

**EXPLANATORY MEMORANDUM TO
THE ELECTRICITY SUPPLIER OBLIGATIONS (AMENDMENT & EXCLUDED
ELECTRICITY) REGULATIONS 2015**

2015 No. 721

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 make further provision about the obligations of electricity suppliers to make payments to fund Contracts for Difference (CFD) 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.

2.2 The ESO Regulations established a mechanism to allow the CFD Counterparty to raise funds from all licensed electricity suppliers in Great Britain to pay for the liabilities that it has to make payments to electricity generators under CFDs and to return money to suppliers where appropriate.

2.3 These Regulations:

- Set out provisions to implement exemptions from CFD costs for certain Electricity Intensive Industries and Green Imported Electricity. These exemptions will reduce the cost to suppliers who supply electricity to large industrial users of electricity and who supply electricity generated in other EU member states from renewable sources to customers in Great Britain.
- Make a number of amendments to the ESO Regulations which are mostly of a technical nature.
- Set the rate for the operational costs levy for the CFD Counterparty which is intended to apply from 1st April 2015.

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

3.1 None.

4. Legislative Context

4.1 The Energy Act 2013 (“the Act”) 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 are known as Electricity Market Reform (EMR).

4.2 The two main mechanisms for reform – the Contract for Difference (CFD) and Capacity Market – are now operational. The first CFD allocation round opened in

October 2014 and the first Capacity Market auction took place in 2014. A second allocation round and auction is planned for 2015.

4.3 These mechanisms were implemented by a suite of secondary legislation and related documents. These regulations make further provisions about the obligations of electricity suppliers to make payments to fund CFDs, and amend the “ESO Regulations” to make changes of a technical nature and to set the operational cost levy rate for the CFD Counterparty for the operational cost period beginning 1st April 2015.

4.4 These regulations form part of a wider set of amendments being made to the existing suite of Electricity Market Reform secondary legislation. For example, wider amendments are being made which implement provisions required as part of the EMR mechanisms successfully receiving State Aid clearance, implement policies the Department has committed to introducing prior to the second CFD allocation round or Capacity Market auction, and include a number of minor and technical amendments to ensure the drafting gives effect to the previously agreed policy intent. This instrument and another of the amendment regulations also reflect the updated levies for the two EMR companies (the CFD Counterparty and the Capacity Market Settlement Body) to recover their operational costs for 2015/16.

4.5 The full set of amendment regulations includes the following:

- The Electricity Supplier Obligations (Amendment & Excluded Electricity) Regulations 2015
- Electricity Capacity (Amendment) Regulations 2015
- Electricity Market Reform (General) (Amendment) Regulations 2015

5. Territorial Extent and Application

5.1 This instrument extends to the United Kingdom.

5.2 Although the Regulations apply to the whole of the UK, Northern Ireland electricity suppliers are not subject to obligations to make payments to the CFD Counterparty. The Government intends to amend the Regulations to impose such obligations on electricity suppliers in Northern Ireland at the point that the CFD scheme is extended to Northern Ireland.

6. European Convention on Human Rights

6.1 Matthew Hancock, 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 Obligations (Amendment and Excluded Electricity) Regulations 2015 are compatible with Convention rights.

7. Policy background

7.1 The electricity market reform programme is intended to incentivise investment in low-carbon electricity generation, while improving affordability for consumers, and maintaining energy security. These regulations are concerned with one element of the wider reform package – ‘Contracts for Difference’ (CFDs).

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

7.3 The CFD Counterparty will raise the money to fund CFD payments through a compulsory levy on electricity suppliers in Great Britain (the ‘supplier obligation levy’). Its operational costs will also be funded by a separate levy on electricity suppliers (the ‘operational costs levy’). Both of these levies are set out in the ESO Regulations.

7.4 The regulations that are the subject of this Explanatory Memorandum introduce exemptions from the supplier obligation and operational costs levies for eligible Electricity Intensive Industries (EIIs), and exempt eligible imported renewable electricity from the supplier obligation levy (the ‘Green Import Exemption’). They also make a number of minor and technical amendments to the ESO Regulations, and set the rate for the operational costs levy in the ESO Regulations which is intended to apply for the operational cost period beginning 1st April 2015. The policy background behind these amendments is set out in greater detail in the paragraphs below.

Green Import Exemption

7.5 As a condition of State Aid approval, the European Commission required eligible renewable electricity imported from other EU Member States and supplied to consumers in Great Britain (GB) to be exempt from contributing to the cost of CFD payments. Only electricity that was generated from stations that commissioned after 1st April 2015 will be eligible for the exemption, to reflect the intention of the CFD scheme to incentivise new low carbon generation in GB.

7.6 These regulations set out how this exemption will be implemented. They provide that eligible imported electricity will not be considered chargeable supply for the purpose of calculating each supplier’s underlying liability for CFD payments. Suppliers will have to submit evidence of eligible imports to the CFD Counterparty within six months of the end of the quarter in which the electricity was supplied. The CFD Counterparty will determine the amount of electricity that qualifies as green excluded electricity according to criteria set out in the regulations, and take this into account when calculating suppliers’ reconciliation payments under the ESO Regulations.

7.7 The regulations put in place a cap on the total amount of imports that can be determined as exempted green electricity in any quarter. The cap for each quarter in

the financial year 2015/16 will be equal to 25% of the amount of imported renewable electricity in the 2013/14 financial year, and will increase by 10% for each year that follows. If the cap is breached in any quarter, an exemption will be granted to each supplier in proportion to the amount claimed in the period.

7.8 The regulations allow Ofgem (the Gas and Electricity Markets Authority) to provide advice to the CFD Counterparty in making the determination.

Electricity Intensive Industry exemption

7.9 In the Autumn Statement in 2011, the Chancellor announced the Government's intention to reduce the impact of Government policy on the costs of electricity for the most electricity intensive industries (EIIs). This included the costs of supporting renewable deployment through the Renewables Obligation, small-scale Feed-in Tariffs, and CFDs. These Regulations set out how suppliers can be exempted from contributing to the cost of CFDs on a proportion of electricity supplied to eligible EIIs.

7.10 The Department has laid draft amendments to the Balancing and Settlement Code (BSC) to support the implementation of the EII exemption. The BSC contains the rules which govern the trading and settlement of the Great Britain electricity system. The amendments to the BSC are required to enable the CFD Counterparty to identify exempt electricity in order to ensure that the exemption is applied accurately.

Application for the exemption

7.11 Electricity intensive businesses wishing to apply for an exemption must submit an application to the Secretary of State in respect of the relevant electricity meter(s). The application will be assessed based on eligibility criteria set out in the Regulations. EIIs are required to submit specific evidence in their application to enable the Secretary of State to assess their eligibility, including earnings and staff costs, the identification number for relevant electricity meter(s), and evidence of electricity used by the business as a whole and in the course of the activity that they carry out which is eligible for the exemption.

EII Eligibility Criteria

7.12 The intention of the EII exemption is to ensure that the most trade and/or electricity intensive businesses are not made uncompetitive due to the impacts of Government renewable and decarbonisation policies on electricity prices. Eligible businesses are identified through a two-stage test: the sector level and business level test.

7.13 The sector level test focuses on ensuring that support is targeted at the most trade and electricity-intensive sectors. Following consultation, the Department for Business, Innovation and Skills has determined the sectors which meet the criteria for trade and electricity intensity, which are listed in the Schedule to the regulations. Only businesses carrying out specified activities that fall within these sectors are eligible for exemption.

7.14 The business level test focusses on businesses' electricity intensity: only businesses whose electricity costs exceed 20 per cent of their Gross Value Added¹ are entitled to an exemption. This assessment is based on historical data provided by the electricity intensive business during a baseline period. This period differs according to how long the business has been trading for at the time it makes its application, with transitional arrangements for businesses who have been trading for less than four financial years. Additionally, to avoid distortions to competition, businesses can qualify for the exemption if they do not pass the business-level test but can demonstrate that they incurred significant costs unrelated to the specified activity, or that the majority of their competitors do qualify for the exemption.

7.15 Where a business satisfies the eligibility criteria, the Secretary of State will issue that business with an 'EII certificate' as long as doing so would not breach the law relating to State aid. A copy of the certificate will also be issued to the CFD Counterparty and the Balancing and Settlement Code Company (BSCCo). The certificate will be valid from the day it is issued or (if applicable) the day after the applicant's existing EII certificate expires, until the last day of the financial year in which it came into force. EII certificates cannot be issued before 1st October 2015.

The Exemption proportion

7.16 In line with the European Commission's guidelines on State aid for environmental protection and energy, the Government is allowing suppliers of electricity intensive businesses to be exempt from CFD costs on up to 85% of electricity consumed in the specified activity carried out by the eligible business. The proportion of electricity supplied to eligible businesses which is exempt from CFD costs will be determined by multiplying the proportion of electricity used in the specified activity by 0.85. The calculated exemption proportion and the meter to which the proportion applies will be set out in the EII certificate.

7.17 If an electricity intensive business does not submit evidence of the proportion of electricity used in the specified activity, the Secretary of State must estimate this proportion using evidence supplied by the business as to the activities it carries out.

7.18 The Secretary of State can amend the exemption proportion if it is later deemed that the initial estimate was incorrect. When the proportion is amended, a notice will be sent to the holder of the certificate, the CFD Counterparty and the BSCCo.

Identifying Exempt Electricity

7.19 To receive the exemption, suppliers must ensure that the relevant arrangements are in place to enable the CFD Counterparty to identify the exempt electricity. The regulations require the CFD Counterparty to publish a document by 30th September 2015 setting out approved arrangements for identifying exempt electricity, and give no less than six months' notice to industry before changing those approved arrangements.

7.20 The Department has consulted on amendments to the Balancing and Settlement Code to enable the CFD Counterparty to identify exempt electricity. The

¹ The contribution to the economy of the UK made by the business.

outcome of this consultation has informed policy decisions on the arrangements that the CFD Counterparty will approve.

7.21 To ensure that the exemption is not claimed incorrectly, the regulations require the holder of an EII certificate to inform the Secretary of State if it ceases to carry out the activity for which they were deemed eligible for the exemption.

7.22 The Secretary of State may revoke an EII certificate, informing the EII and relevant parties, if it becomes evident that:

- The evidence in an application was false or misleading in a material respect;
- The business ceases to carry out the activity measured by the EII meter; or
- The certificate was issued in error.

7.23 The revocation will take effect from the sixth working day after the certificate is revoked.

Minor and technical amendments to the supplier obligation

7.24 These regulations also make a number of minor and technical amendments to the ESO regulations, to bring them into line with policy intent and correct drafting errors. The more significant amendments are described briefly here.

7.25 The ESO Regulations enable claims from CFD-holding generators with respect to a breach of contract by the CFD Counterparty to be met through the supplier obligation levy. However, as currently drafted a claim of negligence against the CFD Counterparty in connection with a CFD could not be funded through the supplier obligation, and would instead have to be met from the CFD Counterparty's operational costs. This could cause financial difficulties for the CFD Counterparty, as the operational cost levy is set out in regulations at the start of the levy period and any amendment to accommodate unexpected costs would require public consultation and approval by Parliament. In order to align the treatment of breach of contract claims with negligence claims, the definition of 'CFD Counterparty payment' has been amended to allow payments under either breach of contract or negligence claims to be funded through the supplier obligation levy.

7.26 If a supplier fails to make supplier obligation payments to the CFD Counterparty, the CFD Counterparty can ask other suppliers to make up the shortfall through mutualisation payments. The ESO Regulations enable the CFD Counterparty to request that suppliers make mutualisation payments within five working days of being issued a notice. However, there are some types of payments by suppliers that could be very large, so the Government has decided to provide suppliers with 30 days' notice when any payments other than daily interim rate payments are mutualised.

7.27 The ESO Regulations require suppliers to pay interest if they are late in making payments to the CFD Counterparty. As currently drafted this includes a situation where a supplier fails to provide sufficient collateral. However, the policy intention was that suppliers would not be charged interest on collateral default because this does not lead to additional costs or losses for other parties. These regulations therefore amend the ESO regulations to remove the requirement on

suppliers to pay interest if they are in collateral default. They also amend the calculation of a supplier's collateral requirement to ensure that the necessary information is available at the time the calculation is made.

Operational costs levy for the CFD Counterparty

7.28 These Regulations also amend Regulation 23 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 costs levy rate in the ESO Regulations that came into force on 1 August 2014 was calculated to recover the operating costs for 2014/15, its first operational costs levy period.

7.29 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 regulations will take place annually, alongside setting the operational costs budget of the Capacity Market Settlement Body. The regulations need to be amended in time to allow for a revised operational costs levy to be in force by the beginning of each operational costs levy period. In this case, the operational costs levy period for 2015/16 will commence on 1st April 2015.

8. Consultation outcomes

8.1 These regulations are informed by the responses to three consultations, the outcomes of which are described below.

Electricity intensive industries – relief from the indirect costs of renewables

8.2 The Department for Business Innovation and Skills and the Department of Energy and Climate Change jointly published a twelve week consultation on 31st July 2014 (*Electricity intensive industries – relief from the indirect costs of renewables*), seeking views on the proposed criteria for identifying and calculating levels of exempt electricity. The consultation received forty-seven responses.

8.3 There was general agreement with the overall approach to eligibility but there were caveats to this agreement, with respondents expressing concerns about a number of aspects including the aid intensity, the sector level test and the business level test.

8.4 Some respondents considered that the Government should provide aid intensity up to the maximum level permitted under the Energy and Environmental Aid Guidelines, i.e. the amount of policy costs they pay does not exceed 0.5% of their GVA. However, we are concerned that limiting costs to 0.5% of a business's GVA could mean that competing companies operating in the same sector would face very different percentage levels of compensation, depending on their levels of GVA. We consider this approach could distort competition and have therefore retained the maximum aid intensity of 85% of cost in the amendment regulations.

8.5 Several respondents felt that the business level test, of an electricity cost impact of 20% of GVA was too high. Alternative suggestions included lowering the threshold or lengthening the baseline period. In light of consultation responses we propose to use a longer baseline period, but have retained a 20% electricity price

impact test to target the most electricity intensive products whilst minimising the redistributive costs to consumers.

EMR: Changes to the CFD supplier obligation

8.6 DECC published a six week consultation on 25 September 2014 (*EMR: Changes to the CFD supplier obligation*), seeking views on the proposals for the implementation of the EII and green imports exemptions, and minor and technical changes to the supplier obligation regulations. Nineteen responses were received to the consultation. The amended regulations take account of feedback raised by stakeholders as part of the consultation, as described below.

Exemption for Electricity Intensive Industries (EIIs)

8.7 The majority of respondents agreed with proposed process for issuing certificates to eligible EIIs. Respondents raised some concerns about the proposed approach to identifying exempt electricity, and several stakeholders suggested an alternative approach. Respondents were also concerned about timings set out for suppliers to update the arrangements that they had put in place if an EII certificate was revoked or when an EII changed supplier.

8.8 In response to the concerns from stakeholders, we have consulted on two approaches to identifying exempt electricity in the consultation² on consequential changes to the Balancing & Settlement Code (published on Monday 24 November 2014).

8.9 As well as formal consultation, we have engaged with a wide range of stakeholders in the development of this policy. We have met with small and large suppliers and electricity intensive businesses, and have tested views and policy options bilaterally, through consultation events, and at Cornwall Energy's *Energy Supplier Forum*.

Green Import Exemption

8.10 There was general support for our approach to the Green Import Exemption, although several respondents requested further details about the evidence that suppliers will need to submit to demonstrate their eligibility for the exemption. We do not consider it appropriate for regulations to set out the evidence requirements in detail, as they may vary according to circumstances and over time. The regulations enable the CFD Counterparty to determine whether the evidence provided by a supplier is satisfactory.

Supplier obligation minor and technical amendments

8.11 There was unanimous support for most of the proposed minor and technical changes to the supplier obligation. However, views were split on the proposal to allow negligence claims against the CFD Counterparty to be recovered through the supplier obligation levy (aligning with the existing ability for recovering breach of contract claims). Given that this change should not widen the costs that could fall upon the suppliers beyond the original policy intent, and given that the amendment removes uncertainty about where these costs would fall, we will implement the amendments as consulted upon.

² <https://www.gov.uk/government/consultations/supplier-obligation-consequential-amendments-to-the-balancing-and-settlement-code>

CFD Counterparty operational costs 2015/16

8.12 The operational costs levy required for the CFD Counterparty to recover its operational costs for 2015/16 has been subject to a four-week consultation, which received five responses. The consultation on the Low Carbon Contracts Company³ and Electricity Settlements Company operational costs 2015/16 closed on 3 December 2014 and following analysis of responses, the operational costs levy rate for the CFD Counterparty included in Regulations is £0.0397/MWh.

8.13 A more detailed analysis of the consultation responses can be found in the Government Responses to the consultations.

9. Guidance

9.1 The Government Responses to the consultations have been published to coincide with the laying of these regulations in Parliament. The Government Responses set out the views of stakeholders and an explanation of the final policy decisions taken.

9.2 Further guidance for electricity intensive businesses on how to apply for an exemption from CFD costs will be published by the Department for Business Innovation and Skills in 2015.

10. Impact

10.1 Electricity intensive industries: This policy will benefit eligible electricity intensive businesses by reducing the price they pay for electricity by 6.7% (saving an eligible company almost £700,000 in 2020). The impact on domestic consumers is expected to be an increase in electricity bills of 0.3% (£1.80) in 2020. For a medium size non-exempt industrial consumer the exemption is expected to add 0.4% (£5,600) on their electricity bills in 2020. An Impact Assessment on the impact of the EII exemption is attached to this memorandum and will be published alongside the Explanatory Memorandum on the legislation.gov.uk website.

10.2 Green Import Exemption: Suppliers who import eligible renewable electricity from other EU Member States will benefit from this provision. It is not expected that there will be a net cost to consumers as a result of this exemption. The overall impact in the early years will be minimal as the expectation is that there will be very little eligible electricity.

10.3 Minor and technical amendments: No expected impact.

10.4 Operational Cost Levy: As outlined in the operational cost consultation, the budget of the CFD Counterparty will be £12,007,000 for 2015/16. These operating costs (when included with those of the Capacity Market Settlement Body), are expected to increase household electricity bills by around £0.18 in 2015/16 (at 2014 prices), which equates to less than 0.05% increase in average household electricity

³ Low Carbon Contracts Company Ltd, a company registered in England and Wales with company registration number 08818711 and designated as a CFD Counterparty under Section 7 of the Energy Act 2013 on 1 August 2014.

bills. We would expect similar percentage impacts for medium-sized businesses and for energy-intensive users (except those that are eligible for an exemption in 2015/16).

10.5 These regulations do not have an additional impact on the costs to Government or National Grid delivering their EMR functions.

11. Regulating small business

11.1 The legislation applies to small businesses as it is expected that some suppliers and EIIs could fall into this category.

11.2 We expect the EII exemption to have a neutral effect on small suppliers as they will pass the exemption onto their customers. We expect eligible EIIs to benefit from the exemption primarily through suppliers passing on their reduced CFD payments via the setting of lower electricity prices.

11.3 We expect that the Green Imports Exemption will have an overall neutral effect on small electricity suppliers. Those small suppliers who import more eligible renewable electricity from other EU Member States than other suppliers will benefit from the exemption, whilst those who import less will face higher costs.

11.4 Overall, we do not expect that these regulations will have a disproportionate effect on small businesses.

12. Monitoring and 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 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 laid in Parliament and be shared with the Devolved Administrations.

12.2 The first of such reports was laid before Parliament on 6th November 2014. As well as fulfilling the reporting requirement, the EMR Annual Update 2014 provides Parliament and other stakeholders with a forward look of the path ahead and a summary of EMR progress since the Energy Bill received Royal Assent in December 2013.

12.3 In addition, section 66 of the Energy Act 2013, requires the Secretary of State to report to Parliament by the end of 2018 on a number of aspects of the operation of the EMR programme. These aspects include the extent to which the original objectives have been met, whether these objectives are still appropriate and whether they could be delivered in a way that imposes less regulation. This requirement covers CFDs, the Capacity Market and the transitional arrangements from the Renewables Obligation.

13. Contact

Michelle Toussaint-Bourne at the Department of Energy and Climate Change Tel: 0300 068 5184 or email: michelle.toussaintbourne@decc.gsi.gov.uk can answer any queries regarding the instrument.