FEED-IN TARIFF WITH CONTRACTS FOR DIFFERENCE
DRAFT OPERATIONAL FRAMEWORK: Supplier Obligation
Response from Opus Energy
10 January 2013

1. About Opus Energy

Opus Energy is an independent supplier of electricity and gas to the UK business sector. Founded in 2002, the company supplies just over 150,000 business sites with energy and purchases renewable power from around 500 small UK generators. From its offices in Northampton and Oxford, Opus Energy employs 450 people. The company's turnover to FYE March 12 was £272million.

Our customers choose us because we provide a real alternative to the 'Big 6'. We are known for offering competitively priced fixed term power products, innovative services, a high standard of customer care, and renewable energy.

2. Executive Summary

2.1 Concerns about the proposed format of Supplier Obligations

We feel strongly that the credit provisions and the funding methodology ("variable rate obligation") which are proposed in the draft operational framework would be damaging to competition in the UK electricity supply sector. In the form proposed, the supplier obligation would harm (perhaps irretrievably) the independent supply sector.

We consider that the proposed approach promotes the interests of investors in renewable technology over and above those of the consumer and UK businesses. It is essential that (i) the payment terms, (ii) the credit terms and (iii) the methodology for managing the variability in payment amounts are amended with a view to addressing this failing. We would support the alternative funding method ('fixed rate obligation') mooted in the consultation document.

2.2 Payment Terms and Credit Terms

To support the proposed payment and credit terms of the CFD FIT scheme (as support transitions from RO to CFD FITs), suppliers will need to increase their capital requirements to such an extent that many independent suppliers could fail or exit the market.

The CDF FIT payment method creates a financial burden on the supplier totalling 18 months of CFD FIT charges. For Opus Energy (turnover £272m) this would equate to an increase in working capital requirement of around £50m. We believe that this financial burden is so extensive it will damage competition.

2.3 Variable Rate Obligation

The Draft Operational Framework also suggests that the supplier should 'manage the variability in payment amounts'.

The 'Big 6' electricity suppliers are multinational organisations many of whom are owned by non-UK governments. In contrast, many of the independent suppliers who bring much needed competitive pressure to this sector are small and medium sized businesses. Many are privately funded and have a much higher cost of capital compared with the 'Big 6'.

The suggestion that suppliers will "manage the variability in payment amounts" is one which has been written purely with the Big 6 players in mind. Independent suppliers do not have the financial capability to act as the party which protects investors of renewable plant from wholesale volatility. Our modelling (which we have shared with DECC) has found that over the last 10 years there have been two periods where volatility in wholesale prices would have led to supplier failures if the RO scheme had been based on the proposed payment method of the new CFD FIT scheme.

We feel strongly that the 'variable rate obligation' proposal should be discarded and replaced with the suggested alternative of a 'fixed rate obligation'. The fixed rate should provide stability across a minimum of 12 months.

A fixed rate obligation would give a consistent, predictable set of charges for the entire industry and would ensure that:

- independent suppliers can plan for future working capital requirements in a timely fashion and raise funding in advance as needed; and
- customers will have forward clarity and stability in their bills.

3. Further Details

3.1 Payment and Credit Terms

3.1.1 Capital Burden

Currently suppliers are able to purchase ROCs to meet their Renewable Obligation up to the end of August following the RO supply year (which runs Apr to Mar). In contrast, the draft operational framework proposes that suppliers will pay the CFD FITs throughout the year, one month in arrears.

As the source of the subsidy changes from RO to CFD FIT, a capital burden is place on suppliers which at its peak in the yearly cycle has a value of 16 months of charges.

In addition, if the supplier is required to post 100% cash/LoC collateral they are, in effect, prepaying all CFD FIT charges. This increases working capital requirements by a further 2 months.

3.1.2 Impact of Capital Burden

Taking the revised payment terms and credit terms together, a capital burden is placed on suppliers which, at its peak in the yearly cycle, has a value of 18 months' of charges.

To quantify this: Opus Energy (turnover £272m) supplies around 3TWhs of electricity a year. This capital burden would create an increase in working capital requirement of around £50million for Opus Energy[1].

This change in working capital is a direct transfer from renewable investors to suppliers and would have the following consequences:

- costs associated with this funding would be passed onto customers as higher bills; and
- independent suppliers who are not financially strong enough to raise this capital would fail or by some other means exit the market place; and
- competition would reduce as only companies of investment grade who have low costs of capital (ie the 'big 6') will remain in the market.

Consequently we consider that the proposed transfer of capital from the independent supply sector to renewable investors will damage the independent supply sector, raise significant barriers to entry, and will damage competition.

We consider that this promotes the interests of investors in renewable technology over and above those of consumers and UK businesses.

3.2 Methodology for managing the variability in payment amounts

3.2.1 Risk Burden

As well as the proposed changes to payment terms and credit terms, the proposal suggests that CFD FIT payments will be collected from suppliers as a monthly variable rate. Depending upon wholesale prices, these payments would be unpredictable and would be volatile. The Draft Operational Framework suggests that the supplier should 'manage the variability in payment amounts', hence transferring all risk relating to a volatile wholesale market from renewable investors to suppliers.

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[1] Based on the total charges paid for the subsidy of renewable investment for the RO scheme for 2011_12 (on the assumption that the CFD FIT scheme will over time replace the RO scheme)

3.2.2 Impact

To manage this risk a supplier would need to:

(i) pass the volatile payments directly through to the user on a monthly basis; or
(ii) attempt to hedge the volatility; or
(iii) smear the highs and lows of costs for the customer to produce an average over time.

It is unlikely a customer will be happy to receive volatile energy bills. Other than those designed for very large energy users, all products in the market place are designed to protect the user from fluctuations in the costs underlying their supply of energy. Consequently option (i) would not be viable other than for large intensive energy users.

Option (ii) is also problematic. It will be difficult for an independent supplier to hedge this risk, since it would have to forecast the output of wind generation for which it may have no skills and certainly has no information, since it has no contractual relationship with the generators creating the risk.

The third option (to smear costs) would only be open to those with strong balance sheets (ie again the 'Big 6'). Hence the proposed methodology of 'variable rate obligation' strongly favours the 'big 6' suppliers and is likely to drive independent suppliers out of the marketplace.

3.2.3 Conclusion

If the intention is that the supplier should 'manage the variability in payment amounts' then this is more appropriately done in a regulated and controlled fashion using a 'fixed rate obligation'. The fixed rate should provide stability across a minimum of 12 months.

Under a fixed rate obligation, an estimate of the next year's charges could be set in advanced and collected throughout the year. Any under or overpayment could then be smeared as an additional collection or refund on the following year.

The under or overpayment charge can also include any recovery element for mutualisation of bad debt.

A fixed rate obligation set in this way would give a consistent, predictable set of charges for the entire industry. This would ensure that:

- Independent suppliers can plan for future working capital requirements in a timely fashion and raise funding in advance as needed; and
- Customers will have forward clarity and stability in bills.

3.3 Mutualisation of Credit

The framework document proposes that the CFD counterparty holds 100% of all prospective default funds. This will lead to overcollateralization by the industry. Given a choice, we are certain that most suppliers would favour a mechanism similar to that used under the DCUSA[2] for recovery of network charges. Under this agreement, credit is given to creditworthy parties and cash/LoC is only required where the CFD Counterparty can evidence a demonstrable default risk.

[2] Distribution Charges Use of System Agreement

Any losses that subsequently arise are recovered through mutualisation of risk in future network charges. This ensures 100% cover for the network operator, but without the excessive costs of industry-wide overcollateralization. There should be a consultation to discover the most cost effective way of achieving credit protection by suppliers since the burden of these costs will be supported by consumers.

Annex 1 – response to specific questions

1. ***Do you have concerns about the predictability of the amount of potential volatility of CfD payments?***
   Yes. Significant concerns as detailed above.
2. ***Does this differ based on different scenarios for how the generation mix evolves?***
   No
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)?***
   This would be very difficult to manage – please see letter for full details.
4. ***Is there a hedge that suppliers can utilise that may mitigate any risks?***
   Yes, but we would be unlikely to do this. There would be too much basis risk caused by the uncertainty of how much volume is likely to be produced by wind generators under the scheme.
5. ***Overall what are your views on the proposed variable rate obligation and are there any other issues we should be considering?***
   The variable rate obligation would cause severe damage to independent suppliers and competition for the reasons outlined in this letter. The alternative of a fixed rate should be used.
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 alongside other requirements in the electricity market;***
   - ***method of data collection;***
   - ***changes to internal systems;***
   - ***and the proposed payment periods?***

   The cost effects of posting collateral and the proposed payment periods are likely to cause many independent suppliers to exit the market.
   We do not consider the costs of changing systems would be material.
   We would suggest that it would be more appropriate for supplier's market share to be provided by Elexon rather than by suppliers to ensure it is calculated on a consistent basis across suppliers.
7. ***7. Are there any factors to consider in order to mitigate risks or shorten the timescale for implementation?***
   Yes, a fixed obligation should be implemented.

Department of Energy & Climate Change

Call for evidence on the Operational Framework for Contracts for Difference

Power NI's Response

15 January 2013

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Introduction

Power NI welcomes the opportunity to respond to the Department of Energy & Climate Change (DECC) call for evidence on the Operational Framework for Contracts for Difference (CfDs).

The introduction of CfDs represents a significant change to the current support mechanisms. Careful consideration and planning will be required to ensure that the new mechanisms deliver the incentive required to meet governmental targets while being mindful of the cost to the end consumer. The transition from the outgoing support mechanisms to the new arrangements will also require detailed planning.

As the largest electricity supplier in Northern Ireland, Power NI is particularly interested in the proposals and their implementation within this region.

General Comments

There are a number of aspects of the proposals which remain unclear at this stage, especially with regard to the specific implementation in Northern Ireland.

The Department for Enterprise, Trade & Investment (DETI) have indicated an intended implementation timetable of 2016/17 for renewable support CfDs. Power NI believes that given this intention it would be inequitable to require Northern Ireland consumers to contribute to a CfD linked supplier obligation prior to the commencement date within the region.

Power NI would also welcome clarification on whether DECC intend to continue to recognise the additional costs incurred by Northern Ireland consumers in the transportation of fuels and generation of electricity. These factors along with a range of socio-economic issues have historically been recognised by a lower Renewable Obligation placed on Northern Ireland consumers. Power NI believes that these prevalent factors will continue and therefore urge DECC to maintain and not increase Northern Ireland's contribution to renewable support mechanisms.

While accepting that issues in relation to nuclear power are not a devolved matter, given that there are no nuclear facilities in Northern Ireland and the limited interconnection with GB; Power NI also believes that it would be unfair to ask local customers to provide a support mechanism for nuclear related CfDs.

Power NI would also ask both DECC and DETI to be particularly mindful of the different wholesale arrangements which exist in Northern Ireland when transposing a national support framework. The Single Electricity Market (SEM) which is an all island wholesale market sets a transparent price for

energy which while at a half hour level would provide a useful 'market price' in the CfD context. It is also important to recognise that the SEM has a de minimis threshold of 10MW, renewable generation above this level must participate in the SEM and do receive a capacity payment. Any CfD issued in Northern Ireland should recognise this additional level of support and ensure that customers are not paying this aspect twice.

A concerning aspect of the proposed supplier obligation is the variable nature of the required payment. Variable payments add an additional layer of unknown cost to suppliers, this serves to increase forecasting requirements and thereby risk. Power NI's preference would be that the charge to the supplier should be at a fixed price per unit set annually. Power NI believes this would be possible in the CfD context by replicating the mechanics used to recover the System Support Services levy which pays for ancillary services; the Public Service Obligation used to fund a number of requirements and the Imperfections Charge used to cover constraint payments. In all three of these examples the required payment out is variable in nature however the charge to suppliers is fixed. This is achieved through the regulated price control of the administrative body. The price certainty which is therefore provided to suppliers assists in both the transparency and stability of end user tariffs. Power NI believes these benefits are in the best interests of consumers and outweigh the administrative and financial burden of implementation.

DECC should also me mindful of the added credit cover requirements which are proposed to support arrangements. Credit cover does incur a cost which will ultimately be passed to consumers. Prohibitive credit regimes could also form part of a barrier to entry for new smaller suppliers.

Power NI welcomes the acknowledgement of Northern Ireland's different energy market within the national context. The secondary legislation, options on strike prices and engagement with local bodies will help provide a useful context. Power NI hopes that DETI will broaden the proposed engagement to the wider participant base.

Conclusion

To achieve the renewable targets set by government support mechanisms are essential. The current arrangements have delivered a significant increase in renewable developments and while the EMR package can renew the framework it is important that the many positive aspects of the current regime are not lost. Power NI believes that the support package must strike a balance between investor confidence and cost to consumers. Northern Ireland customers should not see an increase in renewable obligation costs as a result of the revised mechanisms.

Power NI welcomes the publication of further information by DECC and would encourage both DECC and DETI locally to engage with industry as the detailed design is progressed.

smartestenergy

By email to:

elec.marketreforms@decc.gsi.gov.uk

14th January 2013

Dear Sirs,

Re: Call for evidence on the proposed approach to the supplier obligation as set out in Annex A.

Annex A states that DECC would welcome suppliers reviewing the detail of the proposed approach for the supplier obligation as set out briefly in that section. SmartestEnergy welcomes the invitation to submit comments and to answer the specific questions laid out in the document.

SmartestEnergy's overall view

The Government is considering implementing a variable rate obligation, where the precise amounts owed to the generators under the CfD contracts in a given period are collected from suppliers as soon as possible after that same period and passed swiftly through to generators. We are very concerned about our ability to hedge this risk from both a price and a volume perspective.

As a supplier and PPA provider we are particularly concerned about being exposed to variable rates for the FiT CfD and RO from 2017 onwards. As a minimum we would ask government to consider fixing RO payments from 2017.

In our view, the proposals should be altered such that there is a centrally determined fixed charge for FiT CfDs with adjustments made for forward tariffs to allow for the correct amount to be collected from consumers.

Separately we are concerned about the unhedgeability of baseload contracts and we believe that using baskets as a reference price will be equally difficult to hedge against.

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Credit/collateral and other issues of scope

We note that the Government considered the option of allowing credit in the form of a Parent Company Guarantee, but do not consider it appropriate as it would disadvantage smaller or independent generators who do not have access to such support. We do not understand or concur with this view. In reality the vast majority of customers will continue to be supplied by companies who have access to PCGs and to prevent this will increase costs for the vast majority of customers.

We believe that government should be looking for ways to ease the strain that credit/collateral requirements place on the industry. Another way of doing this would be to facilitate the ability of companies to provide collateral for others e.g. suppliers guaranteeing pay back on the generators side in arrangements where payments flow through them. This would help smaller, independent generators. This would not be feasible if the supplier would be required to put up double amounts of collateral to be allowed to handle this set up.

We welcome the continued commitment to introducing a collateral requirement on generators when there is a threat that market prices will go above strike prices and that a failure to do so would be a termination event. We would like to be sure that there is no room for discretion if generators do not post collateral in later years i.e. a termination event is a termination event.

Annex A states that the Government is not planning to mandate that the costs of the supplier obligation are passed on through consumer bills although it is likely suppliers will do so. In our view this should be mandated. Our experience from the standard FiT arrangement is that suppliers who have not initially included the costs in their tariffs have caused disruption to competition in the retail market and then gone back to recover monies anyway. It is important that there is no disproportionality across different customer bases.

We note also that it is planned that the supplier obligation is a compulsory levy on all licensed suppliers in Great Britain and Northern Ireland. We think this is a mistake as it does not take into account directly connected sites who supply themselves as transmission connected BSC Parties. Whilst we understand that the Government intends to exempt Energy Intensive Industries from the cost of CfDs it is not likely that there will be a strong correlation between directly connected demand and Energy Intensive Industries which are part of the manufacturing process of renewable products as the Government intends. We believe, therefore, that National Grid needs to use the import data of directly connected sites in its calculations.

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Answers to DECC's specific questions

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

   Yes, we have very serious concerns in this area for both price risk (ability to hedge the correct index) and volume risk (amount of variable generation receiving subsidy).

   Whilst we recognise the intention is to reduce risk on generators, this arrangement is simply passing that risk to suppliers who will reflect such risk in their tariffs thereby increasing the relative cost of the CfD.

   Moreover, without mandating the approach suppliers should take to recovering such charges, there is likely to be a damaging effect on competition. As stated in our introduction, our experience from the standard FiT arrangement is that suppliers who have not passed on the costs have won undue levels of business in the retail market and then gone back to recover monies on what were perceived to be fixed contracts.

   Also, the Grid (with the support of Govt) is much better placed to manage and reduce the impact of CfD payment volatility not least given the fact that it is supplier who would otherwise have to forecast prices.

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

   Yes, the balance of the two basic different risks will vary. However, it is difficult to assess which risk is the greater.

   If all the subsidy were to go to wind generation the main risk faced would be that of the ability to predict the volumes. Whilst complex, it will be possible to hedge a position in the day ahead markets. However, there will be an added complication in that it will be necessary to predict the amount of wind on the system receiving subsidy in any one day. In other words it is not sufficient to know one's own market share (difficult in itself) but there is a requirement to forecast national wind generation.

   If all the subsidy were to go to nuclear, the volume risk would be significantly reduced as this would be easy to predict (unplanned

outages aside). The issue here would be an ability to hedge that volume in the correct reference market.

We note the proposal to calculate the price by averaging each day during the year ahead. Whilst we appreciate that this may make it easier for owners of large plant to sell their power it strikes us that this will make it hugely difficult for suppliers, particularly small suppliers, to hedge their positions i.e. they will have to hedge their proportion of the volume commitment on the seasons, but because these products are not daily, but the hedging activity will have to be daily, the volume commitment to be hedged will have to be divided by the number of days in the year i.e. it will be a tiny amount which is not hedgeable. We are not convinced that moving to basket prices would make the situation any more hedgeable.

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)?

   As previously stated a complex system of forecasting and hedging would have to be developed to reduce the risks as far as possible. These difficulties are explained below:

   Total CfD volume – This is the total metered output eligible to receive CfD payments. As the CfD includes intermittent generation on a day-ahead reference the total CfD volume will change on a daily basis dependent on various factors, particularly solar intensity and wind speed. In order to accurately produce this figure Smartest would need to have visibility of all CfD eligible generation and a highly sophisticated model for forecasting output from these sites on a daily basis.

   Supplier Market Share – The supplier market share will determine the proportion of the total CfD volume a supplier is liable for. In order to calculate this we would need to know the overall UK supply volume and the proportion of this that we supply. Again, this information is dynamic and would need to be re-forecast on a daily basis.

Weighted Average Strike Price – Different technologies will receive different Strike Prices. Therefore a supplier will need to know the Strike Price of each technology and the relative weighting of each in the make-up of the daily CfD volume mix in order to accurately forecast the weighted Strike Price due to generators. Again, we would need to have visibility of all CfD eligible generation and a highly sophisticated model for forecasting output from these sites on a daily basis.

Market Reference Price – In order to calculate the difference payment due to the generator we would need to know the Market Reference Price as well as the Weighted Average Strike Price. By leaving a proportion of the supply position un-hedged a supplier can counter the floating Market Reference Price that the CfD is to be settled against. In order to do this we will need to have accurate forecasts of the expected Supplier Market Share and manage the open position accordingly.

It is therefore clear that there are multiple risks associated with the forecast of the CfD supplier fee and despite best efforts Smartest may not be in a position to manage these risks adequately. The only real mitigation a supplier would have for these risks is to place large risk premiums on the CfD charge, leading to the potential for over recovery from customers or the development of estimation and reconciliation of the charge, leading to consumer price uncertainty. Large suppliers may be at an advantage as some of the sophisticated tools required to manage the CfD risks may already exist within their business for other purposes. This may lead to large suppliers offering prices and products that small suppliers cannot compete with.

It should also be noted that very few of our customers will budget for a price that changes over the course of the year – either monthly as is being suggested or even quarterly as per the reconciliation of FIT payments – as may happen with a pass through product. Our customers generally want a single fixed price that lasts over the year and do not want a massive bill at the end due to under recovery.

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

   As previously stated, there is a hedge that can be achieved for the day ahead reference price. Whilst the "GB Hub" may not be a product in itself, hedging in proportion to the market share that the UKPX and N2EX have would remove a basis risk. The associated liquidity for this

purpose is difficult to judge, as is the ability to forecast exact requirements.

It is difficult to answer this question in relation to the baseload product, but our impression is that, whatever the arrangement, unless it were on the day ahead, would be very difficult to hedge indeed.

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

The document states: "Under a fixed rate obligation, the risk of underpayment would need to be managed to avoid damaging investor confidence in the regime. The most straightforward way to mitigate this would be over-collection from suppliers." Even if there were over-collection there would still be the risk that this would not be enough and the issue still remains as to whether generators or Government would take the remaining cash flow risk.

In reality we do not consider talk of flat rates being achievable if there is no movement on the question of the single counterparty, government or generators being prepared to take the cash flow risk.

In our view, there should be a centrally determined fixed charge for FiT CfDs reviewed in advance annually and adjusted for over/under recovery from prior years. This ensures that ultimately Customers only pay the actual cost of the scheme without the risk of uncertainty adding to the cost. This also ensures a consistent approach across all Suppliers and reduces the ability of larger Suppliers to subsidise the rates in certain sectors to the disadvantage of smaller suppliers.

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 alongside other requirements in the electricity market;

Clearly, a collateral requirement is important to mitigate against any default risk. We are, however, concerned about the costs involved and anticipate the collateral requirement to be of the order of that provided to Elexon for imbalance. As the risk will be

greater for suppliers with no corresponding generation position we believe that it is appropriate to allow for the netting of positions.

We note that the Government considered the option of allowing credit in the form of a Parent Company Guarantee, but do not consider it appropriate as it would disadvantage smaller or independent generators/suppliers who do not have access to such support. We do not understand or concur with this view. In reality the vast majority of customers will continue to be supplied by companies who have access to PCGs and to prevent this will increase costs for the vast majority of customers.

We believe that government should be looking for ways to ease the strain that credit/collateral requirements place on the industry. Another way of doing this would be to facilitate the ability of companies to provide collateral for others e.g. suppliers guaranteeing pay back on the generators side in arrangements where payments flow through them. This would help smaller, independent generators. This would not be feasible if the supplier would be required to put up double amounts of collateral to be allowed to handle this set up.

- method of data collection;

  We approve of the method of data collection (use of BM Units) because it uses data that has been validated and uses proven secure mechanisms. This is far superior to the arrangement under the RO whereby suppliers have to submit the data.

  It is important to note, however, that the method of collection should not determine the inclusion criteria i.e. if there are sites which should be included but whose data is not collectable through a BM Unit, provision should be made to include this data.

- changes to internal systems;

  Aligning as much of the Operational Framework as possible with existing systems and process will reduce cost and time impacts of the Obligation. However, there are elements of the framework which are non-standard and will require careful consideration – as discussed above – as well as others that will take time to implement. It is not cost effective or efficient to initiate system and process change in advance of clear detail on the design of the

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Obligation; it should also be noted that excessively complex changes can take upwards of a year to 18 months implement. We note the timeline set out in Next Steps, but would highlight the potential difficulty of completing systems changes by "mid 2014" if there is slippage in publishing clear details of the Obligation's design.

- and the proposed payment periods?

We were initially of the view that collection of FiT CfD payments should be daily (not monthly) as this would reduce the collateral requirement and would align more easily with the Elexon bill. However, daily collection would increase our working capital requirements as we would collect from customers on a monthly basis. Monthly seems a good compromise between speed of payment and differences in the timing of payments.

We are slightly concerned about the details of the design, i.e. how long it will take the Counterparty to inform suppliers of the levels of charges and then how long it will take to pass that payment on to the customer. We understand the desire to make payments to generators as quickly as is reasonable/possible – but our ability to comment on whether that is possible also depends on how quickly the Counterparty can turn things around.

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

We do not see much scope for shortening the timescale for implementation. A project to implement the risk mitigation mentioned above would take up to 18 months. We note a slight conflict between the Chapter 5 and Next Steps in terms of when a response to the Call for Evidence will be published. We would clearly support the earlier date of May 2013, though would reiterate that any response will need to be clear on the detail if we are to meet the future timeline.

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Should you wish to discuss any aspect of this matter, please do not hesitate to contact me.

Yours sincerely,

[redacted]
Deputy VP Commercial – Head of Regulation
SmartestEnergy Limited.

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SSE Response to DECCs Call for Evidence on the CfD Supplier Obligation

One of the main reasons for introducing the CfD low carbon support mechanism is that it will reduce risks for generators, thereby lowering the cost of financing projects and encouraging more investment in low carbon generation. The funding model for CfDs is therefore extremely important – if generators do not feel their income is guaranteed i.e. that they will be paid in full at regular, agreed intervals over the period of their contract then the CfD becomes a riskier, and consequently a less attractive, investment proposition.

In the CfD Operational Framework, published on 29th November 2012, DECC outlined its current thinking on how CfD will be funded. At this stage:

- DECC is currently minded to introduce a variable rate obligation on all UK licensed electricity suppliers;
- This will allow the precise amounts owed to generators in a given period – likely to be a month – to be collected as soon as possible after the period has ended, and passed quickly on to generators (up to a month in arrears);
- Suppliers will be charged based on their market share of MWh supplied over this period;
- In order to ensure that monies are always available to pay generators suppliers will have to post sufficient collateral to cover their potential exposure;
- In addition if suppliers fail to comply with the obligation then it will be treated as a breach of a suppliers licence, resulting in fines and/or a potential loss of licence to operate.

The Operational Framework notes that concerns have been raised about this approach including the challenge of accurately forecasting a variable levy and collecting it from consumers, the potential financial exposure this could leave suppliers with, and the cost and scale of collateral requirements. The release of the Supplier Obligation call for evidence is designed to explore these, and other potential issues, in greater depth.

This response to the call for evidence outlines SSE's views on:

1. The risks that suppliers would be exposed to under a variable rate obligation;
2. The potential impacts on suppliers of these risks;
3. The significance of this risk exposure;
4. The likely outcomes of introducing a variable rate obligation; and
5. Alternative options which should be considered.

1. Risks for Suppliers

Under a variable rate obligation the CfD counterparty body does not know how much it will need to collect from suppliers each month in order to pay generators. Instead it will wait until it has generation data for a given period – likely to be a month – calculate the total amount owed, and then ask suppliers for a proportion of that amount based on their market share of electricity supplied. Suppliers would be required, through their licence conditions, to pay whatever amount is requested to the CfD counterparty.

As suppliers will not know how much they will be required to pay in any given month they will have to attempt to forecast their potential liability, and then collect it in advance through additions to consumer tariffs. The frequency of tariff changes and the need to notify customers in advance are affected by regulatory requirements, logistical considerations and considerable administrative expense. Aside from

extreme circumstances, it is reasonable to assume that such changes will normally be limited to a 6-9 month gap between changes.

To accurately forecast what their 6-9 month liability might be will be extremely challenging for suppliers, as there are a number of volatile variables to consider:

. . . . . .

1. Volume of Low Carbon Generation – CfDs will be available to renewables, nuclear and CCS. It will not be known how much these plants will produce in any given time period. This means that if it is windier than expected; a large plant commissions earlier or later than expected; or a plant has an unexpected problem and is producing less than anticipated, or returns to power production from an outage earlier than expected, then generation volumes will vary significantly from forecasts.

   Experience to date has shown that wind volumes, for example, can easily be 20% higher or lower than forecasted in a given year. This problem will be more acute over shorter time periods e.g. a 6-9 month tariff setting period, or a single month, with the variation potentially much greater i.e. for a month, outturn could be double expected volume. Experience has also shown that the exact commissioning date of any large generation project is extremely hard to predict; and that unplanned outages are common. This makes forecasting low carbon output extremely challenging and will lead to under or over collection of CfD payments from consumers.

   This forecasting challenge is increased by the fact that suppliers will have to move from managing and forecasting output from their own portfolios, which they have good information on, to forecasting the entire UK generation mix. The only organisations which could have full visibility of the UK mix in this way would be the CfD counterparty body and possibly the System Operator.

   Some suppliers may be able to make an attempt to partially hedge volume risk caused by windiness but this will be imperfect at best. Suppliers are not able to hedge volume risk caused by uncertain station commissioning/outages.

   This is different to the current situation with the RO, where wind generators face volume risk, However under the RO this also acts to their benefit, since exposure to premium collection error (via recycle payments) partially offset lower generation volume in low wind years. There is no such benefit for suppliers under the CfD.

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2. The Average Strike Price of the CfD Fleet – Strike prices will vary by technology, and within a technology class e.g. offshore windfarms will have different strike prices depending on when they commissioned. In order to try and calculate how much to add to consumer tariffs suppliers will have to try and forecast what the average strike price is for each MWh of electricity generated under a CfD.

   The average strike price will depend on which plant is operating in a given period, and at what load factors. It is therefore very closely correlated to volume – if volumes change then the average price will also change. This exacerbates the undesirable consequences of inaccurate volume forecasting described above – collecting too much or too little from consumers - with suppliers having to accurately forecast volumes and blend of technologies over a 6 month period.

Suppliers will not be able to hedge this risk i.e. if the MWh weighted strike price from wind generation changes due to variations in performance between different wind farms.

3. Market Share – to calculate the proportion which each supplier owes in a given period the CfD counterparty body will aggregate the amounts owed to generators, and then charge suppliers based on their anticipated market share i.e. how much volume they are expected to supply. It is proposed that supply data from the Balancing and Settlement mechanism is used to try and calculate this as accurately as possible.

   However supply volumes are subject to both demand erosion and customer churn – and as the call for evidence notes supply data is not normally finalised until 15 months after a supply day. This means that suppliers may be asked for money which does not correlate to their market share, with the result that if less volume than forecasted is supplied then they will have not collected enough from consumers, further exacerbating the problems outlined above.

   It should be possible to mitigate the impacts of reconciliation payments through a well designed system. There are a number of existing DECC policies with reconciliation mechanisms which could inform any design process.

An additional risk could also be created if large industrial users are given an exemption from CfD payments. In this scenario a supplier would have to estimate the volume of exempt demand it would have going forward, and use this as the basis of its price setting. This would make suppliers forecasting and tariff setting even more challenging.

It is worth highlighting that SSE does not believe that changes to the wholesale price, which will feed through to CfD reference prices, represent a risk under the variable rate obligation. Movements in reference prices that change the size of CfD difference payments can be hedged against the strike price, with suppliers charging the average strike price of the UK mix per MWh to consumers. However, as outlined above, forecasting this average strike price will be extremely challenging.

2. Potential Consequences of these Risks

As highlighted in section 1 none of these variables can be fully hedged. This means that the variable rate obligation would create significant risks which in theory could negatively impact suppliers, and have knock-on consequences for the wider electricity market.

For example if forecasts of any of the variables described above are incorrect, which is likely given their volatility, then suppliers will have to either:

Collected too much from consumers – this would mean that they risk being more expensive than their competitors and losing customers (market share). In theory this would:

- Impact on overall profitability, which impacts the share price. This could potentially have an adverse impact on credit rating assessment where one exists, in turn potentially breaching covenants and triggering material adverse change clauses with resultant cash-call impacts or the possibility of entering

contractual default. This could result in an increased burden on short-term funding facilities, as well as a potential need to refinance in the longer-term at less attractive terms.

- Impacts on suppliers ability to invest in generation (this applies to both small and large suppliers that have generation arms – more below); or

Collected too little from consumers – this would mean they had insufficient funds to pay the CfD counterparty body. This shortfall would have to be made up through short term borrowing or working capital. In theory this would:

- Impact on overall profitability - suppliers would hope to make up any shortfall in the future from further additions to consumer bills. However the ability to claw back in this way is unlikely to be possible due to competition in the retail market - it is likely that a tariff increase would make a supplier which had previously undercollected uncompetitive. Shortfalls will therefore have to be written off as losses, which impacts on suppliers profitability (see above).
- Potentially lead to a supplier default - if short-term borrowing and/or loss absorption is not possible then suppliers will have to default on their obligation, and go out of business.
- Lead to less investment in generation – for suppliers with generation arms are forced if their supply business is forced to absorb significant losses this will impact on the profitability of the entire business, increasing the entire company's cost of capital, and reducing its ability to invest, particularly in projects with higher levels of risk e.g. generation assets compared to network assets.

It is worth highlighting that the P&L impact of CfD premium forecast error is not symmetrical i.e. P&L loss from under collection will tend to be greater than any additional P&L value from over collection resulting in a net expected loss on average. This applies to errors suppliers make relative to other suppliers:

- If a supplier over collects relative to other suppliers, then they will tend to lose market share, so less than 100% of the value of over collection will reach their P&L. The loss of market share will reduce profits in subsequent periods as well. A supplier will not be able to use their over collection to reduce prices for the next period to recover their market share, since they would need to carry the reserve to cover for periods when they under collect.

- If a supplier under collects relative to other suppliers, then they will tend to increase market share over the period, which would magnify the loss they incurred since the under collection will be applied to a greater supply volume (although this may be partially mitigated by greater profit in subsequent years due to the greater market share). It would not be possible for suppliers to recover undercollection in subsequent periods, since if they increased their prices relative to the competition then they would lose market share.

The collateral requirements that suppliers will have to put in place will also have an impact. In order to ensure that suppliers are unable to default before they pay the CfD counterparty body (thereby protecting generators revenue), they will be required to post collateral to cover their full liability. This will be forecast by Government and will probably include 'headroom' to allow for forecasting errors. As collateral is seen as working capital requirements for it will further restrict suppliers' ability to invest and, in the case of smaller suppliers, may be unobtainable. Collateral costs will either have to be absorbed as losses or recouped through increases to consumer tariffs.

The variable rate obligation will expose suppliers to risks which cannot be hedged, and which have a number of potential undesirable consequences for suppliers and the wider electricity market. There are therefore two key questions to consider:

1. How significant/ material is this exposure likely to be? For example if the answer is that it will not be significant, then the negative potential impacts described above are unlikely to actually happen. Suppliers would therefore have little need to be concerned about being exposed to these risks.

2. What will the impacts of this exposure actually be? i.e. will some or all of the potential consequences outlined in section 2 actually occur?

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3. Significance of Risk Exposure & Collateral Costs

The evidence available shows that suppliers' exposure will be extremely significant. In May 2012 PriceWaterhouseCoopers (PwC) analysed the potential financial impacts of supplier's exposure to these risks. SSE understands that this is the only piece of publicly available work which has done this although it is aware that other suppliers have carried out their own internal analysis. To date no one has questioned PwCs analysis, and SSE feels that the quantification of volume and strike price risks that it carried out remains valid:

- Base Case Scenario – PwCs base case scenario leaves a supplier with a 15% market share with a £674m liability in 2020 i.e. it would be asked, over the course of the year, for this amount by the CfD counterparty body. This equates to £56.16m a month.

- Exposure to Volume Risk – if wind volumes were 20% higher than forecast across the year, then this would expose the supplier to an additional £119m of CfD payments annually, or c. £10m a month. If all technologies were 20% higher than forecasted this would result in an exposure of £139m annually.

- Exposure to Strike Price Risk – if the average CfD strike price is 5% higher than forecast then this would expose the supplier to an additional £84m annually, or £7m a month; and a 10% increase would be £167m annually.

Therefore in a scenario in 2020 in which wind volumes were 20% higher than forecast, and the average strike price was 10% higher than forecast e.g. there was more generation from offshore compared to onshore, then a supplier with a 15% market share could be exposed to £286m of additional CfD difference payments (it's total liability would be £980m). It is important to note that the exposure is greater in the years following 2020 when more CfD generation comes onto the system.

As noted in the sections above this amount would probably have to be absorbed by the supplier as a loss. SSE's group profit before tax in 2011/12 was £1.3bn – it's exposure to additional CfD difference payments would therefore be extremely significant.

Suppliers will have to post **collateral** to cover their full liability. As explained above this requirement is designed to provide generators with comfort that they will receive their CfD difference payments.

A supplier with a 15% market share could have a requirement to post c. £1bn worth of collateral over the course of year. Given that CfDs will be settled every month, with a billing and payment period of 2 months, collateral is likely to be required on a rolling two monthly basis.

Suppliers are likely to use cash to provide the necessary collateral, and SSE has analysed the potential costs of doing this. A supplier with a 15% market share could have a 2 month collateral requirement of £150m – a facility of this size this would cost c. £1m over the period if left undrawn, and up to £3m if all or part of the facility was utilised. This would leave suppliers with an annual cost of between £6 - £18m.

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4. Probable Outcomes if a Variable Rate Obligation was Introduced

The evidence outlined in section 3 illustrates that supplier's financial exposure to variable CfD volumes and average strike prices will be significant – and this leaves suppliers exposed to the possible consequences outlined in section 2. If suppliers are put into this position they will try and take mitigating actions to prevent these consequences occurring where possible; and prepare for those which have no solutions.

This section outlines what SSE believes the probable outcomes for the electricity market would be if a variable obligation was introduced:

Unnecessary Increases in Tariffs

Under the variable rate obligation the Government is asking suppliers to manage volatile risks on their balance sheets. This is a risk which is extremely difficult to manage and exposes suppliers to undesirable consequences if they are unable forecast correctly. Like any other business risk, suppliers will have to value it, and then charge an appropriate risk premium to consumers. Suppliers would also look to pass through the costs of posting collateral.

Domestic customers would receive a premium through an increase to their tariffs. In years in which suppliers were able to forecast relatively accurately then this would lead to increases in retail profits, and vice versa. This will result in volatility in retail profits, increasing political risk – Government intervention to 'clawback' any supplier upside would be a very real possibility, further increasing the risk profile of the sector.

Industrial and Commercial (I&C) and Small and Medium Sized Enterprises (SMEs) customers normally favour fixed rate contracts. This means that suppliers would have two options - either a risk premium included in the fixed contract rate; or suppliers offer a flexible tariff which allows CfD variability to be passed through to the customer. Most I&C/ SME customers favour fixed price contracts which means that the average prices of these contracts will rise to reflect the additional risks which suppliers are being forced to manage.

It could be argued that competition will reduce the risk premium charged. However, because the balance is such a fine one and ramifications of mistakes so significant, it is unlikely that risk committees and shareholders would allow risk premiums to not fully reflect the risks involved. This will therefore increase the overall costs of CfDs for consumers.

This cost increase is unnecessary as the cost to suppliers of managing this risk will be much greater than for other organisations because of the relative cost of borrowing. Suppliers borrowing costs are much higher than the Governments, particularly currently, which mean the overall costs of CfDs to society are unnecessarily high.

It is worth highlighting that the objective of the CfD scheme was to reduce the cost to society, but this is not achieved if the increase in cost to suppliers, and therefore consumers, is similar, or greater than the reduced cost to generators.

Reduced Profitability and Less Investment

The Government's stated aim for the CfD is to reduce risks for low carbon generators in order to encourage more investment at a reduced cost to society. However increasing risks for suppliers will impact on their ability to make this investment, either through restricting the availability of capital or by increasing its cost e.g. by increasing the required return for investors e.g. shareholders.

SSE believes that it is likely that some, if not all, suppliers will be impacted by forecasting errors and will have to absorb losses as a result, reducing profitability and potentially forcing some players out of the market.

This in turn will impact the entire company's ability to make investments. Overall this will result in less investment in low carbon generation in the UK from the major utilities. This would make the CfD ineffectual - the risks faced by suppliers, and the costs associated with these, will simply negate or outweigh any potential financial benefits that the CfD offers generators.

Barriers to Entry in the Retail Market

As noted above suppliers could go out of business under the variable rate obligation. Smaller suppliers, with smaller balance sheets and less access to capital, will be most at risk as they do not have the forecasting capabilities of the Vertically Integrated Utility's (VIUs) to be able to accurately predict the generation mix, and would be less able to absorb losses. This would reduce competition in the retail electricity market, which Ofgem and DECC are keen to increase.

The variable rate obligation would also prevent new suppliers from entering the retail market. A new supplier would be faced with all of the challenges that new entrants face today, coupled with an unpredictable, volatile obligation that has the potential to put it out of business. This is unlikely to be an attractive business proposition for an investor.

The variable rate obligation will therefore reduce competition in the retail market, which works against the aims of Ofgem's Retail Market Review.

5. Alternative Options

The only other funding mechanism that DECC appears to have considered is a fixed rate obligation. This would involve the CfD counterparty body setting a £/MWh supplied figure and asking suppliers to collect this from consumers.

Most suppliers are in favour of this approach as it would leave the risk of forecasting errors with the CfD counterparty body to manage – and they believe that the CfD counterparty body would be better placed to

forecast the mix and volume of CfD output. The counterparty body will have full visibility of the entire UK electricity market i.e. the Target Commissioning Windows for different projects, anticipated start dates, levels of support that each project has received – and will therefore be better placed to forecast the different variables. It will have to do this in any case in order to set the collateral requirements for suppliers and generators.

As with the variable rate obligation it will not be possible to accurately charge suppliers because exact market share isn't known until after the event. A reconciliation mechanism would therefore be required. Reconciliation could potentially lead to large supplier price shocks if volumes have been inaccurately forecasted. However SSE believes that a mechanism can be designed to mitigate this risk and that it will have to be introduced under both types of obligation in any case.

DECC has stated that it does not favour the fixed rate obligation because forecasting errors could lead to major surpluses or deficits in collection, restricting the CfD counterparty body's ability to pay generators. It has also argued that a fixed-rate obligation is not workable because any surplus that the CfD counterparty body was able to build up would have to be paid into the Governments consolidated fund at the end of each year. This means that it would not be able to build up a buffer against volume shocks in future years, which would unnecessarily increase costs to consumers.

SSE is curious about these claims given previous experience with NFFO (where Ofgem held excess monies), and would like to see more details outlining exactly why a similar model can not be used again. It is also worth noting that Parliament can vote to release money from the Consolidated Fund the year after it has been collected – if this were to happen then it could be passed back to consumers, or given back to the CfD counterparty body. SSE would therefore be interested in why this option has not been considered.

Another option would be for the CfD counterparty body to set the fixed rate obligation at a level that is less than it believes will be required, and then borrow any shortfall from the capital markets. As it will be Government backed it will be able to do this very cheaply, and then pass the costs back to suppliers through resetting the fixed rate obligation.

DECC should also consider using another organisation, such as the Transmission System Operator (TSO), to collect a levy from. The TSO could manage the risks more easily than suppliers as it has the ability to recoup any shortfalls as a result of its forecasting errors through Transmission Use of System (TNUoS) charges, and is also able to borrow more cheaply thereby reducing the overall costs of the scheme for consumers. National Grid's involvement in EMR will mean that it will be better placed, compared with suppliers, to accurately forecast the variables outlined in section 1.

6. Conclusion

Currently DECCs preferred option is for the CfD to be funded via a 'back-to-back' variable levy on energy suppliers. SSE has consistently been opposed to such an approach, and continues to be for the following reasons:

- It will expose suppliers to significant financial risk which they will have to attempt to manage and mitigate. This will result in higher costs than it would be if it was managed by the Government, increasing consumer prices and the overall cost of the scheme unnecessarily.
- If suppliers are unsuccessful in managing these risks, which is likely given their unpredictability, then their businesses will be adversely impacted. Analysis undertaken by PwC illustrates that the

potential liabilities which suppliers could be exposed to under this model are significant - £100s of millions annually. This will have knock-on consequences for the companies involved, including reduced profits, lower share prices (which means higher borrowing costs), and less investment in new generation, the objective of EMR (see below).

- It creates a major barrier to entry in the electricity retail market, reducing competition as new suppliers will find forecasting risk to challenging to manage; and is likely to distort the retail market as different companies will treat and price risk differently – this runs contrary to the aims of Ofgem's Retail Market Review;
- It is likely to result in less investment in low carbon generation being made by those suppliers which also have generation arms. This runs contrary to the aim of the CfD, which is designed to encourage additional investment in the sector.

SSE would therefore urge DECC to consider alternative options, including allowing the CfD counterparty body to manage CfD funds; or using organisations which are better placed to manage the risks involved than suppliers. SSE understands that this may be challenging but believes these options need to be explored further as the variable rate obligation would result in undesirable consequences for suppliers, consumers, and the wider electricity market.

Responses to Call for Evidence Questions:

1. Do you have concerns about the predictability of the amount of potential volatility of CfD payments?
Yes, SSE has serious concerns about the volatility of CfD payments and its abilities to forecast this correctly. As highlighted in section 1 this volatility is not possible to hedge and could, in a very plausible scenario, leave a supplier of SSE's size with £100's millions of financial exposure. Section 2 outlines the financial implications in more detail.

2. Does this differ based on different scenarios for how the generation mix evolves?
No, all low carbon mix scenarios would cause suppliers difficulties.

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)?
SSE believes that the variables that will cause volatility in CfD difference payments will be volume, and the average weighted strike price. Movements in reference prices that change the size of CfD difference payments can be hedged against the strike price, with suppliers charging the average strike price of the UK mix per MWh to consumers.

However the forecasting of the average strike price will be extremely challenging, and errors are likely to occur which will leave suppliers exposed.

4. Is there a hedge that suppliers can utilise that may mitigate any risks?
Apart from the hedge for price risk noted in the answer to question 3 there are no hedges that suppliers could use to offset the risks around volume or average strike price forecasts. The only option which

suppliers will have if they are required to manage these risks will be to charge a risk premium to consumers.

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

As outlined in sections 4 & 6 SSE believes that the variable rate obligation will:

- negatively impact on suppliers businesses,
- unnecessarily increase costs to consumers and businesses,
- reduce competition and transparency in the retail market,
- create increased political risk for investors,
- reduce investment in low carbon generation

It would therefore urge DECC to consider alternative options, as outlined in section 5.

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 alongside other requirements in the electricity market;
- method of data collection;
- changes to internal systems;
- and the proposed payment periods?

The costs of posting collateral are detailed in section 3. Collateral is viewed as working capital and additional requirements, particularly of the scale that the variable rate obligation will require, will therefore restrict suppliers' ability to invest elsewhere.

EMR Team
Department of Energy & Climate Change
3 Whitehall Place
London
SW1A 2AW

15th January 2013

Dear Sir / Madam,

Re: CfD Supplier Obligation Call for Evidence

TGP Gas & Power (TGP) welcomes the opportunity to comment on the Government's call for evidence relating to the Supplier Obligation for CfD. TGP is an electricity supplier in the GB market, supplying industrial and commercial (I&C) customers. TGP are also well known as one of the largest I&C gas suppliers in the UK, as well as offshore producers in the North sea, however our response is focused on the electricity market and our experiences as a small electricity supplier.

Supplier Obligation
As supplier in the I&C market, a primary concern is the competitiveness of our prices. To this end, we need to be able to forecast our supply chain costs and factor these into our prices – these need to be as stable and predictable as possible to minimise the risk premiums that need to be factored into our supply prices and minimise the occurrence of pass through charge reconciliations to end consumers.

The current design of the CfD payment model does not allow us to do that efficiently, and instead introduces new and unwelcome risks, which we ultimately have to past to customers. TGP believes that the best way to manage the risks associated with the mechanism's design, for suppliers, generators and their customers, is to fix the CfD costs faced by suppliers on a rolling, annual basis.

Fixed vs Variable Payment Models
TGP do not support the Government's proposed variable CfD payment model. The model introduces forecasting and cash-flow management problems for all electricity suppliers' businesses. Not having the ability to predict the obligation payments, which could be highly volatile, will mean that prices to customers will need to include a risk premium, i.e. increase the electricity price to mitigate cash-flow risks. Instead of introducing a problematic variable payment model, TGP believe that a fixed payment model will represent better value for customers, with less risk for suppliers, without creating problems for the generators. In effect, a fixed payment model would translate into a fixed £/MWh value which the supplier could recover through its customer base. TGP recognises that the generator payment needs to be protected,

to make their projects financeable, so we would propose some form of payment uplift on the forecast supplier obligation to cover costs and smooth the increases in the fixed charge between years.

In practice, the Government should instruct the SO to provide a forecast of the total output of all the CfD contracted plant and a forecast of the differences between their relative strike prices and the forward reference price(s). This forecast can then be used to estimate the total size of the likely CfD payment 'pot'. To create financial stability and remove liabilities from the counterparty, an uplift of small percentage uplift could be applied to the total, resulting in an explicit requirement for suppliers to overpay and thus create a buffer that ensures generator payments are not short.

Given the variable nature of wind power, an alternative is for the Government to require the SO to take a 'worst case scenario' approach i.e. factor wind running at a high load factor, therefore ensuring that CfD payments to generators are always covered in each payment period, rather than over the course of the year. The Government should then factor in the resulting overpayment made in year 1 to year 2, and so on, smoothing the cash flows, but ensuring that the counterparty body does not carry any liabilities. By smoothing the volatility of payments and thus supplier costs, prices will be lower to customers and risks for both suppliers and generators reduced.

Ofgem need to take timely action to improve liquidity in the market, so the accuracy and integrity of the reference price forecasts will improve and therefore the annual forecast process will become more robust. It is also expected that as wind power penetration increases, its load profile flattens, reducing the volatility of output which should also make forecasting the annual 'pot' easier.

To summarise, the benefits of adopting a fixed supplier payment model are threefold:

- It will reduce the volatility of payments between suppliers and the CfD counterparty, making forecast of supplier costs more accurate and thus consumer prices lower.
- For smaller and I&C suppliers, who do not have a large domestic customer base to smear costs over, fixing charges enhances competition. It is effective competition that drives down prices and improves services to customers.
- By creating some form of 'over payment', the counterparty body will have no risk of being unable to pay the generators, and the generators can ensure they receive full payment in a timely manner. This creates a more robust, risk free environment for both.

The details of the forecasting of the required subsidy would need to be worked out with the SO. National Grid must also undertake similar forecasting to allow the Government to check the level of subsidies against the Levy Control Framework in agreeing CfDs with new renewable generators, as well as its general forecasting work, so this should not be onerous. TGP recognises that the degree of overpayment, in proportion to the required pot, may initially need to be high (due to the volatility in the required payment profile, and the lack of experience), but over time this should reduce. As the customers will ultimately be making the over payment, it should be recognised that they too will benefit by explicitly overpaying

rather than facing a hidden cost from the risk premiums that suppliers will otherwise be forced to factor into bills.

Credit

TGP recognises the concerns that many parties have raised over the credit arrangements surrounding the CfD FITs. We believe that credit must be robust, so a defaulting party cannot leave either other suppliers, nor generators facing any additional costs. The arrangements under the BSC appear to result in too much credit cover, primarily as a result of the volatility in cash-out. Again a fixed payment system will allow for credit that can be fixed by the supplier each year and better reflect their likely exposures without persistent adjustment or the risk of having unsecured liabilities.

Market Liquidity

TGP has been feeding views into Ofgem's work to improve market liquidity. We have long argued that the wholesale power market does not provide any robust reference pricing accept on a day ahead basis. This is a major barrier to market entry and to the efficient operation of the market. We urge the Government to put pressure on Ofgem to speed up its work, which is vital to the market as well as the accurate and efficient functioning of the CfD regime. Without robust forward curve the market, giving a clear and reliable cost indicator the regime may be open to gaming.

Information Transparency

Concurrently, the SO must run an open and transparent price discovery process for the setting of the strike price. For the market to monitor the success of the regime it needs to understand all elements: the strike prices; the reference price; the installed capacity and the forecast load factors. These details, recognising the commercial nature of specific projects, need to be available to the market in a timely manner and an easily accessible format.

Conclusions

While TGP understands the reasons for Government initially proposing to opt for a variable payment model, which does match cash flows through the mechanism in an economically pure manner, we feel that there are too many problems with it for it to be a viable option. It will be detrimental to competition, add to supplier costs and to customer prices. TGP's proposed fixed payment method provides greater certainty and removes many of the issues that the variable model introduces.

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TOTAL

We hope that the Government will reconsider its position and we would happy to discuss any of the issues that we have raised in our response with you or your colleagues.

Yours sincerely,

Head of Regulation
Total Gas & Power Ltd
UK Energy Retail

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Feed-in Tariff with Contracts for Difference: Operational Framework
Response by the Wood Panel Industries Federation

The Wood Panel Industries Federation (WPIF) represents all UK manufacturers of wood-based panels. The industry is the second largest processor of UK-sourced wood. The sector has an annual turnover of over £650m and provides 8,700 FTE jobs, the majority of which are in rural areas. There are six UK manufacturing sites across England, Scotland and Wales.

The introduction of a large scale, heavily subsidised new entrant into the domestic wood market poses a significant risk to the future of the wood processing industries. The availability of wood is becoming increasingly uncertain, with prices also set to rise significantly.

Burning wood for biomass, rather than processing wood into products, emits more carbon and undermines the Waste Hierarchy. Whilst there is a place in the energy mix for good quality CHP, using the valuable and limited wood supply for electricity generation is an inefficient use of a valuable resource.

CfD price-setting and allocation

WPIF welcomes the Government's intention to exclude biomass technologies from the "General Pot". Unlike other renewable energy technologies biomass requires a feedstock which already has existing users and markets. The impact of the subsidy on the price and availability of these feedstocks (namely wood), and the subsequent impact on wood processors, must be closely monitored. This must also be taken into account when formulating the subsidy for biomass, in part by differentiating the subsidy support for domestic and imported feedstocks used.

The Contract

The document states that "*Contractual arrangements should be largely standardised across technologies, but variations will be needed in some cases*". A variation in the terms must be included for biomass technologies. Given the unique nature of biomass feedstocks amongst renewable technologies (i.e. the existence of existing competing users for the feedstock) it is essential that measures to monitor and reduce the impact of subsidised new entrants into the market are included in the contractual arrangements.

"*The contract will provide investors with a degree of protection against certain changes in law and regulation*". This must not include any changes to sustainability standards. Existing users of wood must comply with improving sustainability standards. It is essential, to ensure the best environmental standards, that any energy entrants into the market must also be subject to improving sustainability standards as well.

For biomass, generators should also be required to provide evidence of their sourcing intentions, alongside evidence of substantive financial commitments. This must include a commitment not to divert UK wood to biomass electricity generation. Given the UK annual wood harvest is only around 10 million tonnes, and demand from biomass is forecast to reach 80-100 million tonnes by 2030, it is essential that steps are taking to prevent the UK wood harvest being diverted to large scale

electricity generation. This commitment must also be included in the Conditions Precedent, to ensure a degree of certainty on future wood availability for domestic wood processing businesses.

The CfD counterparty

As discussed above, biomass is unique amongst renewable energy projects due to the need for feedstocks for which there is a large existing market. The CfD counterparty should have an obligation to monitor the impact of biomass electricity production on these existing users, to ensure that the subsidies being paid are not distorting the market.

Data Collection

For biomass generation it is essential that sourcing data is also supplied, to ensure that the most accurate picture possible is drawn of the source of biomass feedstocks, and the consequent impact on existing users of the feedstocks.