EXPLANATORY MEMORANDUM TO

THE ELECTRICITY SUPPLIER PAYMENTS (AMENDMENT) REGULATIONS 2018

2018 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 (a) the Contracts for Difference (Electricity Supplier Obligations) Regulations 2014 (S.I. 2014/2014, the "ESO Regulations") and (b) the Electricity Capacity (Supplier Payment etc.) Regulations 2014 (S.I. 2014/3354, the "Supplier Payment Regulations").

2.2 The ESO Regulations impose an obligation on electricity suppliers to pay an "operational costs levy" that funds the operational costs of the Contracts for Difference ("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 financial transactions relating to the Capacity Market.

2.3 This instrument makes the following changes-

- regulation 2 sets new rates for the operational costs levy for the next three financial years in the ESO Regulations;
- regulation 3 sets new settlement costs levy rates for the next three financial years in the Supplier Payment Regulations, and also makes a correcting amendment to that instrument; and
- in both cases, the levy set for the third financial year remains in place until next amended.

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 Contracts for Difference ("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.

4.4 These Regulations set new operational costs levy rates to enable the CFD Counterparty to recover its operational costs and new settlement costs levy rates to enable the Settlement Body to recover its operational costs, for the next three financial years. Previously the department has set new levy rates on an annual basis.

5. Extent and Territorial Application

5.1 The extent of this instrument is the United Kingdom, except for regulation 3 which extends to Great Britain only.

5.2 The territorial application of this instrument (except for regulation 3) is the UK, although 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 3 is Great Britain.

6. European Convention on Human Rights

6.1 Claire Perry MP has made the following statement regarding Human Rights:

"In my view the provisions of the Electricity Supplier Payments (Amendment) Regulations 2018 are compatible with the Convention rights."

7. Policy background

What is being done and why

Operational costs levy for the CFD Counterparty

7.1 The CFD Counterparty enters into and manages CFDs with low carbon electricity generators. This includes managing the CFD portfolio to ensure pre-generation contractual milestones are met and compliance and reporting obligations are fulfilled. The CFD Counterparty also sets and collects the levy on electricity suppliers to pay for the cost of low-carbon generation under the CFD scheme. In addition, it contributes to CFD development and manages delivery of revisions to the CFD settlement system to reflect policy changes, to ensure continued correct processing of transactions.

7.2 The CFD Counterparty recovers its operational costs by a separate levy on electricity suppliers, which is set out in the ESO Regulations. These regulations amend regulation 23 of the ESO Regulations to revise the operational costs levy that liable electricity suppliers must pay. The levy rate is calculated by dividing the total operating cost budget of the CFD Counterparty for a financial year by the total forecast electricity demand for the same period.

7.3 Previously there has been an annual process to consult on and amend the operational costs levy for the next financial year set out in the ESO Regulations. To offer stakeholders greater visibility of the estimated operational costs and to reduce the administrative burden on the CFD Counterparty and Parliament, BEIS consulted on the operational costs budgets and resultant levy rates for the next three financial years (2018/19, 2019/20 and 2020/21) and the required levy rates are now set out in this instrument.

7.4 The levy set for 2020/21 would continue to apply until next amended. BEIS intends to consult in advance of any subsequent operational cost period and amend the levy as necessary to ensure that it is set to recover the CFD Counterparty's expected operational costs.

7.5 The CFD Counterparty's operational costs budget reflects the costs of its expected activity during each financial year. The current operational budget for 2017/18 is £14.788m and the proposed budget in 2018/19 is £16.519m, representing an increase of £1.731m. The budget subsequently increases by around £0.5m in 2019/20 and in 2020/21. The core net operating budget of the CFD counterparty has been kept flat in 2018/19 with the small increase in the last two years needed to account for potentially managing more contracts as a result of future CFD allocation rounds. The budget also now includes a substantial contingency for managing disputes.

7.6 In the event that the total amount of levy collected exceeds the CFD Counterparty's actual operational costs, the surplus at year-end will be reimbursed to electricity suppliers.

Settlement costs levy for the Settlement Body

7.7 The Capacity Market aims to incentivise sufficient availability of electricity 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 is responsible for all financial transactions relating to the Capacity Market, including making capacity payments to capacity providers and managing supplier credit cover and capacity providers' auction credit cover. It also contributes to Capacity Market development and manages delivery of revisions to the Capacity Market settlement system to reflect policy and rule changes, to ensure continued correct processing of transactions.

7.8 The Settlement Body recovers its operational costs by a separate levy on electricity suppliers, which is set out in the Supplier Payment Regulations. These Regulations amend regulation 9(2) of the Supplier Payment Regulations to revise the total amount of the settlement costs levy that liable electricity suppliers must pay to fund the operational costs budget of the Settlement Body. The amount that suppliers are charged is proportionate to their share of total electricity supplied during the winter 'period of high demand'[1].

7.9 Previously, BEIS has consulted on the Settlement Body's operational costs and amended the settlement costs levy on an annual basis. However, to offer stakeholders greater visibility of estimated operational costs going forward and to reduce the administrative burden on the Settlement Body and Parliament's time, BEIS has consulted on settlement costs levy rates for the next three financial years and these are now set out in this instrument.

7.10 The levy set for 2020/21 would continue to apply until next amended. BEIS intends to consult in advance of any subsequent financial year and amend the levy as necessary to ensure that it is set to recover the Settlement Body's expected operational costs.

7.11 The Settlement Body's operational costs budget reflects expected activity during each financial year. The current operational budget of the Settlement Body for 2017/18 is £6.241m. The proposed budget in 2018/19 is £7.629m which represents an increase of £1.388m for 2018/19, and remains broadly flat in 2019/20 and 2020/21. The full

[1] For any financial year, the amount suppliers are initially charged is proportionate to their share of total electricity supplied during the previous winter's 'period of high demand' (4pm to 7pm on working days between November and February inclusive). Suppliers' shares of the levy are then revised after 16 March to reflect actual supply data relating to the 'period of high demand' for that financial year.

Capacity Market auction has been brought forward by a year and the number and range of participants is much higher than expected. In light of this, additional funding is required so that the Settlement Body can increase its operational capability. The costs of the 'core settlement provision' have also increased in line with the projected number of Capacity Market participants.

7.12 In the event that the total amount of levy collected exceeds the Settlement Body's actual operational costs, the surplus at year-end will be reimbursed to electricity suppliers.

Consolidation

7.13 BEIS does not intend to consolidate the relevant legislation at this time.

8. Consultation outcome

8.1 The levy rates required for the CFD Counterparty and the Settlement Body to recover their operational costs for the next three financial years 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. In addition the consultation has been advertised on the website of the CFD Counterparty and Settlement Body and that of the Settlement Service Provider[3]. The consultation closed on 8th December 2017.

8.2 In total, 3 responses to the consultation were received; these generally supported the proposed operational cost budgets and no substantive concerns were raised. All the respondents welcomed the proposal to set levies for three financial years in advance, rather than one. They considered that this offers electricity suppliers and other stakeholders better visibility of these costs and provides greater cost certainty for a longer period. Although one respondent recognised that forecasting costs further ahead could mean that those forecasts were less accurate, with a risk of over or under collection of levies, they considered that the benefits of greater visibility outweigh this risk.

8.3 The respondents recognised that, in setting operational cost budgets for the CFD Counterparty and the Settlement Body, BEIS has to strike a balance between ensuring that the companies have adequate resources to maintain investor confidence in the CFD regime and Capacity Market and ensuring that costs to consumers are minimised. One respondent acknowledged that the forecast operational costs for the next three financial years appropriately strike such a balance. Another respondent noted that the budget setting process includes external scrutiny as well as internal auditing of costs and considered this vital to ensuring that the operational costs of the CFD Counterparty and Settlement Body are properly justified.

8.4 One respondent noted that the CFD Counterparty's budget had increased from 2017/18, principally due to inclusion of a provision set aside for disputes. The respondent sought assurance that this provision would be kept under review. The government response to the consultation explains that, in providing robust management of CFDs, it is important that the CFD Counterparty has sufficient funds to defend a dispute as necessary. The contingency budget for potential disputes, along with the wider budget will be kept under review over the next three years. If the

[2] https://www.gov.uk/government/consultations/low-carbon-contracts-company-and-electricity-settlements-company-operational-costs-2018-2019-to-2020-2021

[3] EMR Settlement Ltd, a wholly-owned subsidiary of Elexon, which settles payments between electricity suppliers and generators for the CFD scheme and Capacity Market.

provision is not utilised for disputes and the surplus levy is not required for other essential operational activity, it will be repaid to electricity suppliers in accordance with regulations.

8.5 One respondent noted that the Settlement Body's forecast costs had increased from 2017/18 as it will be managing increased capacity and market complexity in the Capacity Market. They also observed that the Settlement Body will require settlement system software upgrades as a result of regulatory and rule changes and acknowledged that these are necessary as the Capacity Market evolves. The government response explains that as the rise in complexity and the requirement for changes to the Capacity Market are expected to continue, the Settlement Body needs further investment to manage this activity and to ensure it continues to effectively deliver all financial transactions for the Capacity Market.

8.6 Following analysis of the responses to the consultation, BEIS is satisfied that the operational cost budgets for the CFD Counterparty and Settlement Body should remain as consulted on. For the CFD Counterparty the budget will be £16.519m in 2018/19, £17.020m in 2019/20 and £17.485m in 2020/21. The forecast gross electricity demand for the three financial years is confirmed as 289.66 terawatt hours (TWh), 287.69 TWh and 284.59 TWh, resulting in levy rates to be included in regulations of £0.0570 per megawatt hour (MWh), £0.0592 per MWh and £0.0614 per MWh respectively. For the Settlement Body the budget to be included in regulations is £7.629m for 2018/19, £7.554m for 2019/20 and £7.502m for 2020/21.

9. Guidance

9.1 Existing electricity suppliers are already aware of their obligation to pay levies to cover the operational costs of the CFD Counterparty and Settlement Body. They are provided with notice of changes to the levy rates through the consultation exercise and subsequent Government Response. When new levy rates are set in legislation the Settlement Service Provider writes to suppliers to inform them of the rates that will apply for the relevant financial years.

10. Impact

10.1 The impact on business, charities or voluntary bodies is limited. The operational costs budgets of the CFD Counterparty and the Settlement Body are levied on electricity suppliers who pass costs through to electricity consumers. The estimated impact on electricity bills is described at paragraph 10.4 below.

10.2 The impact on the public sector is limited. The operational costs budgets of the CFD Counterparty and the Settlement Body are levied on electricity suppliers who pass costs through to electricity consumers. The estimated impact on electricity bills is described at paragraph 10.4 below.

10.3 An Impact Assessment has not been prepared for this instrument.

10.4 BEIS estimates that the total impact of the combined operational cost budget of the CFD Counterparty and the Settlement Body on the average annual household electricity bill for the period 2018/19 to 2020/21 will be around £0.30 per year (at 2016 prices). This equates to around 0.1 % of an average household electricity bill. The expected annual impact of the total operating costs for an illustrative small-sized business energy user's electricity bill is around £20 (in 2016 prices). In percentage terms this equates to around 0.1% of a small-sized user's bill. The estimated impact of the total operating costs for an illustrative medium-sized business energy user's electricity bill is around £880 per year (in 2016 prices). In percentage terms this equates to around 0.1% of a medium-sized business user's electricity bill.

11. Regulating small business

11.1 The legislation applies to activities that are undertaken by small businesses, as we expect some small electricity suppliers would be classified as small businesses.

11.2 The Regulations will not have a disproportionate effect as the proposed operational costs levy rates will be charged in relation to the amount of electricity supplied daily by each electricity supplier and the settlement cost levy rates will be charged to electricity suppliers in proportion to their share of total electricity supplied during the winter 'period of high demand'. The operational costs levy and settlement costs levy are expected to be passed through to electricity consumers rather than be borne directly by the electricity supplier. Electricity suppliers as consumers of electricity will therefore bear costs as outlined in 10.4 above.

12. Monitoring & review

12.1 The operational budgets of the CFD Counterparty and the Settlement Body will be kept under review over the period concerned. In the event that, due to unforeseen circumstances, the operational costs were found to be higher than expected BEIS would consider amending the operational costs levy rates and settlement costs levies as necessary, following consultation.

12.2 In accordance with regulation 84 of the Electricity Capacity Regulations 2014 (as amended) the Settlement Body is also required to produce an annual report on the performance of its functions in respect of each capacity year. The annual report must, no later than three months after the end of the capacity year to which it relates, be provided to the Secretary of State and published. The latest report was published in December 2017.

12.3 Section 66 of the Energy Act 2013, requires the Secretary of State to review a number of aspects of the operation of the Electricity Market Reform programme as soon as reasonably practical 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 Fiona Reynolds at the Department for Business, Energy and Industrial Strategy Telephone: 0300 068 6113 or email: fiona.reynolds@beis.gov.uk can answer any queries regarding the instrument.