

01 October 2018

Dear Energy Security Team,

Capacity Market and Emissions Performance Standard Review

The Low Carbon Contracts Company (LCCC) and The Electricity Settlements Company (ESC) are private companies wholly owned by the Secretary of State for Business, Energy and Industrial Strategy (BEIS). They perform central functions in the operation of the Contracts for Difference and Capacity Market schemes. The LCCC carries out the functions of its sister company ESC, via a cost-sharing arrangement.

ESC in its role as the Capacity Market Settlement Body is primarily focussed on making payments to Capacity Providers, funded by collecting the Capacity Market supplier charge. In addition, we hold credit cover for Capacity Market auction participants and undertake the meter assurance required before the successful participants start receiving payments. We also support BEIS and Ofgem on amendments to Capacity Market Regulations and Rules.

As independent organisations we have a key role to play in keeping these schemes fit for purpose, by providing objective advice based on our operational experience of scheme delivery to inform Government as it considers changes to policy, whilst minimising operational risk and maximising operational efficiency.

We do however recognise that our operational focus must consider wider market priorities and how the schemes interact with each other and with other market arrangements. Our recommendations to the Government are therefore also considerate of four key principles that we feel best support a holistic approach to promoting investor confidence and minimising cost to consumers:

1. Maximising competition – as this will deliver lower costs in auctions
2. Promoting cost-reflective outcomes – thus ensuring better whole system outcomes and a more stable policy landscape for investors
3. Facilitating innovation – this encourages investment that is necessary for the longer-term delivery of lowest cost to consumers
4. Coherence and Simplicity – reducing complexity in market arrangements to reduce participation costs and the potential for unintended consequences from complex interactions.

Summary of key messages

Objectives of the Capacity Market

- For the foreseeable future, ESC believes the Capacity Market's objectives remain appropriate. However, we believe there are some unintended consequences resulting

from how the Capacity Market interacts with other market forces, which could be further investigated.

Managing Fraud and Error

- ESC as the disburser of Capacity Market funds to scheme participants is conscious of the risk from fraud and error, especially as the sums of monies paid out are substantial. ESC was set up as a direct consequence of Capacity Market payments being classified by HM Treasury as public money and therefore requiring Accounting Officer oversight.
- It is therefore vitally important that ESC has access to all the information it needs to manage these risks, and procedures to minimise its exposure and escalate any suspected or confirmed cases accordingly. ESC sees two key opportunities to tackle these risks during the applicant journey:

1. Know Your Customer (KYC) post-award and prior to payment instructions

- ESC would strongly advocate following the Contracts for Difference approach whereby agreements do not enter into force until KYC has been completed.
- Ideally this would allow a reasonable time period for desk-based verification of new Capacity Market agreement holders before ESC asks EMRS to set up payment instructions, without delaying the payment commencement date.

2. Monitoring performance and suspension of payments during the Delivery Year

- Upon commencement of payments, ESC suggests that BEIS should consider as part of this call for evidence how to more closely monitor Capacity Market agreement holders post-award in line with the KYC approach outlined above with regular due diligence checks.
- ESC would advocate having powers under the Capacity Market for monitoring performance and suspending payments, in line with the normal vires of an accounting officer responsible for public funds.
- Therefore, ESC is seeking changes to the Capacity Market Regulations to provide for clearer roles and responsibilities across delivery partners to improve the management of fraud and error risk.

Penalties

- ESC acknowledges the need for a debate on the possible strengthening of penalties in the Capacity Market to ensure the correct behaviours under the scheme during a stress event.
- We recommend that any proposed policy changes take into account options for implementation that result in minimal settlement system changes to help manage complexity in the scheme and to enable shorter timescales for implementation.

Annual Rule change process

- ESC recognises that there is a benefit in the annual change process, however, the current timing of this process for the implementation of changes can be problematic,

as often system development has to be undertaken at risk, with designs revised or occasionally aborted if the final rules deviate from the consultation proposals.

- ESC therefore suggests that more time is allowed for delivery partners to develop system solutions once rule changes are finalised, which could be achieved by Ofgem consulting on changes at least 12 months prior to the delivery year for which they are intended.
- We also support the development of criteria and guidance by Ofgem to assist Capacity Providers in designing change proposals that will deliver benefits in line with the objectives of the Capacity Market.
- We will continue to seek, where possible, to reserve some development space for operational improvements such as increased automation, which will benefit all participants by reducing error rates and leading to greater efficiencies within our settlement operations.
- We would therefore expect to see specific criteria for critical changes that need to be fast-tracked, which we envisage would be limited to changes that correct errors such as loopholes that undermine the intended effects of the scheme.

Managing Complexity and minimising unintended consequences

- The outcome of the Capacity Market five-year review could result in material policy and regulatory changes. ESC will continue to engage with BEIS to ensure that policy intent is delivered whilst managing change and complexity to the Capacity Market settlement system and working to minimise the potential for unintended consequences.
- We also recognise that as the Contracts for Difference and Capacity Market schemes evolve in their own ways, along with wider changes to the BSC resulting from Project TERRE and other European Union and industry-led initiatives, there could be potential for incoherence between market mechanisms.
- LCCC and ESC advocate for alignment of approach across schemes, where differences are not key design features essential to meeting scheme objectives and where alignment enables efficiencies in our operations. A recent example of EMR scheme alignment in 2018 has been the move from net to gross demand charging in the Capacity Market, to bring the approach in line with that of the CFD.

Yours Sincerely,

Omer Ahmad

**Policy and Regulation Manager
Strategy and Development Team
LCCC and ESC**