

FAO: Capacity Market applicants

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Dear Capacity Market applicants,

### **Capacity withholding in the capacity market**

This letter is to remind providers participating in the Capacity Market (CM) of the prohibition on capacity withholding, and sets out our expectations regarding how exit bids should be prepared to ensure that they are consistent with the design and intent of the CM.

#### *Capacity withholding in the CM*

The CM was introduced in 2014 to ensure security of electricity supply by providing fixed payments to potential capacity providers so as to encourage investment in new capacity or to incentivise existing capacity to remain open. Two annual auctions are held, with Capacity Market Units (CMUs) which are successful in an auction awarded a Capacity Agreement for the auction delivery period, guaranteeing them a fixed payment per kilowatt of de-rated capacity. In return, the unit must be available to deliver electricity at times of system stress in the specified delivery period, regardless of whether it is in fact called upon to deliver power.

All CMUs which are successful in an auction are paid the same price per unit of capacity. A key consideration at the time of introduction of the CM was the risk that market participants would seek to push up the price paid to providers under the CM by withholding capacity within their portfolio from the auctions – i.e. making it appear that supply was lower than it was, in order to secure a higher price for those of their units which went on to receive agreements.

It was recognised that this risk of capacity withholding could present itself prior to an auction being held, or during the auction itself. In particular, at prequalification, a provider might seek to make its capacity unavailable in order to reduce the pool of providers available to bid into the auction or could seek to understate the amount of capacity that a

given CMU was able to provide. During the auction, a provider could seek to submit exit bids at an inflated level, with the objective of influencing the auction clearing price.

In order to help reduce this risk, a number of measures were put in place as part of the CM design. Among others, this included rules stating that:

- The capacity values for individual CMUs are administratively determined via standardised de-rating factor for different technology types. This prevents providers from understating the true capacity value of their plants.
- Existing CMUs (with some exceptions) are required to formally opt-out if they do not wish to participate in an auction. As part of this process, the provider must confirm to the Delivery Body whether it intends to operate in the delivery year to which the auction relates, and if not, whether it would be retiring the plant or closing it temporarily. This allows the expected availability of capacity outside of the auction to be taken into account when setting target capacity.
- Existing CMUs are also generally required to act as a Price-Taker, meaning that they are not permitted to submit exit bids into the auction (and thus make themselves unavailable) above a given threshold in £/kW. In contrast, most new-build CMUs are 'Price-Makers' and are permitted to submit exit bids at any value up to the price cap of the auction. Where the net costs of providing the capacity of an existing CMU are unusually high, such that a clearing price above the Price-Taker threshold is required in order for that unit to remain operational, then providers can request Price-Maker status for that CMU.<sup>1</sup>

#### Prohibition on market manipulation

In addition to these mechanisms within the design of the CM, capacity providers are also directly prohibited from engaging in capacity withholding under both the CM Rules, as well as Regulation (EU) No 1227/2011 on Wholesale Energy Market Integrity and Transparency as incorporated into UK law (REMIT).

In particular, 5.12.1 of the CM Rules prohibits capacity providers from engaging in market manipulation, defined as:

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<sup>1</sup> In particular, to reflect the concern that from time-to-time specific existing CMUs may face unusually high costs, providers are able to request that existing CMUs be exempted from the Price-Taker Threshold, and be given Price-Maker status. To do so, they must submit a Price-Maker Memorandum to Ofgem and submit Ofgem's receipt of the memorandum and a Price-Maker Certificate to the Delivery Body. A Price-Maker Memorandum should contain reasons for the decision of the Applicant's board directors or officers to nominate the relevant CMU for Price-Maker status (and evidence of that decision). It should also contain key information and analysis supporting the statement that the forecast economics and the estimated net going forward costs of the relevant CMU require it to secure a Capacity Agreement at a price above the Price-Taker Threshold in order to continue to operate in the Delivery Year. Net going forward costs are defined as the company's total revenue requirement with respect to the Relevant CMU less risk-adjusted market value from sales of energy and ancillary services with respect to the Relevant CMU.

- (a) *the submission of Applicant Confidential Information and/or Bidding in a Capacity Auction, in each case which:*
- (i) *gives, or is likely to give, false or misleading signals as to the supply of, demand for, or price of a Capacity Agreement;*
  - (ii) *secures, or attempts to secure, by a person, or persons acting in collaboration, the Clearing Price of a Capacity Agreement at an artificial level; or*
  - (iii) *employs or attempts to employ a fictitious device or any other form of deception or contrivance which gives, or is likely to give, false or misleading signals regarding the Clearing Price obtained in a Capacity Auction; or*
- (b) *disseminating information through the media which gives, or is likely to give, false or misleading signals as to the supply of, or demand for, or likely Clearing Price of a Capacity Agreement in the Capacity Auction or value of a Capacity Agreement in the Secondary Market where the person doing this knows or ought to have known the information to be false or misleading*

This definition of market manipulation is modelled on that which exists within Article 2 of REMIT. The prohibition on market manipulation under REMIT itself also directly applies to exit bids submitted in a CM auction, because those bids qualify as orders to trade in a wholesale energy product. A Capacity Agreement is a wholesale energy product under REMIT because it places an obligation on providers to supply electricity at a specified level in MWh when called upon to do so.

The primary guidance on the application of the prohibition on market manipulation under REMIT is that published by the EU Agency for the Cooperation of Energy Regulators (ACER). At the time of the UK's departure from the EU, Ofgem took the decision to continue to interpret REMIT when carrying out its monitoring and enforcement responsibilities with regard to the ACER guidance.<sup>2</sup>

Version 6 of the ACER Guidance<sup>3</sup> sets out the factors which may be taken into account in determining whether an order or transaction gives a false or misleading signal, or secures a price at an artificial level, and thus whether market manipulation has occurred. Of particular relevance to capacity withholding in the CM is the definition of a non-genuine order or transaction as one which:

*"might not result from a genuine interest in procuring/selling a wholesale energy product at the offered price, but might rather be used instrumentally to achieve another purpose..."*

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<sup>2</sup> [Ofgem letter on EU exit REMIT contingency arrangements, October 2020](#), p2

<sup>3</sup> [ACER Guidance on the application of REMIT, 6th edition](#)

The ACER guidance also provides a (non-exhaustive) list of types of practices that constitute market manipulation which can occur through giving false or misleading signals and/or securing the price at an artificial level, set out in section 6.3.2. This includes under item “t” the specific example of electricity generation capacity withholding defined as *“the practice of keeping available generation capacity from being competitively offered on the wholesale electricity market, even though offering it competitively would lead to profitable transactions at the prevailing market prices.”* The ACER Guidance then goes on to define “economic” withholding in footnote 106 as *“Actions undertaken to offer available generation capacity at prices which are above or at the market price and do not reflect the marginal cost (including opportunity cost) of the market participant’s asset, which results in the related wholesale energy product not being traded or related asset not being dispatched.”*

#### Implications for bidding in CM auctions

To avoid the risk of breaching market rules relating to capacity withholding when bidding in a CM auction, providers should ensure that their exit bids do not exceed their best estimate of the additional CM revenue required by a CMU to break even, given their forecast of the net costs of providing the capacity of the specific CMU in the specified delivery period as of the time of the auction. A pay-as-clear (rather than pay-as-bid) design was chosen specifically so that providers would bid in line with their estimates of the net costs of providing capacity, rather than trying to anticipate or influence the auction clearing price via their bids.

Providers should take steps to ensure that they have documented and are ready to demonstrate how their exit bids have been arrived at in light of their estimates of expected future revenue-streams (including sales of energy and ancillary services) and the costs of providing the capacity (including for example any additional construction or refurbishment costs, operational costs, and financing or capital costs). For existing CMUs, this includes with reference to any Price-Maker Memorandum submission – including explaining any changes in expected costs in the event that the bid submitted differs to the net going forward cost assessment that formed the basis for that submission.

Where a provider is submitting bids for a number of CMUs in its portfolio, those bids should be set independently of each other, and providers should be ready to demonstrate the steps taken to ensure this was the case. The exception is in the specific circumstances where material and demonstrable cost synergies exist between certain CMUs, such that the cost of providing the capacity of one CMU depends significantly on whether another receives an agreement. This could arise where, for example, multiple proposed new-build units located at the same site share certain infrastructure. In this case, it is open for providers to reflect these synergies in the exit bids of the specific CMUs which would benefit from the cost savings.

5.13.1(e)(iii) of the CM Rules allows information about exit bids to be shared between companies within an Applicant group. This ensures that where CMUs share a single management team, those individuals are not excluded from taking decisions across multiple CMUs. However, for the avoidance of any doubt, this does not entitle bidders to withhold capacity which could be economically offered to the auction in order to increase profitability across the group's portfolio, nor does it permit the submission of false and misleading signals regarding the price level at which a provider would be willing to supply the capacity of a CMU in its portfolio.

Providers must ensure that they have the necessary training in place to ensure that all staff involved in the preparation of exit bids are aware of and understand the relevant market rules, including the prohibitions on market manipulation and requirements under competition law. In any situation where there is any uncertainty as to the legitimacy of a proposed bidding strategy, providers should seek legal and professional advice.

#### Next steps

Protecting the integrity of the CM is of utmost importance given the role of the CM in safeguarding electricity security of supply and encouraging investment in capacity, and the very substantial costs of the scheme. These costs are ultimately paid for by household and business customers via their electricity bills (with over £20bn of Capacity Agreements having been awarded since the first auction was held in December 2014). Ofgem will continue to monitor the market closely, and will not hesitate to take action if we become concerned that a participant has breached market rules.

Yours sincerely

**Amy O'Mahoney**

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