



Department
of Energy &
Climate Change

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The Rt Hon Matthew Hancock MP
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Dear Tim

Thank you for your letter outlining industry concerns with the treatment of demand side response (DSR) in the Capacity Market. Let me start by confirming that I have agreed to meet with demand-side response providers so that I can discuss the issues you raise with them in more detail.

I would like to use this opportunity to emphasise Government's desire to support the growth of the DSR sector. Capacity Market policy has been developed with on-going consultation with the DSR sector, including the aggregators who attended the ECCC hearing and commissioned the NERA report to which you refer. The industry representative body sits on the Capacity Market Expert Group – which has played a key role in helping to develop the policy - and a number of specific design features they requested have been included in the Capacity Market to assist the growth of this sector. These include:

- A low de-minimis threshold of 2MW to encourage smaller providers to participate. DSR with capacity of under 2MW will be able to aggregate, providing a level of flexibility to the provider and aggregator.
- The choice to participate in either the four year ahead or one year ahead auction, allowing DSR providers to decide when to participate and plan their business priorities accordingly.
- Participation in the auction as price makers, enabling DSR to be free to bid up to the overall auction price cap – an option which is not available to the majority of generation assets.
- Numerous detailed adaptations to rules to accommodate DSR, including the choice of three metering options to allow for a wider participation of DSR resources.
- Transitional arrangements available for two years exclusively to DSR and embedded generation to help grow the sector ahead of the T-1 auction.

This represents a substantial package of measures aimed at both ensuring that DSR can participate in the enduring regime as well as growing the sector in the short-term.

Restrictions on auction participation

The DSR sector has argued previously that it would not expect to be in a position to participate in a four year-ahead auction as they could not reasonably be expected to attract investors with the promise of payments beginning so far into the future. They therefore requested an auction to be held nearer to the delivery year. The sector also requested transitional arrangements with the purpose of helping a relatively nascent sector prepare for full participation ahead of the first one year-ahead auction in 2017. These representations have been reflected in the current policy design.

It is also important to emphasise that we have ensured the policy design enables the DSR sector to participate in the four year ahead auction - it is then each prospective provider's decision as to whether it prefers to put any individual units forward for these auctions or the transitional arrangements. However, as has always been intended there is a restriction regarding the eligibility for the transitional arrangements in order to ensure that it achieves its intended purpose of helping the sector to prepare. Rather than limit the development of DSR we believe this will help support the development of *new* DSR capacity – particularly load shifting/reduction capacity - as opposed to providing an additional revenue stream over the coming years for existing providers with established capacity. To allow this to occur could push out nascent providers from the transitional arrangements auctions, effectively undermining its intent.

As the cost of the transitional arrangements are met by consumers, it would not serve consumers to offer transitional arrangements agreements to established providers that have already demonstrated their preparedness by successfully obtaining capacity agreements in the four year ahead auction.

Limit on agreement lengths

New generation is able to access capacity agreements of up to a maximum of 15 years within the Capacity Market. This is because longer term agreements allow investors to spread the capital costs over an extended period, providing greater revenue certainty and enabling them to secure finance for these projects. Whilst Government has received representations from the DSR sector that they also required longer agreements in order to be competitive, no robust evidence has been provided that demonstrates the need for longer-term agreements to access finance in the same way.

Ministerial cancellation of DSR capacity

The key purpose of the one year ahead auction is to 'true up' the amount of capacity procured four years ahead as analysis closer to the time provides a more accurate understanding of the amount of capacity needed. The Secretary of State has announced that 2.5GW of capacity will be set aside for the first T-1 auction. However, in recognition that the DSR sector requires some additional certainty over procurement levels in the T-1 auction, DECC has made a policy commitment to procuring at least 50% of the 2.5GW set aside.

It is also important to note that the T-1 auction can only be cancelled if National Grid provides a report to the Secretary of State stating that no DSR capacity will be able to come forward for the T-1 auction. Therefore as the DSR Sector has said that the one year ahead auction is significant for their participation, there is little chance of the auction being cancelled.

NERA report

My officials have now had the opportunity to review the NERA report commissioned by the DSR sector, and I will discuss this with DSR providers when we meet. I should say that we do

not agree with a number of key assumptions within the report and therefore do not accept the headline analysis which you quote.

National Grid

I would also like to provide further reassurance to your concerns regarding National Grid's interest. The Government has appointed a Panel of Technical Experts, an advisory group of independent consultants, which provides additional certainty and independent oversight. The Panel impartially scrutinises and quality assures the analysis carried out by National Grid in its role as EMR Delivery Body including that for the Capacity Adequacy Assessment. As part of its remit the Panel also considers potential conflicts of interest National Grid might have in influencing the analysis.

A handwritten signature in black ink, appearing to read 'Matt', with a flourish above it.

The Rt Hon Matthew Hancock MP