EXPLANATORY MEMORANDUM TO

THE CONTRACTS FOR DIFFERENCE (ALLOCATION) REGULATIONS 2014

2014 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.

This memorandum contains information for the Joint Committee on Statutory Instruments.

2. Purpose of the instrument

2.1 The Contracts for Difference (Allocation) Regulations 2014 set out, in Parts 2 to 9:

a) how applicants must apply for a Contract for Difference (CFD);

b) how the delivery body must assess an application;

c) how the Secretary of State establishes an allocation round;

d) how an allocation framework (which contains the rules for the competitive process applied to applications for CFDs) is applied to an allocation round;

e) what an allocation framework must and may contain;

f) how a budget is set for allocation rounds;

g) how the delivery body must decide whether a competitive process is required for the allocation of CFDs;

h) when a CFD notification must be given and the process the delivery body needs to follow in respect of giving a CFD notification. (By section 14(1) of the Energy Act 2013, where a CFD notification is given, a CFD must be offered to the eligible generator).

2.2 The Regulations also include a review procedure, an appeal process to the Gas and Electricity Markets Authority (commonly referred to as "Ofgem") and for appeals on a point of law to the High Court or, in Scotland, the Court of Session.

2.3 Part 10 of the Regulations provides for CFDs offered further to a direction of the Secretary of State.

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

3.1 These Regulations are the first regulations to be made using the powers contained in Chapter 2 of Part 2 of the Energy Act 2013 (c. 32)("the Act") which provide for the procedure to be followed in order that CFD notifications (see section 12(1) of the Act) may be made. The Regulations also make provision in Part 10 for a separate procedure by which CFDs may be entered into, further to a direction of the Secretary of State.

3.2 The procedure contained in Parts 2 to 9 of the Regulations applies to "eligible generators", the definition of whom, for the purposes of Chapter 2 of Part 2 of the Act, is contained in the Contracts for Difference (Definition of Eligible Generators)

Regulations 2014. Where a CFD notification is made further to these Regulations, the process for offering a CFD is contained in the Contracts for Difference (Standard Terms) Regulations 2014.

3.3 A requirement which applies in respect of certain applications is that the applicant must provide a supply chain statement. The procedure for obtaining such a statement from the Secretary of State is included in the Electricity Market Reform (General) Regulations 2014. Part 4 of those Regulations also contains a provision, made under section 63 of the Act, which restricts claims in damages against the national system operator (designated as the delivery body in respect of these Regulations) and certain persons employed or engaged by the national system operator, when the national system operator is exercising functions under these Regulations.

3.4 The Regulations provide that requirements placed on the delivery body are to be treated as relevant requirements on a regulated person for the purposes of section 25 of the Act. Therefore, a breach can be treated, in effect, as if it were a breach of a licence condition allowing the enforcement authorities to obtain an order to secure compliance, and/or impose financial penalties.

4. Legislative Context

4.1 The Act makes provision for Electricity Market Reform (EMR), which enables the Secretary of State to implement measures to reform the electricity market to encourage low carbon electricity generation and ensure security of supply.

4.2. The electricity market reforms will be implemented by a suite of secondary legislation and related documents. The suite includes the following:

- Contracts for Difference (Allocation) Regulations 2014
- Contracts for Difference (Definition of Eligible Generator) Regulations 2014
- Contracts for Difference (Standard Terms) Regulations 2014
- Contracts for Difference (Electricity Supplier Obligations) Regulations 2014
- Electricity Market Reform (General) Regulations 2014
- Electricity Capacity Regulations 2014
- Capacity Market Rules 2014
- Modifications to the Transmission Licence of National Grid Electricity Transmission plc. (NGET) which deal with preventing conflicts of interest; and
- Consequential code and licence modifications

5. Territorial Extent and Application

5.1 Except for Part 10, this instrument extends to Great Britain.

5.2 As required by section 24 of the Act the Scottish and Welsh Ministers have been consulted.

5.3 The Department for Enterprise, Trade and Investment (DETI) are also statutory consultees under section 24(1)(c) of the Act. Although Parts 2 to 9 of these Regulations do not apply to Northern Ireland at this point, DETI have been consulted

in order to ensure that their views on the CFD mechanism and design are reflected as it evolves in advance of its applicability to Northern Ireland.

6. European Convention on Human Rights

6.1 Michael Fallon, Minister 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) Regulations 2014 are compatible with Convention rights.

7. Policy background

7.1 The EMR programme is intended to incentivise investment in low-carbon electricity generation, while improving affordability for consumers, and maintaining energy security.

7.2. EMR is the Government's response to the following examples of the challenges facing the electricity sector:

- The UK faces very rapid closure of existing capacity as older, more polluting plant go offline;
- The need to transform our generation mix to respond to the challenge of climate change and meet our legally-binding carbon reduction and renewable targets; and
- The expectation that electricity demand will continue to increase over the coming decades.

7.3. These challenges amount to a significant investment challenge, with an estimated £100 billion of further investment needed in the sector up to 2020. Without EMR the market is unlikely to deliver this investment at the scale or pace required. Nor is the market likely to deliver the diverse generation mix needed to meet our carbon reduction and renewables targets or ensure security of supply. EMR has been designed as a set of transitional arrangements which work with the market and address market failures to ensure that low carbon electricity generation is an attractive investment opportunity.

7.4. The key elements of this market reform will be delivered through two new mechanisms to incentivise the required investment. CFDs will support investment in low carbon generation by providing long-term revenue stabilisation to low-carbon plant, allowing investment to come forward at a lower cost of capital and therefore at a lower cost to consumers. The Capacity Market will provide a regular retainer payment to reliable forms of capacity (both demand and supply side); in return for such capacity being available when additional electricity supply is required at times of peak demand. This will reduce the threat of blackouts due to insufficient capacity on the system. The Allocation Regulations cover the CFD and, in particular, what information applicants need to provide, how the budget is set out and allocated, and how the appeals process works.

<u>The Legal Structure</u>

7.5 The Act contains both powers and duties for the Secretary of State in setting up the application and allocation process for CFDs. The duties ensure certain safeguards are always applicable. For example, the Secretary of State must prepare and publish an Allocation Framework (AF) in respect of an allocation round. This affords relevant stakeholders with an opportunity to familiarise themselves with the rules which will operate for the allocation of a CFD. Similarly, applicants have protections in regulation 12 of these Regulations that prevent allocation budgets reducing during the allocation process.

7.6 These Regulations contain the fundamental components of the allocation round. They contain the obligations which need to be imposed on the Delivery Body, the CFD Counterparty, and the Authority.

7.7 The AF sets out the technical rules of the allocation round. It is a document which is produced to deal with the prevailing circumstances and covers those details – e.g. of the auction process – which may need to change ahead of an allocation round being started, and this requires the ability to make changes relatively quickly.

7.8 In reaching our decision to implement the allocation mechanism using a three-tier system consisting of the Act, the Regulations and the AF, the Department considered, but ruled out, the possibility of using a negative procedure SI for the AF. This was ruled out for the following reasons:

- the type of information which will be included in the AF is more in the nature of "rules" about a competitive process than information which needs to have a legislative character[1];

- the AF should not be subject to the parliamentary process in order to ensure that allocation rounds can be organised and run quickly and are not subject to any uncertainty about their timing. A negative resolution procedure SI would always run the risk of being prayed against. If this risk materialised it would delay the timing of an allocation round. In turn, this would create investor uncertainty and possibly also lead to wasted costs;

- given the need for flexibility in order to manage the Levy Control Framework (LCF) – the framework which controls the amount of money to be spent on policies such as EMR - and CFD budgets, it is possible that the Secretary of State will want to hold more than two allocation rounds in a year. If each allocation round required an SI to set out its rules, this would result in two or more SIs needing to be produced. Each of the SIs would only be valid for a particular round and therefore would need to be revoked in due course, relatively soon after an allocation round had been completed. In our view, it is therefore not desirable to spend significant policy and legal resource producing SIs which will have only a limited "shelf-life";

[1] We recognise that the Department has recently made Smart Metering Regulations which contain the "rules" for a tender process, see The Electricity and Gas (Competitive Tenders for Smart Meter Communication Licences) Regulations 2012. However, these are distinguishable on the basis that they do not need the flexibility in relation to managing a fluid budget or having to react to prevailing circumstances.

- it is possible to envisage circumstances in which it is desirable for an allocation round to be held at a time when Parliament is prorogued. Whilst it may be possible to have made and laid an SI before Parliament was prorogued it may not be. Therefore, it is not desirable to subject the making of the allocation round rules to the parliamentary process.

7.9 A three-tier system for implementing a policy is not unusual in regulating the energy sector. Secondary legislation is often supported by licences or energy codes. Therefore, energy stakeholders are accustomed to having to navigate three tiers of "rules" as part of complying with obligations and duties imposed on them by energy legislation.

7.10 Section 6 of the Act allows for the Secretary of State to make regulations about Contracts for Difference for the purpose of encouraging low carbon electricity generation. Section 13 allows the Secretary of State to set out particular provisions as to how the CFDs are to be allocated to eligible generators.

7.11 Part 2 of the Regulations provides detail on the publication of information relating to the setting up of an Allocation Round and the issuing of an Allocation Framework Notice. An Allocation Framework is necessary for each Allocation Round and must specify to which Round, or Rounds, it applies. It is the Department's intention to ensure that there is sufficient notice for industry to make decisions in good time about applying in a particular CFD allocation round, as well as ensuring that the Delivery Body has sufficient time to make any required system changes to administer the allocation process. The administratively set strike prices applicable to each technology are also to be set out in the budget notice. The strike price is the price for one megawatt hour of electricity generated by a CFD unit. Where the market price obtainable for one megawatt hour of electricity generated by a CfD Unit is below the strike price, the eligible generator is paid the difference between the strike price and the market price. Where the market price for one megawatt hour of electricity generated by a CfD Unit is above the strike price, the CfD counterparty body is paid the difference between the strike price and the market price by the eligible generator.

7.12 Part 3 of the Regulations provides for the duties on the Secretary of State with regard to the budget for an Allocation Round. This includes ensuring that Budget Notices are publicly available, that they include all details of any minima, maxima, or sub-budget to be applicable in a given Allocation Round as well as restricting the Secretary of State's ability to change the budget(s) within 10 days of the start date of an Allocation Round.

7.13 Part 4 of the Regulations sets out the detail of the Application Process for CFDs. This – with Schedule 1 - includes the evidence and declarations that an applicant must provide in order to satisfy the Delivery Body that they are applying as an eligible generator or its Agent. The eligibility criteria are aimed at ensuring that only credible projects with a strong likelihood of progressing to construction are able to be allocated a CFD. This aims to address issues experienced with previous Non-Fossil Fuel Obligation schemes where projects were allocated contracts but were never built.

7.14 Part 5 of the Regulations includes provisions which apply immediately before and after the Allocation Process, i.e. the process set out in the Allocation Framework. Part 5 includes how applications are to be valued for the purpose of determining whether they are affordable under the budget, as well as what happens if the allocation process is delayed. Chapter 4 of Part 5 sets out the auditing procedures.

7.15 Part 6 deals with how the Delivery Body gives a CFD notification to the CFD Counterparty in respect of a successful application.

7.16 The detail of how the Allocation Process is to be run is set out in the Allocation Framework (including the bid rules, any bid flexibilities allowed, any handicapping of bids, what happens where there is a tiebreaker). The Allocation Framework may also include amendments to certain notice periods for Rounds.

7.17 Parts 7 and 8 set out the appeals mechanism where an application is determined by the delivery body as not a qualifying application.

7.18 Part 9 sets out the details of the Allocation Report that the delivery body must provide to the Secretary of State at the end of an allocation round. It also includes provision for enforcement and giving of documents.

8. Consultation outcome

8.1 The policy set out in this instrument was subject to an 11-week consultation. *Electricity Market Reform: Consultation on proposals for implementation* was published in October 2013 alongside a draft version of this instrument for stakeholders to provide feedback. This built on extensive, earlier consultation on policy issues and the appropriate approach to the allocation of CFDs.

8.2 123 responses were received to the October consultation.

8.3 Following extensive feedback from industry and others through the consultation and stakeholder interaction (expert groups, industry workshops and bilateral discussions), the Government has amended the Regulations to ensure increased certainty of budgets for industry, confirmed the eligibility criteria in place to protect consumers and applicants from the potential adverse consequences of false applications, and to further clarify the division of detail between the Regulations and the Allocation Framework.

8.4 A more detailed analysis of the consultation responses and outcome can be found in the Government Response to the consultation.

9. Guidance

9.1 The Delivery Body will issue guidance to industry on the application process in September 2014. This will cover details of the application and the allocation processes, such as user accounts, information to be provided and the auction process.

10. Impact

10.1 Applying for CFDs is voluntary. The impact of these Allocation 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 of National Grid delivering their EMR functions and those associated with setting up the single counterparty body.

10.3 An Impact Assessment is attached to this memorandum and will be published alongside the Explanatory Memorandum on the legislation.gov.uk website. This Impact Assessment also covers The Contracts for Difference (Definition of Eligible Generator) Regulations 2014, The Contracts for Difference (Standard Terms) Regulations 2014, and Parts 2 & 3 of The Electricity Market Reform (General) Regulations 2014, laid in Parliament alongside this instrument.

10.4 A number of Impact Assessments relating to the broader CFD regime and the EMR programme have previously been prepared and published on the Parliamentary website alongside the Energy Act and its preparatory documents.

11. Regulating small businesses

11.1 The legislation applies to small businesses who would be free to apply for a CFD if they were building an eligible generating station. However, the Regulations provide that there are types of application for a CFD which are excluded from Parts 2 to 9 of the Regulations, including where the small scale Feed-in Tariff 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 EMR. However, the Department has sought to consult as widely as possible to ensure the views of stakeholders have been taken into account in the development of EMR. In addition, the Department established two working groups to help develop proposals to support the participation of smaller independent generators.

12. Monitoring and review

12.1 Section 66(1)(a) of the Act requires the Secretary of State to carry out a review of Chapter 2 of Part 2 (i.e. the CFD powers) and as part of that review SoS must consider the objectives of the CFD provisions, assess whether those objectives have been achieved, and whether they remain appropriate, and if so, the extent to which they could be achieved in a way which imposes less regulation.

13. Contact

13.1 Irum Kareem at the Department of Energy and Climate Change Tel: 0300 068 8082 or email: irum.kareem@decc.gsi.gov.uk can answer any queries regarding the instrument.