EXPLANATORY MEMORANDUM TO

THE CONTRACTS FOR DIFFERENCE (ALLOCATION) (AMENDMENT) REGULATIONS 2015

2015 No. [XXXX]

1. This explanatory memorandum has been prepared by the Department of Energy and Climate Change and is laid before Parliament by Command of Her Majesty.

2. Purpose of the instrument

2.1 This instrument amends *The Contracts for Difference (Allocation) Regulations 2014* (S.I. 2014/2011) ("the 2014 Regulations") to enable the Secretary of State to implement the policy of a Non Delivery Disincentive (NDD) in respect of the allocation of Contracts for Difference (CFD) under Parts 2 to 9 of the 2014 Regulations, and the instrument corrects a cross-referencing error in regulation 51(8) of the 2014 Regulations. The NDD is intended to incentivise applicants who have been successful in the CFD allocation process to sign the CFD offered to them and to minimise the risk that those who enter into a CFD fail to deliver the project. This is an important mechanism to ensure the efficient allocation of budget to viable projects whilst deterring speculative applications, thus ensuring the Government's carbon reduction targets are met in the most effective manner.

3. Matters of special interest to the Joint Committee on Statutory Instruments

3.1 By regulation 1, these Regulations come into force on the day after the date on which they are made. It is necessary to implement amending legislation as soon as possible. We intend for the NDD to apply to offers of CFDs and CFDs entered into further to the first allocation round, which opened for application on 16 October 2014. We published a policy update on 14 October 2014 announcing the finalised policy before the CFD auction. Ensuring that these Regulations come into force as soon as possible will give industry certainty about how the exclusion and exemption process will work in respect of the next allocation round, likely to be in the autumn of 2015.

3.2 Once the legislation is in force and after completion of the first allocation round, the CFD counterparty (the Low Carbon Contract Company Ltd (LCCC) has been appointed to that role) will publish a register list of any sites to which there applies the temporary site exclusion established by these Regulations. Developers in a subsequent round will be able to look at the register to assess whether a site in respect of which it intends to make a new application is affected by an excluded site. If so, an applicant will assess whether an exemption may be applicable and it can then make a request to the Secretary of State for an exemption. The period during which an applicant can request an exemption is expected to open 50 working days before the allocation round commencement date.

3.3 The NDD applies to an application made in an allocation round where, in a previous allocation round, an offer of a CFD was allowed to lapse by the applicant or

a CFD was entered into but it was terminated for non-delivery within 13 months of the CFD notification. Where a temporary site exclusion applies, a person who wishes to make an application in the next allocation round may apply to the Secretary of State for an exemption certificate, which may be given in limited cases. Regulation 14A provides that no exclusion applies to an application in an allocation round where there is no opportunity before the round to request an exemption certificate.

3.4 The temporary site exclusion only applies for a period of 13 months following the CFD notification which precedes the CFD offer. The exclusion needs to be sufficient to ensure that applicants do not seek to tie up budget by deliberately distorting the auction in one allocation round, perhaps in order to allow them to apply into the subsequent round. A period of 13 months is considered to be sufficient to ensure that such "gaming" behaviour does not occur, given that allocation rounds are likely to take place each 12 months and so such behaviour in one round will have consequences in the next round.. The disincentive has though been balanced against the policy objective of ensuring that sites which can be used for low carbon generation and which can be supported by a CFD will not be excluded for long periods, one of the criticisms levelled at a former scheme, the Non Fossil Fuel Obligation[1].

3.5 The temporary site exclusion only applies to the site of the main structures of the generating station and not the whole of the site as described in the planning consents which accompany an application. Further, ground 1 of the exemptions applies where the overlap of an excluded site and the site of the main structures under a new application is less than 51%. Grounds 2 and 3 of the exemptions are designed to protect the property interests of persons who held an interest in an excluded site before 14 October 2014 (when the NDD was announced) and who may have been unable to enter into contractual arrangements with an applicant in the first allocation round who then did not take up the CFD offered or who caused the CFD to be terminated early, thus causing a temporary site exclusion to arise. Grounds of exemption are introduced which are intended to deal with those cases where an exclusion may arise other than by reason of "gaming" behaviour.

3.6 Further exemptions are available where:

- the CFD was terminated by reason of a "Qualifying Change in Law" or "Relevant Construction Event" (as those terms were defined in the CFD);
- relevant court proceedings were commenced or concluded after the last date on which the successful application could have been withdrawn from the allocation round; and the applicant's ability to comply with the terms of the CFD which was offered would have been subject to a "Material Adverse Effect" (as that term was defined in the CFD),

  and these exemption recognise that a termination or refusal to accept the offer of a CFD in such cases would not be related to "gaming" behaviour.

[1] https://www.ofgem.gov.uk/environmental-programmes/non-fossil-fuel-obligation-scottish-renewable-obligation

4. Legislative Context

4.1 The Energy Act 2013 ("the Act") contains powers enabling the Secretary of State to implement measures to reform the electricity market to encourage low carbon electricity generation and ensure security of supply. The reforms which have been implemented are known as Electricity Market Reform (EMR) and a number of statutory instruments have already been made in relation to CFDs or are before Parliament in draft:

- The Contracts for Difference (Allocation) Regulations 2014;
- The Contracts for Difference (Definition of Eligible Generator) Regulations 2014;
- The Contracts for Difference (Electricity Supplier Obligations) Regulations 2014;
- The Contracts for Difference (Standard Terms) Regulations 2014;
- The Electricity Market Reform (General) Regulations 2014; and
- The Electricity Capacity Regulations 2014.
- The Power Purchase Agreement Scheme Regulations 2014
- The Electricity Capacity (Supplier Payment etc.) Regulations 2014

Those currently before parliament in draft:

- The Electricity Market Reform (General) (Amendment) Regulations 2015
- The Electricity Supplier Obligations (Amendment and Excluded Electricity) Regulations 2015
- The Electricity Capacity (Amendment) Regulations 2015

4.2. The first CFD allocation round opened in October 2014. A second allocation round is planned for autumn 2015.

4.3 These Regulations introduce the NDD which aims to prevent CFD auctions being distorted by applicants who do not intend to enter into a CFD if it is offered or who cause a CFD to be terminated early for non-delivery. Such applicants may put in bids of strike prices which are not realistic for their projects. Such behaviour prejudices other applicants who may otherwise have had successful applications and could deliver viable projects and leads to an inefficient use of the limited CFD budget in each round.

4.4. The Energy Act enables the Secretary of State to provide for an allocation round process which includes eligibility requirements. Regulation 14 of the 2014 Regulations already provides for types of applications which are excluded and new regulations 14A to 14D provide for a further case of exclusion, subject to exemptions.

5. Territorial Extent and Application

5.1 This instrument extends to Great Britain.

6. European Convention on Human Rights

6.1 Edward Davey, Secretary of State at the Department of Energy and Climate Change has made the following statement regarding Human Rights:

> In my view the provisions of the Contracts for Difference (Allocation) (Amendment) Regulations 2015 are compatible with Convention rights.

7. Policy background

7.1 The electricity market reform programme is intended to incentivise investment in low-carbon electricity generation, while improving affordability for consumers, and maintaining energy security. These regulations are concerned with one element of the wider reform package – 'Contracts for Difference' (CFDs).

7.2 CFDs are contracts between a low carbon electricity generator and a Government-owned company, the CFD Counterparty. Under a CFD, the CFD Counterparty will pay the generator the difference between a fixed 'strike price' and a market reference price (or, if the reference price is higher than the strike price, the generator will pay the difference back to the CFD Counterparty). In this way they provide long-term price stabilisation to low carbon plant, allowing investment to come forward at a lower cost of capital and at a lower cost to consumers.

7.3 The intention of the NDD is:

- To ensure that an allocation process is in place which incentivises legitimate projects which can be delivered under the terms of the CFD.
- To prevent an inefficient allocation of the LCF budget and to deter speculative applications from being part of the CFD auction.
- To ensure that where a temporary site exclusion applies, appropriate exemptions are in place to deal with cases where "gaming" has not occurred..

7.4 NDD has been welcomed by industry who are concerned that some participants may act to distort the allocation process. After considerable stakeholder discussion it was decided that the temporary site exclusion in conjunction with the grounds of exemption was a necessary but proportionate way to prevent such distortion of the CFD allocation process.

8. Consultation outcome

8.1 The policy set out in this instrument was subject to a six week. *Consultation on Non-Delivery Disincentive Exemptions,* published on 25 September 2014[2], which allowed stakeholders to provide feedback on the proposals.

8.2 Eleven responses were received to the consultation. These responses were supportive of the proposals or proposed minor changes to the policy that fall outside the scope of the regulations themselves. Details can be found in the Consultation on

[2] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/358462/Consultation_on_Non-Delivery_Disincentive_Exemptions_-_FINAL.pdf

Non-Delivery Disincentive Exemptions: Government Response published alongside this document.[3]

9. Guidance

9.1 The Government Response to the consultation has been published to coincide with the laying of the draft Regulations in Parliament. The Government Response sets out the views of stakeholders and an explanation of the final policy decisions taken.

9.2 A policy update setting out the finalised policy on NDD was published on 26 January 2015, in advance of the period for sealed bid submission in the CFD auction in the first allocation round.

9.3 It is intended to publish further guidance on the NDD exemption process in the coming months in order to give industry further information on the implementation of the process and forms of evidence to support an exemption request.

10. Impact

10.1 Applying for a CFD is voluntary. The impact of these Regulations on businesses, charities or voluntary bodies is only applicable if an eligible generator applies for a CFD in respect of an eligible generating station.

10.2 The impact on the public sector is the cost borne by Government and National Grid delivering their EMR functions and those associated with setting up a CFD Counterparty.

10.3 An Impact Assessment relating to the wider CFD regime within which these Regulations sit is attached to this memorandum and will be published alongside the Explanatory Memorandum on the legislation.gov.uk website. The impact of these Regulations is minor, such that it falls within the costs and benefits within that existing Impact Assessment, first published in June 2014.

11. Regulating small business

11.1 The legislation applies to small businesses who would be free to apply for a CFD if they are building an eligible generating station. However, by regulation 14 of *the Contracts for Difference (Allocation) Regulations 2014* there are types of application for a CFD which are excluded from Parts 2 to 9 of those Regulations, including where the small scale Feed-in Tariff (FiT) is available for the generating station, such as onshore wind, hydro, solar PV or anaerobic digestion generation of less than or equal to 5MW.

11.2 Given the nature and scale of investment in electricity infrastructure that the CFD scheme aims to encourage and the existence of the small scale FiT, it is unlikely that firms with less than 20 people will apply for support under CFDs. However, the

[3]https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/405332/Government_Response_Consultation_on_Non-Delivery_Disincentive_Exemptions.pdf

Department has sought to consult as widely as possible to ensure the views of stakeholders have been taken into account in the development of CFDs.

12. Monitoring and review

12.1 Section 5(4) of the Energy Act 2013 requires the Secretary of State to prepare and lay before Parliament a report setting out how the Secretary of State has carried out his EMR functions. The section requires the Secretary of State to report, before 31 December each year and beginning in 2014, on how he has carried out his functions in Part 2 of the Act in order to deliver EMR's objectives. The report must be laid in Parliament and be shared with the Devolved Administrations.

12.2 The first of such reports was laid before Parliament on 6 November 2014. As well as fulfilling the reporting requirement, the EMR Annual Update 2014 provides Parliament and other stakeholders with a forward look of the path ahead and a summary of EMR progress since the Energy Bill received Royal Assent in December 2013.

12.3 In addition, section 66 of the Energy Act 2013, requires the Secretary of State to report to Parliament by the end of 2018 on a number of aspects of the operation of the EMR programme. These aspects include the extent to which the original objectives have been met, whether these objectives are still appropriate and whether they could be delivered in a way that imposes less regulation. This requirement covers CFDs, the Capacity Market and the transitional arrangements from the Renewables Obligation.

12.4 Evaluation will help to provide evidence for whether the EMR programme and its processes are as efficient and effective as possible and on whether the benefits of the programme are being achieved. The Government has commissioned independent contractors with appropriate expertise to provide evaluation of the first CFD allocation, first Capacity Market auction and the Final Investment Decision (FID) Enabling for Renewables process (which awarded Investment Contracts, early CFDs). The outcome of this evaluation will help inform future decisions in relation to the delivery of EMR and DECC's policies more broadly.

12.5 The Government currently envisages that evaluation work over the lifetime of the instruments will include (but not be confined to) an assessment of the extent to which the first round of awards of CFDs under the enduring regime have furthered the UK's low carbon energy objectives at least cost to consumers; the extent to which the FID Enabling for Renewables process has prevented investment hiatus; the extent to which the first Capacity Market auction has met expectations of providing security of supply; an assessment of whether the institutional framework underlying the programme is fit for purpose and an evaluation of the early impacts of the programme. The timing of these reviews and their outputs are still being considered.

13. Contact

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