

**EXPLANATORY MEMORANDUM TO  
THE ELECTRICITY FROM NON-FOSSIL FUEL SOURCES  
ARRANGEMENTS (ENGLAND AND WALES) ORDER 2006**

**2006 No. 2388**

1. 1.1 This explanatory memorandum has been prepared by the Department of Trade and Industry and is laid before Parliament by Command of Her Majesty.  
  
1.2 This memorandum contains information for the Joint Committee on Statutory Instruments.
2. **Description**
  - 2.1 This Order modifies certain contracts made between certain electricity generators (the Municipal Industrial Waste (MIW) with Combined Heat and Power (CHP) electricity generators) and the Non-Fossil Purchasing Agency Limited (NFPA).  
  
2.2 Article 1 states how this Order may be cited; when it is to come into force; and its territorial extent.  
  
2.3 Article 2 sets out the definitions of various terms used in the Order.  
  
2.4 Article 3 sets out the amendment to be made to the contracts in question.
3. **Matters of special interest to the Joint Committee on Statutory Instruments**
  - 3.1 Under the contracts in question, the intention was that, if the MIW CHP generators met certain requirements in terms of supplying heat to third parties, they would be paid a 'premium' price for the electricity which they generated by the NFPA. If they failed to meet those requirements, then they would receive from the NFPA a 'reference' price, fixed at a level below the premium price. Unfortunately, it has since emerged that the way in which the two prices are calculated results in the reference price being higher than the premium price, which has removed the intended financial incentive for generators to meet the requirements placed upon them in relation to supplying heat. The amendment to be made to the contracts in question by this Order will correct this anomaly.
4. **Legislative background**
  - 4.1 This Order is made under section 67(1)(c) of the Utilities Act 2000 (the 2000 Act), which confers a power on the Secretary of State to amend contracts entered into pursuant to orders made under section 32 of the Electricity Act 1989 (the 1989 Act).

4.2 Section 32 of the 1989 Act (prior to its substitution by section 62 of the 2000 Act) allowed the Secretary of State to require public electricity suppliers to enter into contracts with generators of renewable electricity for the provision of specified amounts of renewables generating capacity.

4.3 Amendments to section 32 of the 1989 Act by the Environment Act 1995 allowed orders to be made requiring public electricity suppliers to enter into contracts with CHP stations of particular descriptions.

4.4 When section 32 of the 1989 Act was substituted by section 62 of the 2000 Act, section 67 of the latter Act enabled the Secretary of State, by order, to provide for section 32 to continue to have effect, subject to modifications. The Secretary of State so provided in the Electricity from Non-Fossil Fuel Sources Saving Arrangements Order 2000 (SI 2000/2727, as amended by SI 2001/3268) (the 2000 Order). Article 8A of the 2000 Order provides for section 32 and certain orders made under it – including the Electricity (Non-Fossil Fuel Sources) (England and Wales) Orders of 1997 (S.I. 1997/248) and 1998 (S.I. 1998/2353) (“the NFFO Orders”) – to continue to have effect for the purposes of the 2000 Order. (Section 67(1)(b) of the 2000 Act enabled the NFFO Orders to be saved, and section 67(1)(c) enables contracts made pursuant to such orders to be modified, replaced or otherwise dealt with.)

4.5 The NFFO Orders have a number of “technology bands”, one of which is for MIW CHP generating stations. Pursuant to those orders, MIW CHP generators entered into contracts with public electricity suppliers. These contracts have now been replaced, so far as was necessary in order to comply with the 2000 Order, with new contracts between the MIW CHP generators and NFFA. These contracts are now being amended.

## **5. Extent**

5.1 This instrument applies to England and Wales only.

## **6. European Convention on Human Rights**

6.1 As the instrument is subject to the negative resolution procedure and does not amend primary legislation, no statement is required.

## **7. Policy Background**

7.1 The NFFO Orders have a number of “technology bands”, one of which is for MIW CHP generating stations. Pursuant to those orders, MIW CHP generators entered into contracts with public electricity suppliers. Under the contracts, if the generators supplied specified amounts of heat to third parties, they were entitled to receive from the electricity suppliers the premium price for the electricity which they (the generators) generated. Failure to achieve the heat target resulted in the generator being paid the reference price only. These

contracts have now been replaced, so far as was necessary in order to comply with the 2000 Order, with new contracts between the MIW CHP generators and NFPA, but the new contracts continue to require the generators to supply the specified amounts of heat to third parties. Unfortunately, it has now emerged that the way in which the premium and reference prices are calculated under these contracts results in the reference price being higher than the premium price, contrary to the department's policy intention.

7.2 This Order amends the contracts to ensure that the reference price will in future be calculated on the average auction price of electricity generated by MIW CHP generators, the effect of which will be to reduce the reference price to a level below the premium price. In addition, in order to ensure that generators who do not fulfil the heat element of their contract will never be paid more for the electricity they produce than those that do, the amendment ensures that if the reference price were ever to rise above the premium price in the future, generators would be paid the lower of either the premium price or the reference price. This effectively places a cap on the price paid for electricity under the contracts, which is fixed at the level of the premium price.

## **8. Impact**

8.1 A regulatory impact assessment is available and can be obtained from Energy Markets Unit, Department of Trade and Industry, 1 Victoria Street London SW1H 0ET. Copies have been placed in the libraries of both Houses of Parliament.

## **9. Contact**

9.1 Any queries regarding the order can be directed to Carolyn Potts at the Department of Trade and Industry (Tel: 020 7215 0233) or e-mail: [carolyn.potts@dti.gsi.gov.uk](mailto:carolyn.potts@dti.gsi.gov.uk).

## FINAL REGULATORY IMPACT ASSESSMENT

### **The Electricity from Non-Fossil Fuel Sources Arrangements (England and Wales) Order 2006.**

#### **1. Purpose and Effect**

##### The Objective

1.1 The purpose of the Electricity from Non-Fossil Fuel Sources Arrangements (England and Wales) Order 2006 is to amend *contracts made pursuant to the Electricity from Non-Fossil Fuel Sources Saving Arrangements Order 2000* (as amended) to correct an anomaly which has arisen since their introduction. The policy intent of the NFFO orders was and remains to encourage generation of renewable electricity. The specific policy intention of the contracts subject to this amendment was to pay an incentive price (the “premium price”) to Municipal Industrial Waste (MIW) generators with Combined Heat and Power (CHP). However, a financial disincentive to fulfil the contracts has arisen because the premium price has fallen below the price paid to contract holders who do not fulfil the heat element of their contract (“the reference price”). Government therefore proposes to correct this financial disincentive by introducing an order to amend the relevant NFFO contracts. The amendment will enable the reference price to be calculated on the average auction price of MIW CHP technology band, the effect of which would be to reduce the reference price to a level below the premium price. In addition, in order to ensure that generators who do not fulfil the heat element of their contract will never be paid more for the electricity they produce than those that do; the amendment ensures that if the reference price were ever to rise above the premium price in the future, generators would be paid the lower of either the premium price or the reference price. This effectively places a cap on the price paid for electricity under the contracts, which is fixed at the level of the premium price.

##### Background

1.2 Support for renewables electricity generation is provided under section 32 of the Electricity Act 1989. As originally enacted it enabled the Secretary of State to require the then public electricity suppliers to enter into contracts with generators of renewables electricity for the provision of specified amounts of renewables generating capacity. A series of orders were made under section 32 and are known as the NFFO Orders. The contracts made under the NFFO Orders between the public electricity suppliers and the generators for the supply of generating capacity (and any which replace those contracts) are known as NFFO contracts.

1.3 In its original form section 32(2) of the Electricity Act referred only to “non-fossil fuel generating stations” as being capable of satisfying the requirements of a NFFO Order. However, section 32 of the Electricity Act was amended by the Environment Act 1995 to include CHP stations generally and CHP stations of any particular description “as being particular descriptions of non-fossil fuel generating stations”. The effect of this amendment was that NFFO Orders could be made requiring public electricity suppliers to enter into contracts with CHP stations of

particular descriptions. The fourth and fifth NFFO Orders took advantage of this new power.

1.4 In 2002 the Renewables Obligation was introduced, replacing the NFFO scheme. However, obligations in the NFFO contracts were preserved using two statutory instruments made under section 67 of the Utilities Act 2000: (i) the Electricity from Non-Fossil Fuel Sources Saving Arrangements Order 2000 as amended by (ii) the Electricity from Non-Fossil Fuel Saving Arrangements (Amendment) Order 2001 (“the NFFO Savings Order”). The NFFO Savings Order required the obligations of the then public electricity suppliers under the original NFFO contracts to be discharged through replacement NFFO contracts made by a single purpose company, nominated jointly by them, called the Non-Fossil Purchasing Agency (NFPA). Under the revised arrangements the NFPA is required to sell the electricity, which it purchases from the generators to the supply companies on the open market.

1.5 Generators with NFFO contracts can only benefit from the successor scheme, the Renewables Obligation, for the element of generation which exceeds their NFFO contract obligation, and where they’ve been accredited as eligible for RO support by Ofgem.

1.6 Under the relevant NFFO contracts NFPA contracted for the purchase of the electricity generated by the MIW CHP stations. Third parties, such as industrial premises and hospitals, entered into separate heat contracts with the MIW CHP stations to purchase the heat they generated. The NFFO contracts provided that, during periods in which the MIW CHP stations performed their obligations under the heat contracts, they would receive a premium price for the electricity which they provided to the NFPA. Whereas during any period in which they failed to perform their heat contracts they would receive only a reference price under their NFFO contract. By fixing the premium price higher than the reference price the policy intent was that MIW CHP stations would have a double incentive for performing their heat contracts as they would get both the price payable for the heat under the heat contracts and the premium price for the electricity supplied to the NFPA under the NFFO contracts.

### Rationale for Government intervention

#### *How the anomaly has arisen*

1.7 When the New Electricity Trading Arrangements (NETA) were introduced in 2001, the original definition of the reference price became obsolete because it was calculated by reference to the price of electricity under the pool system, which the NETA system replaced. The replacement definition of the reference price in the contracts included the value of ROCs associated with the electricity generation (“the ROC component”). However, the reference price includes a ROC component irrespective of whether the electricity came from ROC eligible sources. Because the reference price includes a ROC component but the premium price does not, the reference price is now higher than the contract premium price.

1.8 This means that where a generator is not performing the heat element in its contracts (i.e. the supply of heat to third parties) it receives a reference price for the electricity it provides to NFPA. However, the reference price is now higher than the premium price that it would have received had it fulfilled the heat element of the contract. The current situation penalises those generators who are meeting the heat element of their contracts, contrary to what was actually intended. This is the anomaly that the Order will address. The Order will rectify this position and provide the requisite price incentive to those generators involved to perform the heat element of their contract, as originally intended.

## **2. Consultation**

### *Within Government*

2.1 Within Government DTI officials have made Treasury aware of these proposals in view of the impact of these proposals on the NFPA trading surplus which is paid by Ofgem into the Consolidated Fund as hereditary revenues of the Crown.

### Public Consultation

In view of the technical nature of the change and because only 4 generators are directly affected, this proposal was subject to a limited six week consultation. 8 responses were received, 4 being from the generators that are directly affected by the proposal, 1 from a generator who bid for a contract but did not take it up. NFPA also responded as did the Environmental Services Association, a trade association representing the waste sector, and the Association of Electricity Producers.

2.3 Two responses supported the approach set out in the consultation document. The others proposed a number of alternative solutions, however, all these options had either been considered previously and discounted for legal reasons, or they did not address the disincentive to produce heat that we are seeking to correct.

## **3. Costs and Benefits**

### *Business Sectors Affected*

3.1 As NFFO has now been succeeded by the Renewables Obligation the amendment to the reference price will in practical terms affect only the 4 renewable electricity generators who have live MIW CHP contracts, the original versions of which were issued under NFFO rounds 4 and 5. There will be no direct effect on the wider renewable energy sector.

3.2 As a result of changes to the RO from April 2006, Energy from Waste generating stations with good quality CHP are now able to apply for accreditation from Ofgem to claim ROCs on any biomass element of the waste burned, if they meet the requirements for Good Quality CHP status. Article 15(4) of the Renewables Obligation Order 2006 provides that these ROCs would be issued by Ofgem to the successful bidder in the relevant NFPA auction and not to the generator. If bidders

became sufficiently confident that these ROCs would attach to such schemes, the prices paid to NFPA could begin to include an element reflecting this so they could potentially rise above current levels. However, to date, due to problems in agreeing appropriate measurement of the biomass element of waste, ROC's have not yet been issued on this basis.

## **Benefits**

3.3 By capping the price paid for electricity under the contract at the lower of the premium price or the reference price the incentive for fulfilling the heat element of those contracts will be restored as originally intended. This may result in heat which ordinarily would have been wasted, used instead for practical purposes. This saves on fuel and realises carbon saving benefits. However, this benefit is likely to be small as there are only four generators who are likely to be affected by the policy.

3.4 Those generators meeting the heat elements of their contracts will continue to benefit from the intended subsidy within the premium price. The incentive for these companies to continue to do so will be restored, through reducing the reference price paid to those who do not fulfil the heat element of their contract . If power prices were to rise to such a significant extent in the future that the reference price was to once again exceed the premium price, all contract holders would be paid the premium price so that the disincentive to fulfil the heat element of the contract could not arise again.

## **Costs**

3.5 The cost to generators who do not fulfil the heat element of their contract will be that they will no longer be able to benefit from the anomaly. However, the Exchequer benefits as the reference price paid will no longer be subsidised. As the net effect on the UK economy is zero, then the policy cost is likely to be negligible.

3.6 NFPA estimate that if no action is taken, and all 4 live contracts failed to meet the heat element of their contracts, and claimed the reference price at its current level then generators would benefit at the expense of the Exchequer in the order of *£9-10 million per year* above the brown power auction price.

3.7 Were all 16 MIW/CHP NFFO projects that were issued under bidding rounds 4 and 5 to be commissioned, and the reference price paid for all, the additional subsidy would be in the order of *£45million per year* above the brown power auction price. However, NFPA judge it unlikely that any of the other 12 projects could be developed to take advantage of this anomaly, though this cannot be ruled out entirely. The excess costs would be paid from the NFPA's trading surplus which is paid by Ofgem into the Consolidated Fund as hereditary revenues of the Crown. A reduction in the surplus therefore represents a reduction in the funds available for other public purposes.

## **4. Alternative Options**

4.1 Do Nothing – *NFPA could pay out the higher reference price to generators who do not meet the heat requirement of their contract on an ongoing basis. However, this would result in a drain of public funds away from Government and would reward those who do not meet the heat elements of their contracts. This approach would also go against the original intent of the policy to incentivise generation of renewable heat through the NFFO arrangements.*

4.2 We looked at whether NFPA could vary the contracts with the generators by mutual agreement to reduce the reference price to below the premium price. However, there would be no guarantee that the companies affected would willingly vary their contract.

4.3 We also looked at relaxing the heat requirement of the contracts so that the amount of heat that would have to be supplied would be reduced as an incentive for generators to accept a lower reference price. We concluded this was not possible as there was no legislative basis for reducing the heat requirements on the generators without the introduction of primary legislation.

4.4 The only remaining option that would reinstate the incentive to fulfil the heat element of the contract would be to raise the premium price to a level above the reference price to reinstate the intended incentive for MIW CHP generators to fulfil the heat element of their contract. However, this option was quickly discounted on two grounds. First it would be unacceptably expensive, as the reference price is already considerably above the market price for electricity. And second, such a move would disadvantage those generators who are parties to NFFO contracts other than MIW CHP contracts. In effect MIW CHP generators would be paid more for the electricity generated than other NFFO contract holders regardless of whether they met the heat requirement of their contract.

## **5. Consultation with Small Business: The Small Firms' Impact Test**

5.1 As only 4 companies are in practice affected by this proposal, none of which are small firms, a small firms impact test has not been undertaken, the Small Business Service are aware of this.

## **6. Competition Assessment**

6.1 Those generators who do not fulfil the heat element of their contracts are currently receiving a higher price for the electricity, putting them at an unfair competitive advantage.

## **7. Enforcement and Sanctions, Compliance and Monitoring**

7.1 Ofgem is given specific ongoing duties under the NFFO Savings Order. It acts as an independent body to ensure that all parties continue to meet their Obligations under that Order. Ofgem also deals with certain administrative issues between NFPA



and the generators. The DTI is responsible for monitoring the impact of NFFO and the RO on the development of renewable energy and collects detailed information on growth in renewable energy generation and projects under development.

## **8. Summary and Conclusion**

8.1 The NFFO scheme was introduced with the intention of encouraging renewable generation in the UK. Due to regulatory changes following the introduction of the scheme there have been unintended consequences which have resulted in those generators not fulfilling the heat element of their contract receiving more subsidy than those generators who do fulfil the heat element. Government proposes to reinstate the incentive for the generators concerned to fulfil the heat element of their contracts, by means of an order to reduce the “reference price” to a level below the “premium price”. *In addition*, if the reference price were ever to rise above the premium price in the future, generators would be paid the lower of either the premium price or the reference price. This effectively places a cap on the price paid for electricity under the contracts, which is fixed at the level of the premium price.

### **Ministerial Declaration**

‘I have read the Regulatory Impact Assessment and I am satisfied that the benefits justify the costs’

***Margaret Hodge***

Minister of State for Industry and the Regions

***5<sup>th</sup> September 2006***

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