

PARLIAMENTARY DEBATES

HOUSE OF COMMONS
OFFICIAL REPORT

First Delegated Legislation Committee

DRAFT ELECTRICITY CAPACITY (AMENDMENT)
REGULATIONS 2016

Monday 27 June 2016

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The Committee consisted of the following Members:

Chair: MRS ANNE MAIN

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| † Atkins, Victoria (<i>Louth and Horncastle</i>) (Con) | † Murray, Mrs Sheryll (<i>South East Cornwall</i>) (Con) |
| † Boswell, Philip (<i>Coatbridge, Chryston and Bellshill</i>) (SNP) | † Pow, Rebecca (<i>Taunton Deane</i>) (Con) |
| † Churchill, Jo (<i>Bury St Edmunds</i>) (Con) | † Quin, Jeremy (<i>Horsham</i>) (Con) |
| Clwyd, Ann (<i>Cynon Valley</i>) (Lab) | † Smith, Jeff (<i>Manchester, Withington</i>) (Lab) |
| † Double, Steve (<i>St Austell and Newquay</i>) (Con) | † Smith, Julian (<i>Skipton and Ripon</i>) (Con) |
| † Hart, Simon (<i>Carmarthen West and South Pembrokeshire</i>) (Con) | † Turley, Anna (<i>Redcar</i>) (Lab/Co-op) |
| † Leadsom, Andrea (<i>Minister of State, Department of Energy and Climate Change</i>) | Umunna, Mr Chuka (<i>Streatham</i>) (Lab) |
| † Lynch, Holly (<i>Halifax</i>) (Lab) | † Whitehead, Dr Alan (<i>Southampton, Test</i>) (Lab) |
| † McCaig, Callum (<i>Aberdeen South</i>) (SNP) | † Wragg, William (<i>Hazel Grove</i>) (Con) |
| | Gavin O’Leary, <i>Committee Clerk</i> |
| | † attended the Committee |

First Delegated Legislation Committee

Monday 27 June 2016

[MRS ANNE MAIN *in the Chair*]

Draft Electricity Capacity (Amendment) Regulations 2016

4.30 pm

The Minister of State, Department of Energy and Climate Change (Andrea Leadsom): I beg to move,

That the Committee has considered the draft Electricity Capacity (Amendment) Regulations 2016.

The draft regulations seek to amend the main secondary legislation package for the capacity market scheme, which was part of the electricity market reform programme in 2013. The powers to make this implementing secondary legislation are found in the Energy Act 2013, which, following scrutiny in the House and the other place, received Royal Assent in December 2013, with cross-party support.

As a reminder to hon. Members, the capacity market will address our electricity needs and ensure that there is sufficient electricity supply towards the end of the decade and beyond. It will achieve that by making a regular capacity payment to providers that are successful in capacity auctions. In return for that payment, providers must meet their obligations to provide supply or to reduce demand when the system is tight, ensuring that enough capacity is in place to maintain security of electricity supply. Ensuring that hard-working families and businesses across the country have secure, affordable energy supplies that they can rely on is our top priority, which is why we already have firm mechanisms in place, working closely with National Grid and Ofgem, to maintain comfortable margins on the system in the coming winter.

Beyond that, it is essential that generators have confidence that they will receive the revenues they need to maintain, upgrade and refurbish their existing plant, and to finance and build new plant to come on stream as and when existing assets retire. Equally, we want to ensure that those who are able to shift demand for electricity away from periods of greatest scarcity without detriment to themselves and to the wider economy are incentivised to do so. That is why we have the capacity market.

The first two capacity market auctions took place in 2014 and 2015, and the first of two separate auctions focusing on demand-side response took place at the beginning of 2016. Those resulted in a good outcome for consumers, as fierce competition between providers meant that we obtained the capacity we need at prices below the levels many had expected. That translates to lower costs on consumer bills.

In order to ensure that the capacity market remains fit for purpose, my Department has reviewed the capacity market mechanism in the light of the experience gained in those first auctions. The clear message from industry and investors is that the mechanism retains their confidence and is the best available approach for ensuring our

long-term security of supply. They also stressed that regulatory stability is crucial. At the same time we heard concerns that we must do more to protect against delivery risks, that we need to tighten the incentives to honour agreements for those that have been awarded them, and that we must avoid the risk of under-buying or buying too late.

UK electricity market conditions have changed considerably since 2014, when the capacity market was established. The huge reduction in global commodities prices has lowered consumers' energy costs but pushed many generators into loss-making territory. As a result, several plant closures have been announced earlier than was anticipated in 2014, and other generating plant may be at risk.

In order to address those points, these regulations will provide for a new supplementary capacity auction for delivery of capacity in 2017-18, together with minor reforms to help the capacity market deliver its objectives. In the context of those amendments, it is important to consider the capacity market as an insurance policy against a material risk of plant closures. As with all insurance policies, there is a premium to be paid. However, this premium is worth paying to ensure a secure and affordable electricity supply.

The risk that we are ensuring against is largely the result of recent declines in wholesale market prices. We should remember that this in itself has led to welcome reductions in energy bills for consumers. The insurance premium they are being asked to pay now is only a small fraction of those benefits. What is more, as with all insurance policies, we must be sure that the insurance will pay out in times of need. That is why we are today debating amendments to the regulations that will increase termination fees for those who renege on their capacity market agreements. The amendments further incentivise capacity market participants to deliver on their commitments and contribute to our security of supply.

I will briefly expand on the amendments. First, the regulations make provision for a supplementary capacity auction to be held this coming winter for delivery in 2017-18. Running that auction mitigates the emerging increased risk to security of supply in 2017-18 by ensuring that enough capacity is available that year. It acts as an insurance policy against a material risk of plant closures because of low wholesale prices. Our analysis shows that that approach is expected to be up to £8.4 billion cheaper than an alternative scenario in which further plant closures would have occurred.

The regulations also provide for a number of amendments in the light of my Department's review of the capacity market. Our public consultation exercise outlined the need for a robust system of checks, both on new build projects, to ensure that they are on track to deliver, and on existing plant, to ensure that agreements are honoured. At the same time, the consultation recognised the importance of ensuring that the system is not so punitive that legitimate projects will be dissuaded from participating in the first place.

We have evidence that, despite the termination fee regime already in place, there have been instances when capacity providers have viewed their obligations as relatively low-cost options and have contemplated renegeing on their commitments. I am therefore proposing measures to help ensure that new build capacity that wins a

capacity agreement has the appropriate incentives, and is exposed to a robust assurance regime, to deliver against their agreement.

These measures include increases in credit cover for projects that cannot demonstrate sufficient progress against the required milestones, and limited but material increases to the termination fees that all those with an agreement must pay if they renege on their commitments. Through the supporting capacity market rules, I am also proposing a prohibition on failed projects from participating in future auctions, and also increased monitoring and reporting milestones.

The regulations must also include measures to make sure that a secondary trading market can develop that supports investment in capacity market units. Those changes will improve the current regulatory framework by dealing with the interaction between transfers of agreements and the penalty regime.

Finally, the transitional arrangements auctions are aimed specifically at the demand-side response sector, recognising that it is a relatively small and immature sector at the moment. We are keen to ensure that funding provided through the next transitional arrangements auction is targeted at those types of resource that need it most. The regulations therefore refine the eligibility criteria for the second transitional arrangements auction so that it focuses on genuine demand-shifting, turn-down demand-side response, rather than the small-scale generation, including diesel, that won many of the agreements in the first auction.

My Department consulted on the changes across two consultations in October 2015 and in March this year. In total, more than 200 responses were received across the two consultations. There was significant support for the majority of the Government's proposals, particularly the supplementary capacity auction for refinements to the eligibility criteria for the second demand-side response transitional arrangements auction and the core proposals relating to delivery incentives. These regulations implement the proposals. I look forward to hearing what hon. Members have to say about the proposed changes.

4.39 pm

Dr Alan Whitehead (Southampton, Test) (Lab): As the Minister has set out, we are discussing a new auction to be put in front of the existing T-4 auctions, which will remain in place, in order to auction capacity four years in advance of the performance of that auction capacity. The purpose of T-4 auctions—I am sorry that the Minister did not mention this—is essentially to procure new capacity that can be on stream at the end of the T-4 period. That new capacity will get its underwriting so that it can be built in the three-year period before the last T-4 auction. That will incentivise building and production, and that is what the underwriting 15-year contracts will consist of. Those 15-year contracts would run alongside shorter term contracts intended to maintain capacity, but that is the central purpose of the original auctions.

An additional auction will now be in place before the T-4 auctions have run their term, but after they have started, in order to secure capacity on one-year contracts only—no 15-year contracts are available in this pre-auction. As the Minister said, that is simply to prevent, among other things, plants from being mothballed or closed

down, so that they can continue to supply capacity even when we were hoping that the capacity from new plants would be coming on stream. This arrangement represents, at the very least, substantial mission creep on the original purpose for capacity auctions.

Not only is it mission creep, but it replaces a fairly well placed device, the contingency balancing reserve, which, even in the context of the original T-4 auctions, was in essence a guarantor that reserve capacity would be available outside the market, and largely bid for by, and separately placed with, plants that might otherwise have been mothballed or closed. As a result, in the period running up to the new plants becoming available, there will be sufficient capacity and reserve to ensure that the loss of load is not significant, so that we are within the limits and, indeed, have a fairly robust method of ensuring that the capacity margins are upheld in that period before the emergence of the new plants.

Something else the Minister did not mention when describing the draft regulations is what has actually happened with the original two T-4 auctions. To all intents and purposes, no new capacity has been procured under the auctions, with the exception of one plant, which does not look as if it will be built, because it bid into the system without having a clear way forward to add to the bidding and to invest in the plant. Overall, however, the vast majority of the contracts were the sort of one-year contracts that it is now envisaged will be the substance of the auction in front of the T-4 auctions.

Not only were they one-year contracts, but they were contracts that have gone to all sorts of producers—coal, gas and, surprisingly, nuclear. We have underwritten existing nuclear power plants to provide capacity, when it would be difficult to envisage how they could fail to provide capacity when required to do so. They would have to switch themselves off and close down for long periods in order not to provide capacity. So the first auctions have a rather perverse outcome, and the proposals essentially start to install those perverse outcomes into a continuing process for capacity auctions.

The first two auctions cleared at relatively low prices, as the Minister mentioned. She states that they were good value for customers, and one might view that outcome—clearing at £20.30 per kilowatt and £18 per kilowatt respectively—as good value, if one did not know what the original purpose of capacity auctions was. Arguably, that good value falls away if no new plants arise from the capacity auction and it is consumed entirely in short-term contracts, some of them for completely inappropriate forms of capacity going into the system.

The mission creep that we see in the regulations before us essentially means that their purpose, as the Minister suggested in her remarks, appears to be keeping plant open and preventing contractors from closing plant, rather than opening new plant. Furthermore, they are trying to bolster the idea—I do not disagree with it—that those who contract to provide power, particularly in a T-4 or 15-year auction but even in a one-year auction, ought to carry out that contract. Dangers have been suggested. A number of contractors have been considering the fact that the penalties for non-performance are considerably less than the potential savings from mothballing a plant; one has actually done the dirty deed. The extent to which the arrangements cause people to keep their plants open has begun to

[Dr Alan Whitehead]

fray. I therefore support the proposals in the regulations to make penalties more appropriate to the power being provided, with high penalties for non-performance.

However, the central question is what analysis has been done of that mission creep to ensure a system that gives us energy security over the next period and reasonably good value for the consumer. By the way, I support the other consideration in the regulations: the question of organising demand-side auctions in a way that is more favourable to demand-side entrants who have had difficulty taking part in the general auction, and who have to some extent been superseded by would-be demand-side entrants that deal with things such as diesel plant. I support the sense of putting that into the system.

I would like to ask the Minister a couple of questions about how the benefit of the proposals has been arrived at. To find that out, we must once again look at an impact assessment, and I am pleased to see that on this occasion we actually have one. That is good. However, the impact assessment has been set against a rather strange counterfactual. If more plants close than predicted, prices will be pushed up, but the instrument might cause fewer plants to close and prices will therefore not go up to such an extent.

However, the impact assessment suggests that if fewer plants close the net welfare could, under some circumstances, be negative. In any event, as the document presents, the very fact that a new capacity auction has been announced causes operators to decide not to close or mothball plant. The counterfactual is therefore undermined by the idea itself, and that seems to be a strange way to conduct an analysis of what the cost is and should be. Indeed, all that the counterfactual arrangements do, in the end, is come out with the difference between a very high cost to consumers and a relatively high cost to consumers.

Can the Minister tell me how reliable she thinks the cost suggestions in the impact assessment are? The Committee ought to think carefully about the suggestion that the likely cost, for this auction alone, is between £2 billion and £3 billion. Over the past few weeks we have debated the gross and net costs of contributions to the European Union, but this is of a different order—it translates into a gross cost of between £28 and £38 on a household electricity bill. That would have an enormous impact on consumers and would dwarf many relatively minor impacts, such as the incentives for renewables to deploy.

However, even if we take the net benefit, which assumes that wholesale prices will be lower as a result of the measure than if no measure was taken—an interesting supposition and perhaps not a safe way of calculating an impact—it is still suggested that the impact on consumers' bills will be between £10 and £21. So at the very least the impact is enormous, even if the changes are considered in the best light.

I have one final question for the Minister. Even in the context of one-year contracts only, the impact assessment sets out an assumed clearing price for the auction, on which all the calculations are modelled, of £62. Would it be a good outcome for consumers to have a clearing price for one-year contracts that would have been high enough if it was a T-4 auction to gain some new long-term contracts, which was the original idea of

capacity auctions? It looks like we might now be getting an auction at very high clearing prices, with no long-term contracts let and under circumstances in which the consumer pays a heavy bill. Will the Minister comment on how we have come to that?

We will not oppose the statutory instrument, but there needs to be close examination and an explanation of the central issue of how the modelling took place to reassure hon. Members and the public that there is value for money and that it is better than the alternatives.

Finally, not only are the counterfactuals as I have described them, but, interestingly, the counterfactual of continuing with the contingency balancing reserve, which I mentioned a while ago, is set against one-year prices, as opposed to what was originally set out in the Energy Bill as a full-blown strategic reserve, rather than a capacity auction. That seems to be a much better counterfactual on which to compare and contrast value.

The whole thing therefore reeks of mission creep not just as far as the measure is concerned, but as far as the analysis of the measure is concerned. That is a worrying development in policy. I am sure that the Minister will want to respond to that and consider it carefully in respect of her future arrangements for capacity auctions.

4.56 pm

Philip Boswell (Coatbridge, Chryston and Bellshill) (SNP): It is a pleasure to serve under your chairmanship, Mrs Main. I will keep this brief, but I will ask the Minister a few questions. First, what likelihood does she see for favourable—in the UK's opinion—European interconnector negotiations for the optimisation of Europe-wide electricity supply and demand, given that the UK is currently marching away from the EU?

On storage, given the Government's extensive cuts to renewable energy initiatives, what funding will they provide for energy storage in the UK? In particular, is there an intent to put in place appropriate funding mechanisms, if they are not in place, for the two major Scottish pump storage projects at Cruachan and Coire Glas that are ready to go? What adjustment, if any, are the Government planning to make to remove the unfair transmission charges currently applied to Scotland, which played a part in the closure of Longannet? Of course, that is part of the reason we are here discussing how we tackle energy shortage issues in the UK.

Finally, we will not oppose the statutory instrument for the reasons that were so well articulated by the hon. Member for Southampton, Test.

4.57 pm

Andrea Leadsom: I am grateful to hon. Members for their comments and questions. It will be a great pleasure to answer them all and hopefully my answers will please hon. Members.

The hon. Member for Southampton, Test asks whether there is mission creep. The capacity market is there as an insurance policy for energy security. It is true that it has the secondary goal of bringing on new investment in new, lower-carbon plant, but its core goal is as an insurance policy that ensures that the lights stay on. As he pointed out, a 15-year deal is not available in the supplementary capacity auction. The reason is that, because it is only for 2017-18, there is not time to build

the plant and start dispatching electricity between now and the delivery date. However, the T-4 auctions are indeed designed not only to provide energy security, but to bring on new investment.

The hon. Gentleman says that that has not been successful, but that is not true. We have had a variety of new build plants, including more than 800 MW of small scale gas and the CCGT that he mentioned. It is crucial that we provide opportunities for new investment, which is why we have announced separately that we will buy more capacity and do so earlier. We will announce shortly what that means for the next T-4 auction.

The hon. Gentleman talked about the counterfactual of the supplementary capacity auction versus the £8 billion cost of early closure. To be clear to all Members, he is exactly right that our best estimate of what the supplementary auction will cost is £2 billion to £3 billion. It is very difficult to assess exactly what that means per consumer bill, but it will be in the region of £11 to £20. As he has acknowledged, the reason for having the auction is the drop in wholesale prices, which has meant that the economics for wholesale generators have been difficult. In fact, the average dual fuel bill is roughly £200 a year lower than it would have been. We cannot be clear about what the bill impact will be, because it is subject to a competitive auction, but our estimate is that it will be between £11 and £20, which is less than 10% of the reduction in wholesale costs for consumers. In net terms, it is a very good deal for consumers and provides energy security at a time of low wholesale prices.

Dr Whitehead: I would be grateful if the Minister confirmed that the estimate she has just given is post the estimates about the dampening effect of wholesale prices of this particular measure, and not the gross effect of what the measures might produce. That is to say, this is the figure after that presumed effect is deducted, and if that presumed effect was not deducted, the cost would be substantially higher to consumers.

Andrea Leadsom: I will have to write to the hon. Gentleman on that point. I am not sure I completely understand his concern. The impact assessment is clear that our best guess is that the bill impact will be in the region of £11 to £20. I have just been informed that that is net. I will write to him if he wants a fuller answer, but I hope that clarifies things.

The average dual fuel bill is £200 lower than a year ago as a result of lower wholesale prices, which make it more difficult for wholesale generators to cover their costs. Bringing forward the supplementary capacity auction will therefore ensure that there is security of supply. The best estimate is that that will cost £11 to £20 per bill, which is very good value for consumers.

The hon. Gentleman also questioned the £8 billion counterfactual. That £8 billion counterfactual assumes that we do not bring forward the supplementary capacity auction. There would therefore be nothing available for wholesale generators, and they would have to deal with the consequences of the poor economics of low wholesale prices. He asked about the contingency balancing reserve. Our estimates show that it would be more expensive than the supplementary capacity auction. That is why we are doing this. The SCA is more cost-effective and provides energy security. I hope that that answers his questions.

The hon. Member for Coatbridge, Chryston and Bellshill asked about interconnector links. I can tell him that they will go ahead. I confirm for all Members that my view is that energy policy will not be impacted at all by the public's decision to leave the European Union, because we will continue to have our energy trilemma and our commitments to decarbonisation at the lowest possible price, to energy security and to interconnectors, which after all are all commercial decisions made between businesses. Our policy for more interconnectors will endure, provided that Ofgem finds on a case-by-case basis that they offer good value to consumers.

Callum McCaig (Aberdeen South) (SNP): That is interesting. May I ask whether the Minister envisages the emissions trading scheme continuing?

Andrea Leadsom: Obviously, the emissions trading scheme is an EU-wide scheme, and the UK's participation will be subject to the negotiation of the terms of our leaving the European Union. There has been a lot of discussion in this very room about the ETS, the amendments the UK would ideally like to make and whether it should count towards our decarbonisation goals at all. I say to the hon. Gentleman that those discussions are not for today, but will of course be part of the negotiation.

The hon. Member for Coatbridge, Chryston and Bellshill raised the question of storage and, as I have said to him before, we remain completely committed to that. The Department believes that storage presents a huge opportunity to provide the certainty that intermittent technologies cannot provide for energy security. We are big supporters of it. Work is going on in the Department to look at what we can do to facilitate storage and to remove any barriers, whether regulatory or structural, to allowing storage to deploy. I hope he will appreciate that nothing has changed and that that enthusiasm will continue. I think I have mentioned to him before that I have met all the trade bodies and developers for storage to hear their views, and we are completely supportive.

Callum McCaig: I am interested in that answer. Is there any indication of the timescales for that review and of what any forthcoming changes may be?

Andrea Leadsom: I am so sorry, but I have to say to the hon. Gentleman that we will announce that as soon as possible. He will be aware that there are a number of announcements that we are keen to make as soon as we can. Some of this work is very complicated and we are keen to get the right answers. During the passage of the Energy Bill, we had a good discussion about storage. We are all on the same side; we all want to see progress. The key thing is to make sure that we get solutions that benefit the deployment of storage and that there are no unintended consequences of the solutions that we choose; it is important that they do not have the opposite effect. We have had that discussion before, so I will leave it there.

The final point made by the hon. Member for Coatbridge, Chryston and Bellshill was on transmission charges for Scotland. As he knows, the transmission charging regime is a matter for Ofgem. As he also knows, it is designed to be cost reflective to ensure the economic and efficient use of the network across Great Britain and, importantly,

[*Andrea Leadsom*]

to keep costs down for consumers. It is true that there are higher charges for generators in Scotland as a result, but that reflects the actual cost that those generators impose on the transmission network. He will also be aware that the greater part is paid by the electricity supply companies, also on a cost-reflective basis. That means that the majority of transmission charges are in fact recovered through consumers in areas of highest demand—namely in England and Wales. Although generators pay more in Scotland, consumers pay less. Ofgem has concluded, having done a recent study on transmission charges, that there would be winners and losers from any change away from cost-reflective charging, and it does not feel as if there is a case for that.

I hope that the responses I have given have been helpful. As I said at the start of the debate, I am confident that with the changes we have discussed today, the capacity market will ensure the security of our electricity supplies in a way that provides the best value for money for consumers. I therefore commend the regulations to the Committee.

Question put and agreed to.

Resolved,

That the Committee has considered the draft Electricity Capacity (Amendment) Regulations 2016.

5.7 pm

Committee rose.