivers</b>	B is penalised, but receives a private payment from A.  A is eligible for over-delivery payments in the ordinary course.	A nominates surplus to B (so A has no surplus and hence receives no over-delivery payments); B receives surplus when off-sets and B has no liability.	B has no obligation. A receives over-delivery payments.	As per obligation trading (window 1).
<b>A and B under-deliver</b>	A and B are penalised. B receives a private payment from A.	Neither A nor B have excess output to reallocate. Both must look for another party to reallocate volume with, or face a penalty.	B has no obligation. A is penalised.	As per obligation trading (window 1).

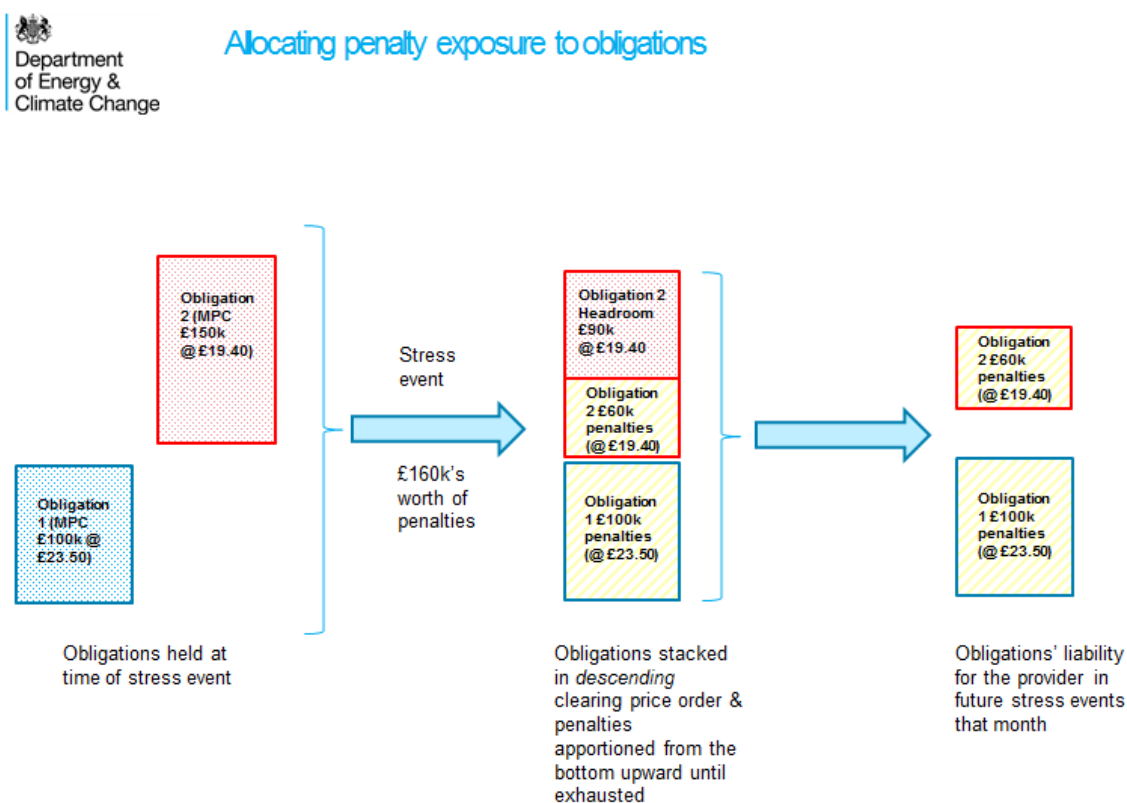


2.1.2 In order to facilitate this calculation the MPC must be calculated on a settlement period basis with the CMU's actual delivery obligation based on those obligations held in the specific stress settlement period; it is only the MPC for that settlement period which has a vestige liability from any previously held obligations.

2.1.3 MPC for each obligation will be calculated as though the obligation is held for a full month to ensure that all CMU's are exposed to the same liabilities during a stress event.

2.1.4 To calculate the MPC where penalties have occurred but obligations are no longer held there is a requirement to apportion penalty liability to individual obligations, in order to determine the obligation's contribution to the MPC for subsequent stress settlement periods. It is proposed this is achieved by stacking the obligations held in a stress settlement period in descending order of their auction vintage's clearing price (i.e. the most expensive clearing price at the bottom), and apportioning any financial penalties for the unit in that settlement period to the lowest obligation in the stack upwards until the penalty liability is exhausted. This is shown in the figure below.

**Figure 4: Apportioning penalties to obligations**



2.1.5 This is significantly simpler than trying to apportion delivery (and non-delivery) of energy to specific obligations. Please note any apportionment is only relevant for the purposes of determining the unit's MPC in future stress settlement periods that month. Transfers of the obligation to other capacity providers will be sterilised and not have any residual penalty liability. This proposal therefore only increases a unit's MPC in direct response to their previous penalty exposure whilst ensuring no additional liability where an obligation is no longer held.

## 2.2 Annual penalty cap (APC)

2.2.1 Under the current drafting providers with auction acquired obligations are exposed to a maximum penalty liability of 100 per cent of their scheduled, rather than actual, annual capacity payments in any particular delivery year – their annual penalty cap (APC).

2.2.2 There are two key issues with respect to the APC and obligation trading – i) how the APC is adjusted in respect of adjustments to MPCs and ii) at what point the APC should apply to limit a party's penalty exposure as a result of a trade.

2.2.3 With reference to the first issue, the proposal is to increase, or decrease, a provider's APC in direct proportion to how their annual payments are adjusted by their trades in and out of obligations, rather than by any increase in their MPC. Any amendments would not have a retrospective impact on penalty exposure, ensuring that providers would not be exposed to higher historic liabilities nor receive any repayments in respect of historic penalties paid in excess of their newly adjusted APC.

2.2.4 With reference to the second issue, the current drafting, if applied to providers with physically traded obligations, would result in potentially very weak and unequal delivery incentives should the transferee only hold the transferred obligation for short periods. For example, where a stress event occurs in two settlement periods, a provider holding a 350 MW auction acquired obligation for a CMU (unit A), priced at £19.40/kW, would be exposed to maximum penalties of £141.5k in each settlement period should they completely fail to deliver (figure 5 below refers). This maximum exposure would apply for any subsequent stress settlement periods where they completely fail to deliver until they reach their monthly cap (set at 200 per cent of their monthly capacity revenue) after circa four hours of total delivery failure. After this time their penalty exposure for the month would plateau and their marginal incentive would decline in response to reaching their 'soft' monthly cap.

2.2.5 However, should another unit (unit B) with no auction acquired obligations acquire unit A's obligation for just one day, their penalty exposure would be capped at their day's capacity payment as a result of the APC kicking in at a much lower level than their MPC. This would result in significantly lower penalties and marginal incentives to avoid a penalty than unit A would have been exposed to had it retained the obligation for those stress settlement periods.

**Figure 5: Comparison of penalty exposure for two stress settlement periods in a month (350MW agreement priced at £19.40/kW)**

	Penalty (£k) stress settlement period 1	Penalty (£k) stress settlement period 2	Explanation
Unit A	£141.5k	£141.5k	Penalty and incentive driven by actual incurred penalty levels (as MPC and APC haven't been reached yet)
Unit B (stress events on same day)	£18.6k	0	APC is lower than either actual penalty level or MPC. Hard cap nature of APC means no delivery incentive in second stress period (on same day)
Unit B (stress events on separate days)	£18.6k	£18.6k	APC is lower than either actual penalty level or MPC. Second stress period occurs on separate day from first stress period (so delivery incentives are greater than those in row two)

2.2.6 This discrepancy is a direct result of the annual penalty cap (APC) – set at 100 per cent of a provider's annual capacity revenue – kicking in and effectively placing a daily cap (i.e. the capacity revenue received for that day) on Unit B's penalty exposure. The impact of this issue reduces as a transferee takes on an agreement for longer durations than a single day. This does, however, present a gaming risk, whereby a provider trades with numerous parties, rather than a single party, to effectively sub-divide the risk and reduce the penalty liability at times of stress. The quantum of the risk exposure is considered to be relatively low, given the requirement to notify the Delivery Body five working days (i.e. sufficiently far ahead of real-time not to be able to forecast a stress event) before the trade is intended to take effect.

2.2.7 The issue in the previous two paragraphs does not apply in respect of the original provider (unit A) at this stage, however, as the APC would not factor until the provider had failed to deliver in six months' worth of stress events (the earliest the APC formula has an effect for such CMU). This means that the interaction between their actual penalty level, the



theoretical maximum penalty and their MPC determines unit A's penalty exposure up until this time, rather than their APC.

2.2.8 In addition unit B may not face any penalties in respect of the second stress settlement period due to the nature of the 'hard' APC (analogous to a cliff edge approach, unlike the 'soft' monthly penalty cap which always provides delivery incentives even when reached). If, however, as shown in row three of figure 5, the second stress settlement period occurs on a separate day to the first, their penalty exposure for the second stress settlement period is the same as that for the first. This is a direct result of more capacity revenue (i.e. the second day's revenue) now being available for the APC calculation.

2.2.9 In order to address this discrepancy in incentives, it is proposed to only apply the annual penalty cap where a unit had completely failed to deliver in 24 hours of system stress events (or their pro-rated equivalent should they partially deliver in any stress event), spread across at least four hours duration in each of six delivery months.

2.2.10 This point is proposed as it would be the earliest that a provider with auction acquired obligations, would reach their annual penalty cap (in the unlikely scenario there had been six months of system stress events every month of at least four hours duration and that the provider had failed to deliver in every event). The 24 figure would not apply if entirely contained within a single month as the MPC would have kicked in after four hours of total delivery failure.

2.2.11 This proposal would still ensure that providers with auction acquired obligations would not face penalties in excess of their original annual capacity revenue, and that the MPC continued to be the primary liability cap for providers until the sixth month of stress events. It could, however, expose parties acquiring obligations via trading to penalties in excess of their annual capacity revenue, depending on how many days they held the obligations for. In such cases their APC, when applied after 24 hours of complete delivery failure across six months, would not trigger the refund of any penalty payments made in the previous five months.

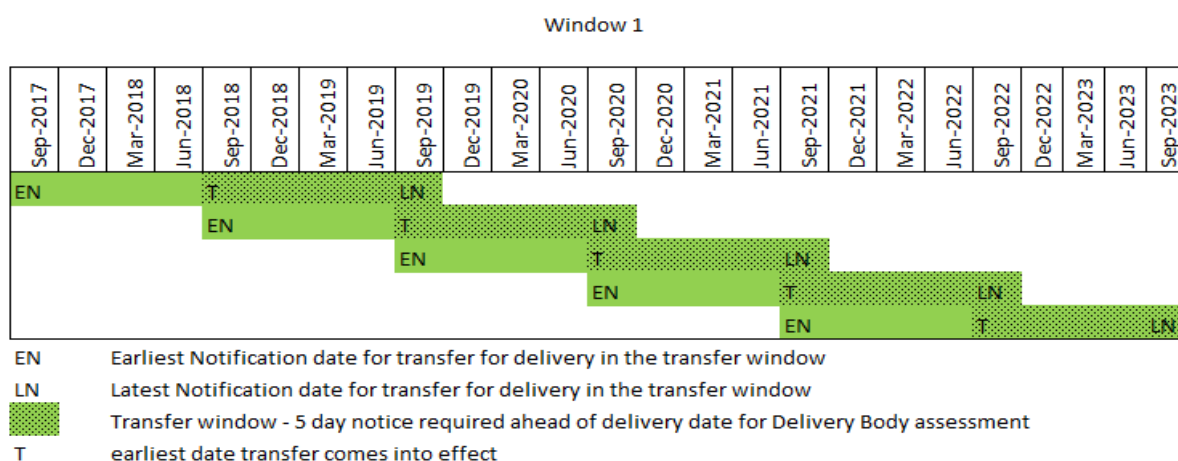
2.2.12 In the above example (figure 5) this would expose unit B to the same absolute delivery incentives as unit A for the two stress settlement periods. However this would mean unit B would now be exposed to the MPC as if they had held the obligation for the entire month, irrespective of how much capacity revenue they receive for that month. Unit B may therefore be exposed to a MPC in excess of 200 per cent of the capacity payments they had received that month (if only held for a short period), falling to 200 per cent of their monthly capacity payments where the obligation was held for the entire month.

## Annex 3 - Obligation trading

3.1 At present obligation trading allows acceptable transferees to take on obligations up to their de-rated capacity.

3.2 Transfers for any time period between one day and one year are permitted and trading can commence for a delivery year once the T-1 auction has taken place. Five business days' notice must be given ahead of the start of any transfer period.

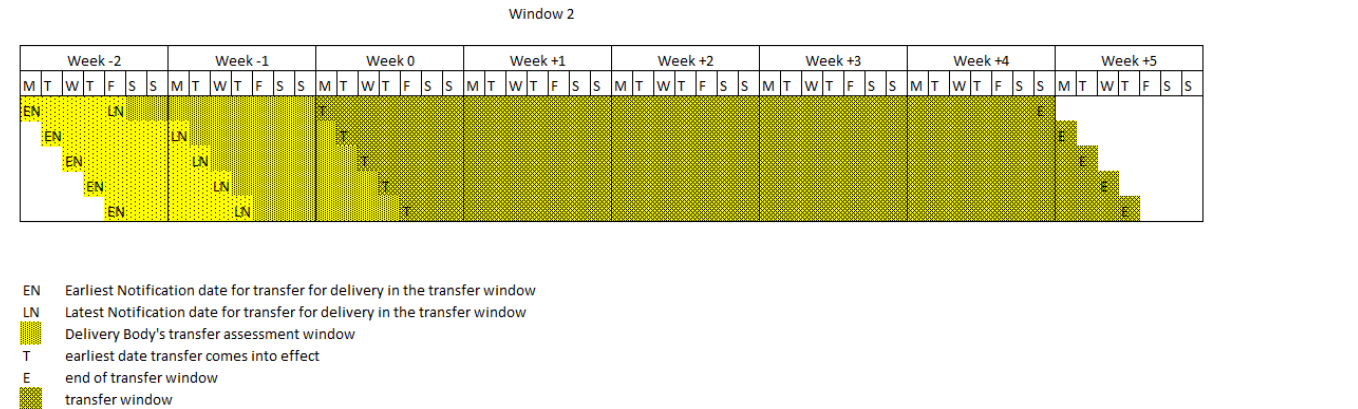
**Figure 6: Obligation trading timeline window 1**



3.3 Obligation trading window 2 becomes “open” much closer to the delivery period as it is intended to allow CMU’s to utilise additional volume available above de-rated capacity.

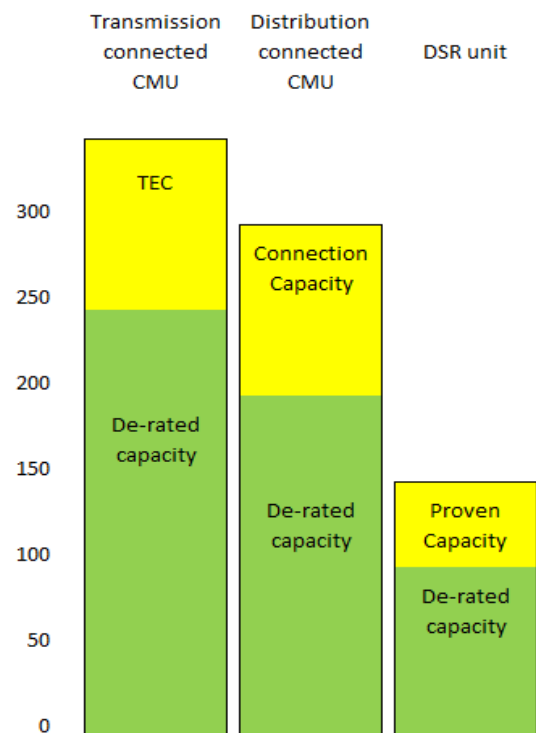
3.4 Once obligation window 2 is open a CMU is still able to trade longer periods through obligation trading up to de-rated capacity, or trade shorter periods closer to delivery above de-rated capacity.

3.5 Window 2 can be traded from 10 business days ahead of the period which is transferred allowing five business days to notify the transfer to the delivery body. The period of transfer can be between one day and five weeks and an example timeline is shown below.



3.6 An acceptable transferee can trade up to the lesser of their TEC or connection capacity for a transmission connected CMU, up to connection capacity for a distribution connected CMU and up to proven capacity for a DSR CMU.

3.7 Where two or more CMUs share TEC, the Capacity Obligation transferred, when aggregated with; (i) all other Capacity Obligations in respect of the CMU Transferee for that Delivery Year and (ii) all other Capacity Obligations in respect of the CMUs which share TEC, will not exceed the lesser of their TEC or connection capacity for Transmission CMUs. An example of the additional capacity available in window 2 is shown below.

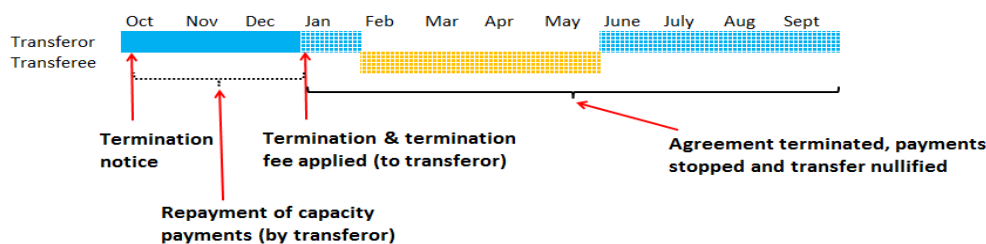


## Annex 4 - Examples of termination events

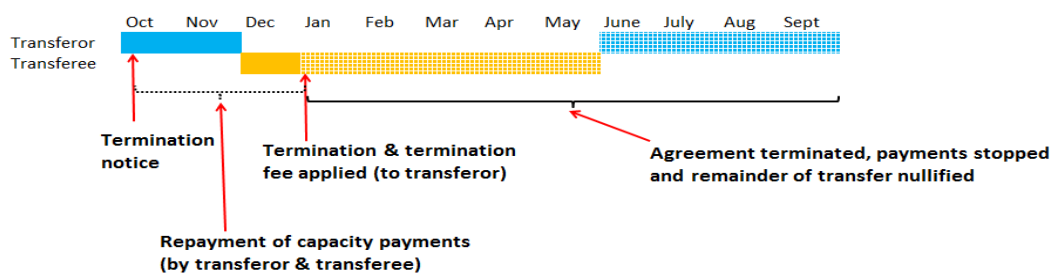
4.1 Examples 1 and 2 show what happens to transfers when a termination is triggered against a transferor. Both the obligation and the transfer would be terminated unless the termination date occurred after the end of the transfer period at which point only the original obligation would be terminated. As this creates a risk to a transferee an agreement could be made through a bilateral agreement in the event of a termination of a transfer.

**Figure 9: Examples of termination events 1 and 2**

**Example one: transferor triggers termination**

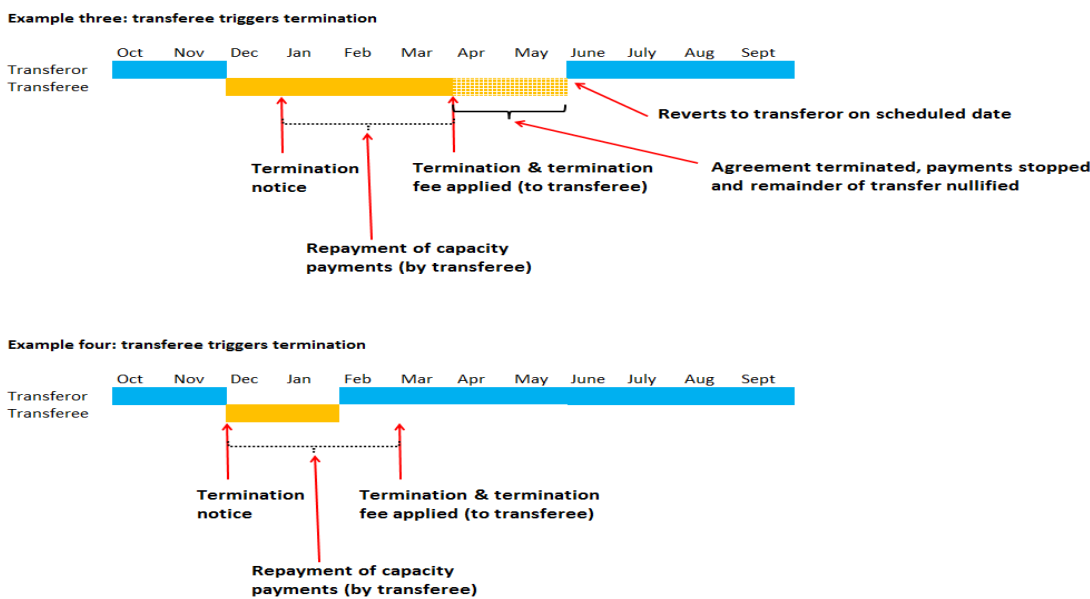


**Example two: transferor triggers termination**



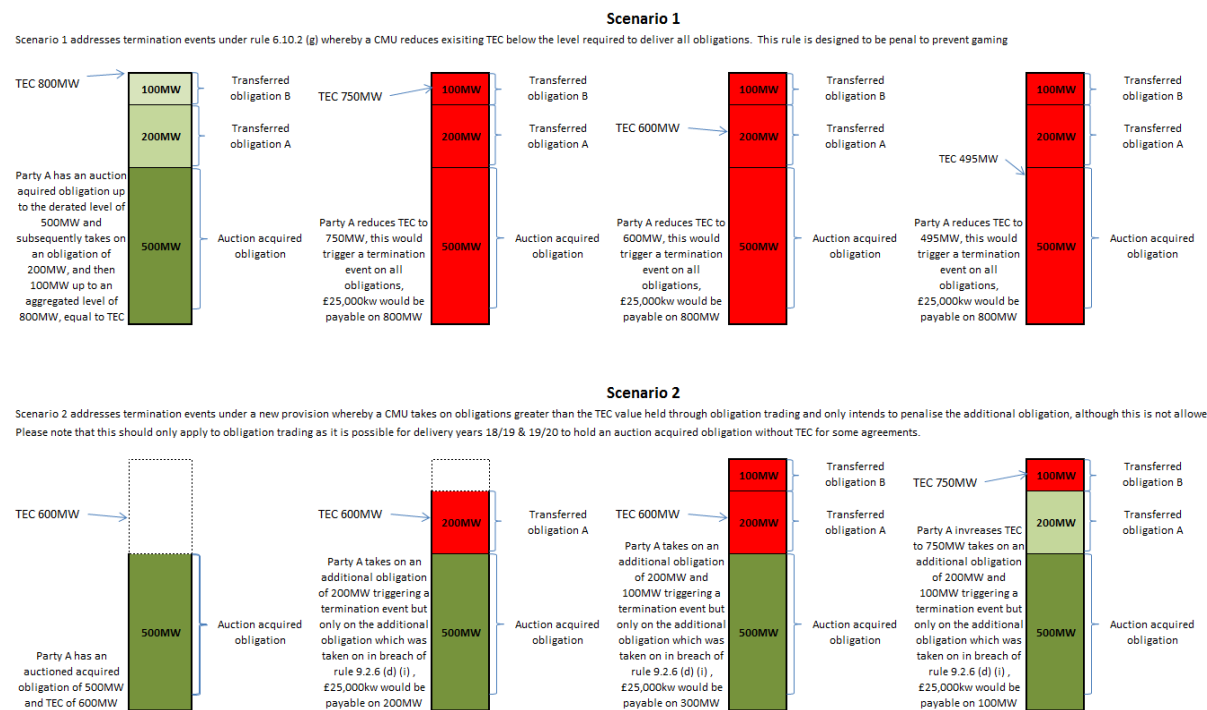
4.2 Examples 3 and 4 show what happens if a termination occurs against a transferee whilst holding an obligation. Such an event would never trigger a termination against the auction acquired obligation holder and this has been designed to protect the auction acquired obligation holder during a transfer.

Figure 10: Examples of termination events 3 and 4



4.3 Example 5 shows 2 scenario's addressing what happens when TEC reduces below the aggregated capacity obligations and where an acceptable transferee takes on obligations above TEC.

Figure 11: Examples of termination events 5 and 6



4.4 Example 6 shows a timeline addressing what happens when TEC is reduced below the required level to obligations held for multiple years.

# Catalogue of consultation questions

## Consultation Question

Q1 - Do you have any suggestions for ways in which the Capacity Market requirements for evidence of planning consent can be better aligned with project development cycles?

## Consultation Question

Q2 - Do you have other suggestions for modifications or improvements which, within the overall framework, would help meet the legitimate needs of new build projects?

## Consultation Question

Q3 - Is 400MW an appropriate threshold for the new pre- and post-auction financeability tests? If not, please explain your reasoning.

## Consultation Question

Q4 - For the pre-auction financeability test, is the requirement for the directors to certify and evidence support for at least 50 per cent of debt level appropriate? Would a higher percentage up to 100 per cent be more appropriate, and if so, why?

## Consultation Question

Q5 - Are the pre-auction financeability test requirements for evidencing commitments from debt providers appropriate?

## Consultation Question

Q6 - Do you agree with the proposal for the directors' certification in the pre-auction

financeability test that equity is available for the balance of funding? If not, please suggest alternative/additional ways of evidencing the availability of equity funding pre-auction (for example letters confirming a willingness to provide equity on a first refusal basis from the third party equity provider). Views are especially welcomed (where equity is to be corporately funded) as to the potential inclusion of a net worth statement (for example to the effect that the equity requirement will not exceed a defined percentage of a metric such as the enterprise value of the applicant or Group) and the appropriate level of any such test in order to help mitigate a potential gaming risk of directors inaccurately certifying that equity is available.

#### **Consultation Question**

Q7 - Do you agree that the pre-auction financeability test should be applied at the bidding confirmation point (10-15 working days before the auction) rather than as part of the prequalification application? If not, please explain your reasoning.

#### **Consultation Question**

Q8 - Should applicants/capacity providers have the flexibility to change the declared debt/equity ratio of their new build projects between their pre-auction declarations and their five month post-auction financing tests? Are there gaming risks associated with increased flexibility and how could these best be mitigated?

#### **Consultation Question**

Q9 - Should the financial commitment referenced in the five month post-auction financing tests refer to the project's financial closure?

#### **Consultation Question**

Q10 - Are the post-auction financing test requirements for evidencing commitments from debt providers appropriate? Would the submission of a summary term sheet (i.e. non-binding and subject to due diligence) with a prescribed set of headings, be preferable to the proposed debt-provider's declaration for the five month test?

#### **Consultation Question**



Q11 - Do you have views on what post-auction financing test requirements for evidencing availability of equity should consist of for project financed and balance sheet funded projects? Should a form of net worth test (as outlined in Q6) be re-applied at these post-auction stages? Would the submission of a summary term sheet (i.e. non-binding and subject to due diligence) with a prescribed set of headings, be preferable to the proposed approach for third-party equity declarations for the five month test?

#### **Consultation Question**

Q12 - Should the pass/fail status of a new build unit in the five and eleven month financing tests be published on the Capacity Market Register? Please explain your reasoning.

#### **Consultation Question**

Q13 - Do you agree with the proposal to focus increased credit cover, and an increased termination fee potential, on those new build projects unable to demonstrate committed finance in the post-auction financing tests? If not, please suggest alternatives.

#### **Consultation Question**

Q14 - Should the requirements for new build CMU to meet their financial commitment milestone be strengthened in light of the proposed post-auction financing tests? Should the requirement to have achieved financial closure be explicitly introduced into the financial commitment milestone?

#### **Consultation Question**

Q15 - Are there core milestones, additional to the existing four milestones, which are sufficiently generic to all new build projects which should be specified in the Rules to provide consistency between progress reports? If so, please provide details.

#### **Consultation Question**

Q16 - Are there any unintended consequences associated with the disqualification

proposals?

#### **Consultation Question**

Q17 - Should the disqualification proposals also apply in respect of new build agreements terminated for failing to provide increased credit cover?

#### **Consultation Question**

Q18 - Are the draft amendments pertaining to this chapter aligned with the policy proposals contained in this document? Are there any unintended consequences associated with the draft amendments?

#### **Consultation Question**

Q19 - Do you think the package of amendments detailed in this chapter effectively balances greater delivery assurance and incentives against the risk of imposing unnecessary or disproportionate additional burdens?

#### **Consultation Question**

Q20 - Are you aware of any class of participants for whom the Capacity Market incentives under the implemented design, when considered alongside their other incentives to deliver at times of system stress, could be considered insufficient to drive the desired behaviour? If so, please suggest how this could be addressed.

#### **Consultation Question**

Q21 - Do you agree with the recommendations and proposed Regulation and Rule amendments?

#### **Consultation Question**

Q22 - Do you agree that DSR CMUs should be able to nominate Satisfactory Performance Days ex-post (as with Generation)? If not, what other steps could be taken to ensure that providers are robustly demonstrating what they can realistically contribute during a system stress event.

### Consultation Question

Q23 - Are there are other areas of the Capacity Market regime that need amending to deal with secondary trading?

### Consultation Question

Q24 - Are there alternative ways to encourage participation, liquidity and competition in secondary trading?

### Consultation Question

Q25 - Do you agree that no Government intervention is required to facilitate a secondary financial trading market?

### Consultation Question

Q26 - Do you think the contents of the (publicly-visible) Capacity Market Register could be expanded to include other items of information which would be useful to those looking to undertake secondary trading? If so what extra detail should be included?

### Consultation Question

Q27 - Do you agree with the proposal for DECC to give notice to Ofgem on proposed changes to the Rules which would require approval by the Secretary of State?

### Consultation Question

Q28 - Do you have views on whether there is a continuing need for three year refurbishment agreements? If not, when would it be appropriate to withdraw this option? Please provide evidence, for example of any planned refurbishment programmes that would not take place without three year agreements (you may mark your reply as confidential if sensitive information is provided)

### Consultation Question

Q29 - How could the eligibility requirements and definitions be further defined? For

example, could the Government outline specific qualifying improvement programmes for each technology or identify what is deemed routine maintenance and therefore should not qualify?

#### **Consultation Question**

Q30 - Do you agree that Unproven DSR providers should not incur the loss of their credit cover and also a termination fee prior to the start of the delivery year?

#### **Consultation Question**

Q31 - Do you agree with the proposed approach to enable Prospective CMUs under 50MW with different legal owners to aggregate and that the individual CMU in the aggregated Prospective CMU can be sold, transferred or disposed of?

#### **Consultation Question**

Q32 - Do you agree that there is no robust basis for applying a price duration equivalence methodology not just for the next, but for any subsequent, auction? If not, please provide evidence.

#### **Consultation Question**

Q33 - Do you have any comments on any of the above payments and credit cover proposals?

#### **Consultation Question**

Q34 - Should the Government extend or make permanent the derogation which allowed appellants to provide additional information at a Tier 1 appeal?

#### **Consultation Question**

Q35 - Do you believe there is an issue with companies who have breached the Rules and have zero or little turnover? If so, do you feel that it requires addressing in the context of the Capacity Market specifically?

#### **Consultation Question**

Q36 - If this were to be addressed, would the preference be for a new section on enforcement to be inserted into the Capacity Market Rules, allowing Ofgem to impose a financial penalty?

**Consultation Question**

Q37 - Do you think the disadvantages of a financial guarantee of a fixed figure to offset any penalty outweigh the advantages?

**Consultation Question**

Q38 - Do you agree with extending the period of time in which the Secretary of State can decide to adjust any of the auction parameters to ten working days?

**Consultation Question**

Q39 - Do you have any evidence to suggest the current arrangements for eligibility as between the Capacity Market and other Government support schemes create any difficulties or uncertainty?

**Consultation Question**

Q40 - Which option do you favour and why? Are there other options which should be considered?

**Consultation Question**

Q41 - Do you believe applicants that enter via a CfD transfer notice, as described in option two, would have an advantage over other applicants in the CfD allocation process?

**Consultation Question**

Q42 - Which, if any, sanctions should be considered for applicants that enter the CfD allocation process via a CfD transfer notice and, for example, are awarded a CfD but do not subsequently sign, or fail to deliver, the project as required under the CfD terms?

### Consultation Question

Q43 - Do you agree that capacity providers found to have made false or misleading declarations should have their capacity agreements terminated, a termination fee of £25k/MW applied and be required to repay their capacity payments?

### Consultation Question

Q44 - Do you have any comments on the table of minor and technical changes?

### Consultation Question

Q45 - Is more clarity needed on the process and responsibility for determining the T-1 'set aside' amount at the point that T-4 auction parameters are announced? Do you have any views on the factors that should be considered to determine this in order to achieve the best balance of security of supply, market access, and value for money for bill payers?

### Consultation Question

Q46 - Does a T-1 auction held 12 months ahead of delivery represent an appropriate balance in terms of being able to access suitably accurate/up-to-date analysis of requirements whilst allowing a broad range of capacity to participate? Are there any arguments for allowing greater flexibility in the Regulations to run the T-1 auction earlier than this?

### Consultation Question

Q47 - Until an EU solution has been agreed, do you have any views on how Great Britain should approach cross-border participation with other Member States, in particular with Member States whose electricity grid is connected to GB?

© Crown copyright 2015

Department of Energy & Climate Change

3 Whitehall Place

London SW1A 2HD

[www.gov.uk/decc](http://www.gov.uk/decc)

