

15 October 2018

Dear Michael,

Open letter on the Five Year Review of the Capacity Market Rules and NGET's incentives

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's role is to oversee the settlement of the Capacity Market to ensure that regular payments are made to capacity providers who have agreed to provide capacity at times of system stress. In addition, we hold credit cover for Capacity Market auction participants; undertake meter assurance for sites not already validated by the Balancing System Code operator; and enable volume reallocation required for secondary trading, which is permitted between those capacity providers who have under/or over-delivered their obligation during a stress event. 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

Ofgem's Annual Capacity Market 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 and test 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 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.
- 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 the risk of error and leading to greater efficiencies within our settlement operations.

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 of fraud and/or error accordingly. Therefore, ESC is seeking changes to the Capacity Market Regulations to provide for clearer roles and responsibilities across delivery partners and Ofgem, to improve the management of fraud and error risk. For example, ESC suggests that Ofgem ensure the risks of fraud and error are considered when it assesses Rule change proposals.

Information Sharing

- In order for ESC to discharge its duties under Managing Public Money, it requires access to the information supplied during the application process and the lifetime of the agreement. The current Regulations and Rules are not explicit that National Grid may share information it collects in its role as Delivery Body with ESC for the purposes of detecting and preventing fraud.

Auction Load Following Capacity Obligation (ALFCO)

- ESC notes that Generating CMUs are defined several times in the Regulations. There may be benefit in reviewing and simplifying the interactions between Rules and Regulations (for example Regulation 5A) on Interconnectors as they become more interlinked to help to manage complexity in the Capacity Market scheme.

Secondary Trading - Volume Reallocation and SF data usage

- Based on our operational experience of volume reallocation to date, ESC recommends that the timing requirement in Regulation 39 and the related Capacity Market Rules are changed so that the window for volume reallocation only begins once the SF becomes available and that only SF data is used.

Transfer of a Capacity Market Agreement (Rule 9.2.4)

- ESC notes that there is a misalignment between Rule 9.2.4 for a CMU Transferee and Schedule 1 (Settlement Calculations) Part 8 in the Electricity Capacity Regulations 2014 (the “Regulations”). ESC recommends that the Rules be amended to accord with the Regulations. We therefore request that Ofgem addresses this as part of its review of the Rules including the secondary trading arrangements.

National Grid Electricity Trading’s (NGET’s) incentives

- ESC recommends that Ofgem should as part of its review of NGET’s incentives add in measures for NGET regarding maintenance of the Capacity Market Register, such as validation or quality assurance of Capacity Market data to minimise the risk of fraud and error. By adding such measures for these key areas, Ofgem will be enabling stronger assurance over these activities in the Capacity Market.
- This will empower both ESC and the EMR Delivery Body to be able to risk assess applicant data at the start of the Capacity Market application process and on an ongoing basis making it easier to identify data quality issues with both applicants’ data and also as part of the pre-qualification and post-agreement award process covering for example, metering data.

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 Ofgem to ensure that policy intent is delivered through the Capacity Market Rules whilst managing change and minimising complexity, and therefore the risk of unintended consequences, as far as possible.

Yours Sincerely,

Omer Ahmad

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