EXPLANATORY MEMORANDUM TO

THE CONTRACTS FOR DIFFERENCE (ELECTRICITY SUPPLIER OBLIGATIONS) REGULATIONS 2014

2014 No. [XXXX]

1. This explanatory memorandum has been prepared by the Department for 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 (Electricity Supplier Obligations) Regulations 2014 establish a mechanism to allow the CFD Counterparty to raise funds from all licensed electricity suppliers in Great Britain to pay for the liabilities that it has to make for payments to electricity generators under the Contracts for Difference scheme, and to return money to suppliers where appropriate. The Regulations set out arrangements for the CFD Counterparty to hold sums in reserve and to cover its losses in the situation of default by an electricity supplier. The Regulations also set out the arrangements for collection of a levy from all licensed electricity suppliers to pay for the CFD Counterparty's operating costs.

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

3.1 None

4. Legislative Context

4.1 The Energy Act 2013 ("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

4.3. Where the Secretary of State is to make regulations under Section 6 of the Act, Section 9(1) of that Act requires that regulations make provision for electricity suppliers to pay the CFD Counterparty for the purpose of enabling the Counterparty to make payments under all CFD contracts to which it is a party. This obligation is fulfilled through the Regulations that are the subject of this Explanatory Memorandum.

5. Territorial Extent and Application

5.1 This instrument applies to the United Kingdom.

5.2 As required by section 24 of the Act the Scottish Ministers, Welsh Ministers and the Department for Enterprise, Trade and Investment have been consulted.

5.3 Although the Regulations apply to the whole of the UK, Northern Ireland electricity suppliers are not subject to obligations to make payments to the CFD Counterparty. The Regulations will later be amended to impose such obligations as the CFD scheme is extended 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 (Electricity Supplier Obligations) Regulations 2014 are compatible with the 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 This instrument concerns Contracts for Difference (CFDs), which will provide 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 as part of the EMR programme. CFDs are contracts between the CFD counterparty and persons concerned with the generation of low carbon electricity which will provide payments between the parties based on the difference between a “strike price” determined under that contract and the market price of electricity at the time of generation.

CFD supplier obligation and CFD Counterparty

7.3 These Regulations are about the supplier obligation, which is a compulsory levy on electricity suppliers that will fund CFDs. The supplier obligation will be managed by the CFD Counterparty; this is a private company limited by shares and wholly owned by the Secretary of State, which will be designated as the CFD Counterparty by Statutory Instrument pursuant to section 7 of the Act by the time these Regulations come into force. Its main roles are to act as counterparty to CFDs and to manage the collection of monies under the supplier obligation to pay for CFDs. Where there is more than one person designated, the Schedule to the Regulations deal with this. It is the Department's intention that there is not more than one CFD counterparty simultaneously (this is only ever likely to occur in extreme circumstances for instance during a handover between two counterparties) so the Regulations are principally drafted on the basis that there is a single counterparty.

7.4. The Counterparty will collect two levies: the supplier obligation and the operational cost recovery levy through which suppliers will fund the costs of the Counterparty.

7.5 Suppliers are liable for the supplier obligation for each quarter based on the amount of payments the CFD counterparty has to make under CFDs. They are liable in proportion to their market share in the period to which the CFD payments relate – i.e. the proportion of total electricity that each supplier supplies in the relevant period. If the CFD counterparty receives more from generators than it has to pay out, then suppliers will be entitled to the excess, again in proportion to electricity supply in that period.

7.6 However, CFD payments are volatile by nature as they will vary every day depending on the "strike prices" set out in CFDs, market prices and volume of electricity generated. In order to help manage this volatility and provide electricity suppliers with some cash flow stability the CFD Counterparty will forecast and set a fixed £/MWh interim rate which suppliers will be charged against the amount of electricity supplied each day.

7.7 Payments from suppliers paid at this interim rate will provide the Counterparty with a relatively stable and predictable income, but is unlikely to exactly match payments out to generators, which will be much more variable. To ensure that the Counterparty has sufficient funds to make CFD payments a reserve fund is needed. This will be funded by suppliers as a lump sum payment at the start of every levy period.

The levy period

7.8 Both the interim rate and the reserve fund will be set on a quarterly basis. This approach ensures that the Counterparty should have sufficient funds to pay generators what is owed whilst minimising the cash call on suppliers through being reset regularly (quarterly).

7.9 The Counterparty will set the interim rate and reserve fund at least 90 days in advance of each relevant quarter.

Sizing of the interim rate and reserve fund

7.10 As set out in the Regulations the interim rate will be set according to the CFD Counterparty's forecast of expected CFD payments, electricity supply and any payments from generators for the levy period. The reserve fund will also be sized according to the CFD Counterparty's forecast of generator payments under more extreme circumstances (such as high wind speeds and low market prices), to ensure the CFD Counterparty has a 95% certainty that they will have sufficient funds to make CFD payments during the levy period.

Interim rate payments

7.11 Suppliers will pay interim rate payments on a daily basis, with amounts owed calculated by multiplying the applicable interim £/MWh rate by the volume of electricity supplied on each billing day. Suppliers will be invoiced, in practice, 7 working days in arrears of the day of supply, and will have 5 working days to make payments. To ensure that the CFD Counterparty can still make payments to generators in the event that a supplier fails to make a payment that is due, all suppliers are required to post collateral calculated to cover 21 days of interim rate payments. If collateral is exhausted the Counterparty is able to mutualise (spread the cost of) any outstanding amounts across the non-defaulting suppliers.

Reconciling against the actual supplier obligation levy

7.12 Each quarter, the CFD Counterparty will reconcile suppliers' interim payments against their underlying liability for CFD payments. To do this, the Counterparty will calculate:

- what each supplier has been invoiced to pay the Counterparty in interim rate and reserve fund payments in the relevant quarter; *minus*
- each supplier's liability for CFD payments in the quarter, according to their market share.

This process will show the amount that each supplier is owed by or owes to the CFD Counterparty – i.e. whether it has paid the Counterparty more or less in interim payments (including the reserve fund lump sum) than its underlying liability for CFD payments. This amount is then likely to be offset against the amount of money required for the following quarter's reserve fund payment.

Data reconciliation

7.13 The amount that suppliers must pay the Counterparty depends on the volume of metered electricity generation and supply on each day of a levy period. It typically takes 14 months – and on occasion 28 months – after the day of generation or supply for metered data to be finalised. Until this data is

finalised, generators and suppliers will be billed and invoiced on the basis of interim data provided through a standard industry process by the Balancing & Settlement Code administrator (Elexon Ltd). This data is updated on a regular basis over the 14 (or 28) month period as updated meter readings are obtained. The CFD Counterparty will use this updated data to adjust the amounts owed by suppliers to the CFD Counterparty (or vice versa) on a regular basis.

Operational costs levy

7.14 Suppliers will be liable for the operational costs of the CFD Counterparty once it is designated under section 7 of the Act. The proportion paid by suppliers will be split on the basis of how much electricity they have supplied during the period specified.

7.15 The first operational cost period will be 1 January-31 March 2015. For this period, the operational costs levy will be recovered from suppliers once the relevant supply data is available for 31 March 2015[1]. The operational cost levy rate for the first operational cost period will be calculated by dividing estimated total operational costs from when the company is designated (1 August 2014) by forecast electricity demand January to March 2015. The levy rate for 2014/15 has been subject to a consultation and is included in the Regulations.

7.16 From 1 April 2015 operational cost periods will be aligned to financial years and the operational costs levy payment will be collected daily along with the supplier obligation.

7.17 As we would expect the CFD Counterparty's costs to change from year to year DECC expects to conduct an annual consultation on proposals to amend the operational costs levy regulation rate. It is anticipated that the Regulations will be amended in early January each year to allow for the operational costs levy to be in force by the beginning of the next operational costs period (1 April).

7.18 Should a supplier fail to make an operational levy payment by the due date simple interest will be charged on the amount outstanding.

7.19 If the CFD Counterparty's expenditure in an operational cost period is less than income from the levy or other sources (e.g. damages), any surplus at the year-end will be refunded to suppliers. The rebate will be based on suppliers' overall market share in the financial year, and will be reimbursed after the end of that year (though this may in practice be offset against other payments due from suppliers under the Regulations).

[1] The payment will likely be required to be made approximately 23 working days after 31 March 2014.

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 for stakeholders to provide feedback.

8.2 123 responses were received to the consultation. Stakeholders expressed a desire to move away from our earlier proposal for a fixed rate supplier obligation levy levied on an annual basis, arguing that it would expose suppliers to large upfront payments into the reserve fund and large reconciliation amounts, which would be particularly difficult for smaller suppliers to manage. A majority of suppliers called for the Counterparty to have access to working capital from Government and for any surplus levy payments to be rolled over into subsequent levy periods to smooth payments and make them easier to manage. DECC explored these options but ruled them out because they would have a fiscal impact on public finances. They are also not in line with the ethos of an industry-funded scheme. However, DECC has carefully considered the concerns raised and as a result, amended the levy design to an interim rate and reserve fund that are set and reconciled on a quarterly basis, which reduces the size of the lump sum payments that are required under an annual levy by at least a third, mitigating the impact on smaller suppliers in particular.

8.3 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 Government Response to the consultation informing this and the other instruments set out in paragraph 4.2 has been published to coincide with the laying of regulations in Parliament. The Government Response sets out the views of stakeholders in response to the previously proposed policy positions, and an explanation of the final policy decisions taken.

9.2 Published alongside the Government Response is *Implementing Electricity Market Reform*. This document is intended to provide a comprehensive source of information on the final design of EMR ahead of the first CFD allocation and capacity market auction later this year. The document will provide stakeholders with detail on final EMR policy decisions and set out how these fit within the legislative framework for EMR.

10. Impact

10.1 Costs to suppliers associated with the supplier obligation can be categorised as administrative and financing costs. Administrative costs relate to establishing and operating the Counterparty. Set-up costs are expected to be £27m - £52m for the period 2012 – 2014. Average annual operational costs over the period 2015 - 2020 are expected to be £66m - £139m.

10.2 Financing costs to suppliers expected to be passed on to customers include collateral financing costs, insolvency risk, a risk premium added to customer tariffs, and up-front reserve fund financing costs. Financing costs are expected to average at £47m - £118m annually from 2015 to 2020.

10.3 This results in a total average cost to suppliers of £66m - £139m per annum for 2015 - 2020, with a net present value of £341m - £715m for 2012 – 2020.

10.4 Operational and financing costs are expected to be passed onto consumers in the form of higher bills. The average domestic bill impact over the period 2014 - 2020 of the supplier obligation under a quarterly fixed unit cost levy is expected to be in the region of £0.60 - £1.40 per annum, with a £/MWh price impact of £0.20 - £0.40 over the same period.

10.5 As outlined in the EMR operational cost levies consultation[2], the proposed cost of the CFD Counterparty is £6,485,000 for 2014/15. These operating costs (when included with those of the Electricity Settlements Company), from when the Regulations are in force in August 2014 until the end of the calendar year, are expected to increase electricity bills by around £0.05 in 2014. Operating costs have only been estimated until March 2015. If it is assumed that costs in the remainder of 2015 are similar to the first quarter, this would result in an annual bill impact of around £0.15 in 2015 (2012 prices, less than 0.05% increase in average household electricity bills. We would expect similar percentage impacts for medium-sized businesses and energy-intensive users. This impact is included in the overall expected annual average domestic bill impact of the supplier obligation of £0.60 - £1.40 for 2014 – 2020.

10.6 The impact on the public sector of the supplier obligation is limited to the cost borne by Government for setting up the single CFD Counterparty (i.e. costs incurred before the Regulations come into force).

10.7 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 Part 4 of The Electricity Market Reform (General) Regulations 2014, laid in Parliament alongside this instrument.

10.8 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 business

11.1 The legislation applies to small businesses.

[2] https://www.gov.uk/government/consultations/consultation-on-the-emr-operational-cost-levies

11.2 Smaller electricity suppliers raised concerns, through the consultation process, about their ability to manage the inherent volatility of CFD payments if they were required to meet actual liabilities on a daily basis. Implementing a supplier obligation using an interim fixed rate will reduce the impact of the supplier obligation by creating a more stable cash flow for suppliers. In addition by sizing the interim rate and reserve fund on a quarterly basis we are reducing the amount of money held by the Counterparty compared with the original proposal for an annual fixed rate and reserve fund, which should benefit smaller suppliers in particular.

11.3 As well as the formal consultation described in section 8 of this document DECC has had a significant level of engagement with electricity suppliers throughout the development of the policy. This included a call for evidence on the type of levy, issued in November 2012, a number of supplier obligation collaborative development workshops and a dedicated consultation event in Autumn 2013. Small suppliers were key participants in these activities. In addition DECC also attended a number of meetings of the Energy Suppliers Forum (for small suppliers) and Energy UK (both small and large suppliers) throughout 2012-2014 to specifically discuss and consult on the details of the supplier obligation policy with suppliers.

12. Monitoring and review

12.1 Section 5 of the Act requires the Secretary of State to report on meeting the 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 Additionally the Act requires the Secretary of State to report to Parliament by the end of 2018 on a number of aspects of the operation of the 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.

12.3 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. DECC intends to commission independent contractors with appropriate expertise to provide evaluation reports on key aspects of the reforms to help inform key future decisions.

12.4 DECC currently envisages that such reports will include (but not be confined to) an assessment of the extent to which the first round of award of CFDs under the enduring regime have furthered the UK's energy objectives at least cost to consumers, and an assessment of whether the institutional

framework underlying the programme is fit for purpose. The timing of these reviews and their outputs is still being considered.

13. Contact

13.1 Rachel Lloyd at the Department of Energy and Climate Change Tel: 0300 068 5336 or email: rachel.lloyd@decc.gsi.gov.uk can answer any queries regarding the instrument.