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**Consultation on the CfD FiT Supplier call for evidence:***Submission by GDF SUEZ Energy International***Introduction**

GDF SUEZ welcomes the opportunity to comment on these proposals and we have outlined our initial thoughts below.

**(I) About GDF Suez Energy International**

GDF Suez Energy International (formerly International Power) is a leading independent power generation company with active interests in closely linked businesses such as LNG terminals and water desalination.

GDF Suez Energy International (GSEI) has strong positions in all of its major regional markets (Latin America, North America, the Middle East, Turkey and Africa, UK-Europe, Asia and Australia). In total, it has 66 GW gross capacity in operation and committed projects for a further 22 GW gross new capacity.

In the UK-Europe region, GSEI has 13.2 GW capacity in operation and a further 1.3 GW under construction. This includes over 7.3 GW of plant in the UK market made up of a mixed portfolio of conventional plant – coal, gas, CHP, a small diesel plant, and the UK's foremost pumped-storage facility. Several of these assets are owned and operated in partnership with Mitsui & Co. Ltd. GSEI's assets represent just under 9% of the UK's installed capacity, making IPR the country's largest independent power producer.

The company also has a significant gas and electricity supply business in the UK. GDF SUEZ Energy UK is firmly established as a specialist energy supplier to industry and commerce across the UK and has been operating in this market since 1999. The company is currently the sixth biggest electricity supplier by volume to the business market and the fifth largest gas supplier by volume to the business market. We offer an innovative range of energy supply products to meet the requirements of all types of business, from smaller industrial and commercial companies, to energy-intensive industrial plants. We are constantly developing new products and adapting our services to meet the needs of business customers.

**(II) Summary key points*****General Comments***

- **GDF SUEZ does not agree that a variable price cost recovery mechanism is the best solution. We prefer a fixed price mechanism which increases the certainty of cash-flows for all concerned and at the same time reduces the risks for suppliers and consumers alike.**
- **Fixed prices add more certainty to consumers in all market segments and can be set ahead of time in a similar manner to the Renewable Obligation (RO) supplier target. It is likely that there would be**

fewer post contract reconciliations between suppliers and consumers and ex-ante not ex-post pricing is simpler and easier to implement into industry settlement systems and supplier systems.

- Fixed price gives greater certainty and price transparency. Price transparency has the added benefit of ensuring that there is no competitive disadvantage to those suppliers who operate in only one market segment. It has been observed recently that prices related to the levelisation costs of small scale FiTs have not always been fully reflected in quoted prices to the non-domestic sector and hence there is the potential for:
  - i) domestic consumers to pick up more than their fair share of the bill; and,
  - ii) An unfair advantage to larger suppliers in the non-domestic market.
- There should be a single mechanism for the levelisation of CfD FiT costs; that is to say that the mechanism should not differ between types of customer (for example NHH/HH or domestic/non-domestic). Any differentiation may lead to unintended consequences such as an unfair competitive advantage to different supply market participants.
- More thought may be given to address the potential risk to CfD generators from a shortfall in the supplier payments for a particular period if a fixed price mechanism existed. Areas that could be considered might include an over/under recovery mechanism and/or the establishment of an advance mutualisation fund (securitised by suppliers) to cover losses in the event of a shortfall. However, it is important that there should be safeguards such that suppliers and consumers should not over-collateralise this process.

(III) Answers to Consultation Questions

**Question 1: Do you have concerns about the predictability of the amount of potential volatility of CfD payments?**

1. Yes it is a concern that suppliers will face the difficulty of predicting and recovering the costs of policy measures over and above that of their own costs to supply. The introduction of a variable price recovery model would expose suppliers to a range of new or exacerbated risks resulting from a range of variables including:
  - Volumes generated under the CfD FiT,
  - Predicting the generation mix including the start dates for new plant,
  - The overall volume weighted reference price,
  - Collateral amounts,
  - Supplier market share movements.
2. Many of these risks are outside of the control of suppliers and it is unreasonable to place such risks on suppliers, particularly smaller suppliers who may be less able to cope with added complexity and/or who are less able to diversify risks for example by owning generation assets.
3. The volatility of a variable cost recovery mechanism combined with the magnitude of the CfD FiT costs will be extremely difficult for suppliers to manage. To illustrate, it is estimated that by 2020 the annual CfD charge for a supplier with a 5% market share would be approximately £180m, rising to £2.4bn by

2028. In 2020 this would relate to around 20% of the wholesale electricity costs<sup>1</sup> subject to uncertainty, rising to more than double the wholesale cost element by 2028.

**Question 2: Does this differ based on different scenarios for how the generation mix evolves?**

4. Yes - see paragraph 1 above, but no-one can foresee how this will evolve with any surety. Given the unprecedented requirement for investment in the system to meet the UK low carbon objectives it is very difficult to forecast the future generation mix given the complex scenarios and many interactions.

**Question 3: How would you manage the fact that CfD payments are changeable, noting that they are inversely related to wholesale price movements, and looking at this from the perspective of variations in total costs to serve (i.e. wholesale price/other cost variations in conjunction with CfD payment variations)?**

5. As highlighted in point 3 above the magnitude of cost variations overall would be significantly increased because of the rise in the overall subsidy level. It is likely that the inverse relationship between the subsidy level and wholesale price could exist but this is unlikely to be a perfectly correlated relationship. Prices on a windy day could easily be higher than average due to other factors such as high gas demand or a nuclear outage. The dependencies on other factors are important and these could add both significant variability and unpredictability.

**Question 4: Is there a hedge that suppliers can utilise that may mitigate any risks?**

6. The introduction of a variable price mechanism to recover the costs associated with CfD FiT would seem to introduce an unnecessary burden on suppliers whereby suppliers would be obliged to hedge against the risk of a government programme. Suppliers already face significant market related risks hedging their own portfolio and hence the introduction of another unknown variable is likely to result in further risk to suppliers and inevitably increased risk premia for consumers.

**Question 5: Overall what are your views on the proposed variable rate obligation and are there any other issues we should be considering?**

7. The variable rate obligation is not suitable for the reasons we have highlighted, our preference is for a fixed rate solution which gives more certainty to suppliers and increased visibility for customers.
8. A model which fixes the price on a year-ahead basis, starting April would work well for suppliers. In the non-domestic market it is highly typical for the vast majority of contract durations to be of twelve month duration and a significant proportion of contracts renew or change supplier in April each year. Suppliers are used to re-setting charges in time to take effect in April each year to take account of regulated charges such as network charges, RO and CCL and it CfD FiT charges should align with this process.
9. Predictability of charging is also an important factor and it would be advantageous for suppliers and consumers alike to know the cost of policy in good time. A fixed price mechanism could set the price in

a similar timeframe to the setting of the RO supplier target which is published by government in October, for commencement the following April.

**Question 6: What are the potential impacts on suppliers of implementing the supplier obligation, including:**

- **Cost effects of posting collateral for both the CfD obligation and alongside other requirements in the electricity market;**
- **Method of data collection;**
- **Changes to internal systems;**
- **And the proposed payment periods?**

10. We have not yet been able to perform an impact assessment on these issues but we are willing to provide further information to DECC in due course. Our immediate observation is that there is certainly likely to be a significantly increased collateral requirement.

**Question 7: Are there any factors to consider in order to mitigate risks or shorten the timescale for implementation?**

11. The simplicity of a fixed price cost recovery mechanism is likely to reduce the cost and lead times required for both industry settlement systems and supplier billing and reconciliation systems. Conversely, the uncertainty introduced as a result of a variable price mechanism may inhibit a timely and cost effective delivery of systems and processes.
12. Additionally, more thought should be given to the issue of addressing the potential of a shortfall risk (in any one period) on generators which may result from a fixed price cost recovery. Areas that could be considered might include an over/under recovery mechanism and/or the establishment of an advance mutualisation fund (securitised by suppliers) to cover losses in the event of a shortfall.

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14 January 2013



*GDF Suez Energy International submission to DECC Call for evidence on the  
CfD FiT supplier obligation*

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<sup>i</sup> Based on current wholesale electricity costs

14 January 2013



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15 January 2013

Dear Sirs

### **FIT with CFD Supplier Obligation Call for Evidence**

Thank you for the invitation to respond to the above consultation. As you are aware, Good Energy is a licensed electricity and gas supplier supplying over 30,000 customers with 100% renewable electricity and around 7,000 customers with gas supporting renewable heat. We also act as FIT Licensee to over 40,000 FIT generators.

#### Executive Summary

It is disappointing that the impact on suppliers is being considered so late in the day. We believe that the decision to choose a variable rate over a fixed rate solution was taken without proper consideration of the impact on suppliers and their ability to set consumer prices efficiently. This is especially an issue for independent suppliers, and creates a barrier to entry. We strongly urge DECC to reconsider this decision in light of the responses to this call for evidence.

We are particularly concerned about the change from supporting low carbon generation based on total generation (as under the RO and FIT) to one based on loss adjusted export. This will have a significant impact on generation where there is significant on site usage. Energy generated and used at the point of generation is more efficient and should be encouraged, and these proposals go the other way in favouring generation only sites. We do not see the need export to be loss adjusted, as this complicates the process, especially for sites embedded in distribution networks (typically 5MW to 50MW sites). More focus needs to be given to how the process works for distribution connected sites, rather than assuming what works for large sites works equally well for smaller sites.

Finally, the impact of posting collateral is significant. Given that the proposals also include mutualisation, Supplier of last resort and the ESCAS regime, we believe that collateral should not be required where a supplier has a good payment record, similar to the regime that exists for DUoS & TNUoS payments. This would ensure a more efficient use of capital to build the new generation.

We have set out below our replies to your specific questions, expanding where necessary to give a full response.

#### Questions:

- 1. Do you have concerns about the predictability of the amount of potential volatility of CFD payments?**

Yes. Both unpredictability and volatility gives us concerns but for different reasons. The cost of the FIT CFD is ultimately borne by customers. However, to ensure consumer prices accurately reflect these costs then

suppliers need to be able to reflect them in their price setting. Current costs faced by suppliers are either controllable, e.g. Hedging against variable wholesale costs through fixed price PPAs, or reasonably foreseeable such as UoS charges. The unpredictable nature of exact costs to the supplier (which they have no control over), means that suppliers will have to err on the side of caution and overcharge customers, or risk undercharging consumers and risk unprofitable sales. Vertically integrated suppliers may be able to take the latter course, especially as they are also likely to be recipients on the generation side, but independent suppliers are more likely to have no option but to take the former. This has the potential to entrench the dominance of the big 6 suppliers as they will be more price competitive, although all suppliers will probably need to adjust retail prices on a more frequent basis.

Whilst there is some mitigation in the fact that high FIT CFD costs will usually be accompanied by low wholesale costs and vice versa, this falsely assumes suppliers are totally exposed to wholesale costs to the same generation mix as the market average. In reality, suppliers are hedging their exposure through long term PPAs with differing generation mix exposure.

On volatility, the issue is one of short term cash flow. The "must pay" requirement means that suppliers will have to ensure that they have sufficient cash to cover what they perceive to be the maximum amount that could be called for. This means that working capital is tied up to cover the worse case scenario which is unlikely to materialise. This could be a particularly acute problem for smaller suppliers with limited access to funds and will raise the barrier to entry for new market entrants.

Both these issues could be resolved by opting for fixed rate obligation. Market share could remain a variable as most suppliers are not exposed to volatile changes in their market share. Reconciliation of the true position could be done on a yearly, biannual or rolling basis thus allowing customer impact to be factored into consumer prices.

If the variable rate option is pursued, then the CFD counterparty should be obligated to forecast the size of the obligation both prior to the event and during the period after the event, but before payment is due. We would envisage something like the predicted costs per month out to a year ahead, updated monthly, then daily values after the event up to the date they are included in an invoice to suppliers. The monthly forecast will allow suppliers to set prices better, and the daily values will allow suppliers to manage their cash flow, and ensure they are able to pay the counterparty invoices.

## **2. Does this differ based on the different scenarios for how the generation mix evolves?**

Different generation mixes will create different problems. A high proportion of intermittent generation may impact daily amounts from different sites, but overall swing may be more balanced if they are geographically dispersed. A high degree of nuclear would be more stable, but due to the size of individual plants, intermittent generation when the plant is commissioning could create exceptionally large swings in amounts due, as would any unplanned outages.

The important thing is that only the counterparty will have the necessary information to predict the generation mix as they will be privy to commissioning dates, planned outages and if mandated, generators contracted position (e.g. Base Load, peaking etc). This information is unlikely to be available to market participants, and even if it was, smaller suppliers are unlikely to have the resource to turn that data in a forecast of the levy.

## **3. How would you manage the fact that CFD payments are changeable, noting that they are inversely related to wholesale price movements, and looking at this from the perspective of**

**variations in total costs to serve (i.e. wholesale price/other cost variations in conjunction with CFD payment variations)?**

We believe that the inverse relationship to wholesale prices is overstated. Whilst we recognise there is a relationship, we also recognise that there will be two reference prices (Day ahead and year ahead) and that the payment timescales are different. Currently, suppliers hedge their position through a mix of long term fixed price contracts, fixed price PPAs and own generation prior to setting consumer prices. This means they are not totally exposed to fluctuations in wholesale prices, and need only to manage a proportion of their total purchases closer to real time. This may mean in periods of excess wind, then they could be selling surplus generation in the market at a lower price than they purchase, whilst still facing a high levy request from the counterparty based on the market position. In the early days when the amounts are small, then they will be risk managed, by factoring in a forecast, with a potential deviation. However, as the amounts settled increase and the amounts grow, then this will become more critical and suppliers will have no choice but to move prudently along the deviation curve to ensure they are not over exposed.

This needs also to be considered with other variable costs that EMR brings. The proposals for a FIT with CFD assumes a move from Fixed price PPAs, to market tracking PPAs. This increases the fluidity to suppliers in their energy costs. Add to this the potential payments in a capacity mechanism and increased collateral costs based on these unpredictable payment obligations, then the proportion of a suppliers costs which are uncontrollable increases significantly.

The net result is this unpredictability will be borne by consumers in the form of a risk premium and more frequent price changes.

**4. Is there a hedge that suppliers can utilise that may mitigate any risks?**

Assuming a variable rate obligation, the most effective hedge will be a greater degree of vertical integration, thus creating a net position exposure to the FIT with CFD regime. This will of course favour the existing vertically integrated companies.

If the counterparty was to provide reasonable forecasts of the amounts expected on a regular basis as described in the response to Question one, then supplier should be able to manage this exposure better by correctly setting consumer prices. This is of course dependent on the accuracy of the forecasts.

**5. Overall what are your own views on the proposed variable rate obligation and are there any other issues we should be considering?**

Our view is that the variable rate is inferior to the fixed rate for suppliers and consumers. We believe that the variability of the pot is best managed by the counterparty, with suppliers managing the variability of market share. As there will need to be reconciliation runs as market share changes, then the actual costs could be brought into the final reconciliation run, or possibly earlier as suppliers will have had good sight of the variance and adjusted prices accordingly.

We believe the Energy Intensive Industry (EII) proposal is unworkable, as it complicates calculation of a supplier's market share, and does not guarantee that the reduced exposure is passed onto the EII customers in full. A far better approach would be for the suppliers to pay in full, and for EII consumers to submit data direct to the counterparty and reimbursed in line with generator payment schedules.

We do not agree that generators should be paid based on their loss adjusted export. RO generators are paid on their total metered generation output, where as this regime pays on loss adjusted export. As losses

can be variable over the days and seasons (and every half hour for transmission losses) this adds a level of complexity that outweighs any benefit. The proposal to account for embedded generation via BM units is even more complex and likely to create chaos on change of supplier.

Embedded generators with on site usage will also lose out on the move from RO to FIT with CFD as currently ROCs (and the Fixed FIT) are provided based on generation, including for MWh used on site. We believe this will lead to strange scenarios where embedded generators over 5MW will have to sell all their generation, and buy 100% of their needs from the network. Alternatively, projects with onsite usage will not be feasible. We strongly recommend that DECC consider this anomaly quickly to assure investors of such schemes they will remain viable. We would be happy to work with DECC on this to find an appropriate solution.

**6. What are the potential impacts on suppliers of implementing the supplier obligation, including:**

- **Cost effects of posting collateral both for the CFD obligation and along side other requirements in the electricity market;**
- **Methods of data collection;**
- **Changes to internal systems;**
- **And proposed payment periods?**

Collateral costs are likely to be significant, especially if the unpredictability creates a situation where collateral has to be frequently adjusted at short notice, or significant sums left in situ to over compensate. We currently hold no collateral with network companies in return for a good payment record, and believe that as the proposals to ensure payment include mutualisation, SoLR and ESCAS, a similar approach could be adopted here. As a small supplier, the slight increase in risk of mutualisation calls, are outweighed by the benefit of not holding collateral in return for a good payment record. For clarity we currently hold no collateral with Elexon, as on balance we trading long, thus ensuring our net position on Imbalance is generally that we are due more than we owe.

It is important that all data is collected on an equal footing. Where possible data such as market share should be sought from the same source such as Elexon to ensure the figures are derived from the same methodology. Generation data should also be retrieved from industry sources rather than from the generator, possible by the counterparty being party to the DCC or DTN networks and able to collect data themselves.

Depending on the final solution, then new systems will have to be built to forecast payments, validate payments and validate subsequent reconciliations. There may also be a need for a process to watch levels of collateral. This will include taking in new data items and reports. The costs of these systems will be more or less equal for all suppliers, so the costs will fall probably fall disproportionately on smaller suppliers.

We are supportive of a monthly approach, although concerned that this could lead to high levels of collateral building up, and then once an invoice is paid, removed and built up again. An alternative approach maybe to mimic the collection of imbalance payments and subsequent reconciliations on a daily basis to the same time schedules. This means that collateral is more balanced in the number of days outstanding, (although amounts will still vary).

**7. Are there any factors to consider in order to mitigate risks or shorten the timescale for implementation?**

The biggest risk to suppliers if a variable rate solution is implemented is the volatility of payments and the difficulty suppliers will have in factoring in these costs to consumer prices. The only practical solution for a supplier is to err on the side of caution and over price to the detriment of consumers and UK businesses. We believe that DECC should reconsider the fixed rate solution taking into account the impact on energy consumers as well as the counterparty or develop a hybrid that lies somewhere in between fixed and variable.

As mentioned above we believe that a good payment history should reduce the need for suppliers to post collateral. This will allow capital to be used to build new generation rather than tied up in escrow. Forecasting collateral requirements should be transparent as they will also aid suppliers ensure they can meet their commitments when invoices are posted, and reduce the risk of default.

To aid implementation we strongly urge that the counterparty systems and processes are developed to ensure that suppliers can have as much visibility as possible, as far out as possible of their liabilities. This will reduce risk of default and may speed up implementation.

I hope you find this response useful. If you have any questions, we would be happy to discuss further so please do not hesitate to contact me.

Kind regards,

Policy & Regulatory Affairs Director



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15 January 2013

Dear Sir or Madam,

**DECC consultation: A call for evidence on the CfD Supplier Obligation**

I am writing to set out Haven Power Limited's view on the questions posed in your call for evidence on the CfD Supplier Obligation proposals. We have provided some general comments on the proposals and identified some areas we feel need examining further.

Haven Power Limited ("Haven") is a non-domestic electricity supplier and has been part of the Drax Group plc. since 2009. We began supplying the SME (Small Medium Enterprise) sector in 2007 and now have ~37,000 customers. In 2009, we entered the I&C (Industrial & Commercial) sector and have grown our customer base to ~1,000.

Our customers generally prefer certainty over the price they pay for their electricity, particularly in the SME sector. As an independent non-domestic supplier we are well aware of the difficulty volatile third party charges can pose when pricing retail contracts for these customers. These charges now represent a significant proportion of the overall energy bill (typically ~45% for a non-domestic customer). Whilst we understand the overall need for electricity market reform to help support low carbon generation, we have some concerns regarding the current thinking around the implementation of the CfD Supplier Obligation and the unintended consequences this may have on independent suppliers and their ability to compete or in the case of prospective new entrants, enter the market at all.

Current plans for the CfD Supplier Obligation would see suppliers exposed to a potentially volatile, unknown market price coupled with an unknown volume liability. Volumes will be highly weather dependent whilst offshore wind is the dominant element of the generation mix and smaller suppliers have limited resource and expertise to make any assessment of this. In addition, all suppliers will be required to estimate their market share – this is especially difficult for those with rapidly changing portfolios.

These factors mean it will not be possible for a supplier to work out a "simple ppu amount" to factor into retail prices as very little information required for such a calculation is known at the time of pricing, which may be several months before supply begins (and there is no visibility for customers to see where the information for this charge comes from or how it is calculated). This will leave a small supplier with the option of either conservatively accounting for the risk in advance and not being able to provide competitive prices (inhibiting growth), or risking under recovery and having to go back to customers for additional payments, which is extremely unpopular (and inhibits growth). Under the current Renewables Obligation (RO), suppliers can assess relatively easily their likely financial obligation; this will not be the case under the current proposals for the CfD Supplier Obligation.

Further, suppliers will be required to post collateral (similar to that required to cover energy imbalance & RCRC under the BSC). This will place another burden on suppliers and will be a particular problem for smaller or newer market participants – there are no such requirements under the current RO arrangements.

Proposals for settlement are in line with energy imbalance and first payments would be due ~29 days after delivery (with subsequent reconciliations). This may greater assist low carbon generators, but it will impact suppliers' cash flows negatively. Customers are not billed in this timeframe and are therefore unlikely to have collected the money before it is due (even from monthly billed customers). Reconciliations could further lead to significant cash requirements at a later point in time if, for example, there are revisions to the data used in the initial settlement. We have seen this in the Government's current micro-generation FiT Scheme, where the annual reconciliation for the 2011/12 Scheme Year saw a significant reconciliation payment due from suppliers (in our case this was ~£180k or ~10% of our total liability for the year).

We also feel there needs to be some consideration of the difficulties that could be encountered by suppliers (and possibly government) in the event that mutualisation payments are required due to supplier failure. Any monies which are unforeseen and have to be paid at short notice have the potential to threaten supply businesses. It would be sensible to review the impact that CfD FiT will have on mutualisation payments in order to limit the chance of contagion in the event of a supplier failure.

We would welcome the opportunity to discuss our concerns set out in this letter with you further and would ask that you consider meeting with us in the near future. In the meantime if you have any questions please do not hesitate to contact me.

Yours sincerely

*Sent by email*

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15 January 2013

### RWE UK response to DECC's call for evidence on Funding the CfD: supplier obligation

RWE welcomes the opportunity to respond to this consultation. We are responding on behalf of RWE companies operating in the UK:

- 1 RWE npower supplies gas, electricity and energy services to over 6.5 million households and businesses. We produce over 10% of the UK's electricity from our eleven gas, coal, oil and biomass-fired power stations, and manage a portfolio of combined heat and power plants across the country.
- 2 RWE npower renewables, the UK subsidiary of RWE Innogy, is one of the UK's leading renewable energy developers with an operational portfolio in the UK of 500MW and a potential UK development portfolio of over 7,700MW, including wind farms, hydro plant and biomass generation to produce sustainable electricity.
- 3 RWE Supply & Trading is one of the leading companies in European energy trading and is responsible for all of RWE's activities on the international procurement and wholesale markets for energy.

Our detailed response to the individual questions is given below. However, we wish to highlight the following key points:

RWE Npower strongly advocates competitive wholesale and retail power markets which encourage efficient economic behaviour. We are concerned that the Government's proposal to levy the CfD supplier obligation as a variable charge on suppliers will lead to distortions in the retail power market, increasing complexity and cost uncertainty for customers. We have seen this with the existing Feed in Tariff (FiT) scheme.

We believe that the most significant risk introduced by the CfD scheme comes from the volume risk associated with intermittent generation output and the lack of visibility surrounding the rate at which low carbon generation capacity will be deployed; particularly given the 'chunkiness' of nuclear and offshore wind generation.

Under an efficient market design risk is allocated to those parties who are best placed to manage it. Because accurate CfD cost forecasting will depend on a detailed view of generation operations across the entire market (including information which is commercially sensitive and should not be available to competing market participants), we believe that suppliers are poorly placed to be able to manage the CfD cost volatility on behalf of their customers.

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It is our view that because suppliers have no control over the CfD costs they are subject to it is inappropriate for these costs to be used as a competitive tool between suppliers, as has happened with the existing FIT regime. Competitive advantage should be achieved through a combination of commercial acumen and operational efficiency.

The retail price volatility resulting from the use of a variable rate obligation will make price comparisons between suppliers more complex without providing any additional benefit to consumers.

The introduction of an unnecessarily volatile cost along with the absence of any framework for how this cost should be treated by suppliers is inconsistent with the approach being taken with regard to tariff simplification as part of the Retail Market Review (RMR).

DECC has previously stated that the proposed variable rate obligation is "likely to be classified as a direct tax for the purposes of the Government administering its taxation programme". Assuming this is the case, notwithstanding the absence of any references to HMRC administering the levy, we note that one of the key objectives of HM Treasury's tax policy framework applicable to all new taxes is simplicity. A variable rate obligation would be significantly more complex to administer (and therefore more burdensome on business) than having a single central forecast of the obligation that all suppliers can price into their tariffs on an equal basis.

Our preference is for a fixed cost recovery mechanism since this will mitigate many of the negative impacts on the retail market which would result from the use of a variable cost recovery mechanism.

We are keen to ensure that CfD generators receive their top-up payments in full and in a timely fashion so we support an approach which ensures that the CfD Counterparty Body always has sufficient funds to meet their payment obligations, whilst minimising distortions in the retail market.

Yours sincerely,

Director of Policy and Public Affairs

## RWE UK response to specific questions

### 1. Do you have concerns about the predictability of the amount of potential volatility of CfD payments?

We have serious concerns regarding the predictability of the extent of potential volatility of CfD payments due to the complexity in forecasting the different variables and how these variables will interact with each other. Should suppliers have to forecast CfD costs themselves, they will carry the forecasting risk associated with:

#### 1. Generation output volumes

UK decarbonisation targets indicate that the amount of intermittent renewable generation will increase significantly between now and 2020. Forecasting the output of wind generation in particular is inherently uncertain and it is our view that suppliers are not well placed to produce accurate forecasts. On an enduring basis, we see this as the largest risk.

#### 2. Generation mix

Under the CfD scheme different technologies will receive different levels of support. Along with this, as the amount of low carbon generation receiving support through CfDs increases there will be varying levels of support within individual technology bands. In order for suppliers to accurately forecast CfD costs there will need to be excellent visibility not only of generation deployment rates, but also the level of support granted to each individual generation project. We regard this as a significant risk, as highlighted through our experience of the existing FiT scheme (discussed further in response to question 5).

#### 3. CfD top-up costs

Whilst there is an inverse correlation between the reference price and the CfD top-up costs, the current proposal to use the GB Hub day-ahead price as the reference price means that most suppliers will not hedge their power demand at the reference price; whilst some of our I&C customers prefer to accept the additional price volatility associated power purchased in the day ahead market, smaller business and residential customers prefer the price certainty achieved through purchasing power further ahead of delivery.

Due to the fact that variations in output from CfD plant will have an effect on the wholesale power price (and therefore the reference price), the interaction between each of these elements is likely to be extremely complex. This will increase the risk associated with forecasting CfD costs beyond that imposed by each individual element.

It is important that the task of forecasting CfD payments is allocated to an industry body with a market wide view of the data required and is best equipped to understand the interactions between the different variables.

Our preference is for central forecasting with a fixed price levy and ex post reconciliation.

### 2. Does this differ based on different scenarios for how the generation mix evolves?

Our concerns regarding the predictability of the extent of potential volatility of CfD costs relate specifically to the absence of centrally produced prices and as such are not dependent on generation mix. However, we would like to highlight some specific risks associated with different types of generation technology:

- We regard the biggest risk to be associated with forecasting the output and deployment rates of intermittent generators.
- It is difficult to predict what the impact Carbon Capture and Storage (CCS) may have on CfD prices and how volatile the associated cost to suppliers is likely to be.
- Volatility in the output of new nuclear plant in early years which will be difficult to predict for parties not involved in the construction of such plant. This will provide an advantage to the operators of new nuclear plant which will not be available to other market participants.
- There could potentially be new technologies that will receive CfDs that are currently under development and therefore unknown.

The forecasting of CfD payments will require full visibility of the build rate of future projects, anticipated dates of generation and the level of support provided for individual projects across the entire market. It is unclear how transparent the information associated with projects receiving CfDs, or around target commissioning windows will be. Some of the information required will be of a commercially sensitive nature and legally should not be available to competing market participants. Because of this we are not convinced that suppliers will have access to information required to forecast and price CfD costs accurately.

**3. How would you manage the fact that CfD payments are changeable, noting that they are inversely related to wholesale price movements, and looking at this from the perspective of variations in total costs to serve (i.e. wholesale price/other cost variations in conjunction with CfD payment variations)?**

If we are required to forecast CfD costs in line with Government's current preference for a variable rate cost recovery mechanism, we would endeavour to forecast these costs as accurately as possible and provide prices for our customers which we believe reflect the costs which will be borne by us. However, we have serious reservations regarding whether it will be possible to price the costs levied through a variable mechanism in a fair manner.

Whilst we note that CfD payments and movements in the reference price are inversely related, we believe that this will only provide price certainty on the generation side. Suppliers typically aim to hedge their wholesale power costs by purchasing power in advance. This strategy reflects the preference of the majority of our customers for price certainty (albeit at a higher price) over the price volatility associated with day-ahead trading.

**4. Is there a hedge that suppliers can utilise that may mitigate any risks?**

Our view is that volatility in CfD costs will primarily be driven by intermittent generation output and deployment rates. One example of how some of this risk could possibly be mitigated is through the use of wind swaps, which are currently available and are used by wind generators to manage the output risk associated with unpredictable weather. This could go some way toward mitigating the impact of output volume risk on suppliers' CfD costs.

It may be possible for suppliers to use financial swaps to mitigate some of the price risk associated with movement in the reference price by using a financial CfD to offset any deviation from their forecast view of reference prices. However, it is unlikely that any party would want to enter into such a swap with suppliers since the same information is available to both parties and consequently their view of future reference prices is likely to be very similar.

Because each hedge will be imperfect an element will remain unhedgable. Along with this the use of these hedges will introduce basis risk. A price premium will be applied to cover the unhedged component and to offset basis risk.

The use of financial instruments to hedge risk comes at a cost and this cost will have to be accounted for on suppliers' balance sheets. Whereas a fixed rate cost recovery mechanism should ensure that supplier's liabilities are limited to the amounts incurred during each settlement month, the cost of hedging will appear on balance sheets as a longer term liability.

In order to achieve the best outcome for the consumer in terms of both price and certainty, the risks associated with forecasting and pricing CfD costs should be allocated to an industry body which is suitably equipped to forecast them. Forecasting CfD costs will require access to a market-wide view of detailed data relating to all generation projects participating in the CfD scheme. This includes real time operational data which will only be visible to individual generators and the System Operator. Much of this data will be of a commercially sensitive nature and so it is unlikely that suppliers will be able to access the information they need to produce accurate cost forecasts.

**5. Overall what are your views on the proposed variable rate obligation and are there any other issues we should be considering?**

Impact on the retail market

We have serious concerns regarding the proposed variable rate obligation due to its potential impact on the retail market in terms of introducing an additional level of volatility and complexity to a marketplace already perceived as being too complex to allow effective retail competition.

We are concerned that it will result in domestic customers paying higher prices due to the inclusion of an additional risk premium (see below) and business customers being subject to increased levels of price volatility and undesirable cost reconciliations.

Suppliers have a duty to domestic customers to smooth direct cost volatility so customers have some certainty over future retail prices, allowing them to budget accordingly. Due to the potential volatility of CfD costs suppliers would either need to apply a risk premium on top of the forecast CfD costs or implement more frequent price changes. It is undesirable to increase retail price volatility for any customer segment but this is particularly true for domestic customers. Frequent price changes in the domestic market are neither welcomed by the customer nor operationally efficient.

In the fixed price, fixed term market which mainly applies to the business market (but also to around 20% of the domestic market), suppliers bear the risk of any change in direct costs during the contracted term. The expected volatility in CfD costs would increase risk to suppliers resulting a greater premium being included in these customers' rates. This would mean that the cost of price certainty for our customers - important to the profitability of their businesses - would increase.

Suppliers are poorly placed to manage CfD costs because they have no control over how the costs are incurred. Given the anticipated levels of volatility associated with CfD payments it is essential that the role of forecasting and pricing these costs is allocated to an industry body well suited to fulfil that role. It is our strong belief that the task of forecasting and pricing CfD costs should lie with a central body which has a good view of the whole market, including likely future CfD strike prices and generation build rates.

Lessons learned from existing schemes

RWE npower has raised its concerns with Government in relation to cost volatility and unpredictability of both FiT and ECO. In relation to FiT in particular (whose cost recovery mechanism can be compared with the proposed variable CfD cost recovery mechanism), accurate forecasting by suppliers of the uptake of the scheme and hence generation output volume has proved not to be possible. This has resulted in a supply market distortion where some suppliers grossly underestimated the costs whilst those that were more prudent lost market share. Over time those suppliers which underestimated FiT costs have implemented reconciliations in order to recover the costs from customers, indicating that the price signals the customers initially received and acted on were inaccurate. Suppliers' ability to forecast FiT costs accurately are unlikely to improve over time since the data required to produce accurate forecasts is not available to suppliers.

The existing FiT regime has been approached in very different ways by suppliers. This has resulted in additional complexity for customers to understand in order for them to be able to compare quotes. It has also increased cost uncertainty as suppliers' approaches have changed over time.

The cost of moving to a low carbon economy is becoming a competitive tool between suppliers. The lack of consistency and clarity as to how these costs are being treated is likely to result in customer confusion. It is difficult to see how this fits with the Retail Market Review and Government's ambition to simplify retail tariffs to allow consumers to make more meaningful price comparisons between suppliers.

Npower conducted an online survey of major energy users during July and August 2012 to gauge their views on the overall effectiveness of the FiT scheme, how it is currently charged and what changes they would like to be made. The results of this are summarised below:

1. Impact of FiT on business

- 78% are concerned about the impact of FiT charges on their business' bottom line
- 76% believe that the introduction of FiT has made budgeting more difficult for their business

2. Views on FiT charges

- 82% agree or strongly agree that evaluating supplier offers is more difficult where there is inconsistency in the way FiT is charged / recovered.
- 57% found the government's communication about the FiT scheme and how the charges will be passed through to customers has been 'inadequate' and 33% thought it was 'confusing'.

3. Changes to FiT

The top three changes that businesses would like to see made to FiT charges are:

- Set one mandatory FiT charge that is used by all energy suppliers (68%)
- Require all suppliers to charge FiT in the same way (60%)
- Require DECC to move to a system whereby any changes to FiT charges are not adjusted retrospectively, but instead added into the FiT charge for the following year (53%)

The costs of transmission and distribution also cannot be hedged as they are not tradable. RWE npower has raised the issue of transmission and distribution cost volatility with Ofgem on a number of occasions with the solution lying in less frequent transportation price changes, greater visibility of the driving factors and more advance notice of price changes. In Ofgem's consultation on the Retail Market Review (RMR) these concerns are acknowledged in Chapter 9, paragraph 9.13, "...we continue to work with the industry to consider potential improvements to the charging methodologies (including proposed modifications to reduce volatility and increase predictability of charges)".

We urge Government to consider the interactions between the CfD cost recovery mechanism and the work being done under RMR.

**6. What are the potential impacts on suppliers of implementing the supplier obligation, including:**

**a. Cost effects of posting collateral both for the CfD obligation and alongside other requirements in the electricity market;**

The Levy Control Framework budget in 2020 is capped at £7.6bn. Based on this figure we expect RWE npower's annual costs under the framework to be up to £1bn. Although we only expect to have to post collateral for a proportion of this, it is still a significant sum of money that will incur costs for us. It is likely that these costs will be ultimately passed on to customers.

**b. Method of data collection;**

It remains unclear as to what data will be collected and in what way; therefore it is difficult to provide a detailed view on the method of data collection. We advocate an approach which is consistent with existing data collection processes within the industry. This will help to minimise the incremental costs of implementation.

Early visibility of data collection methods is essential in order to allow industry to ensure that the processes and systems are in place in a timely manner.

**c. Changes to internal systems;**

Without knowing exactly how data will be used under the CfD scheme it is not possible to provide a comprehensive assessment of the impact on our internal systems.

We will be aiming to provide as much price transparency to our customers as possible and it is therefore likely that we will need to make modifications to our billing systems in order to accommodate the new CfD charge. Our initial modelling indicates that the CfD mechanism is unlikely to result in payments from generators to suppliers over the course of each billing cycle but if this view proves to be wrong we will endeavour to pass any payments we receive back to our customers; this will result in significantly increased complexity in our billing systems.

**d. And the proposed payment periods?**

We currently believe that a monthly settlement process would provide the most benefit to all market participants involved in the CfD process.

**7. Are there any factors to consider in order to mitigate risks or shorten the timescale for implementation?**

We understand the importance of ensuring that the implementation of the CfD scheme is carried out in accordance with the Government's published timetable, but we advocate an approach which favours the development and implementation of the best possible mechanism over shortening implementation timescales.

We have serious concerns surrounding the impact that the implementation of a variable rate CfD cost recovery mechanism could have on the retail market. It is important that the consequences of implementing such a mechanism are fully assessed and all potential alternatives are fully explored before a decision is made. This is essential for ensuring that the risks associated with implementation are mitigated as effectively as possible. If suppliers are forced to implement a complex new charge over short timescales, the negative consequences for the retail market could be severe and could undermine consumer confidence in both the energy industry and Government's aspirations for moving to a low carbon energy sector.

In order to avoid risks of unexpected costs for generators and suppliers, the VAT status of payments in either direction under both the CfD and the Supplier Obligation should be confirmed by HMRC. If any income was exempt from VAT, then there could be risks of material losses of input VAT which would increase costs that would need to be ultimately passed on to consumers.

Suppliers should be able to accommodate a fixed rate cost recovery mechanism more quickly than a variable rate mechanism due to the fact that it is a simpler, less volatile charge and as such will require less extensive system changes and customer communication.



Direct Dial:

Email: [ofgem.gov.uk](mailto:ofgem@gov.uk)

Date: 15 January 2013

Dear,

### **Ofgem response to EMR call for evidence on the CfD supplier obligation**

Thank you for the opportunity to respond to your call for evidence on the proposed design of the supplier obligation for Contracts for Difference (CfDs). This call for evidence is an important stage of policy development, and we would welcome further clarity on intermediate steps before publication of your response in July.

We think it is important that the supplier obligation is designed in a way that minimises market distortions and takes into account the impact on end-users, both directly through prices and indirectly through competition. We have therefore structured our response around what we think are the two main issues; volatility and credit and collateral requirements.

### **Impact on competition and consumers**

#### Volatility

As your consultation recognises, the introduction of the CfD supplier obligation will require suppliers to make payments that are significant, both in terms of absolute size and their volatility over time. The unpredictability of payments may be difficult for suppliers to manage, particularly smaller suppliers and potential new entrants who may not have the same access to finance as larger players. We may also expect that some suppliers will be less able to pass these costs through to their consumers as quickly as others due to the proportion of variable and fixed price deals their consumers are on, putting them at a relative competitive disadvantage. For example, suppliers to smaller non-domestic consumers are likely to have a higher proportion of fixed term contracts of one or two years with a fixed price, and therefore may be less able to pass through the risk caused by the supplier obligation compared to a supplier with mainly half-hourly metered consumers who often have fixed term contracts, but with variable prices.

We acknowledge there may be potential to hedge the price risk of the CfD if suppliers purchase power on the same indices as are used in the calculation of the reference price. This would reduce the price risk associated with CfD generation plant, but would not provide a hedge for the unpredictability of the volumes being generated. We therefore caution against over-stating the benefits of this hedge for suppliers. We also recognise that this unpredictability affects all suppliers proportionately, but suppliers without either a natural hedge from having CfD generation, or other business interests, may find it more difficult than others to manage the risk. This may cause potential distortion of competition in the retail market.

The combination of impacts outlined above may negatively impact competition and distort the retail market due to the differing impacts on suppliers with different characteristics. This may result in higher and or more volatile prices for end consumers. Our Retail Market Review revealed a significant lack of trust by consumers in suppliers, which this obligation could exacerbate and lead to a reduction in effective consumer engagement in the energy supply market. Unpredictable end-user prices are also difficult for consumers to manage, and are likely to have a greater impact on fuel-poor households. It is important that the impacts of the obligation, both on consumers and the wider market, are fully taken into account when deciding on the final design.

#### Credit and collateral

Credit and collateral is important for the energy industry to function effectively. We have previously raised concerns in our submission to the Energy and Climate Change Committee (ECCC) during its pre-legislative scrutiny of the draft Energy Bill about the potential impact of increased credit and collateral requirements on smaller suppliers and potential new entrants. The size of credit and collateral required for CfDs is a significant addition to the total levels already required to operate in the market and we would encourage you to consider your policy design within the context of the energy market as a whole. These new requirements may adversely affect suppliers that are less able to manage risk through their balance sheet, irrespective of their market share. We recognise there is a balance between mitigating the impacts of supplier failure and reducing the barriers to entry and expansion in the retail market. We would encourage you to work with industry to establish the best approach to achieve a suitable balance.

Currently, market participants are able to develop their trading and hedging strategy to suit their business model and characteristics, including their collateral requirements. By minimising their collateral exposure, they are able to operate in the market with a smaller balance sheet. The supplier obligation for CfDs removes this choice and imposes a significant capital cost on suppliers, which will act as a barrier to entry to the market, weakening competition.

On the decision to remove energy-intensive industries from the calculation of liabilities, notwithstanding the principle of this approach, we think there may be unintended consequences from this methodology. There is currently no restriction on how a supplier with both EII and non-EII customers can recover the costs of environmental policies, so a supplier with EIIs may be at a competitive advantage. Whilst there is currently strong competition in the market for energy-intensive users, there is a risk that the perception of an unfair competitive advantage could become problematic.

#### **Considerations for effective policy design**

We think there are options to mitigate some of the negative impacts we have highlighted above.

#### Volatility

The exploration of alternative payment structures that mitigate or minimise the volatility of the supplier obligation may be beneficial, particularly for those suppliers for which the obligation is disproportionately burdensome. One potential solution could be to develop a mechanism that smooths the volatility of CfD payments.

We have previously voiced concerns about the decision to pay CfDs on metered output during the ECCC's pre-legislative scrutiny of the draft Energy Bill. The output of CfD plant is weather-dependent and thus volatile, making it more difficult to forecast compared to the estimation of plant availability which is likely to be more stable over time. Therefore linking CfD payments to metered output may increase the unpredictability and burden on suppliers, which may negatively affect consumers. This is a further reason to reconsider this approach.

### Unpredictability and forecasting

It is important that suppliers are able to appropriately forecast their long-term liabilities for effective business planning. Without sufficient information, suppliers may find long-term business planning difficult, and consequently find it more difficult to finance their activities. This could put upward pressure on the prices suppliers charge their consumers. Publishing as much information as possible in areas such as the amount of low-carbon generation to be brought forward at each allocation stage and the associated strike prices will help suppliers to forecast their liabilities.

A robust reference price is vital to forecasting expenditure, both for suppliers and for managing the Levy Control Framework. Industry concerns about an unpredictable reference price could be mitigated through effective set up and management of the choice of market indices. We therefore support the use of a basket of indices for baseload generation. When choosing the composition of that basket, it is important to take into account the impacts on liquidity over various timescales. An appropriate choice of reference price, particularly for baseload generation, should avoid potential negative effects on wholesale market liquidity. It is important that we continue to work together on the choice of these indices and liquidity interactions.

### Credit and collateral requirements

It may be appropriate for collateral requirements to be set lower than the full exposure of parties to reflect the benefit from the Supplier of Last Resort (SoLR) and special administration arrangements. These arrangements have been designed to limit the exposure of the industry and suppliers in event of supplier failure, so the credit and collateral requirements may not need to be as high as before their implementation.

Lastly, we would like to draw your attention to text describing the Supplier of Last Resort (SoLR) arrangements, in section 5 of the CfD Operational Framework document. The text states that:

*"The SoLR process can be instigated by Ofgem with respect to a supplier in financial distress and would facilitate the continued flow of CfD payments from consumers to generators in event of supplier failure".*

We think there is value in clarifying that Ofgem's powers in this area focus on continuity of supply of energy to customers of a failed supplier. SoLR arrangements do not manage the continuity of payments such as for CfDs, and any outstanding liabilities of the failed supplier would be subject to standard insolvency law.

We would be happy to discuss any of these issues further with your officials if it would be helpful. If so, please contact [ofgem.gov.uk](mailto:ofgem.gov.uk).

Yours sincerely,

Senior Partner, Markets  
Ofgem

