PARLIAMENTARY DEBATES

HOUSE OF COMMONS
OFFICIAL REPORT

Second Delegated Legislation Committee

DRAFT ELECTRICITY CAPACITY (AMENDMENT) REGULATIONS 2017

Thursday 19 October 2017

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Monday 23 October 2017

The Committee consisted of the following Members:

Chair: PHILIP DAVIES

Carden, Dan *(Liverpool, Walton)* (Lab)
† Debbonaire, Thangam *(Bristol West)* (Lab)
† Donelan, Michelle *(Chippenham)* (Con)
† Harrington, Richard *(Parliamentary Under-Secretary of State for Business, Energy and Industrial Strategy)*
† Heald, Sir Oliver *(North East Hertfordshire)* (Con)
† Hendry, Drew *(Inverness, Nairn, Badenoch and Strathspey)* (SNP)
† Hoey, Kate *(Vauxhall)* (Lab)
† Jones, Sarah *(Croydon Central)* (Lab)
† Latham, Mrs Pauline *(Mid Derbyshire)* (Con)
† Moore, Damien *(Southport)* (Con)
† Morris, David *(Morecambe and Lunesdale)* (Con)
† Rutley, David *(Lord Commissioner of Her Majesty's Treasury)*
† Sheerman, Mr Barry *(Huddersfield)* (Lab/Co-op)
† Shelbrooke, Alec *(Elmet and Rothwell)* (Con)
† Stevens, Jo *(Cardiff Central)* (Lab)
† Sunak, Rishi *(Richmond (Yorks))* (Con)
† Whitehead, Dr Alan *(Southampton, Test)* (Lab)

Gail Bartlett, *Committee Clerk*

† attended the Committee

Second Delegated Legislation Committee

Thursday 19 October 2017

[PHILIP DAVIES *in the Chair*]

Draft Electricity Capacity (Amendment) Regulations 2017

11.30 am

The Parliamentary Under-Secretary of State for Business, Energy and Industrial Strategy (Richard Harrington): I beg to move,

That the Committee has considered the draft Electricity Capacity (Amendment) Regulations 2017.

It is a great pleasure to serve under your chairmanship, Mr Davies, and to see the shadow Minister, the hon. Member for Southampton, Test. The Opposition Whip and I were texting him, but I knew he would be here. I am sure I will face a reasoned and thought-out speech, which we Ministers do not like, but which will be a pleasure to hear in his case.

The draft regulations will amend two secondary legislation packages for the capacity market. The powers to make and implement the secondary legislation are found in the Energy Act 2013, which received Royal Assent in December 2013 with, I am pleased to say, cross-party support following scrutiny in the House and the other place. I will explain the changes in detail, but first, for hon. Members who are less familiar with the capacity market, I will explain it in terms as I understand them.

The capacity market is an insurance policy to ensure that the necessary supply is always available. The money is used to ensure that power is available as demand from the grid goes up and down, perhaps because a particularly interesting horse race or an episode of "EastEnders" is on the television, or more typically because of a good cold snap—or a bad cold snap, depending on how one looks at it. In many cases, suppliers are paid when supply is not needed, but the market has allowed us to have a consistent and readily available source of capacity for all contingencies. That main purpose received cross-party support. It is for Members on both sides and for the Government to secure that capacity, and they have done it pretty well.

Mr Barry Sheerman (Huddersfield) (Lab/Co-op): This stuff will be quite difficult to digest not just for the Committee but for our constituents, who have to pay a hell of a lot of money for their electricity. I hope the Minister will go into some detail about risk finance schemes and applicant credit cover, because I cannot go back to my constituents in Huddersfield, who are highly intelligent people, without an explanation.

Richard Harrington: I agree with the hon. Gentleman's analysis of the good burghers of Huddersfield, because I come from Leeds—

Mr Sheerman: We tend to look down on Leeds.

Richard Harrington: I could not possibly comment, but we are all Yorkshiremen, including you, Mr Davies—not that that would affect your chairing of the Committee.

From memory, the actual cost of the capacity for our constituents is about £2 a year on their bill. I am not making light of it, but for what we get from it as a country and for what suppliers get for their customers, I think it is good value for money. There have been power cuts in other countries—even in quite developed places such as California and Australia—where they did not have such a sophisticated system, so there is a risk. When I said it was for hon. Members on both sides to ensure capacity, I did not mean just members of this Committee; the whole of Parliament in 2013 realised that this was a good thing to do.

I will go into more detail, and if the hon. Gentleman then feels that I have not answered his questions I will be able to do so—it will be nearer lunch time, and he may feel that I have covered most of it.

Sir Oliver Heald (North East Hertfordshire) (Con): Does the Minister agree that it is one of the Government's duties to ensure security for citizens? Energy security is a vital part of that, and if it costs £2, it is probably £2 well spent.

Richard Harrington: I agree, as I think most other people would, because generally the system works. To use the layman's language I always use—being a Yorkshireman, I try to simplify things in a way so that I understand them; I cannot claim to have the technical expertise of the shadow Minister on this—the regulations propose a tweaking of something that works, rather than radical and complete change. I will make some progress, and if hon. Members would like to ask questions or intervene, they should obviously do so, subject to your largesse, Mr Davies.

The five changes in the draft instrument are essentially technical. They will improve fairness, ensure the competitiveness of auctions and provide important clarifications to scheme operations. The Department held a fairly lengthy public consultation on the changes and the majority of respondents agreed with them—more than 75%. I agree that it is important that people know how much the market costs, but if we did not have a capacity market and every individual had the choice of paying £2 or x pounds to make sure they do not have blackout periods, I am sure that most people would probably pay it anyway. It is not like that, but thinking about it in terms of what it means to customers and our constituents is right, as the hon. Member for Huddersfield mentioned. All the technical stuff we are here to discuss does not matter if in the end it boils down to continuity of supply at that price. He was absolutely right to mention that, as was my right hon. and learned Friend the Member for North East Hertfordshire.

We have the capacity market to ensure—as is the Government's job—that we always have sufficient electricity capacity in Britain for the winter periods and for periods of exceptional demand. We need to give generators the confidence that they will receive the revenues they need to maintain, upgrade and refurbish their existing plants, and to finance and build new plants to come on stream as and when existing assets retire. They have to think ahead, and knowing that they are going to get these funds is part of their planning.

The capacity market also ensures that those who are able to shift demand for electricity away from periods of greater scarcity, without detriment to themselves and the wider economy, are incentivised to do so. It does so by offering capacity providers who are successful in these competitive auctions—there are two types; some bid for one year ahead and some for four years ahead—a steady, predictable revenue stream on which they can base their future investments. In return for those capacity payments, providers must meet their obligations to deliver electricity at times of system stress, or not deliver it if it is not needed, or face penalties.

Mr Sheerman: On the longer four-year period, we have a rapidly changing energy market, and many of us are delighted with the diversity of more sustainable energy providers coming on and providing a lot of our energy needs. Will the four-year period allow us to have that more flexible, diverse energy market?

Richard Harrington: That is a valid question, as I would expect from the hon. Gentleman. Having both four years and one year takes care of that. Four years is needed because of the investment cycle; suppliers have to plan and have some consistency. Things change a lot, and there is a lot of uncertainty when predicting four years ahead.

Mr Sheerman: There might be an election.

Richard Harrington: I believe that is extremely unlikely, but we all have our views on that subject; certainly, if this measure is voted down today, I am sure the Prime Minister will have no choice. In all seriousness, the hon. Gentleman makes a valid point, but if it were left only to the shorter, one-year cycle, I cannot see people taking the kind of investment decisions needed. Of course, it is arguable—some might say they want 10 years. When the rest of the electricity supply market—not the capacity market but the normal supply market—starts to build huge wind turbine farms and gets planning permission to build nuclear power stations and all those other things, those are all judged on 20 to 30-year cycles, so it is difficult.

The officials think that four years and one year are right, but it is always up for review, and if the market changed completely we would want the flexibility to be able to act. For the moment, it works. It sounds arrogant for Government to say it, but I think most people think the capacity market is working. Self-evidently, it is working.

Dr Alan Whitehead (Southampton, Test) (Lab) *indicated dissent.*

Richard Harrington: I notice with fear and trepidation the shadow Minister shaking his head. I will try to make some progress, then keep quiet while he makes his comments, and then I will do my best to counter them.

The capacity market is working and there is fierce competition. We have the required capacity at prices significantly lower than many detractors of the scheme expected. I hope the shadow Minister agrees that it is working from a competitive point of view. As the hon. Member for Huddersfield said, that is good for consumers because it has translated to lower costs on bills. Whatever one's view of bills generally, this is not a big chunk of bills.

The capacity market is driving investment in new and flexible capacity. The most recent four-years-ahead auction secured more than 3.4 GW of new build generating capacity, including combined-cycle gas turbines, open-cycle gas turbines, small flexible engines and battery storage, as well as 1.4 GW of demand-side response. 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.

Industry and investors stress that regulatory stability is crucial, but also that the scheme, which is operating in a rapidly changing environment, must be reviewed regularly to ensure it remains fit for purpose. That goes back to the four year, one year point. The changes set out in the instrument are the latest in a series of amendments that ensure the scheme is kept relevant and workable. If the Committee bears with me, I will briefly expand on the amendments made by the draft regulations.

First, the instrument amends the method by which the costs of the capacity market are recouped from suppliers. It was felt that the current supplier charge arrangements potentially gave an unfair advantage to embedded generators—the smaller generators connected to the lower voltage distribution network—and could distort the outcome of the capacity auctions. I had better explain what that means. That arises because, under the current arrangements, suppliers are charged according to their share of demand at peak times, measured by the demand they place on the transmission grid. That is called the net demand.

By contracting with embedded generators to run over winter peaks, some suppliers are able to reduce their net demand and therefore their share of capacity market costs, which means others have to pay more. With some of the savings inevitably being passed on to the embedded generators, such arrangements unintentionally risk giving them a double payment for what is essentially only one contribution to security of supply. Nobody is operating illegally, but it is basically a loophole that needs shutting off. As my great hero Basil Fawlty said in another context,

"that particular avenue of pleasure has been closed off."

We need to shut that off.

The instrument addresses the issue by amending the basis of the capacity market supplier charge and settlement cost levy from net to gross demand. That is a fairer way of sharing costs between suppliers. It ensures that suppliers' costs reflect their overall demand and helps to ensure a level playing field between different generators in the auction. That is the first of what I hope are non-contentious amendments—although, looking at my shadow, perhaps that is a victory of hope over logic.

Secondly—I will be as quick I can—the instrument seeks to prevent new and refurbishing plants from being overcompensated within the capacity market when they are also in receipt of aid through risk finance schemes such as the enterprise investment scheme, the seed enterprise investment scheme and venture capital trusts. We do not want to have a double subsidy, whereby plants can get this payment and tax breaks as well, because that would distort the outcome of capacity auctions.

To ensure fair competition and value for money for consumers, the regulations assert that where a capacity provider has accessed investment through one of these risk finance schemes to provide or help to fund their

[Richard Harrington]

capital expenditure, their capacity payments must be reduced until that has been offset. They can switch systems, but only after they have used up the original tax breaks. These offsetting arrangements ensure that the total amount of aid is capped at the amount awarded in the capacity market auction.

Thirdly, the regulations will remove an inconsistency between how demand-side response capacity and other capacity types are de-rated. For hon. Members who are less familiar with de-rating than we are in the Department, I should explain that it is the process by which the volume of a provider's capacity is adjusted to reflect the reliability of the technologies being used. Unlike other participants, demand-side response providers can nominate a lower amount of capacity to bid in an auction than the capacity that they estimated at the pre-qualification stage, but that nominated amount is not currently subject to de-rating. The regulations will address that inconsistency by ensuring that the nominated value is de-rated, thus improving the overall reliability of the capacity procured and enabling us to know more exactly what we are getting. Again, it is about closing a loophole.

Fourthly, the regulations clarify the requirement for capacity market participants to maintain credit cover until they have fully discharged all the requirements against which it has been lodged. Additionally, they put it beyond doubt that a party's credit cover will not be drawn down where a termination fee is due, unless the termination fee is unpaid.

Finally, the regulations will amend the name, though not the substance, of the capacity market warning—the statutory notification that has to be issued under the scheme in specific circumstances. We believe that "capacity market notice" will better reflect the nature of the notification and be clearer for all participants.

My Department published two consultations on our proposals in September and October 2016 and received 38 responses. Significant support was expressed for the majority of the proposals. I look forward to hearing what hon. Members have to say about them.

11.47 am

Dr Alan Whitehead: It is a pleasure to serve under your chairmanship, Mr Davies. I am afraid the feeling may not be reciprocated this morning because of my habit of turning up for Committee sittings 10 seconds before they start. I vow to turn over a new leaf and turn up earlier in future.

My support for the capacity market, as the Minister may have gathered from my non-verbal intervention to his speech, is lukewarm at most. I agree that it has been successful in securing a capacity margin over time, but its overall achievements have come at an enormous cost to the public and its results bear little relation to what was originally intended. I will spend a minute or two reflecting on the overall unsuccessfulness of the design, as opposed to the operation, of the capacity market in securing a capacity margin for the country.

The Minister has helped the Committee greatly this morning by setting out how the capacity market works and what it is about. It is a device that is supposed to secure capacity and to procure the long-term building of additional capacity by holding regular auctions. It is supposed not only to provide power on a one-year basis, as the majority of the auctions have concentrated on, but to receive competitive bids to supply power on a long-term basis. That entails building new plants and receiving not a one-year capacity contract, but a 15-year contract.

As far as the capacity market is concerned, bids can come either from existing suppliers for one-year contracts in order for them to continue to exist, or for 15-year contracts to build new power stations and for those power stations, once built, to exist. Hon. Members need to be clear that the capacity market does not procure any energy as such. All it does is ensure that the plants which might supply energy will be in place to do so when they are called upon. Those power stations then get the market rate, whatever it is at the time, for actually supplying the power. They are rewarded doubly through the capacity market. First, they are rewarded for existing. Secondly, they are rewarded when they supply power in the normal way when they are asked to do so. The capacity market is essentially a device that secures the continued existence of power stations, or the possible existence of new power stations. It is nothing to do with the actual supply of power.

The Department has now held a number of auctions along those lines and has spent to date—I say this very slowly—£4.8 billion. That money comes from consumers. As is reflected in the report today, the devices by which that money comes from the supplier, and thus from consumers, are set out in the explanatory notes and in some of the passages in the SI itself, but £4.8 billion has gone to power generators.

One of the aims, as I mentioned, has been to secure the development of new gas CCGT plants in order to secure a long-term capacity for those plants. Hon. Members will know that a number of gas power stations are closing in the near future and a number have been mothballed. Perhaps the idea of procuring new gas power stations to replace those is not so bad in theory, but in practice, after £4.8 billion has been spent, no significant new plants have been procured. Actually, that is not quite true: one plant was secured in the initial auction, but it was not built and has now been cancelled, and a small CCGT plant—I think at King's Lynn—has been secured, but otherwise no significant large CCGT plants have been secured.

It is true, as the Minister says, that some other plants have been procured—small open-cycle plants from reciprocating engines. Some of those reciprocating engines are unfortunately diesel engines, which from a public policy point of view might be the worst idea in terms of securing new power capacity. Those are very small in individual capacity and collectively they do not add up to more than what would have been the output of about one new CCGT plant.

As far as one-year contracts are concerned, two thirds of what has been procured has been for the continuation in existence of fossil fuel plants, including, for example, coal plants, which are supposed to be phased out by 2025. Arguably, the capacity market has led to the continued operation of coal plants that otherwise would have closed down already.

Even among non-fossil fuels, in the December auction for example, the largest sum went to—I am not making this up—procuring the continued agreement of nuclear power stations to generate, to the tune of £177 million, when we know that it is not possible for nuclear power stations to switch off and not generate. We have thus very smartly procured a commitment to supply from the sector of the market that is unable to not supply; nuclear plants receive £177 million for the privilege of continuing to supply and not to switch off. From that point of view, the capacity market has not been a conspicuous success; put another way, it has arguably been a monumental waste of money, which eventually finds its way to customers' bills, as shown in the mechanisms outlined in the SI.

It is not as though capacity markets were the only show in town. They were invented during the energy market reform process, hence the Electricity Capacity Regulations 2014, the starting point of capacity markets' operation. The Minister has outlined how the SI seeks to make a number of mostly minor amendments to those regulations, which he described as "tweaks". I agree that they are tweaks; with regard to the market working in its own right, they are perfectly sensible and reasonable and we should have no concern about them, with one caveat.

A significant impact assessment, published by the Government while considering the establishment of the capacity market, looked at it against the main possible alternative: a strategic reserve whereby capacity is reserved outside the market, for example from power stations already mothballed, and is released should there be a strain on the main market leading to very high prices per half hour of power. At the time, that was assessed as far cheaper for the public to underwrite, but for complex reasons it was not advanced instead of the capacity market, even though the impact assessment showed that the change in net welfare for the strategic reserve was twice as good as for the capacity market.

The strategic reserve has been my personal preference all along. I think even now it would be possible to establish a strategic reserve to ensure capacity margins and to discontinue the capacity market. From the explanatory notes alongside this SI, however, I see that the capacity market is now supposed to last for 10 years, with a review of its operation five years after its introduction, which I take to be 2014. We currently have a capacity market; it is prudent to look at its detailed workings and amend them to obtain better results if possible, which is essentially what these measures do. To that extent, with one caveat, I am happy to see them proceed and will not seek to divide the Committee.

My caveat is a measure in schedule 2 to the regulations, which, as the Minister has outlined, seeks to change the formula for securing a measure of payment from suppliers to underwrite the capacity market. The payment required is based on a supply share of total demand at peak times over the winter, and is based on power through the transmission grid. The suggestion is that some suppliers reduce their liability by sourcing some of their supply from embedded generators connected not to the transmission grid but to the distributed grid. In theory, they might gain a market advantage by, in effect, being paid twice: once through the indirect benefit to them from their dealings with the supplier, and once through their own activity.

As the explanatory note sets out, the theory is:

"It is expected that suppliers will pass on most of this saving to the embedded generator."

It is by no means clear that that actually happens; if it does not, through the envisaged change from charging net supply to charging gross supply, the embedded generator loses rather than gains through the process. I would be grateful for the Minister's thoughts on the process set out in schedule 2, and to know whether he is clear that it does set out the benefits he has described to us. I would ideally be grateful for an indication that he will have a further look at this section, to see whether further amendments might be made to the payments regime, reflecting better solutions that have been identified to the problem he quite rightly outlines.

Finally, returning to my initial point about the overall failure of the capacity market to do what it was intended to do, and the enormous cost incurred in the process, I would have thought it would be prudent to bring forward the review set out in the explanatory notes from five years after the beginning of the capacity market in operation to four years. If the review happened next year, we could see whether the capacity market has been working in the way it was intended and whether there may be better alternatives to the capacity market to secure capacity in the future.

The Minister and I agree that this is a fundamental part of the process we need to get right over the next year as we continue to deal with close capacity margins. We need to ensure that the lights stay on. I will be interested to hear from the Minister whether he is considering doing that review. If he is not, will he consider that in the not too distant future?

12 noon

Richard Harrington: I am extremely grateful to the shadow Minister for his speech. He has provided food for thought on a lot of points. I thank him for his support for most of these technical tweaks or arrangements. I greatly appreciate it.

I have listened carefully to the hon. Gentleman's views on the capacity market. You, Mr Davies, and others may get rather impatient if I go into great detail about the market itself, but I am happy to meet the hon. Member for Southampton, Test—I think I am seeing him on Monday anyway—to talk about it in the detail it deserves, rather than occupying the Committee now. If it is acceptable, I will stick to talking about the technical arrangements themselves.

The hon. Gentleman raised some specific issues that I should mention to get them on the record, if Members will bear with me. I did not actually mention the 15-year agreement in my opening remarks, but what he said was correct. The capacity market selects plant at auction simply by price. It is a safe assumption that an existing plant, because it has probably written off its investment, will be cheaper than a new plant, which faces significant up-front investment costs.

Some of the nuclear plants that the hon. Gentleman referred to are near the end of their life. They could be turned off, and in fact that was the intention with many of them, subject to the great safety requirements necessary. The operator, EDF, is extending the life of those plants, but for a short period. He is right about turn-on and turn-off—it cannot be done instantly—but the plants can be kept going within a safe limit for comparatively short periods, compared with their full life.

[Richard Harrington]

The majority of resources are able to access only one-year agreements. An exception was made for new and refurbished plant because investors required more certainty to invest in large capital projects. Where not necessary, longer-term agreements risk needlessly locking consumers into paying a long-term price. That goes against the valid point that was made about things moving quickly in the energy market. What seems like a good deal in year one could seem absolutely ridiculous in four years. The Government, as usual, have to try to strike a balance. The hon. Gentleman may feel and is perfectly entitled to feel that the balance has not been struck properly, and I look forward to discussing that with him.

The capacity market is technology-neutral. The types of energy or technology are not decided in advance, because all types are eligible to participate. That is correct, and it includes coal and other fossil fuels. Broadly, those get Government subsidies in the same way so as to comply with state aid rules. Value for money is very important for energy. For those less familiar with the energy market, there are other auctions, such as contracts for difference and other systems. We could discuss those at length. Members will be delighted to hear that I will not do that now, but those systems take care of the point that the hon. Gentleman raised.

Should we pay to keep new and existing plant going through the capacity market? The Government think there are good reasons to do so, but there are arguments to the contrary. I fully accept the hon. Gentleman's point that the Government have a popular policy—popular in most parts of the country—of removing fossil fuels as soon as possible. We are doing that, as hon. Members know, but it does means that there might be some fossil fuel use in the short term, because fossil fuels can be turned on and off quite easily. I suppose that gas is the easiest to turn on and off, with coal just behind, but that is nothing to do with the Government's strategy, which we are sticking to, of removing fossil fuels in the next few years. It is a well publicised strategy, and the owners of the power stations know about it and are on track for it.

Rather than going into more detail now, I would love to debate the more technical points that the hon. Gentleman has made with him later. Having worn the patience of the Committee significantly by going into more detail than some Members on both sides might have wanted, I am happy to speak to anybody individually. Obviously, I have regular meetings with the shadow Minister and the Scottish nationalist party spokesman, the hon. Member for Inverness, Nairn, Badenoch and Strathspey, and if they would like me to put this matter at the top of the agenda, I will happily do so, in a meeting with officials if they would prefer to go into those details.

Dr Whitehead: Before the Minister resumes his seat, would he say for the record whether a further view will be taken on the question of embedded generation and gross payments and, secondly, whether the review of the capacity market might be expedited over the coming period?

Richard Harrington: I listened carefully to the hon. Gentleman's points on that subject. He asked me to give some thought to those options before we decided that we were not going to pursue them. I am giving thought to them both, and I look forward to discussing them with him.

Question put and agreed to.

Resolved,

That the Committee has considered the draft Electricity Capacity (Amendment) Regulations 2017.

12.7 pm

Committee rose.