

Consultation response:

Proposals for technical amendments to the Capacity Market

10 January 2019

EXECUTIVE SUMMARY

Meeting the UK's climate and energy market obligations while maintaining security of supply requires a **cohesive and evidence-based policy approach**, which takes account of **technological and market developments**. The Capacity Market (**CM**) must not undermine the UK's **coal phase-out** and other emissions reduction objectives, place less environmentally harmful technologies at a **competitive disadvantage**, or otherwise prohibit the disruptive innovation and investment needed for a flexible and low-emissions energy system.

We are surprised that the Government intends to continue to operate parts of the CM during the standstill period, pending a formal Phase II State aid investigation into the CM by the European Commission (**EC**). The Government **has not provided sufficient information** for interested parties to properly assess the commercial, legal and policy implications of its proposals. In particular, further detail is needed in respect of:

- The proposed course of action in the event that the **EC does not approve the CM**, or only approves the scheme on a **conditional basis**, which requires amendments to the policy design. How does the Government intend to **compensate capacity providers for their time and resource** without breaching State aid rules? Or is the intention that such parties would **not be compensated** in those circumstances? There is also uncertainty over how agreements will be **enforced**.
- The **reassurance from the EC** about the nature and outcome of the formal investigation, which is alluded to in the consultation paper.
- The constitutional and procedural implications of the proposed measures, including **compatibility with State aid rules** and the need to comply with **domestic requirements**, such as proper **consultation procedure**, the provision of a full **Impact Assessment** and **appropriate Parliamentary scrutiny**.

Given these uncertainties, and the need to provide an enduring and robust solution which promotes decarbonisation and competition: **We recommend that the Government use the existing CM Statutory Review process to urgently reconsider whether a CM continues to be justified. Any CM that remains in place must be genuinely technology neutral and non-discriminatory.** It is imperative that the Government show leadership and initiative to attract clean-tech innovators and investors and to provide a **secure, decarbonised and efficient energy system**. Failure to do this will expose the UK to further **uncertainty, cost, environmental harm** and possible future **litigation**.

BACKGROUND AND GUIDING PRINCIPLES

1. ClientEarth is a leading non-governmental public interest environmental law organisation based in London, with offices in a number of global cities, including Brussels, Berlin, Madrid and Warsaw. Within the UK, our work focuses on topics including securing a just transition to a low-carbon energy sector, reducing emissions from greenhouse gases and protecting the rights of all to breathe clean air. In particular, we have considerable expertise on matters of State aid, energy and EU law.
2. Security of electricity supply is of course an essential part of safeguarding the economic and wider public interest. However, achieving a just transition in the energy system means that security of supply at any cost to the consumer and to the environment is no longer an option. It is essential that resource adequacy measures are only introduced if they are genuinely needed to address an unavoidable market failure. To the extent that intervention *is* necessary, such measures must not undermine the UK's coal phase-out and other emissions reduction objectives, place less environmentally harmful technologies at a competitive disadvantage, or otherwise prohibit the disruptive innovation and associated investment needed to build the flexible, zero-carbon, smart energy system of the future.
3. In our February 2017 response to the Government's consultation paper "*Coal generation in Great Britain: The pathway to a low-carbon future*"¹ (the **Coal Phase-out Response**), we welcomed the Government's commitment to managing a coal phase-out by the introduction of an EPS. We also called for a genuinely technology-neutral EPS, with a stricter emissions threshold than 450g/kWh, and an earlier implementation date of 2023. We emphasised the need to ensure that retiring coal capacity is not replaced by investment in large-scale gas and biomass plants. Converting coal plants to burn biomass is not a sustainable solution and emissions from burning biomass are not properly accounted for under the current carbon accounting mechanisms. These principles apply equally to our assessment of the CM.
4. It is imperative that the CM operates in the context of a coherent policy framework. If regulatory schemes are not joined up, we risk penalising coal and other polluters with one hand only to reward them with the other. This would undermine both the UK's environmental and security of supply objectives, while making energy consumers pay twice. In our Coal Phase-out Response, we proposed making EPS compliance a pre-requisite for CM entry (or preventing coal operators from bidding at all), at least in relation to the T-4 auctions for delivery from 2022-2023.
5. In October 2017 we also proposed a CM rule change to Ofgem, which would have required that, where a generating unit is covered by the Large Combustion Plant Best Available Techniques reference document (the **LCP BREF**), it could only bid for a capacity agreement under the CM if it held a permit stating that it would comply with the best available

¹ <https://www.documents.clientearth.org/wp-content/uploads/library/2017-02-08-coal-generation-in-great->

techniques in relation to emissions and energy efficiency set out in the most recent LCP BREF.

6. The intention behind these proposals was to ensure that the CM design does not compromise the effectiveness of the EPS or prevent the UK from meeting its legally binding duties under the Paris Agreement, Climate Change Act 2008 and the Industrial Emissions Directive. Our Coal Phase-out Response included a detailed assessment of the UK's national and international legal obligations to bring an end to coal (and other fossil fuels).
7. In our October 2018 response to the Government's Capacity Market Review Call for Evidence (the **CM Review Response**), we further recommended that the CM Statutory Review should include an **independent and updated resource adequacy assessment**. Following the November 2018 ruling of the General Court of the EU's judgment in Case T-793/14 Tempus Energy Ltd and Tempus Energy Technology Ltd v European Commission (the **Tempus case**), the European Commission will now be required to undertake a thorough assessment of current UK security of supply risk, as part of its formal Phase II investigation into compatibility of the CM with State aid rules.
8. In our CM Review Response, we noted that current CM Reliability Standard implies that National Grid should use its out-of-market measures to balance supply and demand for three hours each year on average (assessed over a period of many years). In its 2017 State of the Market Report², Ofgem stated that National Grid has in fact carried out around 12 hours of out-of-market actions in total since 2005, about one hour each year on average, not three. Ofgem concluded that *"[g]iven that out-of-market actions have typically been less than expected in the reliability standard, this suggests a risk that security has been maintained at a higher cost to the consumer than necessary"*.
9. Ofgem's 2017 report also highlighted that the risk of loss of load does not maintain constant, but varies across settlement periods. There is recent National Grid data available to estimate the risk of a loss of load for each half-hour settlement period across the year. This provides another way of measuring outcomes against the reliability standard. For example, in 2016-17 there were 437 hours when the risk of a loss of load was above zero but less than 10%, and 1.5 hours when the risk was between 20% and 30%. This suggests that the cumulative expectation of a loss of load across the year was around 45 minutes, a quarter of the reliability standard currently used by the Government. In addition, Ofgem reported that capacity margins are consistently less tight than forecast by National Grid. The margin between peak demand and available supply has generally been falling since 2010. In other words, National Grid has consistently overestimated the capacity gap, if it exists³.
10. Since we submitted our CM Review response, Ofgem has published its 2018 State of the Market Report⁴. The 2018 report stated that for winter 2017/18, National Grid procured more

² https://www.ofgem.gov.uk/system/files/docs/2017/10/state_of_the_market_report_2017_web_1.pdf

³ See page 99 of Ofgem's 2017 State of the Market Report

⁴ https://www.ofgem.gov.uk/system/files/docs/2018/10/state_of_the_energy_market_report_2018.pdf

than its target capacity amount (54.4 GW compared to the target of 53.6 GW). The explanation for this offered by Ofgem was that “*capacity levels come in indivisible quantities (i.e. you can’t procure 1/5 of a power station for example), making it difficult to buy the exact amount, and also because the auction price was significantly lower than anticipated*”. The Loss of Load Expectation for winter 2017/18 was 0.01 hours. This is, once again, substantially below the three-hour reliability standard. Ofgem commented that, as with previous years, this “*indicates that there may have been a risk that security of supply has been maintained at a higher cost to the consumer than necessary*”⁵.

11. The 2018 report also flagged that National Grid’s forecasts of transmission demand have been consistently above out-turns since 2011 by an average of around 1.5GW each year. In respect of this, Ofgem concluded that:

*“[W]hilst it can be considered prudent for the System Operator to take a conservative approach to forecasting demand, this needs to be balanced against the costs of procuring additional capacity. Over the past year National Grid has made a number of changes to its demand forecasting process, which overall resulted in reductions to its view of underlying demand.”*⁶

12. As part of its formal investigation into the CM, the EC will examine the latest data relating to demand forecasting and supply margins, which has become available since the CM was originally notified in 2014. It will also assess the extent to which increases in wholesale electricity prices since the standstill period was imposed on the CM could bring forward capacity in the energy-only market.
13. In addition to market developments that have taken place since 2014, the EC investigation will need to take into account subsequent regulatory changes (for example cash out reform), as well as the increased contribution of interconnection and the growth of low-carbon capacity resources such as DSR, storage and renewable generation. These developments are covered in more detail in our CM Review Response.
14. The CM Review Response also recommended various **substantive amendments to the Capacity Market policy design**, to be made in the event that a CM scheme does continue to be justified following a resource adequacy assessment. Our recommended amendments are summarised in the final section of this response.
15. In addition to coherence with environmental and climate governance, the CM must be designed and continue to operate in a manner that does not undermine energy markets regulation or competition law. This includes the Energy Act 2013, Electricity Act 1989, Competition Act 1998 and Utilities Act 2000. Domestic powers must be exercised only in accordance with their proper purpose, as intended by Parliament at the time of approving the relevant provisions. At the EU level, the Third Energy Package and new Clean Energy Package, Renewables Directive, Energy Efficiency Directive and EU State aid rules apply.

⁵ See page 105 of Ofgem’s 2018 State of the Market Report.

⁶ See page 105 of Ofgem’s 2018 State of the Market Report.

16. In order to bring forward the investment in nascent technologies required to achieve an affordable, clean and secure energy system (as it becomes increasingly electrified), the UK needs a liquid and fully unbundled energy-only market, with transparent wholesale pricing and clear price signals to promote efficiency on both the supply and demand-side.
17. A predominantly renewable, intermittent supply-side can only be achieved by building out a smart and flexible demand-side. This will require the continued growth of “true” turn-down DSR smart meters and appliances, electricity storage and Distributed Energy Resources (DERs). It will also require fully independent distribution grid operators, which are incentivised to innovate and to encourage localised trading and balancing solutions. In the future, this might include the use of disruptive technologies such as blockchain or other distributed ledgers, to ensure secure and verifiable transactions without the need for expensive, centralised institutions. Consumers and “prosumers” must be empowered to become active market participants. Third parties can facilitate this, but end users must be given direct access to wholesale, balancing and ancillary markets, not limited to interacting with markets only via a licensed electricity supplier (especially in the current vertically integrated and illiquid market conditions).
18. Market intervention should only be resorted to where all alternative options have been thoroughly and openly investigated by an independent authority, taking into account the need for standardisation of methodologies and regional assessments where interconnected markets are making parallel assessments.
19. Capacity mechanisms should only be introduced to the extent that there is an authentic and persisting resource adequacy problem, with a built-in strategy for closing the scheme if this ceases to be the case. Capacity agreements should be awarded on a genuinely technology neutral basis, which means that the scheme must be open to new market entrants in practice, not just on paper. Any competitive auctions must therefore be accessible, non-discriminatory and transparent, with the exception of restrictions necessary to ensure consistency with EPS and other environmental standards (see above). Agreement lengths should be set at an appropriate level to incentivise behavioural shifts, enable investment decisions and promote the development of new business models. However, long-term agreements granted to conventional generation capacity providers can undermine the clean energy transition and should therefore be avoided.
20. The above recommendations, principles and context guide our response to the consultation.

RESPONSE TO MATTERS RAISED IN CONSULTATION

Approach to responding and summary of proposals

21. We note that most of the questions posed in the consultation are of a technical nature and refer to the steps required to implement the proposed changes to CM regulations.

22. However, the majority of our comments are broader points relating to the substantive policy decisions themselves; focusing on questions of certainty, proper process and legality. These concerns apply across the proposals. **Therefore, we have framed our response in order to prioritise the matters that we consider demand most urgent attention and to avoid unnecessary repetition.**

23. Our interpretation of the consultation is that the Government proposes to:

- Run the cancelled T-1 auction (that was originally scheduled for January 2019) in the summer of 2019 instead, for delivery winter 2019/20, based on the pre-qualification process that has already taken place;
- Decouple the auction results from the awarding of CM agreements. Instead the successful bidders will receive a right to be granted a CM agreement, but only in the event that State aid is approved and the scheme is "reinstated";
- Continue to "enforce" existing CM agreements in the meantime, with the promise of making deferred payments to CM providers if the scheme is approved. The consultation paper and EMR Deliver Body Guidance⁷ suggest that failure to comply with CM agreement obligations, including the obligation to make capacity available during a stress event, will result in agreement holders incurring penalty charges. However, collection of these charges will be postponed until such time as the scheme receives State aid approval. The same arrangement will apply to termination fees;
- Make various amendments to milestone commitments and credit cover requirements to account for the reduced lead-time and uncertainty. Agreements holders may request to have credit cover returned during the standstill period but must re-lodge credit cover as soon as the standstill is lifted;
- Allow electricity suppliers to continue to collect money from customers under the Supplier Obligation as usual.

24. **We would be grateful for clarification in the event that the above description does not represent an accurate reflection of your intentions.**

Factual and legal questions arising from the proposals

25. It is essential that investors, capacity providers and customers fully understand that the EC will be considering the compatibility of not only the forward-looking aspects of the re-notified CM scheme, but also of the scheme as implemented to date (i.e. prior to the judgment in the Tempus case).

⁷<https://www.emrdeliverybody.com/Prequalification/Advice%20for%20capacity%20agreement%20holders%20and%20capacity%20market%20applicants%20v2.0.pdf>

26. As explained in the previous section, there is no guarantee that the EC will conclude that a capacity mechanism is necessary to meet the UK's security of supply needs at all, let alone the CM in its current form.
27. The Government's policy proposals must make provision for all possible eventualities. This includes the possibility that the EC might conclude that the scheme as implemented to date is not compatible, or only partially compatible, with the internal market. It must also include the possibility that existing CM agreements are rendered null and void.
28. **The consultation paper does not consider the full range of factual and legal possibilities, and certainly does not explain the Government's intended actions in relation to those possibilities.**

Factual omissions in the proposals

29. We are keen to understand what the Government considers the implications of a partial or conditional State aid approval (following the Phase II investigation) to be, for the following parties:
- **Existing capacity agreement holders** including those being called upon to make capacity available and to meet other requirements during the standstill period. We understand that the Government intends to enforce the CM agreements by allowing penalties to continue to be incurred (albeit not collected) during the standstill period. Presumably agreement holders will be expected to make capacity available in the absence of any guarantee of remuneration, as there will be no certainty over the State aid outcome at the time of requiring action? How could these parties be compensated for their actions in the event that the scheme is not approved in its current form, without the UK being in breach of State aid rules? Will penalties and termination charges be waived in the event that State aid approval is not granted?
 - **Successful bidders in the proposed replacement 'top up' T-1 auction**, to the extent that they are granted rights and expected to meet obligations, which are based on elements of the policy design later rendered incompatible by the EC's decision. Would those rights and obligations only materialise in the event of full State aid approval? The consultation does not explicitly address the possibility of bidders committing resource and time for nothing, which would only undermine investor confidence further. Would such a situation not also unfairly favour existing generators (which will be running anyway) over other capacity providers? It seems likely that the latter would need to make operational changes, build or install equipment etc. so would not be able to justify such a commitment in the absence of any certainty over revenue.
 - **Potential CM bidders** that did not win capacity agreements in previous auctions or are not successful in the T-1 top up auction, by virtue of elements of the scheme later found to be incompatible. Does the Government envisage a compensation mechanism for these parties, if the CM is not approved in its current form?

- **Customers** who have been charged for the scheme since the Supplier Obligation was commenced - including charges that will continue to be made during the standstill period under the latest proposals - and the **electricity suppliers** that are collecting funds under the Supplier Obligation. Would suppliers also be required by the amended regulations to return to customers all funds collected since the Supplier Obligation commenced, in the event that the CM is not approved in its current form? Or would the Supplier Charge only be returned to suppliers, as mentioned at page 19 of the consultation? If customers are to be the final beneficiaries, this would presumably need to be incorporated into the trust or escrow arrangements mentioned at page 20.

30. The same questions apply to an even greater extent in the event that the CM scheme is not approved at all, at the conclusion of the formal investigation.

Legal and procedural issues arising from the proposals

Assurances from the EC and State aid rules

31. The tone of the consultation paper suggests that the Government has received some informal words of comfort from the EC, both in terms of the lawfulness of its proposed interim measures, and the outcome of the formal investigation. For example:

“We are working closely with the Commission to ensure that the CM is reinstated as quickly as possible” (Page 5)

“[F]ollowing consultation with the Commission since the judgement, we now expect that, if and when our State Aid case is approved, we will be able to make deferred payments for all suspended payments. The Commission have also confirmed that they have no objection to us resuming collection from suppliers during standstill.” (Page 6)

“To the extent that the European Commission’s Opening Decision in its formal investigation in early 2019 is expected to provide reassurance that the Commission is ‘minded to’ approve the CM scheme, this should provide capacity providers with sufficient confidence to continue to comply with the majority of their obligations.” (Page 15)

32. **As a matter of State aid law, it is clear that the EC cannot reach a conclusion as to the compatibility or non-compatibility of a State aid scheme until the conclusion of its Phase I or, where relevant, Phase II investigation.** In particular, the EC is neither capable of reaching, nor permitted to reach, such a conclusion during the pre-notification discussions between the Member State and the EC. This point is emphasised by the General Court⁸ in the Tempus case judgment, examined in more detail below.

The Tempus judgment

⁸ See paragraphs 74-116 of the General Court’s judgment.

33. The General Court found that the EC should not have approved the aid without opening a formal Phase II investigation. On this point, we refer to the statement in the judgment that *“such guidance from the Commission in the form of informal, advance contact during the pre-notification phase cannot be considered to be the official position of the Commission, which is adopted after examining the notification.”*⁹
34. In this context, the Government has a responsibility to ensure that both industry, and the customers who will ultimately fund payment of the Supplier Charge, appreciate that the EC will only open a Phase II investigation in circumstances where *“doubts are raised as to the compatibility with the internal market of a notified measure”*. Therefore, the very fact that a Phase II is to be opened is indicative of significant risk to the scheme as it stands.
35. It is surprising and concerning that the government has assured stakeholders¹⁰, and the energy minister has assured Parliament¹¹, that the judgment *“did not challenge the fundamental nature of the Capacity Market”*. In the Tempus case ruling, the General Court considered that a substantial number of the concerns raised by Tempus Energy should indeed have caused the EC to have doubts as to the compatibility of the measure with the internal market. These include concerns that:
- The EC had not properly assessed the potential for low-carbon capacity resources to contribute to resource adequacy objectives in the UK;
 - The vastly differing CM agreement lengths for different technologies (15 years for new generators, 1 year for DSR) could be discriminatory and distort the auction pricing;
 - Other features of the auction design, such as minimum size thresholds; credit cover; notice of capacity events; lack of "time-bound" capacity products; and eligibility for transitional auctions, could present unnecessary financial, administrative and practical barriers to new entrant, lower-carbon capacity providers, while either benefiting or being neutral to generators;
 - The “cost-recovery methodology” – i.e. the means by which the money for the scheme is taken from customers – has the potential to artificially inflate the capacity amount procured and therefore the cost of the scheme. Also that the methodology could create a perverse incentive for large commercial customers to run highly polluting and carcinogenic diesel on-site generators, which are too small to be covered by emissions standards.

⁹ See paragraph 90 of the General Court’s judgment.

¹⁰ See page 4 of the consultation paper.

¹¹<https://www.parliament.uk/business/publications/written-questions-answers-statements/written-statement/Lords/2018-11-19/HLWS1061/>

36. Furthermore, the General Court observed that the fact that the Government had conducted a public consultation into these aspects of the CM design was no substitute for the need for the EC itself to gather all the information from interested parties that is relevant to assessing compatibility of the aid with EU law. This was especially pertinent because three different types of electricity operator had contacted the Commission spontaneously prior to the contested decision in 2014 with their thoughts on compatibility of the aid, and this also indicated that there were doubts as to compatibility with the internal market¹². The Court concluded that the EC could not be satisfied merely by the openness of the measure and conclude, consequently, that it was technology neutral, without examining in greater detail the reality and effectiveness of the appreciation of DSR (and other low-carbon capacity providers) in the CM¹³.
37. Having regard to the Tempus ruling, EC will therefore conclude its Phase I assessment with an Opening Decision that can be expected to list a significant number of doubts regarding the compatibility of the CM scheme with the internal market. The Phase II investigation will, unlike the original Phase I assessment and approval procedure in 2014, allow third parties to provide the EC with the necessary information to fully assess the compatibility of the CM scheme with the internal market (including whether a scheme is necessary at all).
- 38. In light of this, there remain substantial doubts as to whether the EC will be in a position to approve the current CM policy design as compatible with EU law. If it does not do so, there will be implications for both industry and consumers. The Government should take this into account when proposing and implementing amendments to the CM scheme, and take care to ensure that industry and consumers are fully aware of this.**
- 39. The Government should not misrepresent the nature and implications of the Tempus case, or the subsequent EC investigation, when communicating with stakeholders and Parliament.**

Letter from Parliamentary BEIS Committee

40. Following our comments above, we concur with the Parliamentary Business, Enterprise and Industrial Strategy (BEIS) Committee in its letter to the energy minister Claire Perry MP on 18th December 2018¹⁴, which stated that:

“[I]t is unclear whether the Capacity Market will achieve State aid approval without redesign, as the legal challenge was brought on the basis that the Capacity Market discriminates against demand-side response (DSR) technologies”.

¹² See paragraphs 109-115 of the General Court’s judgment.

¹³ See paragraph 154 of the General Court’s judgment.

¹⁴<https://www.parliament.uk/documents/commons-committees/business-energy-and-industrial-strategy/Correspondence/chair-Claire-Perry-17-19.pdf>

41. We note that the BEIS Committee letter also asked the Government to provide further information on its discussions with the EC relating to the timescale for the investigation and the approval of the CM.
42. **We recommend that the Government publish its reply to the BEIS Committee, so that the industry and investors have an opportunity to benefit from this clarity.**
43. **We also recommend that the Government take this opportunity to also answer the factual and legal questions that we have set out in this response.**

Domestic procedural and public law concerns

44. In addition to the State aid and Phase II procedural concerns set out above, the proposed actions and the manner in which they have been consulted gives rise to some UK public law and procedural issues:
- **Improper consultation:** As explained above, the consultation paper does not accurately reflect the legal and factual situation or the commercial risks to stakeholders. It is instead presented as a consultation about “technical” amendments, with references to “deferred” (as opposed to potential) payments. The consultation period is only three weeks, over the Christmas period. The limited framing of events, risks and proposals has the potential to preclude proper participation from stakeholders, in breach of their procedural rights.
 - **Parliamentary scrutiny and proper purpose of powers:** We are not aware of any indication being given, when the primary powers in the Energy Act 2013 were laid before Parliament, that the powers could be used in the manner currently proposed. As is conventional in State aid matters, the apparent intention has always been to run auctions only “subject to State aid approval”¹⁵. There was certainly no suggestion that auctions might be run, or agreements enforced, in the absence of such approval. Given this departure from the likely assumptions of Parliament at the time of passing the primary legislation, it is especially important that Parliament be given a proper opportunity to assess the proposals, and their potential impact, now. The original CM regulations were made under the affirmative resolution procedure, in accordance with section 40(5) of the Energy Act 2013. We consider that the significant (and not purely “technical”) amendments to the scheme that the Government is now proposing should also be subject to this procedure, so that both Houses of Parliament are given the opportunity to scrutinise, debate and actively vote on the measures.
 - **No Impact Assessment:** Following on from the point above, we presume that the Government is not currently minded to make the implementing amendments to the CM regulations via the affirmative procedure, because no Impact Assessment has been

¹⁵ See, for example, the introduction to the EMR Delivery Plan 2013, by then Secretary of State for Energy Ed Davey MP.

published alongside the consultation paper. As noted above, the consultation proposals have obvious financial and operational implications for investors, capacity providers, suppliers and customers. There are also legal risks, which could have ramifications for these stakeholders. It is of paramount importance that stakeholders and Parliament have the opportunity to view the Government's full assessment of the impact of its policy, and to comment on and challenge that assessment where appropriate.

45. We therefore recommend that, if the Government decides to continue with its intended policy proposals further to examining consultation responses, it should at the very least:

- **Re-consult on the proposals in a manner that honestly and unambiguously describes the current legal and political situation and makes clear the proposed policy action in relation to each of the foreseeable outcomes. The new consultation should have an appropriate title and a consultation period of not less than six weeks;**
- **Take steps to ensure that Parliament is properly briefed of the full circumstances and the new proposals and has an opportunity to comment and approve them, including making the proposed amendments to the CM regulations via the affirmative resolution procedure;**
- **Publish a full Impact Assessment alongside the new consultation paper.**

Moving forward towards a decarbonised energy system

46. While the Tempus case judgment has created uncertainty in the energy market, it has also provided a timely opportunity for the government to take stock of the current CM scheme in light of:

- The findings of the EU General Court;
- The final draft of the new EU Clean Energy Package;
- The Paris Agreement of 2015;
- The EPS and LCP BREF requirements;
- The latest data on electricity demand and supply forecasts in the UK, including the increasing role of interconnectors;
- New technology developments in, and political understanding of, low-carbon capacity resources, which have emerged since the CM was introduced 2014.

47. The Government is in the process of undertaking a Statutory Review of the CM and is due to report its recommendations to Parliament later in 2019. Therefore, some Parliamentary time must already be committed to reviewing the CM and a legislative vehicle for assessing and amending the scheme exists.

48. **We recommend that the Government expand its CM Review focus considerably, making it a priority to invite evidence in order to reassess:**

- **Whether a CM continues to be necessary at all to achieve resource adequacy;**
- **In the event that a CM is still deemed necessary, the inclusiveness of the CM in relation to other low-carbon capacity resources in order to ensure that innovation and competition are not prohibited, and to create better confidence in compatibility with State aid rules and the Clean Energy Package.**

49. The “Background and guiding principles” section of this response reflects on the latest data concerning resource adequacy. In addition, our CM Review Response set out recommended amendments to the existing CM scheme, to be implemented in the event that a CM remains justifiable. These are summarised briefly below:

- Changes to the **CM auction design** to: enable all technologies to bid for **all contract lengths** and to **remove very long-term contracts**; reduce **financial barriers** for new entrants; increase **certainty and consistency of T-1 auctions**; and ensure that **derating factors and penalties are proportionate** to actual risk of non-delivery.
- A fresh assessment of **stakeholder and expert evidence on the impact of the cost-recovery methodology used for setting the Supplier Obligation**. This should include price signal incentives for load shifting, viability of a secondary market, capacity over-procurement risk, cost-effectiveness and unintended consequences, e.g. rise in diesel generation.
- The creation of a **separate climate and competition objective for the CM**, which is not limited to carbon emissions.
- The introduction of a **“One Stop Shop” for CM amendment proposals** and a central **CM Handbook** of up-to-date policy and procedures, to assist new entrants.
- The creation of a **longer-term comparative study examining inherent institutional conflicts of interest** and investigating solutions being tested in other markets, e.g. the Distribution Service Provider model in the US.

50. Any amendments to the CM would still need to be notified to the EC (or the UK Competition and Markets Authority, depending on the final Brexit outcome). However, a proactive approach would at least allow the Government to give interested parties a clearer picture of the final policy outcome and likely timescale, while boosting investor confidence in the enduring nature of the scheme.

51. Attracting businesses, including energy intensive industries, and innovators to the UK will be more important than ever after Brexit. Moving forward with a progressive solution, which genuinely seeks to facilitate emerging technologies and competition, would be an excellent way of demonstrating this. Crucially, it is also the only way to ensure that the UK will be able to meet 2030 targets and decarbonise its energy system at the lowest cost to customers.
52. The time has come for the Government to show genuine leadership and initiative in the pursuit of energy system efficiency, security and decarbonisation. If the Government does not wake up to the current legal, political and climate reality and take urgent steps to pivot its energy policy, it risks not only being left on the back foot pending the EC formal investigation, but also creating unnecessary cost to businesses and customers, perpetuating environmental harm, and exposing itself to future litigation.