**EXPLANATORY MEMORANDUM TO**

**THE ELECTRICITY SUPPLIER PAYMENTS (AMENDMENT) REGULATIONS 2016**

**2016 No. 0000**

## 1. Introduction

1.1 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 These Regulations relate to the obligations of electricity suppliers to make payments to fund Contracts for Difference ("CFDs"), which are set out in the Contracts for Difference (Electricity Supplier Obligations) Regulations S.I. 2014/2014 (the "ESO Regulations"), and make a number of amendments to the ESO Regulations. These Regulations also make an amendment to the Electricity Capacity (Supplier Payment etc.) Regulations S.I. 2014/3354 (the "Supplier Payment Regulations").

2.2 The ESO Regulations established a mechanism, the 'supplier obligation', 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 payments to electricity generators under CFDs and to return money to suppliers where appropriate. The ESO Regulations also impose an obligation on electricity suppliers to pay an operational costs levy that funds the operational costs of the CFD Counterparty. The Supplier Payment Regulations impose an obligation on electricity suppliers to pay a settlement costs levy that funds the operational costs of the Settlement Body which is responsible for transactions relating to the Capacity Market.

2.3 These Regulations:

- Make a number of amendments to the ESO Regulations which are mostly of a technical nature;
- Make related provision about the obligations of the CFD Counterparty under the Contracts for Difference (Standard Terms) Regulations S.I. 2014/2012 (the "Standard Terms Regulations");
- Make an amendment to the ESO Regulations to set a new rate for the operational costs levy for the CFD Counterparty; and
- Make an amendment to the Supplier Payment Regulations, to set the new settlement costs levy that funds the budget of the Settlement Body.

## 3. Matters of special interest to Parliament

***Matters of special interest to the Joint Committee on Statutory Instruments***

3.1 None.

***Other matters of interest to the House of Commons***

3.2 Disregarding minor or consequential changes, the territorial application of this instrument varies between provisions.

## 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 following the Act are known as Electricity Market Reform ("EMR").

4.2 The two main mechanisms implemented under EMR are the Contract for Difference (CFD) scheme and the Capacity Market – both of which are now operational. The first CFD allocation round opened in October 2014 and the first Capacity Market auction took place in 2014. A second Capacity Market auction took place in 2015.

4.3 These mechanisms were implemented by a suite of secondary legislation and related documentation. These Regulations amend the ESO Regulations to make changes of a technical nature affecting the obligations of electricity suppliers to make payments to fund CFDs. These Regulations also amend the Standard Terms Regulations to make further provisions about the obligations of the CFD Counterparty to publish certain information concerning projects that have secured a CFD. These changes are being made to increase the efficiency of the supplier obligation and to improve transparency of CFD costs, in order to reduce the costs of the scheme for suppliers and their consumers.

4.4 These amending Regulations also set the new operational costs levy rate for the CFD Counterparty and the new settlement costs levy that funds the budget of the Settlement Body.

## 5. Extent and Territorial Application

5.1 These Regulations extend to the United Kingdom, except for regulation 24 which extends to Great Britain only.

5.2 Although the ESO Regulations apply to the whole of the UK, the CFD scheme does not currently operate in Northern Ireland, so electricity suppliers in Northern Ireland are not subject to obligations to make payments to the CFD Counterparty.

## 6. European Convention on Human Rights

6.1 Andrea Leadsom, 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 Electricity Supplier Payments (Amendment) Regulations 2016 are compatible with the Convention rights."

## 7. Policy background

***What is being done and why***

7.1 The Regulations that are the subject of this Explanatory Memorandum make a number of technical amendments to the ESO Regulations, set the new rate for the operational costs levy in the ESO Regulations and set the new settlement costs levy in the Supplier Payment Regulations. These Regulations also make amendments to the Standard Terms Regulations. The policy background behind these amendments is set out in further detail below.

***Technical amendments to the supplier obligation***

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 CFDs provide long-term price stabilisation to low carbon plants, allowing investment to come forward at a lower cost of capital and at a lower cost to consumers.

7.3 The CFD Counterparty raises the money to fund CFD payments through a compulsory levy on electricity suppliers in Great Britain (the "supplier obligation"). Suppliers are liable for the supplier obligation for each quarter, based on the amount of payments the CFD counterparty has to make under CFDs and the proportion of total electricity supply that they have supplied in the period to which the CFD payments relate (their 'market share').

***Principal technical amendments to the supplier obligation***

7.4 These amending Regulations make a number of changes to the supplier obligation. The most significant of these changes are as follows.

*Interim levy rate calculation*

7.5 Under the existing regime, suppliers are required to make two types of prepayment designed to cover the net amount that the CFD Counterparty expects will be paid to CFD generators. These prepayments are:

- a fixed £/MWh payment charged against the amount of electricity supplied each quarter, and set at a rate to provide sufficient revenue for the CFD Counterparty to meet their expected, central case payments to generators in the quarter (the "interim levy rate"); and
- a quarterly contribution to a reserve fund ("the total reserve amount"), which is set at a level intended to ensure the CFD Counterparty will have sufficient funds to pay CFD generators in 19 out of 20 scenarios; each supplier's individual contribution (their "reserve payment") depends on the size of an individual electricity supplier's market share.

An electricity supplier's prepayments are reconciled against suppliers' liabilities for actual CFD payments following the end of each quarter.

7.6 These amending Regulations will change the way the interim levy rate is calculated. At present, the CFD Counterparty calculates the rate by reference to the estimated CFD payments to generators that the CFD Counterparty will have to make in the quarter to which the rate relates. However, at the end of the quarter each supplier's total liabilities are assessed in relation to CFD payments to generators in respect of the period (i.e. accrued during the quarter rather than paid during the quarter). The difference between payments made during the quarter and payments accrued during the quarter arises from the CFD Counterparty making payments to CFD generators 28 days after the day of generation. This means that the interim levy rate is not an estimate of suppliers' eventual liabilities for the quarter, and suppliers have less transparency over what their actual liabilities will be.

7.7 To remedy this, these Regulations amend the calculation of the interim levy rate so that it is based on an estimate of expected net CFD liabilities within the quarter. On

average, this change is expected to lead to an increase in the interim levy rate over time compared to the current calculation (because CFD payments are expected to increase over time), and a corresponding reduction in reserve payments.

*Notice for decrease of interim levy rate*

7.8 These amending Regulations also provide the CFD Counterparty with greater flexibility in changing the interim levy rate. It can currently be changed with a minimum of 30 days' notice. This length of notice is not necessary when reducing the rate, however, and without change may result in the CFD Counterparty over-collecting from suppliers. These Regulations amend the ESO Regulations so that if the interim levy rate is adjusted downwards, the reduced rate can come into effect the working day after the notice is published. The CFD Counterparty will still be required to provide a minimum of 30 days' notice for an increase in the rate.

*Notice for reserve payments*

7.9 Currently the CFD Counterparty is required to set the total reserve amount, and issue a notice to each electricity supplier setting out their share of this amount (the reserve payment), by the same deadline. In practice, this causes the CFD Counterparty to have to calculate the total reserve amount earlier than necessary. To resolve this, these Regulations change the deadline for sending notices to suppliers to a later date.

*Publishing forecasts*

7.10 Suppliers currently have little visibility of estimated CFD costs and supplier obligation payments beyond the next quarter, which creates some uncertainty over their expected liabilities. These Regulations create a new requirement for the CFD Counterparty to publish information which relates to its estimates of CFD costs for three consecutive quarters, two quarters in advance. This information must include, at a minimum, the CFD Counterparty's estimate of the interim levy rates, the total reserve amounts, and the CFD payments which would arise for each of the quarterly obligation periods due to CFDs which have already been awarded.

***Minor and technical amendments to the supplier obligation***

7.11 In addition to the more significant changes outlined above, these Regulations make several minor and technical amendments to the ESO Regulations. These include clarifying the set-off and netting provisions, amending the mutualisation provisions to change the reference period used to calculate mutualisation payments and mutualisation notices, excluding certain information from non-payment notices issued by the CFD Counterparty, allowing the CFD Counterparty 15 working days to make mutualisation and interest repayments, and restricting to category of electricity suppliers to which the CFD Counterparty is required to issue notices. Together, these changes improve the functioning of the payments system, streamlining that system where potential issues have emerged since the ESO Regulations were made.

***Minor and technical amendments to the Standard Terms Regulations***

*Publication of CFD Start Dates*

7.12 The Standard Terms Regulations require the CFD Counterparty to publish within a public CFD Register certain information regarding the projects that have successfully entered into a CFD. The reason for this is to allow for transparency in the CFD

regime, allowing suppliers visibility of parameters that will affect their future liabilities and the public visibility of the way in which CFDs are operating.

7.13 One important factor in determining CFD costs is the date on which CFD generation payments start being paid to a generator (the "CFD Start Date"). Under the CFD standard terms, before they start generating, generators are required to provide the CFD Counterparty with their estimate of when this date will occur, and to update this estimate monthly. These Regulations introduce a requirement for the CFD Counterparty to publish a CFD Start Date for each CFD project within the public CFD Register, and to update this information on a quarterly basis.

*Change to exclusion of information from the CFD Register*

7.14 Under the current Regulations, the CFD Counterparty is entitled to exclude information from the public CFD Register if, in its opinion, it could do so under the Freedom of Information Act 2000 or the Environmental Information Regulations 2004. This exclusion was designed to ensure the protection of generators' potentially commercially sensitive information. These Regulations change the exclusion so that the only categories of information that may be excluded are:

- CFD Start Dates; and
- the CFD Counterparty's reasons for agreeing to modify the CFD standard terms.

7.15 The aim of this change is to ensure the exclusion only applies to information that could be potentially commercially sensitive. As the other categories of information are unlikely to cover commercially sensitive information, the CFD Counterparty should not be entitled to withhold information falling within them.

***Operational costs levy for the CFD Counterparty***

7.16 These Regulations also amend regulation 23 (as amended) of the ESO Regulations. This amendment revises the operational costs levy that electricity suppliers must pay to the CFD Counterparty for it to recover its operational costs. The operational cost levy rate for the CFD Counterparty is calculated by dividing its total operational cost budget by forecast gross electricity demand.

7.17 It is expected that the CFD Counterparty's operational costs will change from year to year, and therefore the process to consult on and amend the operational costs levy set out in the ESO Regulations will take place annually, alongside setting the operational cost budget of the Capacity Market Settlement Body. The ESO Regulations need to be amended in time for a revised operational costs levy to be in force at the beginning of each operational cost levy period.

***Settlement costs levy for the Settlement Body***

7.18 The Capacity Market aims to incentivise sufficient capacity to ensure security of supply at minimum cost to consumers. The payments made under capacity agreements are funded by electricity suppliers, with payments flowing via the Settlement Body. The Settlement Body recovers its operational costs for the capacity market by a separate levy on electricity suppliers (the "settlement costs levy"), which is set out in the Supplier Payment Regulations. These Regulations amend regulation 9(2) of the Supplier Payment Regulations (as amended) to revise the total amount of the settlement costs levy that liable electricity suppliers must pay in order to fund the operational costs budget of the Settlement Body.

7.19 It is expected that the Settlement Body's operational costs will change from year to year, and therefore the process to consult on and amend the settlement costs levy set out in Supplier Payment Regulations will take place annually, alongside setting the operational costs budget and levy rate for the CFD Counterparty.

## 8. Consultation outcome

8.1 These amending Regulations are informed by the responses to two consultations, the outcomes of which are described below.

***Technical amendments to the supplier obligation***

8.2 The Department of Energy and Climate Change published a consultation on 14th September 2015[1], seeking views on proposed changes to improve the efficiency and transparency of the supplier obligation and a number of minor amendments.

8.3 As the consultation concerned an existing policy with which stakeholders were already actively engaged, and as the proposals were non-contentious and mostly technical in nature, the consultation was open for six weeks, in line with Cabinet Office consultation principles. An impact assessment was published alongside the consultation, with draft regulations published on 19th October 2015 to help inform respondents on how the consultation proposals would be implemented. A stakeholder event was held on 5th October 2015 to discuss the proposals with interested parties.

8.4 The consultation received 26 responses from a range of stakeholders including large and small electricity suppliers, generators, developers, trade associations and electricity intensive industries. There was general agreement with the proposals, with some caveats which are outlined below.

*Interim levy rate calculation*

8.5 All respondents were positive on proposals to amend the calculation of the interim levy rate and to allow the CFD Counterparty to reduce the interim levy rate without notice. Some respondents requested that the CFD Counterparty provide a minimum period of notice, such as 5 working days, when the rate was reduced within quarter in order for suppliers to update their billing systems. The current drafting allows the CFD Counterparty to do this, by using its discretion to provide notice, if in its opinion it would be prudent to do so.

*Notice for reserve payments*

8.6 Responses to the proposal to allow the CFD Counterparty to calculate and provide notice of individual electricity suppliers' reserve payments by the 13th working day of the quarter before the payment is due was supported by 11 out of 14 respondents, but 2 respondents suggested a shorter time-period. DECC agreed with this suggestion, and the new Regulations require the CFD Counterparty to calculate and provide notice before the 8th working day of the relevant quarter.

*Publishing forecasts*

8.7 Proposals to increase transparency were well received by electricity suppliers. Some generators raised concerns over how the CFD Counterparty may use generator

[1] The consultation document 'CFD Supplier Obligation: Consultation on improving efficiency & transparency' is available at https://www.gov.uk/government/consultations/contracts-for-difference-supplier-obligation-improving-efficiency-transparency.

confidential information in this process. Suppliers and some generators requested limiting the amount of flexibility that the CFD Counterparty has over what information it is required to publish. In order to address these concerns, these Regulations are amended to specify what information the CFD Counterparty must publish. That information now includes forecasts of the interim levy rate and the total reserve amount, and cost estimates. This addresses suppliers' concerns by ensuring the information published would be useful to them, and addresses generators' concerns by omitting any requirement for the CFD Counterparty to publish information that might include commercially sensitive material. The information that the CFD Counterparty is required to publish provides transparency, whilst allowing the CFD Counterparty to use its discretion over the use of project-specific information, which may be commercially sensitive.

*Minor and technical amendments to the Standard Terms Regulations*

8.8 The responses to the proposal to publish CFD Start Dates on the CFD Register were mixed: suppliers were generally strongly in favour whilst generators generally were not, requesting that the CFD Counterparty should be able to exclude CFD Start Dates from publication when those dates would be commercially sensitive. We consider that the benefits of increasing transparency of CFD costs are significant. The Regulations require CFD Start Dates to be published on the CFD Register, but allow generators to make representations to the CFD Counterparty if they consider their CFD Start Date should not be published.

8.9 The majority of respondents (12 of 13) agreed with the proposal to restrict the ability of the CFD Counterparty to exclude information from the CFD Register.

*Minor and technical amendments to the supplier obligation*

8.10 A number of minor and technical amendments were consulted on and are taken forward in the Regulations, including clarification of set-off and netting provisions, amending the mutualisation provisions to change the reference period used to calculate mutualisation payments and mutualisation notices, excluding certain information from non-payment notices issued by the CFD Counterparty, allowing the CFD Counterparty 15 working days to make mutualisation and interest repayments, and restricting to which electricity suppliers the CFD Counterparty is required to issue notices. The majority of respondents supported these proposals.

***CFD Counterparty and Settlement Body operational costs 2016/17***

8.11 The levies required for the CFD Counterparty and Settlement Body to recover their operational costs for 2016/17 have been subject to a four-week consultation[2]. A four-week consultation period was considered appropriate due to the limited and focussed nature of the material to be reviewed. Approximately 550 stakeholders (including electricity generators, suppliers and consumer groups) were alerted to the consultation launch. The consultation closed on 3rd December 2015.

8.12 Two responses to the consultation were received and both generally supported the proposed operational cost budgets. One respondent queried whether the CFD Counterparty's budget would be adjusted if by April 2016 it was not managing a CFD

[2] The consultation document 'Low Carbon Contracts Company and Electricity Settlements Company operational costs 2016/17' is available at https://www.gov.uk/government/consultations/low-carbon-contracts-company-and-electricity-settlements-company-operational-costs-201617.

for nuclear generation at Hinkley Point C (as assumed in the proposed budget). That respondent also sought confirmation that the CFD Counterparty would not require additional budget to manage Carbon Capture and Storage ("CCS") CFDs. The Government Response to the consultation explains that the CFD Counterparty would not adjust its 2016/17 budget solely in relation to when it starts managing a CFD for Hinkley Point C. Instead, in the event that there is an underspend in total operational costs at the end of the financial year, surplus funds would be reimbursed to suppliers. The Government Response also clarifies that since no CCS CFDs will be awarded in the near term, the CFD Counterparty will not require additional budget for managing such contracts. The other consultation respondent noted that the forecast of gross electricity demand for calculating the CFD Counterparty's operational cost levy is likely to be subject to estimating errors, due to a lack of historical forecasting data. The Government Response confirms that Government is satisfied that the forecasting model for gross electricity demand is fit for purpose, but acknowledges that as more historical data on gross demand becomes available, future forecasting will be refined further.

8.13 DECC has decided that the analysis of responses did not justify any changes to the levies. However, post-consultation the CFD Counterparty and Settlement Body re-assessed the costs they expect to incur in 2016/17 for depreciation charges and settlement operational activity, which resulted in a slight revision to the split of costs between the CFD Counterparty and the Settlement Body. DECC has decided that the levies should be revised accordingly. The total budget (£18,690,000) remains unchanged, but the operational cost budget for the CFD Counterparty has been increased from £14,216,000 to £14,407,000 and the budget for the Settlement Body has been reduced from £4,474,000 to £4,283,000. The operational cost levy rate for the CFD Counterparty included in Regulations is £0.0509/MWh.

## 9. Guidance

9.1 The CFD Counterparty manages the operation of the supplier obligation. It engages in regular communication with suppliers to inform them of their real and expected liabilities. The CFD Counterparty itself has been closely engaged in the development of the changes to the supplier obligation and is therefore already aware of the changes implemented by these Regulations.

## 10. Impact

10.1 There is no impact on charities or voluntary bodies.

10.2 There is no impact on the public sector.

***Technical amendments to the supplier obligation***

10.3 The impact on business is that this policy will benefit electricity suppliers by a net saving of £15.8m over 5 years (2016-2020, net present value, 2015 prices), which we expect to be passed onto electricity consumers. This is the estimated impact of amending the calculation of the interim levy rate. It is expected that the publication of up-to-date information on CFD generator start dates and forecasts will improve the ability of suppliers to manage risk, but sufficient data is not available to quantify this impact. Internal assessment suggested that the minor and technical correctional amendments would have small or negligible impacts, which is a position supported by

responses to the consultation, and so these changes are not considered in the associated impact assessment.

10.4 An impact assessment is submitted with this memorandum and will be published alongside the Explanatory Memorandum on the legislation.gov.uk website.

***Operational and settlement costs levies***

10.5 As outlined in the consultation document, the combined operational cost budget of the CFD Counterparty and the Settlement Body (£18,690,000) is expected to increase household electricity bills by around £0.20 in 2016/17 (at 2014 prices). This equates to around a 0.05% increase in average household electricity bills.

## 11. Regulating small business

11.1 The legislation applies to activities that are undertaken by small businesses, because we expect that some small suppliers would fall into this category. Overall, we do not expect that these Regulations will have a disproportionate effect on small businesses; these Regulations are expected to help all suppliers manage their obligations more easily. This assessment is based on the feedback that was received during the consultation. Therefore, no specific action is proposed to minimise regulatory burdens on small businesses.

## 12. Monitoring & 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 her EMR functions. The section requires the Secretary of State to report, before 31st December each year and beginning in 2014, on how she has carried out her functions in Part 2 of the Act in order to deliver EMR's objectives. The report must be published and be shared with the Devolved Administrations. The first report was laid in November 2014, and the second in October 2015.

12.2 In addition, section 66 of the Energy Act 2013, requires the Secretary of State to review a number of aspects of the operation of the EMR programme as soon as reasonably practicable after the end of the period of 5 years beginning with the day on which the Act was passed (i.e. by the end of 2018). 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. The Secretary of State's conclusions must be set out in a report laid before Parliament.

## 13. Contact

13.1 Carly Leighton at the Department of Energy and Climate Change Telephone: 0300 068 5650 or email: carly.leighton@decc.gsi.gov.uk can answer any queries regarding the instrument.