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CAPACITY MARKET SPECIFICATION: POLICY TEAM'S WORKING SYNTHESIS PAPER

Section 1: INTRODUCTION

1. The October 2013 consultation on proposals for implementation of the Electricity Market Reform (EMR)¹ included detailed proposals on the Capacity Market (CM). These outlined a consistent and complete specification for the Capacity Market so it effectively delivers its stated objectives: i.e. to enable the provision of adequate reliable capacity at minimum cost to consumers and in a way that minimises unintended consequences and risks and supports delivery of wider Government objectives.
2. We have been reviewing the proposed Capacity Market design during and after the consultation closed in December 2013 to ensure they meet these objectives while taking into account stakeholders' feedback from the consultation. We did so by engaging in a series of 'mini-projects' focusing specifically on cross-cutting policy aspects, in addition to identifying areas of the CM design which could be simplified. This further phase of policy development has been discussed and tested with stakeholders through the Capacity Market Expert Group (CMEG) and CMEG papers have been published online² for transparency.
3. The Government confirmed certain final aspects of the Capacity Market design on 19th March, subject to the will of Parliament and State aid approval.³ In light of this announcement and in response to stakeholders' requests for further urgent clarity on current policy development, this paper aims to provide an update of the work of the design team on finalising the Capacity Market design at the time of writing. This paper outlines both key changes and continuity with the October proposals. It includes proposals previously presented in CMEG papers and any further relevant updates where possible.
4. The formal Government response to the October 2013 Consultation will be published in late Spring, at the same time as secondary legislation is laid in Parliament. **This legislation will set out the full details of the Capacity Market design. Therefore, the proposals outlined in this paper (other than those confirmed on 19th March) do not represent a statement of Government policy or policy intent, and may be subject to change.**

Section 2: AMOUNT TO AUCTION

5. The Government confirmed in the EMR Delivery Plan published in December 2013⁴ that an enduring reliability standard will guide the quantum of capacity obligations to be let by the auction. The Delivery Plan confirmed that the **reliability standard** for Great Britain is a loss of load expectation of 3 hours per year.
6. The Secretary of State will determine an estimate of the **target capacity** needed to meet this reliability standard in each delivery year. This target will be divided into a four year ahead (T-4) target and one year ahead (T-1) target, with the T-1 estimate informed by the prospects for Demand Side Response (DSR).

¹ Link [here](#).

² Link [here](#).

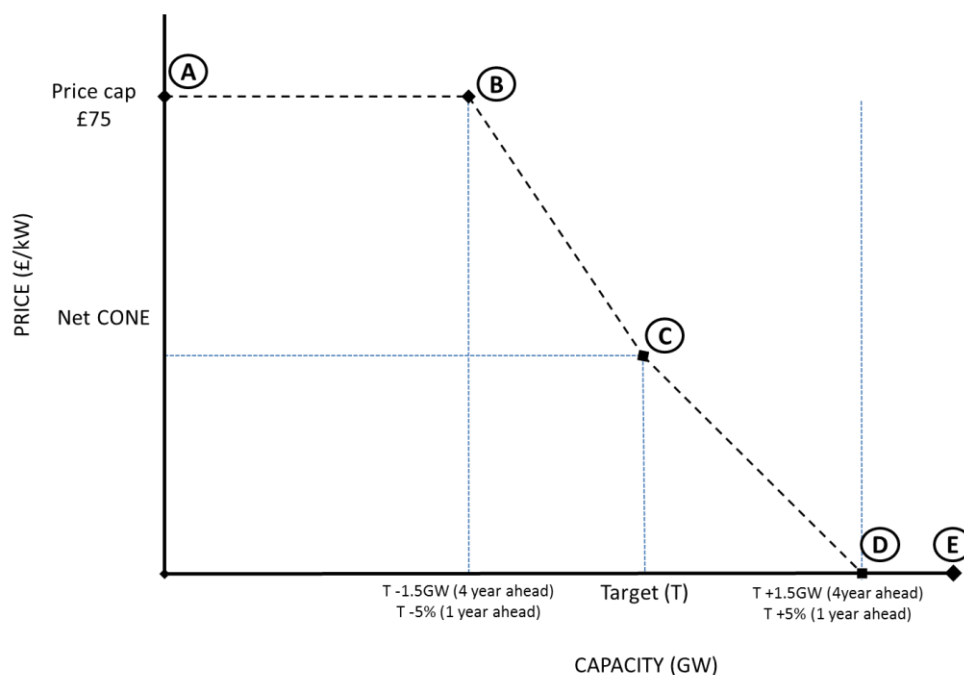
³ Link [here](#).

⁴ Link [here](#).

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7. This estimate will be based on independent analysis and advice from the System Operator in its role as EMR Delivery Body (DB) on the electricity supply and demand outlook over the period. The DB will consult stakeholders as part of the Future Energy Scenarios process. Further details of this process have been discussed at the Expert Group meeting on 24 January 2014.⁵ As announced through the DECC EMR Stakeholder Bulletin on 21st March 2014, an independent Panel of Technical Experts has been appointed to scrutinise the analysis carried out by the DB, including on the amount of capacity to contract.
8. Consumers' willingness-to-pay for reliability will be expressed by a demand curve which will be determined in advance of every capacity auction. The Secretary of State will determine an enduring methodology by which this curve will be prepared. This will enable the trade-off between cost and reliability to be automatically determined at the auction.
9. The **demand curve** for the first capacity auction will be a line passing through each of the following points, as shown in Figure 1:
 - Price cap of £75/kW at a capacity of 0GW (Point A in Fig. 1)
 - For the four-year ahead auction, the price cap (£75/kW) at a capacity 1.5GW less than target level. For the one year ahead auction, the price cap (not yet set) at a capacity 5% less than the target level. (B)
 - Net-CONE at the target level of capacity. (C)
 - For the four-year ahead auction, £0/kW at a capacity 1.5GW more than the target level. For the one-year ahead auction, £0/kW at a capacity 5% more than the target level. (D)
 - Where the price is zero, we would buy as much capacity as is available (E).

Figure 1: Illustrative capacity demand curve



⁵ See paper CMEG33.01.

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10. The Secretary of State will determine these parameters in advance of each auction and the DB will incorporate them in their publication to be known as Auction Guidelines.
11. As announced on 19th March 2014, we confirm the proposal set out in the October 2013 consultation document to administratively set **a price cap of £75/kW per year** for the December 2014 auction. A price cap is necessary to protect consumers from unforeseen design problems with the auction, such as a lack of competition or abuse of market power. This price cap has been calibrated to allow participation from a wider range of projects/technologies and enable competitive forces to clear the auction.
12. We propose to state the £75kW price cap at 2012 price levels and require bids for the December 2014 auction to reflect price levels in the base year (2012). The capacity price will then be adjusted to account for changes in the Consumer Price Index (CPI) to the start of each delivery year. This will apply to all capacity agreements, including those for existing plants with one-year capacity agreements and for refurbishing and new plants with longer-term capacity agreements.

Section 3: ELIGIBILITY AND PRE-QUALIFICATION

13. The Capacity Market is proposed to be technology-neutral where all types of capacity can participate. However, to avoid overcompensation, the October 2013 consultation document proposed **exclusion of low carbon capacity** where this is already in receipt of other forms of support.
14. We propose to retain the proposals set out in October as they avoid any risk of double payment. As proposed in a previous Expert Group paper⁶, applicants will be required to declare in their Capacity Market applications whether their CMU benefits from low carbon exclusion at the time of the application, and to acknowledge that the regulatory bodies will liaise in such a way as to satisfy themselves of the truthfulness of the declaration. Specifically, a system of random spot checks will be implemented and widely communicated as part of an agreed fraud prevention and audit strategy.
15. In addition, we also propose to exclude providers who hold long-term contracts to provide short-term operating reserve (LT STOR), unless they make an irrevocable declaration in their pre-qualification application to terminate their existing STOR contracts if successful in the capacity auction. The DB would make a similar commitment to accept such declarations, enabling the providers to leave their LT STOR contracts on a goodwill basis with no contractual penalties or prejudicial treatment in any future annual STOR round. This will provide LT STOR providers with the ability to either stay in their LT STOR contracts or enter the Capacity Market and potentially access future annual STOR contracts.
16. We propose that applicants will be able to nominate their own '**connection capacity**' in their pre-qualification application, to which the centrally determined de-rating factors are applied. They will be required to select from their Connection Entry Capacity (and distribution equivalent) or the mean of their three highest generation outputs demonstrated within the two previous calendar years.

⁶ See paper CMEG31.02 from 13 December 2013 CMEG meeting.

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17. With regards to the **dispute resolution process**, as discussed at the Expert Group meeting on 13 December 2013⁷, we have been considering changes to streamline the process. We therefore propose to:

- reduce the grounds of appeal to now only include: pre-qualification decisions, updates of the register, amendments to capacity agreement notices, and the issue of termination notices;
- not include a specific timeframe for Ofgem to resolve Tier 2 disputes. Instead, an indicative non-legally binding timeline will be set out by Ofgem in their forthcoming guidance. This will ensure participants have an understanding of the timeframe by which Ofgem will seek to determine Tier 2 disputes.

18. We have engaged with industry and agreed a definition of Capacity Market Unit.⁸

Section 4: AUCTION

19. The Capacity Market auctions will incorporate the following features:

- The auctions will follow a descending clock format with a pay-as-clear mechanism;
- The criteria by which the auctions will be run will be announced prior to each auction;
- Successful participants with existing capacity will be awarded one-year capacity agreements. Successful new/refurbishing plants will be allowed to access longer-term agreements.

20. As outlined in a previous Expert Group paper⁹, this corresponds to a 'fixed prices' auction format under which the Government does not set minimum or maximum targets for how much of each agreement length it seeks to buy. Capacity is procured on price-alone basis, so that only the least-cost capacity is selected, irrespective of the duration of the capacity agreements offered to successful participants.¹⁰

Price duration curves and multi-criteria auction

21. Under a fixed-prices auction format, the Government can set out the price spreads that define the difference in price for a given agreement length and which would render the Government indifferent between various agreement lengths and a single-year offer. We therefore propose to set **price spreads of zero for the 2014 auction**, so that capacity

⁷ See paper CMEG32.02.

⁸ Generating units (defined with reference to: providing electricity, being capable of independent control, net output measured by half hourly meter(s), capacity in excess of 2MW) may participate individually as a CMU or aggregate with other eligible generating units under the following conditions: (i) the units all form part of the same Trading Unit (i.e. power station); or (ii) where all the units are connected to the system at the same Boundary Point (BSC term) - i.e. the same site, but where the Trading Unit concept does not apply; or (iii) where the aggregate capacity of all the units is between the minimum (2MW) threshold and 50MW (effectively embedded generation spread across several sites; thresholds included to prevent aggregation of larger generation capacity across sites).

DSR CMUs are defined with reference to a commitment to reduce demand, by the DSR provider being (i) a DSR customer; (ii) owning the DSR customer; or (iii) having contractual DSR control over the DSR customer. Such commitment should cause the DSR customer to reduce the import of electricity (as measured by half hourly meters) and/or export electricity generated by on-site generating units which are owned by the DSR customer. In addition, each component should be connected to a half hourly meter and the provider's total DSR capacity should be between 2MW and 50MW.

⁹ See paper CMEG30.02 from 22 November 2013 CMEG meeting.

¹⁰ Except that in the event of a tiebreaker, where the shorter term would be selected.

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will be effectively selected on price basis only. However, the Government will take powers to set price duration curves in future auctions.

22. The capacity auction will be mechanistically run. We proposed in a previous Expert Group paper¹¹ that the first capacity auction should be allowed to run up to 4 days, with 4 rounds per day. This should ensure that the **price decrements** remain small (e.g. £5/kW) and that parties have more time to consider their bids in light of the outcome of the previous round. The decrements should be rounded and should be approximately equally sized. The price schedule will be announced prior to the auction as part of the Auction Guidelines published by the DB.

Auction cancellation and role of the Auction Monitor

23. We propose that plants which have successfully pre-qualified must confirm 10 business days prior to auction whether they are participating in the auction. They must also confirm whether they intend to participate as price makers or takers if they are existing plants (if price makers, they must also provide justification for why they need the higher price); and their choice of contract length if new/refurbishing plants. 2 business days later, the DB will send the Secretary of State the list of confirmed participants and their status.¹²
24. On the basis of this information and other information and circumstances, the Secretary of State will assess whether the auction is likely to be sufficiently liquid and competitive and will decide at his discretion whether the auction should be cancelled. If the Secretary of State does not act, then the auction proceeds.
25. The auction will be monitored by an **Auction Monitor**, who will assess whether the DB conducted the auction in accordance with the rules. The Auction Monitor will be appointed by the DB, but it will provide a report directly to the Secretary of State. After receiving the report, the Secretary of State will have to decide whether to annul the provisional results of the auction.

Other auction rules

26. We propose that the following information about participation in the auction is published:
- Following pre-qualification:
 - Which CMUs qualified for the auction and at what de-rating, and whether as existing, new or refurbishing plant – but not whether they qualified as price maker or taker;
 - Which CMUs have opted out and how much capacity will be deducted from the demand curve;
 - Which CMUs said they will be retiring / unavailable (and so not had their capacity deducted from the demand curve).
 - During the auction:
 - How much spare capacity there is at the conclusion of each auction round (rounded to the level set out in the Auction Guidelines).
 - After the auction:
 - How much spare capacity there was in each round (unrounded) – but not the price at which individual units exited;

¹¹ See paper CMEG34.01 from 7 February 2014 CMEG meeting.

¹² This list will also be published, though omitting whether existing plants are participating as price makers or takers.

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- Which CMUs received contracts and at what de-rating/contract length.

27. As outlined in a previous Expert Group paper¹³, we propose to remove previous requirements for companies to restrict information about bidding strategy so as to limit opportunities for dissemination of insider information ('Chinese walls').

28. The Secretary of State will determine a **price-taker/price-maker threshold** for every auction (based on Net CONE). Existing resources will default to price taker status unless a memorandum is lodged with Law Debenture justifying the need for price-maker status. New resources and DSR will default to price-maker status.

Length of capacity agreements

29. If successful at the auction, an existing generation unit or a DSR unit will be awarded a one-year capacity agreement at the clearing price. Longer-term contracts will be available for refurbishing plants and prospective generators (including storage). It is proposed to set the thresholds for qualifying as refurbishing/new plants at the levels set out in the October consultation document, and clarify that they are based on de-rated capacity.

30. As confirmed on 19th March, new plants will be able to access **capacity agreements of up to a maximum of 15 years**. This will allow investors to spread the capital costs over a longer period, providing greater revenue certainty and enabling lower bids in the auction. It should also enable a more efficient debt structure to be put in place and allow refinancing within the agreement term which again should result in lower prices and wider participation. We continue to propose that plants undertaking significant refurbishment will be able to access **capacity agreements of up to a maximum of 3 years**.

Grandfathering of key terms

31. During the consultation process, stakeholders highlighted concerns about the absence of change-in-law protection. We therefore proposed in a previous Expert Group paper¹⁴ that the key terms of a capacity agreement would be '**grandfathered**' (i.e. set out in the Electricity Capacity Regulations) so that they would endure for the duration of any capacity agreement.

32. These key terms are:

- agreement length;
- capacity price and entitlement to payment (still subject to the principles of the payment model);
- capacity obligation and de-rating figure;
- completion milestones and termination fees applicable;
- maximum liability for penalties: i.e. monthly and annual caps (while penalty rates may change).

Section 5: SECONDARY TRADING

33. Capacity obligations, which are dynamic (i.e. 'load following'), are originated at auction and purposefully: (a) 'stapled' to homogenous physically verified resources; and (b)

¹³ See paper CMEG34.01 from 7 February 2014 CMEG meeting.

¹⁴ See paper CMEG35.02 from 12 February 2014 CMEG meeting.

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optimally configured for peak conditions. At other than peak times, where there will exist by definition a surplus of capacity, it is economically sensible – and systemically important – to enable capacity providers to self re-configure the set of capacity obligations **provided that the same quantity and quality of physical performance can be assured**. This in turn would enable capacity providers, who are also participants in the energy market, to arrange their commercial affairs in such a manner as to preserve the commitment and dispatch order that would ordinarily obtain absent the Capacity Market.

34. Moreover, from the capacity provider's perspective such a re-configuration is an important risk management device.

35. The rules and processes to enable this have been variously referred to as 'secondary trading' or 'secondary market' over the course of the CM policy development.

36. The Government's has a vital interest in enabling this 'secondary market' by creating the necessary conditions, removing barriers and fostering liquidity. We confirm that the Government will not intervene (nor has it the legal powers) to establish an organised secondary market. This is a matter for participants to organise privately, if they find this convenient. Nonetheless, we are mindful that certain prospects (particularly non established smaller enterprises) have stated their wariness (particularly in light of a similar issue which arose in Ofgem's Retail Market Review). We will keep this area under review.

Table 1: Capacity Market Secondary Trading Arrangements

	Financial Trading	Volume Reallocation	Obligation Trading
Eligibility	Parties can treat with whomever they choose (e.g. each other or insurers)	Parties can reallocate excess output to another CMU	Parties can only move obligations to pre-qualified resources to the limit of their de-rated capacity and which do not have obligations (i.e. empty vessels).
Payment for holding capacity obligation	Unaffected	Unaffected	Payment goes directly to whoever holds the obligation.
Timing	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.
Size of trading blocks	As privately negotiated.	No restrictions on size, reallocation made on settlement basis (half hourly)	Same de minimis threshold as prequalification criteria, minimum trading blocks of a calendar day.
Example agreement:			
Purpose to transfer risk from B to A	For a fixed fee, A agrees to pay B an amount if B becomes liable for a penalty		B transfers the capacity obligation to A. B has no obligation. A has the same obligation B once held
B fails; A performs	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 is paid for its performance.
A and B fail	B is penalised. A is not paid for over-delivery (in the ordinary course). B receives a private payment from A.	A has no excess output to reallocate, so B is penalised. A will have to privately compensate B.	B has no obligation. A is penalised.

37. Accordingly, we have reviewed the proposals for 'secondary trading' and discussed it with Expert Group members and the new proposals reflect feedback from stakeholders

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during the consultation process.¹⁵ As a result, we anticipate three forms of secondary trading, whose main characteristics and differences are set out below and summarised in Table 1.

- **Financial trading** (mentioned for completeness): this is financial engineering undertaken by the capacity provider and entirely private and confidential. It could be between capacity provider(s) or with a wider group of interested parties;
- **Obligation Trading**: where capacity obligations can be transferred from the original CMU to another resource subject to consent; and
- **Volume reallocation**.

38. The 7th February Expert Group paper also included a proposal to enable over-delivery and penalty rates to be inversely related, meaning that any revenue shortfall at the end of the year could be accrued (for subsequent recovery) or a surplus refunded. Such a proposal would have been most beneficial to contributing to the prospects for financial trading. However, this will not be possible to implement within the rules for public finance management for the time being but may be possible in subsequent years. Therefore, the over-delivery rate (and hence payments) can and will be only calculated and paid out at the end of the year, so that they equal the totality of penalty revenues received.

Section 6: DELIVERY

39. Each delivery year will run from 1 October to 30 September as set out in the October 2013 consultation.

Penalty regime

40. Capacity providers will receive steady capacity payments in return for their promise to deliver energy at times of system stress. They will face penalties proportional to any deficit and over-delivery rewards for surplus. This ensures value-for-money for consumers, is consistent with market practices whereby undertakings receive payments if they deliver the product or service they have committed to provide, and it is required by EU State aid rules which prohibit undertakings from obtaining windfall profits as a result of the aid measure.

41. Feedback from stakeholders during the consultation process highlighted that the design and calibration of the penalty regime set out in the October 2013 consultation document risked imposing an excessive burden on capacity providers and in particular on independent generators that rely on project finance (as they require the certainty of sufficiently ring-fenced revenues to raise debt and make the project viable).

42. We reviewed the design of the Capacity Market penalty and testing regimes to ensure they deliver the objectives they are intended to serve without creating unmanageable risks which could discourage wide participation. We presented various options under consideration at the Expert Group meeting on 12th February.¹⁶

43. As confirmed on 19th March, the revised penalty regime will have the following features:

- Penalties will be capped at 200% of a provider's monthly capacity revenues. This means that, given the weighting of monthly payments according to system demand,

¹⁵ See paper CMEG34.02 from 7 February 2014 CMEG meeting.

¹⁶ See paper CMEG35.01.

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providers *may* be exposed to a penalty liability of up to 20% of their annual revenue in any one month.

- Penalties will be also subject to an overarching annual cap of 100% of annual revenues.

44. We also propose that:

- The penalty rate will be set at 1/24th of the annual capacity payments received by an individual provider. Under this approach all providers failing to deliver their obligations would reach their monthly caps in circa four hours (depending on the profiling of the month's revenue) – irrespective of their auction vintage and clearing price. Whilst providers of different auction vintages may be exposed to different per MWh incentives in any specific settlement period, they will have the same proportional exposure relative to their annual payments and monthly cap. This is likely to make it easier for the market to engage in secondary trading.
- We will be retaining the definition of system stress events from the current demand control instructions/load shedding focus, as previously proposed (i.e. not expanding the definition as discussed at the 12th February Expert Group meeting).
- The revised penalty regime will be complemented by a strengthened testing regime to ensure capacity providers have sufficient incentives to deliver.

45. In addition, we propose to retain the proposals set out in the October 2013 consultation document with regards to force majeure and maintenance windows, and to remove proposals (i) allowing applicants to select a de-rating figure from within a range published by the DB (as this was originally proposed to enable applicants to determine their risk exposure in the context of annual penalty caps); (ii) applying a penalty cap at portfolio level; (iii) imposing any capacity obligations, and therefore penalty liabilities, in the four hour period following the publication of a capacity warning.

46. As discussed at the Expert Group meetings on 13th December 2013¹⁷ and 12th February 2014, we also propose amendments to the algebra of the Balancing Service Contract Capacity Credit which gives effect to the agreed principle that resources can simultaneously participate in the Capacity Market and provide Balancing Services and that an exception should be granted to resources that are unable to perform due to a deficiency in the transmission system. These changes will avoid double counting in the determination in the CM obligations and will better take into account instructions issued by the DB.

Testing regime

47. To complement changes to the penalty regime, we propose to strengthen the testing regime. We propose to require generators to nominate (*ex-post*) any three settlement periods, across separate days, in which they have delivered at least their de-rating figure over the winter peak period (October to April). DSR providers will have to nominate a maximum of six periods in advance, in which they must demonstrate a prescribed demand reduction on three occasions unless they are using performance in a Capacity Market stress event to demonstrate delivery.

48. Providers unable to nominate three periods where they have demonstrated their capacity by the end of April forfeit their payments until they can demonstrate their capacity on three occasions of their selection after this point. Providers would forfeit a minimum of

¹⁷ See paper CMEG31.03 from 13 December 2013 CMEG meeting. An oral update was given on 7 February 2014.

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one month's payment, irrespective of when their third demonstration occurred. Obligations would be discharged by the provider retrospectively nominating settlement periods in which they have performed to the requisite level, rather than being spot tested by the DB.

49. Those providers which have not demonstrated capacity by the end of the year will be required to repay all net capacity revenues received across the year, and their payments will be forfeited in the following delivery year until they demonstrate their capacity as above.
50. In addition, providers completely failing to deliver during the course of stress events in two months or more will have their testing requirements doubled as a consequence. This would mean that those failing to deliver in two month's stress events and on six occasions over winter would forfeit their payments until they could demonstrate six times over the summer. Those failing to achieve the six occasions will have to repay net payments received over the year.

Additional rules for refurbishing and new plants

51. Prospective generators are subject to a series of additional checks and incentives aimed at demonstrating their commitment to delivering in the relevant delivery year. In recognition of the fact that prospective plants will have already incurred sizeable development and consenting costs to get to the stage where they can demonstrate such requirements, we presented various options to simplify these requirements at the Expert Group meeting on 7 February 2014.¹⁸

52. We now propose the following:

Parameter	Proposed requirements
Financial commitment milestone	18 months after the auction, prospective units would need to demonstrate: (i) that they have spent at least 10% of the total project costs (independently verified); <u>or</u> (ii) relevant project commitments - such as Board commitment to undertake project and financial close, Director's certificate of sufficient financial resources and contractual robustness – with supporting evidence, evidence of an engineering, procurement and construction (EPC) contract or of an agreement to supply major components representing at least 20% of total project costs, again independently verified.
Substantial completion milestone ('long stop date')	Any new capacity failing to have operational at least 50% of the amount specified in its capacity agreement by 12 months after the start of the first delivery year will have a six month cure period applied before its obligation is terminated, and be subject to a termination fee.
Termination fee	A termination fee (rate to be determined) will apply for failing to meet the financial commitment milestone and for failing the long-stop date milestone of [£15/kW] for TF1 and £25/kW for TF2.

¹⁸ See paper CMEG34.03 from 7 February 2014 CMEG meeting.

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53. Refurbishing plants will not be required to have completed their refurbishment two years after the relevant auction, as proposed in the October consultation document, but will be required to complete the works by the beginning of the delivery year. Implications of failing will remain as per the October consultation document: i.e. their capacity agreement term will be reduced to one year; they will have their de-rated capacity for the delivery year adjusted to their pre-refurbishment level, and they will be restricted to bidding for annual capacity agreements for the following two years.
54. The October 2013 consultation document set out that the Secretary of State has a 60 business day discretionary period for deciding whether to direct the withdrawal of a capacity agreement. It is proposed to expand this provision to enable the Secretary of State to temporarily extend this period by a further 60 business days.

Section 7: PAYMENT

55. In a previous Expert Group paper¹⁹, we proposed to change the October proposals in a charging methodology under which supplier charges are based on suppliers' forecast market share over longer periods of higher demand. We believe this takes account of suppliers' principle concerns around the variability of a peak-charge approach without losing the demand reduction incentive. In summary:

- Suppliers forecast their demand over the period 4pm-7pm on all weekdays from the start of November to the end of February (the period from which the Triad periods are taken) by three months before the capacity year;
- Supplier charges are determined based on their forecast market share and monthly charges are levied; and
- Charges are updated to reflect actual data after it becomes available.

Section 8: CAPACITY MARKET INSTITUTIONAL FRAMEWORK

56. Following concerns raised by stakeholders on the need for greater clarity as to the governance process under the Capacity Market Regulations and Rules, we propose to spell out a set of objectives within the Capacity Market Regulations governing future rule change by Ofgem. The objectives aim to provide reassurance to participants that the underlying principles of the Capacity Market will be preserved even if details of the design and functioning of the Capacity Market evolve over time.
57. In particular, we propose that, when considering changes to the Capacity Market Rules, Ofgem must have, in addition to its principal objectives and general duties, regard to the following objectives:
- Promote investment in capacity to ensure security of electricity supply;
 - Facilitate the efficient operation of the Capacity Market and implementation of the Capacity Market Rules by administrative parties;
 - Ensure the compatibility of the Capacity Market Rules with EMR legislation.

Section 9: DSR PARTICIPATION IN CM AND TRANSITIONAL ARRANGEMENTS

58. Demand Side Response (DSR) has the potential to offer capacity that is reliable and provide an effective alternative to investing in generation infrastructure. This is why participation of DSR is an important feature of the Capacity Market.

¹⁹ See paper CMEG33.03 from 24 January 2014 CMEG meeting.

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59. Overall, during the consultation, stakeholders expressed positive feedback with regards to the DSR policy design. However, some adjustments have been made to the DSR Transitional Arrangements (TA) and the Capacity Market enduring regime to simplify and align processes. Some of these proposals have been discussed at the Expert Group meeting on 24th January 2014.²⁰ In brief, they include:

- Changing the design of the TA time banded and load following²¹ sub-auctions to procure both products in one auction;
- Aligning the TA and CM in year testing requirements;
- Introducing a maximum size for an aggregated CMU of 50MW and removed the size limit on CMU components.
- Splitting the verification checks into two stages: capacity output and metering set up;
- Proportionate return of bid bond if proven capacity is 90% or above the capacity obligation;
- Adjustments to the baseline methodology for DSR.²²

60. Subsequent changes to the Capacity Market penalty regime have aligned it more closely to the intended Transitional Arrangements penalty regime. As a result, the TA and the CM now have the same penalty regime.

61. In addition, we propose to simplify credit cover requirements for DSR by reducing the number of acceptable types of credit cover set out in the October 2013 consultation document to the following two: cash and letters of credit. This will also continue to be the case for collateral posted by prospective generators.

Section 10: UPDATE ON PROPOSALS TO ALLOW INTERCONNECTED CAPACITY TO PARTICIPATE IN THE CM

62. As outlined in the October 2013 consultation document, interconnected capacity will not be able to participate in the 2014 capacity auction. However, it is a strategic objective of the Government to support investment in interconnection whilst ensuring value for money for consumers. The Government acknowledges the benefits that interconnected capacity can provide in relation to security of supply and notes the importance of recognising this value through the Capacity Market. For this reason, we are working to develop a detailed policy solution which would allow participation of interconnected capacity in the Capacity Market for subsequent capacity auctions from 2015.

63. In finding a solution to this issue, we are looking at all policy options. We recognise that equal treatment of interconnected capacity may not necessarily mean the same treatment as GB capacity providers, and any solution will need to preserve the integrity of the internal energy market, respect the EU Target Model and accommodate the new Market and Network Codes. It will also need to take into account the extent to which the UK can rely on interconnected capacity to deliver energy during a stress event and finally, the need to ensure value for money for GB consumers.

64. We are doing additional policy thinking to develop final proposals and amend the Capacity Market secondary legislation accordingly, in time for interconnected capacity to

²⁰ See paper CMEG33.02.

²¹ Time banded product: Providers are only obliged to respond to stress events over winter daily peak times. Load following product: Providers are obliged to respond to stress events throughout the delivery year as they would in the CM.

²² Please note that there will be terminology changes in the updated Regulations and Rules, such that for example the 'Customer Demand Response (CDR)' term is now defined as 'DSR'.

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participate in the 2015 capacity auction. Detailed policy proposals will be discussed with the Expert Group in due course. In addition to this, we continue to engage with a wider range of stakeholders and welcome all contributions.

65. It is also important to note that Ofgem is progressing work on the regulatory framework for new electricity interconnection through a cap and floor model in relation to the proposed Nemo interconnector and through the Integrated Transmission Planning and Regulation (ITPR) project. Depending on the outcome of this work, it is possible that there could be interaction between a future GB regulatory framework for interconnection and a policy design to enable interconnected capacity to participate in the Capacity Market. We are working with Ofgem to consider the issues associated with any such interaction and, should they arise, Ofgem will aim to discuss them in future publications.

66. The timeline of the work programme we have defined to enable participation in the Capacity Market is as follows:

- Consultancy work: Started Q1 2014
- Develop detailed policy proposal: Q2 2014
- Public consultation on proposals: Q3 2014
- Secondary legislation laid in Parliament and final approval: Q1 2015.

Section 11: NEXT STEPS

67. This paper presents a synthesis of the Capacity Market design at the time of writing. We seek feedback from the Expert Group on the consistency and completeness of these proposals.

68. The Government will hold page turning sessions with industry on the updated Electricity Capacity Regulations and Capacity Market Rules on the 9, 10 and 11 April. **The intention of these sessions is to focus on the drafting of the Regulations and Rules and not to discuss policy which underpins the Regulations and Rules.** As space is limited and to ensure representation from across industry, we will reserve places on a first come first served basis and, if the need arises, we will also limit the number of people attending from the same organisation. Invites have been already circulated widely, but if you would like to attend please email: will.lochhead@decc.gsi.gov.uk.

69. Full details of the Government's response to the October 2013 consultation will be published in late Spring, as secondary legislation is put before Parliament.