EXPLANATORY MEMORANDUM TO

THE ELECTRICITY SUPPLIER PAYMENT (AMENDMENT) REGULATIONS 2017

2017 No. XXXX

1. Introduction

1.1 This explanatory memorandum has been prepared by the Department for Business, Energy and Industrial Strategy ("BEIS") and is laid before Parliament by Command of Her Majesty.

2. Purpose of the instrument

2.1 These Regulations amend the Contracts for Difference (Electricity Supplier Obligations) Regulations S.I. 2014/2014 (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 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.

4.2 The two main measures implemented using these powers are the CFD scheme and the Capacity Market – both of which are now operational.

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 changes are being made to increase the efficiency of the supplier obligation, 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 The extent of this instrument is the United Kingdom, except for regulation 19 which extends to Great Britain only.

5.2 The territorial application of this instrument, save for regulation 19, is the UK, though 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. The territorial application of Regulation 19 extends to Great Britain only.

6. European Convention on Human Rights

6.1 Jesse Norman MP has made the following statement regarding Human Rights:

"In my view the provisions of the Electricity Supplier Payments (Amendment) Regulations 2017 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 supplier obligation in 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. 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.

7.4 These amending regulations make a number of changes to the supplier obligation in order to increase the efficiency of the scheme, which are described below.

Making reconciliation payments more quickly

7.5 Currently, suppliers are required to make two types of prepayment to cover the net amount that the CFD Counterparty expects to pay to CFD generators. Firstly, a fixed £/MWh payment (the "interim levy rate") is charged to suppliers against the amount of electricity supplied in each quarter, and is set at a rate to cover the expected, central case payments to generators in the quarter. Secondly, suppliers contribute 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 that individual electricity supplier's market share.

7.6 Following the end of each quarter, a reconciliation determination is made in which each electricity supplier's prepayments are reconciled against their liabilities for actual CFD payments, and any difference is notified to suppliers in a reconciliation notice.

7.7 Currently reconciliation payments are made to (or collected from) suppliers 90 days after the end of the quarter for which the total reserve amount is intended to cover.

7.8 These Regulations reduce the period of time that payments are due from 90 days after the issue of the reconciliation notice to 5 working days after the issue of that notice. In order to align the payment of the reserve payment and the reconciliation payment, these Regulations also amend the ESO Regulations so that reserve payments from suppliers are due 5 working days after the issue of the reconciliation notice.

Total reserve amount calculation

7.9 The total reserve amount is currently calculated for a given quarter to provide the CFD Counterparty with sufficient revenue to be able to pay CFD generators in 19 out of 20 scenarios within that quarter. However, under the current system the CFD Counterparty does not receive reserve payments from suppliers until the 7th working day of the quarter, and this will change to the 13th working day following the implementation of these Regulations (see paragraph 7.8). This leaves a period of payments to CFD generators that is not taken account of when calculating the total reserve amount.

7.10 These Regulations shift the period over which the CFD Counterparty assesses cash-flow risk to cover the period running from the 13th working day of a quarter to the commencement of the 13th working day of the next quarter.

Reducing the total reserve amount

7.11 Currently the CFD Counterparty is able to increase the total reserve amount with a minimum of 30 days' notice, but is not able to reduce the total reserve amount if it is set too high.

7.12 These Regulations allow the CFD Counterparty to reduce the total reserve amount without notice (until the reconciliation notice that triggers the payment of a supplier's reserve payment is issued) by recalculating the total reserve amount where it considers that it would collect significantly more from electricity suppliers than needed in order to make all CFD payments to generators in 19 out of 20 scenarios.

CFD payments after the 10th reconciliation determination

7.13 The ESO Regulations classify two types of payments that can be made to CFD generators: payments which are made in respect of generation that occurred on a specific day ("generation payments"), and all other payments, for example lump sum compensation payments ("non-generation payments"). Suppliers are liable for generation payments according to their market share on the day of generation, whereas suppliers are liable for non-generation payments based on their market share over the quarter that the payment liability falls in.

7.14 In certain circumstances generation payments made to generators could be adjusted retrospectively (for example, where the generator is owed compensation following a qualifying change in law), and the CFD Counterparty would need to recover any additional amounts required from suppliers under the supplier obligation. However, the reconciliation process is limited to 10 quarters. Therefore, the CFD Counterparty is currently unable to recover costs for any generation payments made to generators after the 10th reconciliation determination of the quarter in which the generation occurred.

7.15 These amending Regulations allow for any payments owed to generators beyond 10 quarters to be classified as non-generation payments and included in the next reconciliation determination in order for the payments to be recovered from suppliers.

Preventing double-counting of exemptions

7.16 The Electricity Supplier Obligations (Amendment & Excluded Electricity) Regulations 2015 introduced two exemptions for suppliers from a proportion of their CFD costs. The first exempts suppliers from payments under the supplier obligation and operational cost levy payments on up to 85% of electricity supplied to eligible electricity intensive industries ("EIIs"). The second exemption is available to suppliers who import renewable electricity from EU Member States (green excluded electricity or "GEE"), and supply it to customers in Great Britain. GEE will not count towards electricity suppliers' market share for the purpose of calculating CFD liabilities.

7.17 Currently, it is theoretically possible for an individual supplier to demonstrate a net negative market share over a quarter if they claim both exemptions for the majority of their supply.

7.18 These Regulations cap the exemptions that can be claimed by suppliers on a quarterly basis so that the total exemption a supplier may demonstrate over a quarter cannot exceed that supplier's total supply over the quarter.

Mutualisation

7.19 The ESO Regulations require non-defaulting suppliers to pay a share of relevant supplier obligation payments when a supplier defaults on their payments. Currently, all suppliers apart from the defaulting supplier (whose payment is being mutualised) should make mutualisation payments. This means that if there was another defaulting supplier whose payments were being mutualised, they would also be expected to make mutualisation payments in respect of the first supplier, even though in reality they may be unlikely to do so.

7.20 These Regulations exclude other suppliers who have defaulted on a payment and whose collateral is exhausted or is likely to be exhausted within five working days from being required to make mutualisation payments.

Operational costs levy for the CFD Counterparty

7.21 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 annual budget by the total forecast electricity demand.

7.22 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

7.23 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.

7.24 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.

Consolidation

7.25 The department does not intend to consolidate the relevant legislation at this time.

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

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

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.

8.5 A government response was published on 25th January 2016, which set out the government's decisions on the proposals. The first phase of amendments to the ESO Regulations was laid in Parliament on 25th January 2016 and came into effect on 1st April 2016. The implementation of the second phase of amendments (the subject of these Regulations) was delayed until 2017 due to the changes required to the settlement system to implement the changes.

Making reconciliation payments more quickly

8.6 All respondents agreed that reconciliation payments should be made more quickly following the issue of the reconciliation notice, but there were mixed views on respondents' preferred approach. Six respondents supported the option being implemented under these Regulations. Three respondents supported the option but with an additional 5 working days' between the issue of the reconciliation notice and the reconciliation payment being due. One of the reasons given was that a direct debit facility was not available at the time of the consultation; this facility is now in place. Four respondents supported an alternative asymmetrical payment option in which payments from the CFD Counterparty to suppliers would be made with 5 working days' notice whereas payments made from suppliers to the CFD Counterparty would be due in 90 days. However, seven respondents were strongly against this option due to the additional complexity and systems changes that would be required.

8.7 In order to mitigate concerns around suppliers having to make payments to the CFD Counterparty at short notice, the CFD Counterparty has developed a 'transparency tool' to provide additional within-quarter updates on actual payments to CFD generators compared to the forecast CFD payments that were expected at the time of making the determination of the interim levy rate and total reserve amount. This provides suppliers with greater foresight over the magnitude and direction of potential reconciliation payments.

Total reserve amount calculation

8.8 The proposal to amend the total reserve amount calculation was supported by 11 of the 14 respondents who expressed an opinion on the proposal. Three respondents disagreed because they argued that the change would result in a higher total reserve amount. However, when assessed as a package, the combination of changes introduced via these Regulations and those that came into effect on 1st April 2016 are expected to reduce the total reserve amount overall.

Reducing the total reserve amount

8.9 All respondents supported the proposed amendment.

CFD payments after the 10th reconciliation determination

8.10 In the consultation the department proposed a more significant change to the ESO Regulations than is being implemented in these Regulations: where the amount paid to

a generator changes after the first reconciliation determination for a quarter (e.g. due to strike price adjustments or changes in metered generation volumes), suppliers' liabilities for these payments would be determined by reference to their market share in the quarter in which the adjusted payments were made to the generator, rather than their market share on the day on which the relevant generation took place.

8.11 The proposal received mixed responses, with 8 respondents in support and 5 against (of those who expressed an opinion). However, of the 8 who supported the proposal, 3 did not consider that the benefits would justify significant implementation costs.

8.12 In light of the consultation responses, the department revised its approach so that any payments owed to generators after 10 quarters would be classified as non-generation payments and included in the next reconciliation determination. This proposal resolves the primary concern of ensuring that the CFD Counterparty has the ability to recover payments from suppliers for costs that relate to generation that occurred over 10 quarters ago, whilst addressing one of the main arguments raised by respondents against the original proposal that generation payments should be paid by suppliers according to their market share at the time of generation. In addition, this proposal will be considerably cheaper to implement because it does not require changes to the settlement system. The department emailed stakeholders on 13th September 2016 inviting comments on the revised proposal and received no responses.

Preventing double-counting of exemptions

8.13 Only one respondent disagreed with the proposal because they considered it to be unnecessary.

Mutualisation

8.14 Three respondents disagreed with the proposal, arguing that it raised the possibility that a supplier could temporarily default and be excused of their share of mutualisation payments.

CFD Counterparty and Settlement Body operational costs 2017/18

8.15 The levies required for the CFD Counterparty and Settlement Body to recover their operational costs for 2017/18 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 500 stakeholders (including electricity generators, suppliers and consumer groups) were alerted to the consultation launch. The consultation closed on 25th November 2016.

8.16 In total, two responses to the consultation were received. Both generally supported the proposed operational cost budgets and welcomed the opportunity to respond to the consultation. One respondent noted the increase in professional and legal fees and emphasised the importance of a strong approach to contracting and outsourcing processes to ensure value for money, when procuring highly skilled external resources. The same respondent also noted that the estimated costs of the Settlement Body are 46% higher than 2016/17 as a result of a one-off software upgrade cost, and

[2] The consultation document 'Low Carbon Contracts Company and Electricity Settlements Company operational costs 2017/18: consultation on the operational cost levies' is available at https://www.gov.uk/government/consultations/low-carbon-contracts-company-and-electricity-settlements-company-operational-costs-201718-consultation-on-the-operational-cost-levies.

the respondent therefore expected this cost to be reversed for 2018/19. The respondent suggested phasing such costs in the future to avoid volatility in the levy.

8.17 The increase in professional and legal fees is necessary to support the CFD Counterparty's management of the Hinkley Point C nuclear CFD and renewables CFD activities. The expertise that is procured will be essential in supporting decision-making which delivers value for money for consumers. The CFD Counterparty's approach to procuring external technical and professional advice, instead of having more of its own in-house resources, allows it to access the required support only when it is needed.

8.18 The government response explains that the CFD Counterparty has in place an effective procurement policy and is required to procure all goods and services, including contracting and outsourcing, in compliance with the relevant requirements in Managing Public Money, certain Cabinet Office controls and public procurement regulations. The company is therefore required to carry out procurement and project appraisal objectively and fairly, using cost benefit analysis and generally seeking good value for money.

8.19 With regards to the software upgrade costs for the Settlement Body, the government response explains that these upgrades are necessary to reflect changes to the Capacity Market regulatory framework[3] and expected changes that have recently been consulted on[4], which will help to clarify and simplify the regulatory framework. As the Capacity Market becomes fully operational and well established, policy, and consequently settlement system, changes should reduce over time. However, as with any IT system, there is likely to be an ongoing need for some software upgrades. Government will look to phase the costs of these wherever possible.

8.20 These software upgrade costs will be expensed in-year and charged in full to the levy in 2017/18. This is different to the treatment of the one-off capital cost of developing and building a settlement system where those costs would be capitalised and recovered through the inclusion of annual depreciation charges in the levy over the useful life of the asset. Government acknowledges that expensing rather than capitalising software upgrades results in costs being recovered in one year rather than over five years, but the overall cost to suppliers is the same. Expensing the costs in year also provides the CFD Counterparty and Settlement Body with the independence to budget for and fund any necessary software upgrades as part of the annual levy setting process, rather than needing to make a separate approach to BEIS in order to secure capital funding.

8.21 Following analysis of the responses to the consultation, BEIS is satisfied that the levies should remain as consulted on. The total operational costs budget for 2017/18 will therefore be £14,788,000 for the CFD Counterparty and £6,241,000 for the Settlement Body. The gross electricity demand for 2017/18 to be used to calculate the

[3] Copies of consultation documents and government responses available at: https://www.gov.uk/government/consultations/2015-consultation-on-capacity-market-supplementary-design-proposals-and-changes-to-the-rules-and-regulations https://www.gov.uk/government/consultations/consultation-on-reforms-to-the-capacity-market-march-2016

[4] Consultation on state aid cumulation: https://www.gov.uk/government/publications/selective-overcompensation-in-the-capacity-market Consultation on 'Capacity Market: proposals to simplify and improve accessibility in future capacity auctions': https://www.gov.uk/government/consultations/capacity-market-proposals-to-simplify-and-improve-accessibility-in-future-capacity-auctions

CFD Counterparty's operational cost levy is confirmed as 282.28TWh[5]. The resulting levy rate that will be included in regulations is £0.0524/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. The impact on business is described in the section below.

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 £22.2m over 5 years (net present value, 2015 prices), which we expect to be passed onto electricity consumers. This is the estimated net impact of amending the calculation of the total reserve amount and making reconciliation payments more quickly. 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 is published alongside the Explanatory Memorandum on the legislation.gov.uk website. It was also published in January 2016 alongside the Electricity Supplier Payments (Amendment) Regulations 2016, when the first phase of the consulted on changes was laid in Parliament. It has not been updated as it includes reference to the changes made across both sets of amending regulations.

CFD Counterparty and Settlement Body operational costs 2017/18

10.5 As outlined in the consultation document, the combined operational cost budget of the CFD Counterparty and the Settlement Body (£21,029,000) is expected to increase household electricity bills by around £0.20 in 2017/18 (at 2016 prices)[6]. This equates to around a 0.05%[7] increase in an average household electricity bill. The impact of the total operating costs of £21.029m for medium-sized business energy users' electricity

[5] This forecast of gross electricity demand is based on a dedicated forecast model developed by the CFD Counterparty. The model uses statistical techniques taking into account trends in electricity demand and embedded generation. At the time of the consultation, the CFD Counterparty forecast a total gross demand of 282.39 TWh. An updated forecast has been provided in this document to be used for the final levy rate calculation. This update makes use of more recent weather and demand data in the forecast model and as a result is marginally different to the original figure presented. There is no impact on the overall levy rate.

[6] The bill impact of the CFD Counterparty and Settlement Body operational costs is estimated by assuming that such costs faced by electricity suppliers are spread evenly across electricity sales. This provides a £/MWh cost which is multiplied by estimated average household consumption to calculate the bill figure, in this case, of around £0.20.

[7] The percentage figures have been revised since the consultation was published in October to reflect the latest available data.

bills is an increase of £720 in 2017/18 (in 2016 prices), in percentage terms this equates to an increase of around 0.07% of a medium-sized energy user's bill.

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.

11.2 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 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 his Electricity Market Reform ("EMR") functions. The section requires the Secretary of State to report, before 31st 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 published and be shared with the Devolved Administrations. The first report was laid in November 2014, the second in October 2015 and the latest one in December 2016.

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 Kieran Power at the Department for Business, Energy and Industrial Strategy Telephone: 0300 068 6189 or email: kieran.power@beis.gov.uk can answer any queries regarding the instrument.