

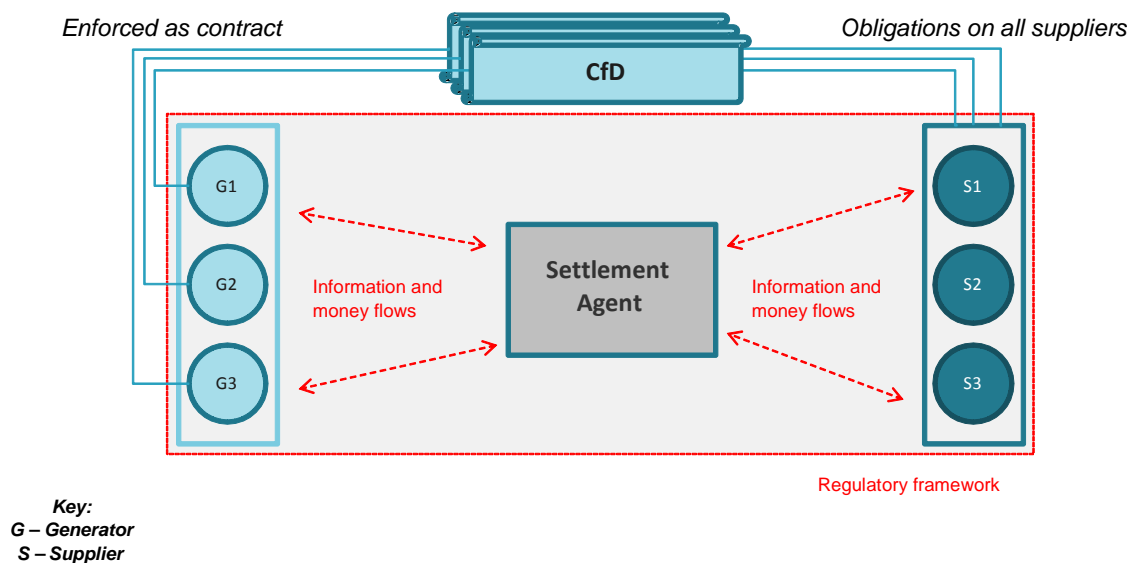
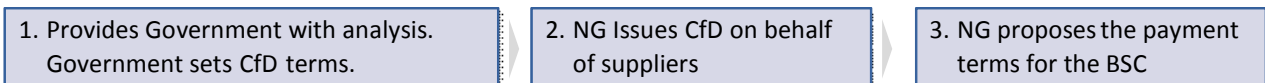
Electricity Market Reform (EMR)

Alternative Payment Model for Contracts for Difference

1. The Government published its draft Energy Bill on 22 May. Alongside this it also published a draft operational framework for Contracts for Difference (CfDs) – the feed-in tariff that will provide increased revenue certainty to low-carbon generators.
2. The CfD legal and payment framework (the “payment model”) describes how CfD payments will flow from suppliers to generators when the CfD strike price is higher than the reference price and vice versa. It also determines what happens when payments do not flow as expected (i.e. in a dispute). The model outlined in the draft operational framework and Bill reflects our current preferred option and has the following characteristics:
 - the CfD will be an instrument created by statute setting out the obligations on a low carbon generator and suppliers
 - on one side is the generator who has applied for a CfD; on the other side are all licensed suppliers who will have payment obligations imposed upon them
 - the generic terms of the CfD are set out in regulations while the project specific instrument is issued by National Grid as the EMR delivery body
 - a settlement agent, Elexon, would settle the CfD payments within this framework through the Balancing and Settlement Code.

Figure 1: Payment model as reflected in May publications

The System Operator (National Grid) as the EMR Delivery Body:

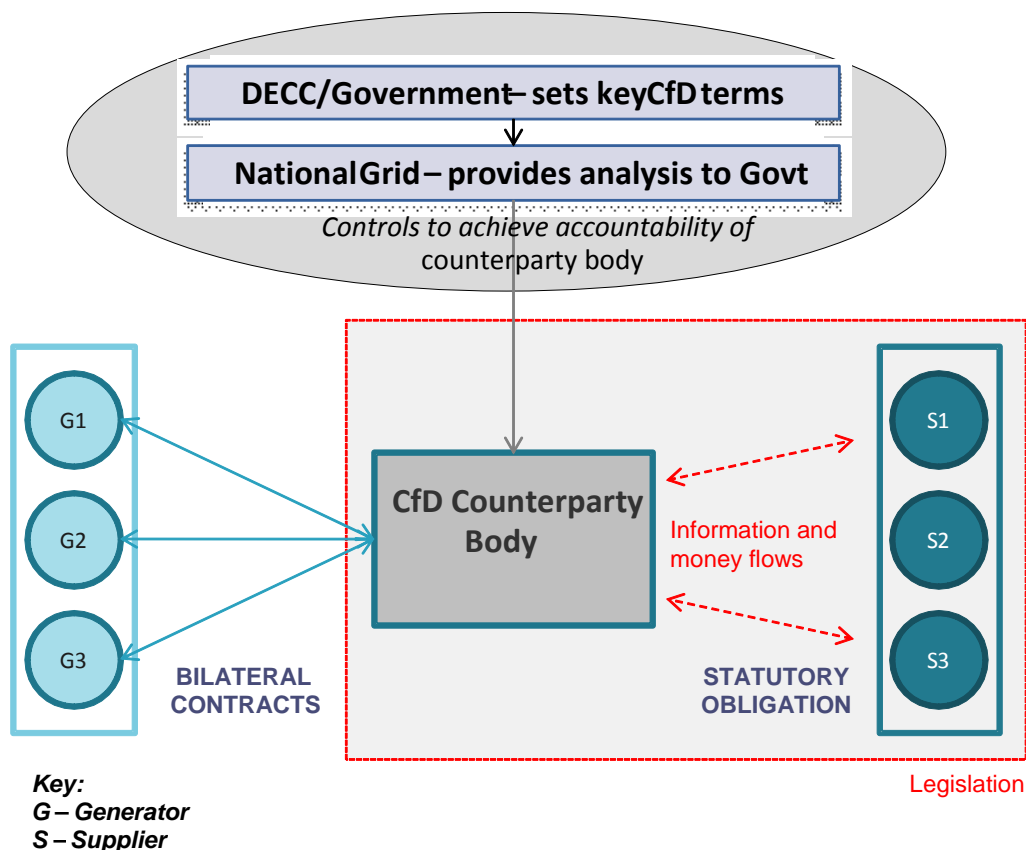


3. Whilst we believe that this model is robust and will meet the needs of Government and industry, the Government recognises that industry has concerns about this model and has suggested an alternative. We are seriously considering this.
4. This note provides a brief outline to the Energy and Climate Change Select Committee on the issues we have been exploring in relation to an alternative model with a single counterparty, and would welcome any comments as part of the pre-legislative scrutiny process on the draft Energy Bill.
5. This document is for discussion purposes only and does not constitute an intention to change the existing payment model. A decision on whether to switch payment model will be made by the autumn.

The Alternative Model

6. Government, in consultation with industry, has been exploring the merits of an alternative model with the following key features:
 - the presence of a central counterparty who would sign bilateral CfD contracts with low-carbon generators
 - the central counterparty would collect payments from suppliers to fund payments to generators.

Figure 2: Alternative model



7. In assessing this model, we have been considering three issues in particular:

- a) the creation of a new body to act as counterparty
- b) how to ensure appropriate controls and accountability
- c) funding of the CfD.

(a) Creation of a new body to act as counterparty

8. As part of this new alternative model, a body would be needed (the “Counterparty Body”) to act as counterparty to the CfD with generators. It would likely need to be a new body and there would be a variety of different options for ownership, both Government and privately owned.

9. One model we have been exploring is to set up the Counterparty Body as a UK private company limited by shares, that would be “remote” from the owner (whose balance sheet would be protected) and be able to outsource relevant functions (such as payment calculations) to Elexon. It could alternatively be a Government owned body.

10. Key considerations that we have been exploring include:

- the relative merits of a privately-owned versus a Government-owned Counterparty Body
- potential accounting implications for the owner of the Counterparty Body
- potential classification of the Counterparty Body e.g. as a public body.

(b) How to ensure appropriate controls and accountability

11. If we were to create a new body with the power to raise money from suppliers and make payments to generators, it is important that we understand the roles and functions for Government, National Grid (as EMR delivery body) and the Counterparty Body. Government would need to ensure consumers’ interests are protected, as the costs of the CfD will be funded by an obligation on suppliers and will be controlled through the levy control framework. Thus our expectation is that Government would need to retain controls over whether or not CfDs were entered into and on what terms, and would also need to control certain changes to a CfD (in particular where those changes could have a material impact on consumers). Such controls may require legislation.

12. The Counterparty Body is likely to be a largely administrative body that processes and settles payments.

13. Key issues that we are considering include:

- what the Counterparty Body must account for e.g. performance, CfD payments, money raised from suppliers, running costs etc.

- who the Counterparty Body would be accountable to e.g. Government, National Grid (as EMR Delivery Body), its owner etc.
- what controls Government should have over the Counterparty Body e.g. issuing of CfDs, changes to contract terms, enforcement etc.
- what controls National Grid should have over the Counterparty Body e.g. directing it to sign CfDs
- how controls are placed on the Counterparty Body.

(c) Funding of the CfD

14. Under the alternative model we would anticipate imposing a statutory obligation on suppliers, perhaps by licence conditions enforceable by Ofgem, to make payments to the Counterparty Body which relate to the terms of the CfD. Payments would be collected on a back-to-back settlement basis based on the CfD terms and charged to the suppliers on their market share of supply in the given period. In order to mitigate against defaults and unsecured losses, the obligation would require suppliers to post collateral to cover any liabilities in a given period, with any unsecured losses mutualised across all suppliers subject to the obligation.
15. The process in which the settlement between suppliers and generators is carried out may be similar to the current model published by the Government on 22 May, utilising the Balancing and Settlement Code mechanisms. Key issues that we are considering include:
 - how Government will ensure the Counterparty Body is accountable for the revenues raised under the supplier obligation
 - the impact of the obligation on suppliers, administratively and financially.