

## **EXPLANATORY MEMORANDUM TO**

### **THE ELECTRICITY SUPPLIER OBLIGATIONS (AMENDMENT AND EXCLUDED ELECTRICITY) (AMENDMENT) REGULATIONS 2017**

**2017 No. 1051**

#### **1. Introduction**

- 1.1 This explanatory memorandum has been prepared by the Department for Business, Energy and Industrial Strategy and is laid before Parliament by Command of Her Majesty.
- 1.2 This memorandum contains information for the Joint Committee on Statutory Instruments.

#### **2. Purpose of the instrument**

- 2.1 These Regulations amend the Electricity Supplier Obligations (Amendment & Excluded Electricity) Regulations 2015 (the 2015 Regulations), which make provision for indirectly exempting eligible energy-intensive industries (EIIs) from part of the costs of funding Contracts for Difference (CFD).
- 2.2 The CFD scheme is a policy designed to encourage investment in large scale renewable generation by providing market stability. However, the costs of funding this policy – by means of a compulsory levy on electricity suppliers, which they pass on to their customers – expose heavy energy users such as EIIs to high electricity bills. As EIIs operate in international markets, these costs place them at a competitive disadvantage and increase the risk that companies may choose to move their production abroad. The 2015 Regulations therefore sought to allow eligible EIIs to apply to reduce the compulsory levy paid by their electricity supplier. These Regulations make a number of technical changes to the 2015 Regulations.

#### **3. Matters of special interest to Parliament**

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

- 3.1 We consider that the exceptions in sections 22(3)(a) and 28(3)(a) of the Small Business, Enterprise and Employment Act 2015 apply to this instrument. This is because the Contracts for Difference (Electricity Supplier Obligations) Regulations 2014 (the ESO Regulations) impose a requirement on licensed electricity suppliers in Great Britain to make payments to fund the CFD scheme to the Low Carbon Contracts Company (LCCC), the Government-owned company responsible for administering it. The cost this imposes on suppliers is passed onto bill payers who do not have a choice as to whether they make this payment – it is compulsory. On this basis the payments have been classified as a notional or imputed tax by the Office for National Statistics and as a result, they are subject to the Levy Control Framework.
- 3.2 The 2015 Regulations amended the ESO Regulations to grant a partial exemption to certain licensed electricity suppliers from the payments required by the ESO Regulations (this is explained in more detail below). The Regulations which are the subject of this Explanatory Memorandum in turn amend the 2015 Regulations. They

therefore make provision varying a levy, or in the alternative, make provision in connection with provision imposing or varying a levy.

*Other matters of interest to the House of Commons*

- 3.3 The territorial application of this instrument includes Scotland and Northern Ireland and is not a financial instrument that relates exclusively to England, Wales and Northern Ireland.

**4. Legislative Context**

- 4.1 The Energy Act 2013 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. One of the mechanisms for reform is the CFD scheme. This scheme was implemented by secondary legislation.
- 4.2 The 2015 Regulations came into force in April 2015 and provide a mechanism for allowing eligible EIIs to apply for an indirect exemption from a proportion of the costs of funding the CFD scheme (the CFD exemption), which takes effect by way of a reduction to the compulsory levy paid by their electricity suppliers.
- 4.3 In December 2015, the European Commission approved the CFD exemption as State aid in accordance with the terms of our notification<sup>1</sup>. However, the terms of the approved notification require us to make changes to the 2015 Regulations, including a move to analysing an applicant's data over a three year reference period (rather than a five year period that was previously used) when assessing eligibility.
- 4.4 We are also making a number of changes to clarify elements of the 2015 Regulations and to improve the administration of the CFD exemption, including amendments to allow new businesses to claim the benefit of the exemption, a requirement for EIIs to notify us in certain circumstances to help us ensure that businesses receive the exemption to the correct level and only if they are eligible, and provisions that allow an EII to apply for the exemption if it does not obtain electricity directly from a licensed electricity supplier. We are also including a facility for data sharing between the LCCC and Ofgem, which administers the related Renewables Obligation (RO) and Feed-in-Tariffs (FIT) schemes (other renewable energy schemes) in respect of those schemes.

**5. Extent and Territorial Application**

- 5.1 The extent of this instrument is the United Kingdom.
- 5.2 The territorial application of this instrument is the United Kingdom.
- 5.3 However, Northern Ireland electricity suppliers are not currently subject to obligations to contribute towards the costs of the CFD scheme. When the CFD scheme is extended to Northern Ireland, the Government will make the necessary legislative amendments to impose such obligations on electricity suppliers in Northern Ireland.

**6. European Convention on Human Rights**

- 6.1 The Minister of State for Energy and Industry has made the following statement regarding Human Rights:

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<sup>1</sup> Commission Case Number SA.43657 (The public version of this Commission Decision is not yet available.)

In my view the provisions of the Electricity Supplier Obligations (Amendment & Excluded Electricity) (Amendment) Regulations 2017 are compatible with the Convention rights.

## **7. Policy background**

### *Policy objectives of CFDs*

- 7.1 The Electricity Market Reform programme is intended to incentivise investment in low carbon electricity generation, whilst improving affordability for consumers and maintaining energy security. These Regulations are concerned with mitigating part of the indirect impact of funding CFDs (one element of the Electricity Market Reform programme) on EIIs.
- 7.2 CFDs are contracts between a low carbon electricity generator and the LCCC. Under a CFD, the low carbon electricity generator is guaranteed a fixed price for the electricity it generates. In this way the CFD provides long-term price stabilisation for low carbon plant, allowing investment to come forward at a lower cost of capital and a lower cost to consumers.
- 7.3 The LCCC raises the money to fund CFD payments through a compulsory levy (called the supplier obligation) on licensed energy suppliers in the UK. Suppliers pass on the costs of this obligation to domestic and business users through their energy bills.

### *Impact of CFDs on EIIs*

- 7.4 EIIs are those businesses in sectors where electricity costs are a high proportion of their Gross Value Added (which is a measure of the value of the goods and services they produce). The costs of the CFD scheme are passed through in bills to EIIs from energy suppliers and as EIIs operate in global markets where commodity prices are set internationally, they are often unable to pass these costs through to the end customer. Therefore EIIs that face higher electricity costs are placed at a competitive disadvantage. Typical EIIs in the UK include chemicals, steel, cement, aluminium, glass, paper, plastics and ceramics.

### *Objectives of the proposed EII exemption*

- 7.5 The 2015 Regulations provide that eligible EIIs can apply to receive an indirect exemption from up to 85% of the costs of funding the CFD scheme. Where an eligible EII successfully applies for the exemption, its electricity supplier will receive a reduction to the costs of the supplier obligation which it can pass on to its EII customer.
- 7.6 This will mitigate the costs of funding the CFD scheme for EIIs, support industrial competitiveness and by being set in legislation provide long-term certainty for businesses. The costs of the exemption for EIIs will be redistributed to domestic and non-eligible business users, increasing their bills. For domestic users this is likely to be an increase of around £1 per year; for a medium energy business user this is likely to be around £3,100 per year by 2023/24.

### ***Consolidation***

- 7.7 As the amendments required to parts of the 2015 Regulations are relatively extensive, we have partially consolidated them in these Regulations. In the event of further amendments to the 2015 Regulations, we will consider a full consolidation.
- 7.8 In light of the partial consolidation of the 2015 Regulations, we are providing an informal schedule to assist Parliament in seeing what amendments are being made to the 2015 Regulations.

### **8. Consultation outcome**

- 8.1 These Regulations were informed by the responses to two consultations held in April 2016 and July 2016.<sup>2</sup>

#### ***Consultation on implementing an exemption for EIIs from the indirect costs of the Renewables Obligation and Feed-In Tariff Schemes***

- 8.2 A consultation took place for 8 weeks from 1 April to 27 May 2016. 69 responses were received from stakeholders including EIIs, electricity suppliers, consumer groups, non-eligible businesses and individuals. However, of relevance to the Regulations which are the subject of this Explanatory Memorandum is the response to a consultation question about allowing Ofgem to access data used by LCCC to administer the CFD exemption in order to validate the data on levels of exempt electricity supplied to EIIs by suppliers. Over 92% of responses agreed with these proposals. The only response which disagreed with these proposals raised concerns about the crosschecking of data that were not supported by evidence.

#### ***Consultation on exemption from the indirect costs of CFDs***

- 8.3 A consultation took place for five weeks from 22 July to 26 August. 46 responses were received primarily from EIIs, energy suppliers and trade associations<sup>3</sup>. As well as formal consultation, we have engaged with a wide range of stakeholders in the development of this policy. We have had discussions with large and small energy suppliers, trade associations representing energy intensive businesses and individual businesses that have contacted the Department. We also consulted the Scottish and Welsh Ministers, the Northern Ireland Department for the Economy, Ofgem and the National Grid.
- 8.4 We consulted on two main areas: Technical changes to improve the administration of the CFD exemption, and options on how to implement a mechanism to recover the monetary value of any over-exemption of EIIs.
- 8.5 The majority of consultation responses supported the proposed amendments to the 2015 Regulations. Responses identified the following main areas of concern. Firstly, a number of respondents raised concerns that scheduled maintenance or refurbishment of plant might be caught by a requirement to notify the Secretary of State of cessation of a specified activity that lasts for 4 weeks or longer. This was not an intended

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<sup>2</sup> The 2015 Regulations were informed by consultations in July 2014, September 2014 and November 2014. The consultations run in respect of the Regulations which are the subject of this Explanatory Memorandum were a continuation of ongoing, long-term engagement with stakeholders.

<sup>3</sup> The consultation and Government Response is available at:  
<https://www.gov.uk/government/consultations/energy-intensive-industries-exemption-from-indirect-costs-of-the-contracts-for-difference-scheme>

outcome and this will be clarified in the guidance published to accompany these Regulations. It has also been addressed in the drafting of these Regulations.

- 8.6 Secondly, respondents raised concerns about how to accommodate changes in business structure such as mergers, acquisitions, divestments or restructurings. To address this issue we have amended the drafting of these Regulations. These Regulations now allow electricity meters certified as supplying electricity benefitting from the exemption to retain their certification following a change in business structure, but where a business wishes to certify additional electricity meters it will need to apply for an exemption in line with these Regulations.
- 8.7 Thirdly, respondents raised concerns that the draft Regulations did not adequately address how the CFD exemption would work in the case of the onward supply of electricity from one business to another. To ensure that the exemption is available in such situations we have revised these Regulations. Businesses that obtain their electricity from another business rather than direct from a licensed energy supplier will be able to apply for the CFD exemption as long as they supply additional information, such as details of the third party business supplier and sufficient information to allow us to determine the proportions of electricity consumed at the meter point by the EII and its third party business supplier respectively.
- 8.8 In addition, the consultation highlighted our intention to remove the provisions in the 2015 Regulations that allow direct competitors of eligible EIIs which are not in themselves eligible to claim the CFD exemption. Under our original proposal, notified to the European Commission for approval as State aid, non-eligible direct competitors would have been entitled to receive the benefit of the exemption. However, this proposal has not been approved, and we are therefore currently unable to extend the CFD exemption to these businesses. Some responses to the consultation raised concerns about proceeding with the CFD exemption whilst excluding direct competitors. Specifically, concern was raised that eligible businesses will receive the benefit of the CFD exemption whilst their non-eligible direct competitors will not, and the latter will face higher energy bills to fund the CFD exemption. The Department is aware of and understands these concerns. Whilst we continue to seek a resolution to this issue, we are also investigating options that may be available to us within the scope of the EU State Aid guidelines.
- 8.9 Although we also consulted on the inclusion of a mechanism for the recovery and redistribution of over-exemptions of EIIs, this mechanism has not been included in these Regulations. Developing such a mechanism is complex and we want to allow sufficient time to develop a workable model. In the meantime recovery, but not redistribution, will be possible under generally applicable law.
- 8.10 Further detail can be found in the Government's response to the consultation, which is provided to provide further information for Parliament on the main issues that were raised.

## **9. Guidance**

- 9.1 BEIS will provide guidance to EIIs on how the exemption will work, how to apply and how to appeal if applicants do not agree with a decision made under the CFD exemption scheme that affects them. The latest draft of this guidance, which is a work in progress, is provided to assist Parliament in understanding how these Regulations will work in practice. An application form will be provided alongside the guidance.

## **10. Impact**

- 10.1 The impact on eligible EIIs will be an indirect exemption from a proportion of the costs of funding CFDs through their electricity bills which will save an average EII over £670,000 in 2023/24 (in 2016 prices). All other electricity users including the public sector, charities and voluntary bodies, households, non-eligible EIIs and other business users will cover the costs of this exemption through rises in their electricity bills passed on by their electricity suppliers. Indicative annual costs by 2023/4 are summarised in section 7.6 above.
- 10.2 An Impact Assessment on the impact of the CFD exemption was prepared in respect of the 2015 Regulations. The amendments in the Regulations which are the subject of this Explanatory Memorandum do not change the background, rationale or objectives of the policy outlined in that Impact Assessment. The Impact Assessment prepared in respect of the 2015 Regulations is provided with this memorandum and will be published alongside the Explanatory Memorandum on the [legislation.gov.uk](http://legislation.gov.uk) website, along with supplementary information providing updated figures showing the best estimate of the impact of the CFD exemption on electricity bills.

## **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 benefit of 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 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 Electricity Market Reform (EMR) functions. The section requires the Secretary of State to report, before 31<sup>st</sup> December each year, on how he has carried out his functions in Part 2 of the Act in order to deliver the objectives of EMR. The report must be laid in Parliament and shared with the Devolved Administrations.
- 12.2 The third Annual Update on progress made by the CFD and Capacity Market Scheme (the policy mechanisms implemented under the formerly titled EMR programme) was presented to Parliament in December 2016<sup>4</sup>. The Annual Update detailed progress in several key areas since the second update in October 2015. It stated that the first CFD project commenced generation in 2016, and plans for the second Allocation Round were announced in November 2016.
- 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

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<sup>4</sup> <https://www.gov.uk/government/publications/contracts-for-difference-and-capacity-market-scheme-update-2016>

delivered in a way that imposes less regulation. This requirement covers the CFD scheme.

- 12.4 We also plan to undertake an evaluation and review of the CFD exemption scheme in 2020 to ensure that it is achieving the objective of mitigating the competitive disadvantage caused by the CFD scheme on energy intensive businesses and that this stems potential investment leakage.

### **13. Contact**

- 13.1 Carolyn Campbell at the Department for Business, Energy and Industrial Strategy (telephone: 0207 215 3991 or email: [carolyn.campbell@beis.gov.uk](mailto:carolyn.campbell@beis.gov.uk)) can answer any queries regarding the instrument.