EXPLANATORY MEMORANDUM TO

THE CONTRACTS FOR DIFFERENCE (SUSTAINABLE INDUSTRY REWARDS) REGULATIONS 2024.

2024 No. 710

1. Introduction

1.1 This explanatory memorandum has been prepared by the Department for Energy Security and Net Zero and is laid before Parliament by Command of His Majesty.

2. Declaration

2.1 Andrew Bowie, Minister at the Department for Energy Security and Net Zero confirms that this Explanatory Memorandum meets the required standard.

2.2 Sarah Redwood, Director for Renewable Electricity Directorate, at the Department for Energy Security and Net Zero confirms that this Explanatory Memorandum meets the required standard.

3. Contact

3.1 Sumaya Jamaale at the Department for Energy Security and Net Zero (email: sumaya.jamaale@energysecurity.gov.uk) can be contacted with any queries regarding the instrument.

<u>Part One: Explanation, and context, of the Instrument</u>

4. Overview of the Instrument

What does the legislation do?

4.1 The purpose of these Regulations is to introduce the Sustainable Industry Rewards (SIRs), formerly known as non-price factors (NPFs), into the Contracts for Difference (CfD) scheme, the UK's main renewable energy support scheme. This will be a temporary replacement for CfD Supply Chain Plans (SCPs) for offshore and floating offshore wind for CfD Allocation Rounds 7, 8 and 9 only. CfD Allocation Rounds run on an annual basis, with AR7 scheduled for 2025.

Where does the legislation extend to, and apply?

4.2 The extent of this instrument (that is, the jurisdiction(s) which the instrument forms part of the law of) is England and Wales and Scotland. The territorial application of this instrument (that is, where the instrument produces a practical effect) is England, Wales and Scotland.

5. Policy Context

What is being done and why?

5.1 The SIRs work within the CfD scheme, which is the Government's main policy for supporting low-carbon electricity generation. A CfD is a private law contract between a low carbon electricity generator and the Low Carbon Contracts Company (LCCC), a government-owned company. CfDs are generally awarded on the basis of a competitive auction, where developers of low carbon power projects submit bids to obtain revenue support for constructing their low-carbon electricity generating station, the lowest priced of which win a contract. The auction mechanism currently awards contracts based on price, budget availability and gigawatt (GW) capacity. A generator party to a CfD is paid the difference between the 'strike price' – a price for electricity reflecting the cost of investing in a particular low carbon technology – and the 'reference price'– a measure of the average market price for electricity in the market. CfDs have been successful in driving down the costs of low-carbon energy. However, the focus on price in the auction incentivises developers to seek the cheapest supply chain options (e.g. turbine or cable manufacturers), over investing in a more sustainable supply chain. For this reason, the SIR addition to the CfD was developed in order to encourage developers to consider factors that are of wider value to consumers and the renewable energy industry, such as the economic, environmental and social sustainability of projects and their supply chains.

5.2 SIRs propose to provide extra revenue support, through the CfD, to offshore and floating offshore wind applicants who (a) support shorter and more socially beneficial supply chains by using factories set up closer to the deployment zones, specifically in deprived areas in the UK, or (b) those who choose more sustainable supply chain companies to build their projects. This can help increase the supply of key offshore wind components in a more sustainable manner, helping to meet the government's ambition to deploy up to 50GW of offshore wind by 2030, including up to 5GW of floating offshore wind. Without the inclusion of the SIR, there would be no financial mechanism to encourage more sustainable supply chain choices in the CfD. Procurement choices of offshore wind developers would default to current practices, which are unsustainable and may put at risk the government's deployment targets and future energy security. SIRs will allocate additional revenue support through a competitive auction process, ahead of the main CfD auction.

5.3 For CfD Allocation Rounds 7, 8 and 9 the SIR will replace the current Supply Chain Plan (SCP) process for offshore and floating offshore wind applicants. Developers of those technologies will be required to make a minimum level of commitment to certain sustainability criteria, as a condition of entry to the CfD.

5.4 This Statutory Instrument will enable us to implement this policy by updating the relevant CfD regulations. The main CfD allocation mechanism, which will take place after the SIR allocation mechanism provided for by these Regulations, will continue to take place as normal.

How will the SIR work?

5.5 The SIR proposes to provide extra revenue support to offshore and floating offshore wind applicants who invest in new factories in deprived areas in the UK in a bid to shorten supply chains by increasing manufacturing capabilities closer to deployment zones, or who choose more sustainable supply chain companies to build their projects. Extra revenue support will be allocated via a competitive allocation process, ahead of the main CfD auction. The SIR process will ask applicants to submit proposals under the pre-determined criteria. These applicants will be scored against the quality and cost of delivering those proposals. The pre-determined criteria were selected with the aim of maximising the social, environmental and economic impact on the supply chain. These criteria are not set out in the legislation but contained within an Allocation Framework, set out on gov.uk. It is expected that applicants submit one or more proposals under the following SIR criteria for Allocation Round 7:

- Criterion 1: Investments in shorter supply chains in UK deprived areas.
- Criterion 2: Investment in more sustainable means of production, anywhere in the world.
- Criterion 3: Investment in shorter, more sustainable means of production, in UK deprived areas (i.e. criteria 1 and 2 combined).

5.6 The criteria and further information on the SIR will be outlined in the SIR Allocation Framework (AF), which will become part of the wider CfD Allocation Framework and will be reviewed each allocation round. The total budget will be made available in the SIR budget notice, published ahead of the SIR allocation process opening.

5.7 SIR applicants will be required to score at or above the minimum standard, meaning a minimum level of investment across the criteria, as a condition of entry to the CfD. This minimum standard will be required of all fixed and floating offshore wind applicants, regardless of whether they go on to win extra financial rewards through the SIR policy. This will ensure that even though applicants did not qualify for extra revenue support, they can only gain entry to the main CfD round by committing to investing in the sustainability of the supply chain.

5.8 Applicants will have the opportunity to challenge their scores before they are ranked, with the option of referring the decision to an expert committee for independent review. The panel will provide a recommendation to the Secretary of State. This will be provided for in the Allocation Framework. Once disputes are settled, the scores will be ranked on the basis of quality and cost. Applicants will compete against each other for funding though the competitive process; this is designed to drive developers to deliver the highest quality proposals for their supply chains at the lowest possible cost. Proposals will be ranked according to their score, with the most value for money proposals drawing down from the SIR budget first, until the budget is exhausted.

5.9 Developers' successful proposals will become contractual obligations, subject to monitoring by the Department. These obligations must be delivered before electricity generation starts to release SIR payments. Developers will be able to apply for an SIR implementation statement from the Secretary of State, demonstrating that their contractual obligations have been met. An implementation statement which confirms delivery of obligations will enable LCCC to release SIR payments (in practice, an addition to regular CfD payments). LCCC will raise the necessary revenue support through the Supplier Obligation levy (the levy on electricity consumer bills), in the same way as it raises other CfD payments. If developers do not deliver on their obligations, a financial performance related adjustment will be applied under the CfD contract. Where an implementation statement only confirms partial delivery of obligations, a partial SIR payment will be released. In the case of non-delivery or delivery below the minimum standard, a performance related adjustment will be applied to an applicant's CfD payments. The Secretary of State will determine how far below the minimum standard a developer may be, and a performance related adjustment proportionate to the underspend below the minimum standard will be applied. The formula to calculate this is expected to be:

SIR performance related adjustment applied to CfD payments =Min standards required spend -actual spend on Min Standards.

5.10 The terms of the CfD contract will provide some relief in respect of performance related adjustments, if the applicant is not at fault or non-delivery is beyond the control of the applicant. There will an opportunity for an SIR statement to be amended due to evidenced material changes.

5.11 In terms of wider impacts, the SIRs will deliver a range of potential benefits for offshore wind supply chains. The SIRs could help to accelerate efforts to invest in newer, cleaner manufacturing capacity with a smaller carbon footprint leading to greater innovation and growth in offshore wind supply chains. The SIR is complementary to the Green Industries Growth Accelerator fund which offers direct grants to renewable energy manufacturers seeking to set up new facilities with high start-up costs.

5.12 This policy is funded as part of CfD payments, raised from a levy on consumer bills. The total impact of this policy on bills is expected to be very small.

What was the previous policy, how is this different?

5.13 Currently, developers of all technologies (e.g. solar, wind, geothermal etc.) require a Supply Chain Plan (SCP) statement to access the CfD scheme. This applies to all floating offshore wind projects of all sizes, and all other projects of 300 megawatts (MW) or more. SIRs replace SCPs for all offshore and floating offshore wind developers (regardless of project size) applying to the CfD. The underlying policy objectives of the SIR and the SCP are similar – both aim to encourage competitive, productive and efficient supply chain plans for low carbon electricity generation projects, and to accelerate investments in a broad range of established and less established low carbon technologies to help ensure delivery of our ambitious Net Zero objectives. However, the SCP became less effective for offshore wind in a context where global supply chain costs soared, and market pressures inhibited long-term investments and more sustainable procurement choices, in favour of a race to the bottom in terms of costs and standards.

6. Legislative and Legal Context

How has the law changed?

6.1 The Regulations will amend four sets of CfD regulations made under the Energy Act 2013, to implement the SIR policy as detailed below.

6.2 These Regulations will amend the Contracts for Difference (Allocation) Regulations 2014 (the Allocation Regulations) to:

- Introduce a new requirement for offshore and floating offshore wind farm developers to obtain a Sustainable Industry Reward statement as part of eligibility requirements for the CfD scheme;
- Enable the Secretary of State to set rules for how Sustainable Industry Reward statements can be applied for and awarded (through the SIR Allocation Framework);
- Set out what factors the Secretary of State must consider when assessing applications for Sustainable Industry Reward statements;
- Enable the Secretary of State to allocate additional CfD funding to developers who make and deliver high quality sustainability commitments;
- Enable the Secretary of State to set a budget for additional funding.

6.3 These Regulations also amend the Electricity Market Reform (General) Regulations 2014 (the EMR Regulations) to allow developers with a Sustainable Industry Reward statement to apply for a statement confirming delivery of their sustainability commitments (a ‘Sustainable Industry Reward implementation statement’). This will be a condition of receiving any additional funding. The criteria used to assess applications for SCP statements (i.e. the existing, legacy policy) from developers of other technologies have also been updated, to align the legacy policy with the introduction of SIRs.

6.4 These Regulations also amend the Contracts for Difference (Standard Terms) Regulations 2014 (the Standard Terms Regulations), to require the Secretary of State to include in the standard terms of a CfD the circumstances in which adjustments to CfD payments may be made, where a developer has not fully delivered on their SIR.

6.5 A minor consequential amendment is made to the Contracts for Difference (Definition of Eligible Generator) Regulations 2014 (the Eligible Generator Regulations). This updates a cross-reference to Part 3 of the EMR Regulations.

6.6 More detail on key aspects of these changes is set out below.

Applicant entry to the SIR.

6.7 As outlined in section 5, the policy intention is that floating and offshore wind developers must apply for the SIRs as a condition of entry to the CfD. The Allocation Regulations currently require CfD applicants with a generating capacity of 300MW or more and all floating offshore wind applicants to provide a Supply Chain Plan statement as part of their CfD application. These Regulations amend the Allocation Regulations to allow for the replacement of the SCP by requiring all offshore and floating offshore wind projects, regardless of project size and as a condition of entry to the CfD, to submit an SIR statement as part of their CfD application. This may be applied by the Secretary of State for allocation rounds 7, 8 or 9.

Setting out a SIR Allocation Framework and SIR budget notice.

6.8 The SIRs will require an Allocation Framework to set out the SIR application process, how applications are assessed, the criteria and minimum standards for commitments, and how additional funding is allocated. The Allocation Regulations will be amended to enable the Secretary of State to set rules for the giving of SIR statements and the allocation of additional funding. These will be in a new part of the CfD Allocation Framework, published separately and dedicated to SIRs ('the Sustainable Industry Reward Allocation Framework').

The scope of the SIR criteria.

6.9 Whilst the scope of the SCP and SIRs are similar, the Regulations set out the overarching objectives of the SIR as:

a) increasing productivity, competitiveness and capacity in supply chains;
b) encouraging innovation in supply chains;
c) developing a diverse and skilled workforce and increasing employment opportunities;
d) increasing investment in and finding technical solutions to improving infrastructure
e) increasing the sustainability of supply chains, in particular—
    (i) increasing the long-term economic sustainability of supply chains;
    (ii) minimising the negative environmental impacts of supply chains; and
    (iii) delivering benefits to the communities in which supply chains operate; and
f) increasing the investment in deprived areas which results from supply chains.

6.10 In practice, this is the same as the scope of Supply Chain Plan regulations, with the addition of provisions e) and f) in the paragraph above.

6.11 The Secretary of State must assess SIR applications against their likely contribution to these objectives, as set out and elaborated in the SIR Allocation Framework.

Minimum standard.

6.12 These Regulations amend the Allocation Regulations to allow the Secretary of State to set minimum standards under the SIR criteria in order to obtain an SIR statement. The minimum standard will take the form of an expended minimum spend across the SIR criteria set out in the draft Allocation Framework, scaled per GW of electricity generated so that smaller projects are not disadvantaged. These standards will be different for floating offshore wind and offshore wind due to the difference in technological development between them.

Funding mechanism and budget raising.

6.13 The current CfD SCP policy does not allocate funding, so there is no mechanism in the current legislation to allow a budget to be set for supply chain-related funding. In contrast, the SIRs will allocate revenue support through an industry-led reward mechanism, providing a financial uplift to a successful applicant's CfD (i.e. a reward) if they deliver the commitments they made under each SIR criteria. These Regulations amend the Allocation Regulations to allow the Secretary of State to set a budget for SIR funding. The process for allocating funding will be outlined in the SIR Allocation Framework.

6.14 Amendments are also required to empower the Secretary of State to assign a budget to SIRs. This will be raised using the same Supplier Obligation Levy as for the existing CfD budget.

Issuing and withdrawing SIR Implementation Statement.

6.15 As noted in section 5.9, developers in receipt of an SIR statement will be required to apply for an SIR implementation statement in order to evidence successful delivery of their SIR commitments. These Regulations amend the EMR Regulations to allow developers to apply for an SIR implementation statement and to give the Secretary of State the power to issue a statement where delivery commitments have been met. The Secretary of State also has the power to issue a 'qualified' implementation statement, showing that commitments have been partly delivered on, or to refuse to provide a statement, in the event that an applicant fails to deliver on the minimum standards required of them. Refusing to issue an SIR implementation statement means an applicant cannot receive SIR payments from the Low Carbon Contracts Company, and may face further financial adjustments to their CfD payments. The EMR Regulations are also amended to allow the Secretary of State to withdraw an implementation statement if it contains an error, or if it was given based on information which is materially incorrect.

Performance related adjustments and appeals.

6.16 Where developers fail to deliver on commitments made in their SIR statements, financial performance-related adjustments may be applied through their CfD contract. These include adjustments to SIR payments and to other payments made under the CfD. These Regulations amend the Standard Terms Regulations to require the Secretary of State to include in the CfD standard terms the circumstances in which payments can be adjusted based on failure to deliver (in full or in part) on SIR commitments.

Why was this approach taken to change the law?

6.17 These Regulations take the approach of amending existing CfD regulations, as opposed to creating a free-standing instrument, as SIRs form part of the existing CfD allocation process. This is considered the most appropriate way to achieve the desired policy outcome of aiding the development of a more sustainable supply chain, in support of low carbon electricity deployment under the CfD, as well as the most time and resource efficient approach. Where appropriate, the Allocation Framework, which sets out rules for CfD allocation, will be used to add detail to the SIR process.

7. Consultation

Summary of consultation outcome and methodology

7.1 The policies reflected in this instrument were subject to an 8-week consultation, from 16th November 2023 to 11th January 2024. Several stakeholder events were held before and during the consultation period to discuss the policy proposals with generators, trade and public bodies and supply chain companies.

7.2 The consultation outlined the policy proposal and desired outcomes, and sought views from industry in response to various questions focused on the mechanics of the SIR policy. There were a total of 74 responses to 17 questions, representing the renewable energy industry, including floating offshore and offshore wind developers, trade and public bodies and supply chain companies.

7.3 At the time this Memorandum was finalised, a full government response was expected to be published on 13 March 2024, published on gov.uk. Broadly, industry responses were supportive of the policy, and the aim to provide supply chain support. Feedback was mainly on the proposed design mechanisms of the policy which will be outlined the draft Allocation Framework. The feedback from the consultation did not lead to the need for a change to the design of the regulations because changes to the policy following consultation are mostly concentrated in adjustments that will be covered in the Allocation Framework, such as improvement to scoring methodologies, minimum standards, performance adjustment methodologies.

7.4 In terms of devolved administrations, the Scottish and Welsh governments were formally consulted, and are content with the purpose of the policy. The CfD does not apply in Northern Ireland (though companies in Northern Ireland can still benefit from Sustainable Industry Reward investments).

8. Applicable Guidance

8.1 Draft SIR Allocation Framework and guidance are expected to be published and available to assist consideration of these Regulations by Parliament. These documents are subject to further amendment.

Part Two: Impact and the Better Regulation Framework

9. Impact Assessment

9.1 A full Impact Assessment will be published and will be found on gov.uk. This presents an assessment of the impact of the policy on business and wider society.

9.2 There is no significant impact on charities or voluntary bodies.

9.3 The legislation does not significantly impact small or micro businesses.

9.4 There is no, or no significant, impact on the public sector because the SIR will be open only to companies involved in the offshore wind industry.

10. Monitoring and review

What is the approach to monitoring and reviewing this legislation?

10.1 Government will review the effectiveness of the legislation with each CfD round the SIR policy applies to, making changes to the SIR Allocation Framework if necessary. The SIR provisions may only be applied in relation to allocation rounds 7, 8 and 9, after which a full formal review of the policy's effectiveness is expected. New legislation would have to be laid should it be desired that the policy continues.

10.2 Given that the SIR provisions will only be applicable for a limited time period, the Department is of the view that it would not be proportionate to include a review clause.

10.3 Accordingly, this instrument does not include a statutory review clause and, in line with the requirements of the Small Business, Enterprise and Employment Act 2015, the Minister Bowie has made the following statement regarding monitoring and review:

"In my view, a review provision is not appropriate because it would not be proportionate taking into account the limited period of time for which the SIR scheme will be in operation, as set out in the Small Business, Enterprise and Employment Act 2015."

Part Three: Statements and Matters of Particular Interest to Parliament

11. Matters of Particular Interest to Parliament

11.1 None.

12. European Convention on Human Rights

12.1 The Minister Bowie has made the following statement regarding Human Rights:

"In my view the provisions of the Contracts for Difference (Sustainable Industry Rewards) Regulations 2024 are compatible with the Convention rights."

13. The Relevant European Union Acts

13.1 This instrument is not made under the European Union (Withdrawal) Act 2018, the European Union (Future Relationship) Act 2020 or the Retained EU Law (Revocation and Reform) Act 2023 ("relevant European Union Acts").