Contracts for Difference - E2E, Set Up Workshop

2nd October 2013

1. Introduction

Introduction – Ronan O'Regan

- The morning will be an overview of policy for CfD up to Payments. The focus of the afternoon will be working through process maps in detail
- Objectives of CfD process – providing stakeholders with an understanding how the processes can be implemented in practice. It is not a forum for reopening or debating policy decisions, the primary focus is on detailed processes around EMR so that stakeholders feel they have a good understanding of what they will need to do.
- Want to provide transparency on the interfaces between stakeholders
- Key outputs by PwC will be Target Operating Models and a detailed implementation plan.
- PwC will capture issues and questions raised during workshops which will be answered either by follow up sessions or via key documents/publications.
- Comments made during the workshop will be non-attributable to individuals

Consultation document

- The consultation document which has a provisional publication date of next week will cover;
    - CfD Allocation regulations
    - Supplier Obligation proposals
    - Supply chain plan proposals
    - Investment Contracts
    - Relationship with the RO Transition Period

2. End to End Policy Overview – What Happens Up to Payments?

Overview of Allocation System

- The Allocation Methodology describes the journey a developer must go through in order to secure and then retain a CfD.
- Within this process there are several clear roles for different bodies
    - The Secretary of State sets the strike price and rules
    - National Grid runs the allocation process, assesses eligibility and allocates CfDs
    - Counterparty Body manages the contract, monitors contract compliance

- Certain information which will be published before the allocation process takes place. This ensures that participants have the required information to decide if they want to apply.

- Applicants will need to provide evidence that they have met the Eligibility Criteria before they are allowed to enter the allocation process. This criteria includes planning permission or development consent, evidence that the applicant is validly incorporated under the laws of the jurisdiction in which it is incorporated and evidence of a valid supply chain plan.

What we intend to focus on within Collaborative Development

- In the upcoming session there will be focus on:
    - First Come First Served Allocation
    - Unconstrained Allocation Rounds
    - Constrained Allocation
    - Appeals

Components of the Allocation Approach

- Once grid has assessed eligibility, there will be a period of allocation following a first come first serve approach. If the applicant is eligible and there is sufficient budget then the delivery body will direct the CfD Counterparty to offer a contract.

- The delivery body will use this process until a certain trigger has been hit - once 50% of the CfD Budget for a Delivery Year has been committed. At this point the Delivery Body will approach DECC to see if DECC can release additional budget to ensure first come first serve can continue.
- Financial data and information on the available budget will be made public via a website.
- If DECC are unable to increase the budget then applicants will be unable to secure a contract through FCFS and the process will move to allocation rounds.

The mechanics of allocation rounds work much like FCFS if no constraints are triggered

- The mechanics of rounds works much like first come first serve. The difference however, is around the time of year as applications are submitted within two specific time windows.
- The Delivery body checks if there is sufficient budget and if there is, then a contract is awarded at the strike price. If the budget is insufficient then a constrained allocation process is run

Under Constrained Allocation, CfDs will be allocated to the cheapest projects, subject to any constraints

- There maybe additional constraints aside from budget which may constrain the allocation of CfDs e.g. maximum levels which government has set for specific technologies. However at this point no actual decision has been made around specific constraints or levels.
- The rationing process will operate on a ‘pay as clear’ basis for each technology or technology group/category.
- The clearing price is the most expensive bid that is accepted in that category. (see slides for more details)
- The strike price will be the lower of the administrative strike price for the technology or the clearing price established for the category.

Appeals

- There will be an appeals process for disputes on an Applicant being deemed ineligible by the Delivery Body.
- These will be in relation to errors in fact e.g. an application is refused as there is no evidence of planning permission deemed by the Delivery Body. However the applicant may believe they have submitted the information correctly. In this scenario the appeals process will involve a right of review by the Delivery Body and (in the event it upholds this decision) an appeal to Ofgem. (See slides for details of timelines)
- An unsuccessful applicant would also have recourse to Judicial Review – in this case the budget will no longer be reserved for the applicant.
- DECC is currently considering whether to provide in statute for a subsequent right of appeal to Court
- DECC is currently considering legislating for independent audits to be conducted in respect of the Delivery Body’s calculations on constrained allocation, moves to allocation rounds, and moves to constrained allocation.
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To retain a CfD a project must show it has made a Substantive Financial Commitment

- This purpose of this step is an attempt to learn from low carbon support schemes in the past.
- Within 1 year of signing the CfD, the developer must demonstrate that it has made a substantive financial commitment.
- Failure to meet this SFC milestone within the prescribed timeframe will give the Counterparty the right to terminate the CfD
- The evidence required to demonstrate the SFC may differ according to the financing structure of the project.
- Developers will be able to evidence SFC by:
    - A) demonstrating a minimum percentage of total project costs have been incurred or irrevocably committed by a given date after CfD award.
    - B) provide a combination of construction contracts, fuel contracts, lease agreements, licenses etc.

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Target Commissioning Windows and Longstop Dates

- Projects often can't be precise on the date they will deliver. Therefore to deal with this, a target commissioning window has been proposed.
- Target Commissioning Window (TCW) is a defined period within which the generator must commission the facility. Whilst the generator can pick their target commissioning date, the length of the window if fixed according to the type of technology.
- If a Supplier delivers outside the window but before the longstop date then the length of the CfD is shortened in proportion to the number of days by which the project was late.
- The Longstop Date is a defined date after the end of the TCW. There is a requirement that at the LSD the generator must have reached 70% of their adjusted capacity and have issued a Start Date Notice.
- If they haven't reached that level by that date then the contract is withdrawn.
- The Long Stop Date may only be extended in limited circumstances:
    1) The generator is affected by a Force Majeure event, or
    2) Grid connection works are not delivered on time (except if due to the fault or negligence of the generator)

Capacity Amendment

- Developers will be unable to state the exact amount of capacity they will be able to deliver when they apply
- As such DECC propose a more flexible, staged process where developers can amend the capacity of the CfD at two different points:
    - At the Substantive financial commitment milestone, by a specified percentage (e.g. 5%) and
    - By Longstop Date, by a specified percentage (e.g. a further 5%)

- Please see slides for the consequences of delivering less than the adjusted level of capacity by the LSD.

CfD provides Developers with a range of flexibilities

- There are several flexibilities in the CfD process which take account for several different dates. See table in slide for more detail.

Questions:

- Industry highlighted that policy seems not to have changed at all since the publication in August despite feedback given from industry. Response: DECC are still considering the feedback they received.

- Budget for CfDs and how these are set - do you need to consider the budget for the life of the CfD? Will people be able to understand where they are in relation to FCFS / constrained rounds? At the margin - would you move to constrained based on strike price? (no - all projects considered simultaneously)

- Components of the Allocation Approach - if one year in the future the round meets the trigger, all years, including previous years will move from FCFS to Allocation Rounds but this may be constrained or unconstrained.

- The trigger relates to individuals years. However, if the government decides to set constraints on specific technologies and the trigger for that technology is met, this will not push the entire system from FCFS to Allocation Rounds.

- Industry asked when there would be clarity around the budgeting process and profile?

3. CfD Counterparty and Supplier Obligation – Helen Dhoot

Why a CFD counterparty and supplier obligation

- There has been a move towards a single counterparty payment model in the Energy Bill
- The CfD became a bilateral contract that would be signed by the generator and the CFD Counterparty.

CfD Counterparty: who it is and what it does

- The CFD Counterparty has two roles – contract management and supplier obligation management.
- The CFD Counterparty contract management function is driven by the clauses of the CfC contract and not covered in these sessions.
- The settlement role will be supported by Elexon. Data from the Balancing and Settlement Code (BSC) will be used to calculate what suppliers owe. Changes will be needed to the BSC and National Grid's transmission license in order to allow Elexon to carry out that role. These changes will happen towards the end of 2013.
- The focus of today's session is Supplier Obligation Management.

Supplier Obligation: Energy Bill

- Points following points have been amended to the bill during its passage given feedback:
- SoS must make regulations that make provision for electricity suppliers to pay a CFD counterparty for the purpose of enabling the counterparty to make payments under CFDs;
    - Must include such provision as is necessary to ensure that a CFD counterparty can meet its liabilities under any CFD to which it is a party;
- Regulations must impose a duty on the CFD Counterparty in relation to the collection of sums;
    - A CFD counterparty must exercise the functions it has to ensure that it can meet its liabilities under any CFD to which it is a party.

Supplier Obligation legislation and timetable

- The Bill provides powers to do certain things that make up the supplier obligation, but the regulations will detail how those powers are exercised. The draft regulations will be published alongside the consultation document.
- Other key elements the bill sets out:
    - SO will be paid by all licensed suppliers in Great Britain and Northern Ireland (although discussion on going as to when NI joins CfD scheme).
    - Payment will be a licence requirement.

Proposed approach to the supplier obligation rate

- In Nov 2012 DECC proposed a variable rate. This means that the amount of money collected from suppliers would exactly match payments to generators and would vary payment period by payment period. . Suppliers had concerns about managing this changing cashflow.
- There were around 25 responses to the call for evidence which resulted in a variety of views but there was a trend in concerns about a supplier's ability to cope with the volatility of payment. Overall the majority indicated that they would prefer a fixed rate and a shorter settlement period although this view was not exclusive and some thought that suppliers should be able to hedge risk.

- Industry has since raised some concerns that a fixed rate would not offer incentives for suppliers to trade in the market place. DECC would like to hear views on whether the different types of levy offered different incentives.

Features of a fixed rate levy

- Consultation published shortly will give details of our proposal for a fixed rate levy set at a £/MWh rate.
- The levy year is 1 April – 31 March
- The £/MWh rate means that payments in from suppliers will not exactly match what is paid out to generators. As such, a reserve fund will be needed in order to smooth payments.
- The reserve fund will be funded by suppliers who will be required to make a lump sum payment to the reserve fund at the start of the year.
- DECC are currently developing how the size of the reserve fund will be determined, further detail will be provided in the impact assessment published alongside the consultation and draft regulations.
- The counterparty would publish information about the levy rate and size of the funds at least 3 months

in advance of collection.
- The insolvency reserve fund would be a feature of any type of levy (fixed or variable), it is a fund that is designed to deal with supplier default

Strength of the Supplier Obligation

- Proposals to post collateral – suppliers were concerned about the amount of collateral that would be required during the call for evidence.
- DECC has moved from monthly settlement towards daily settlement, which alongside other measures has decreased the amount of collateral from c.50 days to 21 days.
- The **Insolvency reserve fund** would be funded by suppliers. The fund is sized to cover CfD payments of suppliers (the three largest small suppliers) for 38 days - DECC would be interested in getting comments on the sizing of the fund through the consultation.
- **Mutualisation of debts** – when the insolvency reserve fund is drawn on (after collateral is exhausted) it would be 'topped up', through mutualisation

- The process is; first collateral is exhausted then the insolvency reserve fund is used in parallel to the mutualisation process.

Disputes and enforcement

- There is no process map on this as the process is self explanatory

Disputes
- Disputes relating to a counterparty decision or notice are resolved with the counterparty directly (e.g. calculation of the levy rate or a non-payment notice).
- Disputes relating to BSC supply or generation data used to calculate payments are dealt with under the BSC.
- Where a supplier is dissatisfied with the resolution of the dispute by the counterparty it may resolve the dispute through judicial review.
- Where a supplier contests the supplier obligation regulations it may proceed to judicial review.

Enforcement
- Breach of licence conditions are enforceable by Ofgem.
- Counterparty recovers unpaid debts through the courts.

Process under Collaborative Development – focus on interfaces with industry

- The aim is to provide information required to provide information to enable development of systems.

Questions and comments:

- Industry asked what the process is for funding the IR fund, what happens to the money at the end of CfD? Answer – the IR fund is pre-funded at the start of the year and suppliers are notified of the amount with 3 months notice. The fund is sized annually so if CfD payments decreased, so would the size of the fund. Money would be redistributed to suppliers as the requirement of the fund decreases.

- Industry asked how the reserve fund is calculated? What is the likely scale of the fund? Answer – It is calculated as 38 days of CfD payments by the 3 largest small suppliers.

- Industry asked whether the finance / investment community were consulted in regard to project financing of CfD payments? Response - yes, they had been consulted previously but the intention was to undertake further consultation over the coming weeks alongside the new proposals.

- Reserve funds will be placed in government banking service accounts which are non-interest bearing.

- The forecasting model is intended to be transparent to participants and the fixed rate (£/MWh) will be made available 3 months before the supplier obligation year.

- DECC are currently speaking to generators and suppliers in order to determine when supplier payments might commence and when capacity will be eligible. Currently estimating this will be in April 2015 although it may be earlier. Lump sum set up payments may be required before this date i.e. the reserve fund payments. As above, 3 months notice at least will be given of the sums required.

- Industry asked whether any thought has been paid to the government paying for funds rather than suppliers? Response – Yes this has been considered, however, the government has taken the position that the scheme will be fully funded by suppliers as other schemes are.

- Industry asked whether the reserve fund / insolvency fund count towards the levy control framework? Response – there is still more work to be done on this.

- Suppliers are expected to post collateral to cover their individual liabilities and also contribute towards the reserve fund and the insolvency reserve fund.

- It is not the current proposal to pool the collateral between the CfD/Supplier Obligation and other collateral requirements of the electricity market. There would be no netting between collateral required for CfDs and capacity market payments? This minimises complexity and provides a clear risk position. Collateral under the supplier obligation will be held in a Counterparty bank account (not in the same pool as collateral held for the purposes of the BSC)

- The gap between suppliers paying the counterparty and the counterparty passing this money onto generators creates working capital for the counterparty. This means that ultimately less money is required for the reserve fund reducing the cost for consumers is reduced . Generators will be provided with a set date when they will receive payments.

- More information on the reserve fund will be available in the consultation document.

- If a supplier leaves the market then adjustments will be made at the end of the year and the insolvency reserve fund monies will be held until the end of the financial year.

Set Up Suppliers and Generators – Process Map

This process map sets out what is required at the beginning of the process. This takes place before the financial year starts and dictates what information the Settlement Agent requires.

1. The Settlement Agent will ensure it has all the information it needs from generators will be drawn from the CfD contracts.. This will include, for example, generators unique ID. The Settlement Agent inputs this information into the Settlement System
2. The Settlement Agent contacts suppliers and generators and provides them with their bank account details for payments which will be required later on. The SA also requests the generators and suppliers to provide their bank account details and payment preference details. This will be inputted into the settlement system.
3. Generators respond to the SA by providing their bank account details and payment preference details
4. Suppliers respond to the SA by providing their bank account details and payment preference details

- For existing suppliers it will be a process of confirming the details that Elexon already have.

Managing Collateral

Overview of the Policy on Collateral for Suppliers:

- Suppliers must post collateral to cover future payments. This covers a period of 21 calendar days.
- There is daily settlement (this was previously monthly)
- Collateral is to be funded by cash or a letter of credit.
- Suppliers will have 10 days to post collateral at the start of the regime

- Calculation of collateral – collateral is set on a supplier's previous 21 days supply data.

- More information will follow in the consultation document.

Process Map – Manage Collateral.

- See process map for details of the process

Changes required to the process maps:

- Step 10 - There should be an action on the agent to confirm receipt of payment.
- DECC anticipates being able to tell suppliers every working day what their collateral requirements are versus what has been posted – this needs to be reflected on process map. DECC anticipate the level of collateral will be fairly stable on a day to day basis. Ways of communicating this is currently in discussion.
- Additional point on process map required - Supplier decides how much collateral they want to top up by.

Additional Comments and Questions:

- If a top up is required, suppliers will be able to post cash in advance of a new letter of credit (given 2 working days not enough time to generate a new letter). DECC confirmed that yes, this would be possible.

- It a supplier required a refunding of collateral, it will take 1 working day for calculation and 2 working days for refunding.

- Participants commented that Elexon, in their role at BSCCo, also collected collateral for other schemes.

- Parent Company Guarantees won't qualify as suitable collateral.

- The cost of collateral forms part of the impact assessment.

- Industry asked whether collateral calculation have inherent headroom? No, given how little supply will change over time, and the rolling calculation reduces risk sufficiently. Would there be a de minimus limit for changes to posted collateral? Not currently proposed.

- DECC are seeking the views of industry on whether they think it would be useful to publish to industry when a supplier has gone into default on their collateral requirements. A number of attendees thought this would be useful.

- DECC are seeking the views of industry on how they would like to be informed of their collateral position and billing. Attendees were keen to use current systems rather than set up a new system.

- It was asked whether estimates for total level of collateral for the whole market will be discussed with banks during the consultation period to ensure that the market would be sufficient to allow suppliers to get letters of credit..

- With regard to the seasonality of collateral requirements, it is expected that more collateral will be required in winter months.

- Industry asked as to the potential for a hidden funding constraint if letters of credit are secured from certain financial institutions, creating a funding problem during spikes in collateral requirements. This constraint will be considered through the consultation process.