



Department
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Supplier Obligation Institutions Expert group 13 February 2014

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Aims

To seek views on:

1. Two potential alternatives to the Supplier Obligation design
 - a. Fixed rate with reserve fund, more frequent reconciliation
 - b. Fixed rate with working capital
2. Market share used to calculate supplier liabilities

Key questions

- How frequently should reconciliation take place?
- Should both the RF size and SO rate be reforecast in-year?
- How should market share be calculated for levy reconciliation?
- How should repayment of working capital work
- How the above approaches would affect pricing and competition



1a. Fixed with reserve fund

Overview

High level description

- Counterparty forecasts the **maximum** expected reserve fund amount for each quarter of the following 12 months
- Suppliers billed for RF amount for the next quarter only, with the counterparty reforecasting and billing for the next period 3 months in advance
- Suppliers pay a lump sum at the start of each period
- Any surplus/deficit is offset between quarters
- SO levy rate remains constant (unless in-year adjustment needed)
- Any data reconciliation for previous periods is accounted for through the reserve fund

Questions

- Recognising that there is a trade off between notification and frequency of resizing what would be the right frequency: monthly, quarterly, bi-annually?
- How would suppliers price this approach into tariffs?
- Should the 12 month forecast be fixed or a rolling 12 months?
- Is it preferable to charge a fixed amount for each quarter instead of reforecasting?
- Should the SO levy rate also be reforecast for each quarter?



1a. Fixed with reserve fund

Reserve fund reconciliation

- At the end of each quarter the Counterparty makes two separate calculations to determine:
 - Suppliers' liabilities to date, comprised of:
 - What each supplier paid the Counterparty over the last quarter (SO rate and RF payment)
 - What payments were actually due over the last quarter (actual market share and CfD payments)
 - Any payment adjustments due to data reconciliation for the previous 14/28 months
 - Reserve fund payment
 - RF amount required from each supplier for the next quarter
- The surplus/deficit of each supplier's liabilities is then offset against their reserve fund requirement for the following quarter



1a. Fixed with reserve fund

Levy Reconciliation

- Any adjustments to supply data (MWh) received within the current quarter will be adjusted through daily invoices at the fixed SO rate
- Any data adjustments after the end of that quarter would be made through reserve fund adjustments, taking account of actual CfD payments, rather than the SO rate
- This total is then included in the calculation to offset liabilities against the RF lump sum payment for the following quarter
- Market share is based on aggregated supply \div total CfD payments over the whole period.



1a. Fixed with reserve fund

Market share for reserve fund

- Use last 3 months market share data to calculate RF lump sum payment
- New entrants pay towards the RF at the start of the following quarter
- Suppliers who exit the market will receive any surplus RF contributions as part of the quarterly reconciliation process

Questions

- Is the last 3 months' market share the right approach to determine the lump sum payment amount?

1b. Fixed with working capital

Overview

N.B. No decision has been made as to whether the Counterparty will be allowed to access working capital.

- Counterparty uses Government working capital instead of reserve fund to cover discrepancy between fixed rate and actual CfD payments over a defined period (e.g. 3 months, 6 months, 1 year)
- Working capital facility capped at similar level to RF (e.g. 'P95')
- Likely to charge a commercial interest rate on funds drawn down
- Suppliers invoiced for their share of funds drawn down (or paid any surplus) at end of period, with a specified period to make repayments
- Default on working capital repayments mutualised across other suppliers according to market share in the relevant period
- Counterparty likely to need ability to raise a reserve fund from suppliers in the event that working capital facility is not sufficient



1b. Fixed with working capital

Issues

1. How frequently should suppliers be invoiced for deficit / surplus?

- More frequent invoicing leads to lower 'dead money' and financing costs: surplus returned faster to suppliers / borrowing repaid more quickly
- But leads to greater uncertainty over cashflows for suppliers

2. What should the repayment terms be?

- E.g. 3 months' notice of first repayment, followed by equal monthly repayments over following 9 months (balance repaid within 12 months)
- Should suppliers have a choice over repaying early?
- Should any surplus be returned to suppliers in a lump sum?

3. Interaction with Reserve Fund

- Where the Counterparty believes the working capital cap is insufficient, should it raise additional funds by setting the levy rate higher, or asking for lump sum reserve fund payments?



1b. Fixed with working capital

Overall assessment

- Believe working capital could reduce ‘dead money’ and financing costs of current proposal or fixed with quarterly reserve fund
- Potentially reduces impact on small suppliers, as gives them longer to make repayments
- But has a fiscal impact (on public sector net debt) and potentially exposes Exchequer funds to risk

Question

- How would this affect your pricing of CfD payments into tariffs?
- Would you seek to collect any deficit / repay surplus in following year’s tariffs?



Cross-cutting issue

Market share under a fixed rate

- Under the existing unit cost fixed rate proposal, suppliers are liable for their share of annual CfD payments according to their annual market share
- An alternative would be to calculate suppliers' liability according to their market share of CfD payments on daily or half-hourly basis
- Pros:
 - Clearer link between the economic event (CfD generation) and supplier liability
 - Makes the supplier obligation a better hedge against electricity costs in the wholesale market, potentially reducing risk premium
- Cons:
 - Potentially leads to perverse incentives (e.g. to supply less when CfD generation is higher)
 - Potentially leads to greater uncertainty over individual supplier's liabilities (as it introduces another variable – daily market share)