



Department for
Business, Energy
& Industrial Strategy

LOW CARBON CONTRACTS COMPANY AND ELECTRICITY SETTLEMENTS COMPANY OPERATIONAL COSTS 2017/18

Consultation on the operational cost levies



October 2016

The consultation can be found on GOV.UK:

<https://www.gov.uk/government/consultations/low-carbon-contracts-company-and-electricity-settlements-company-operational-costs-201718-consultation-on-the-operational-cost-levies>

© Crown copyright 2016

You may re-use this information (not including logos) free of charge in any format or medium, under the terms of the Open Government Licence.

To view this licence, visit www.nationalarchives.gov.uk/doc/open-government-licence/ or write to the Information Policy Team, The National Archives, Kew, London TW9 4DU, or email: psi@nationalarchives.gsi.gov.uk

Any enquiries regarding this publication should be sent to us at LCCC-ESCOperationalcosts@beis.gov.uk

Contents

General information	1
Purpose of this consultation	1
How to respond	1
Confidentiality and data protection	2
Quality assurance	2
Introduction	3
Budget proposals for the Low Carbon Contracts Company and Electricity Settlements Company	3
Consultation questions	4
What happens next?	4
Part 1: Low Carbon Contracts Company and Electricity Settlements Company operational costs – background information	5
Overview	5
Company functions	5
Governance	6
The Operational Cost Levies	7
Key assumptions underpinning cost estimates	9
Part 2: The companies' estimated costs for 2017/18	10
Low Carbon Contracts Company	10
Electricity Settlements Company	17

General information

Purpose of this consultation

This consultation document seeks views on the proposed 2017/18¹ operational cost budgets and resulting levies for the Low Carbon Contracts Company (LCCC) and the Electricity Settlements Company (ESC).

Issued: 28 October 2016

Respond by: 25 November 2016

This is a short consultation period due to the limited and focussed nature of the material to be reviewed.

Enquiries to:

Fiona Reynolds/Sally Comber
LCCC/ESC Shareholder Team – Clean Electricity Directorate
Department for Business, Energy & Industrial Strategy
Fourth Floor Area E
3 Whitehall Place
London, SW1A 2AW

Tel: 0300 068 6113/2814

Email: LCCC-ESCooperationalcosts@beis.gov.uk

Territorial extent:

This consultation applies throughout Great Britain.

How to respond

You are invited to respond to this consultation either by email to our official mailbox LCCC-ESCooperationalcosts@beis.gov.uk or by post to:

Fiona Reynolds
LCCC/ESC Shareholder Team – Clean Electricity Directorate
Department for Business, Energy & Industrial Strategy
Fourth Floor Area E
3 Whitehall Place
London, SW1A 2AW

¹ 1 April 2017 - 31 March 2018

Your response will be most useful if it is framed in direct response to the questions posed, though further comments and evidence are also welcome. If you have any comments on the operational cost budgets and levies as set out in this document it would be helpful if you could provide supporting analysis to explain your position, where appropriate.

Additional copies:

You may make copies of this document without seeking permission. An electronic version can be found at <https://www.gov.uk/government/consultations/low-carbon-contracts-company-and-electricity-settlements-company-operational-costs-201718-consultation-on-the-operational-cost-levies>.

Other versions of the document in Braille, large print or audio-cassette are available on request.

Confidentiality and data protection

Information provided in response to this consultation, including personal information, may be subject to publication or disclosure in accordance with the access to information legislation (primarily the Freedom of Information Act 2000, the Data Protection Act 1998 and the Environmental Information Regulations 2004).

If you want information that you provide to be treated as confidential please say so clearly in writing when you send your response to the consultation. It would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded by us as a confidentiality request.

We will summarise responses and confirm the outcome of the consultation in the Government response, which will be published on the [GOV.UK website](#). The Government response will include a list of organisations that responded but not people's personal names, addresses or other contact details.

Quality assurance

This consultation has been carried out in accordance with the [Government's Consultation Principles](#).

If you have any complaints about the consultation process (as opposed to comments about the issues which are the subject of the consultation) please address them to:

Email: enquiries@beis.gov.uk

Introduction

Budget proposals for the Low Carbon Contracts Company and Electricity Settlements Company

1. This consultation document seeks views on the proposed 2017/18 operational cost budgets and resulting levies for the Low Carbon Contracts Company (LCCC) and the Electricity Settlements Company (ESC).
2. The operational costs of LCCC and ESC are recovered through levies on electricity suppliers as set out in legislation (the Regulations^{2, 3}). In line with the Energy Act 2013⁴, we are consulting before making any regulations to amend the levies for 2017/18.
3. The levies proposed for 2017/18 are based on estimated operating costs (including applicable depreciation) of £14.788m for LCCC and £6.241m for ESC. The proposed levy to be set for LCCC is £0.0524/MWh, taking into account estimated electricity demand for the levy year. The total estimated operational costs for ESC will be set out in the relevant legislation and collected from electricity suppliers in proportion to the electricity they supply during the relevant period.
4. We estimate that the total impact of LCCC and ESC costs on household electricity bills to be around £0.20 in 2017/18 (at 2016 prices)⁵, which equates to around 0.04% of an average household electricity bill.
5. Part 1 of this consultation document sets out LCCC's and ESC's functions and describes their governance structures, the assumptions underlying the operational costs budgets, and the timing for collecting the levies. Part 1 is for information purposes only; it is not the subject of this consultation.
6. Part 2 of this document sets out LCCC's estimated operating costs for 2017/18 and electricity demand in Great Britain over the same period (the levy year). These estimates allow a £/MWh levy rate to be calculated for inclusion in the relevant legislation. Part 2 also sets out ESC's estimated operating costs for 2017/18.

² Regulation 23 of the Contracts for Difference (Electricity Supplier Obligations) Regulations 2014 (as amended).

³ Regulation 9 of the Electricity Capacity (Supplier Payment etc.) Regulations 2014 (as amended).

⁴ The Energy Act 2013 http://www.legislation.gov.uk/ukpga/2013/32/pdfs/ukpga_20130032_en.pdf

⁵ The bill impact of LCCC and ESC operational costs is estimated by assuming that such costs faced by electricity suppliers are spread evenly across electricity sales. This provides a £/MWh cost which is multiplied by estimated average household consumption to calculate the bill figure, in this case, of around £0.20.

7. A list of consultation questions is set out below and responses are invited from all interested parties by 25 November 2016. Details on how to respond can be found on page 1.

Consultation questions

Consultation questions	
1	Do you have any comments on LCCC's estimated operational costs as set out in this consultation document?
2	Do you have any comments on the forecast electricity demand from which the £/MWh levy rate for LCCC is derived?
3	Do you have any comments on ESC's estimated operational costs as set out in this consultation document?

What happens next?

8. We will analyse responses and address any issues raised in a Government response to the consultation, which we plan to publish by early 2017. We will then amend the relevant legislation to reflect the new levy rates for 2017/18.
9. If there is a material increase to the total estimated operational costs of LCCC and ESC between the publication of this consultation document and the laying of regulations in Parliament, we will publish an amendment to this document. In these circumstances, responses will be required by the latest of either two weeks from publication of the amended consultation, or by the original closure date. Should there be minor adjustments to the budget during consultation or as a result of the consultation process these will be outlined in the Government response.

Part 1: Low Carbon Contracts Company and Electricity Settlements Company operational costs – background information

Overview

10. LCCC and ESC were established in 2014 to help deliver the Capacity Market and Contracts for Difference (CFDs), which are designed to incentivise the significant investment required in our electricity infrastructure to keep energy supplies secure, affordable and to help meet our climate change targets. The key functions of each Company are outlined below:

Company functions

11. LCCC, as counterparty to CFDs (including the Investment Contracts which have been transferred to LCCC⁶), enters into and manages the contracts with low carbon generators and is responsible for payments thereunder. During 2017/18, it will have particular responsibility for:
 - setting the quarterly supplier obligation interim levy rate and total reserve amount;
 - collecting the operational cost and supplier obligation levies, the total reserve amount and the suppliers' collateral payments;
 - managing payments under the supplier obligation reconciliation process;
 - dealing with requests for minor and necessary modifications to CFDs pre-allocation;
 - signing and managing CFDs through their key contract milestones and handling any contract disputes that arise;
 - managing the Hinkley Point C nuclear CFD to ensure it meets all compliance and reporting requirements;
 - supporting the ongoing review and development of existing and future CFD standard terms and conditions;
 - supporting ongoing CFD consultations concerning potential changes to settlement activities, CFD structures and any other related regulations;

⁶ Investment contracts, which have been transferred to LCCC, are treated by virtue of regulation 2(4) of the Contracts for Difference (Electricity Supplier Obligations) Regulations 2014 as CFDs for various purposes. Any reference to a CFD in this document is to be treated as including any such Investment Contracts.

- providing projections for future quarterly supplier obligation interim levy rates and total reserve amounts and cash utilisation via the Transparency Tool;
 - metering verification of any private network generators that have been allocated a CFD;
 - approval and ongoing monitoring of Fuel Monitoring, Sampling and Sustainability proposals for relevant CFD holders;
 - making payments to generators under CFDs; and
 - continuing to provide services to ESC, which will be reimbursed at cost.
12. ESC is responsible for financial transactions relating to the Capacity Market, including making capacity payments to capacity providers, controlling collateral and managing auction bid bonds. In 2017/18, it has particular responsibility for:
- securing credit cover and payments from electricity suppliers to support capacity payments;
 - payments to Demand Side Response (DSR) providers who were successful in the Transitional Arrangements Auction and subsequently met the required meter assurance criteria. The auction capacity secured pre-metering assurance amounted to 803MW for the delivery year starting 1 October 2016;
 - payments to capacity providers successful in the 2016/17 capacity auctions which are expected to secure around 70GW of capacity with a delivery year starting 1 October 2017;
 - managing the collection, holding, monitoring and, where appropriate, refund of credit cover collected from auction applicants;
 - verifying the meter arrangements of those providers whose capacity agreement is conditional on the company approving their meter configuration;
 - delivering revisions to the Capacity Market settlement system to reflect policy and rule changes, ensuring continued correct processing of transactions; and
 - supporting ongoing Capacity Market consultations concerning potential changes to settlement activities and any other related regulations.

Governance

13. LCCC and ESC are private limited companies wholly-owned by the Secretary of State for Energy and Climate Change⁷. The Companies have day-to-day operational independence, subject to certain limited exceptions which require shareholder

⁷ Following machinery of Government changes, the Secretary of State for Business, Energy and Industrial Strategy will become the Shareholder of LCCC and ESC when a Transfer of Functions Order comes into force on 9 November 2016.

consent. The relationship between the Companies and the shareholder is set out in separate Framework Documents⁸.

14. Both documents also contain a guiding principle. This requires that, in carrying out its activities, LCCC should seek to maintain investor confidence in the CFD regime and ESC should seek to maintain market participants' confidence in the Capacity Market settlement processes. The guiding principle also requires both companies to minimise costs to consumers.
15. As Government-owned companies, LCCC and ESC are subject to the Government's framework for managing public money⁹.
16. The Accounting Officer (AO) of the Department for Business, Energy and Industrial Strategy (BEIS) is accountable to Parliament for the performance of the two companies alongside the Chief Executive Officer of LCCC and ESC, who is the AO for these companies. Two Shareholder Representative Directors sit on the Board of both companies.

The Operational Cost Levies

17. The operational cost levies of LCCC and ESC have been designed so that the methodology of payment calculation and the frequency of payment are consistent with the principal supplier obligations for the CFD regime and the Capacity Market.

Low Carbon Contracts Company

18. The operational cost levy rate is calculated by dividing LCCC's proposed annual budget by the total forecast electricity demand for 2017/18, as set out in Part 2 below.
19. The operational cost levy will be collected alongside the principal supplier obligation (the interim levy) in the same daily invoice using the same settlement system. The Settlement Service Provider (EMR Settlements Ltd, a wholly-owned subsidiary of Elexon) will administer the collection process on LCCC's behalf.
20. Since the levy rate is based on estimates of LCCC's operating costs and the overall electricity supplied in the corresponding period, the amount collected is unlikely to match actual expenditure. Any surplus recorded at year-end will be reimbursed to suppliers¹⁰. In the event of a forecast deficit, Government will in the first instance

⁸ The Framework Documents are published on the Companies' website – see <https://www.lowcarboncontracts.uk/corporate-governance>. The LCCC document is available at <https://www.lowcarboncontracts.uk/sites/default/files/publications/Low%20Carbon%20Contracts%20Company%20Framework%20Document%20-%20August%202014%20-%20Signed.pdf> and the ESC document is available at: <https://www.lowcarboncontracts.uk/sites/default/files/publications/Electricity%20Settlements%20Company%20Framework%20Document%20-%20August%202014%20-%20Signed.pdf>

⁹ Available at: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/454191/Managing_Public_Money_AA_v2_-jan15.pdf

¹⁰ Contracts for Difference (Supplier Obligation) Regulations 2014

require LCCC to manage its costs within its own budget, including re-prioritising spend where possible. Government may also increase the levy rate in-year if there is a significant discrepancy between projected levy income and estimated expenditure which LCCC can justify but cannot manage. To do so, it would be necessary first to consult publicly, as any change to the levy rate would require amending legislation. Where appropriate, and solely at its discretion, BEIS can provide the Company with grant-in-aid to cover any levy deficit or unplanned expenditure.

Electricity Settlements Company

21. The total amount levied on suppliers will be equal to the budget included in the Electricity Capacity (Supplier Payment etc.) Regulations 2014, as amended. Operational costs will be budgeted, and the levy set, for the period April to March even though the principal levy will be based on Capacity Market delivery years, which run from October to September. Initially the amount charged to suppliers will be proportionate to their share of the total electricity supplied during the previous winter's 'period of high demand' (between 4 and 7pm on working days between November and February), reflecting the approach taken for the main Capacity Market supplier charge¹¹. This levy will then be revised to reflect actual supply data relating to the same 'period of high demand' for the current levy period (in this case November 2017 to February 2018).
22. The operational cost levy will be collected on a monthly basis, with the Settlement Service Provider administering the collection process on behalf of ESC.
23. In the event that the total amount of levy collected exceeds ESC's actual operational costs, the surplus at year-end will be reimbursed to suppliers. As with LCCC, where there is a deficit, Government will in the first instance require ESC to manage its costs from within its own budget, including re-prioritising spend where necessary. Government may also seek to increase the levy in-year if there is a significant discrepancy between projected levy income and estimated expenditure which ESC can justify but cannot manage. Again, it would be necessary to consult on, and obtain Parliamentary approval for, any change in the levy. Where appropriate, and solely at its discretion, BEIS can provide the company with grant-in-aid to cover any levy deficit or unplanned expenditure.
24. Operational expenditure data for both LCCC and ESC is published in their annual accounts, which are audited by the National Audit Office and made available on the Companies' website¹².

¹¹ BEIS will be consulting separately on proposals to amend the Electricity Capacity (Supplier Payments etc.) Regulations 2014 so that the Capacity Market supplier charge and ESC's operational cost levy are collected based on gross, instead of net electricity demand.

¹² The 2015/16 Annual Report and Accounts are available at:
<https://lowcarboncontracts.uk/sites/default/files/LCCC%20Annual%20Report%202015-16.PDF> and
<https://lowcarboncontracts.uk/sites/default/files/ESC%20Annual%20Report%202015-16.PDF>

Key assumptions underpinning cost estimates

25. The cost estimates presented in this consultation document are underpinned by a number of assumptions, which are subject to some uncertainty. In setting the budget, a balance must be struck between ensuring that the companies have sufficient resources to perform their role effectively, while minimising:
- the risk of over collection (notwithstanding that any surplus will be reimbursed to suppliers); and
 - the uncertainty that could be caused for suppliers by the need to change the levy rate in-year.

LCCC assumptions

26. LCCC currently manages 39 CFDs to which it is a direct counterparty (including the nuclear CFD for Hinkley Point C). In addition, LCCC manages a further CFD under an Agency Agreement on behalf of BEIS who is the counterparty until the contract is transferred to LCCC.
27. The proposed budget includes some provision to manage additional CFDs that would result from further CFD allocation rounds.

ESC assumptions

28. ESC will continue to make payments to DSR providers successful in the January 2016 Transitional Auction and will commence payment to the higher number of capacity providers with significantly larger capacity agreements with a delivery year from 1 October 2017. It will also control the collection and monitoring of increasing levels of collateral required from suppliers and manage the collection and repayment, as necessary, of applicant auction bid bonds.
29. As the number of auctions and applicants continue to increase there will be an increase in meter assurance activity required to support payments to capacity and DSR providers.

Part 2: The companies' estimated costs for 2017/18

Low Carbon Contracts Company

30. The total estimated budget for the Low Carbon Contracts Company for 2017/18 is £14.788m, representing a £0.381m increase on the £14.407m budget for 2016/17. The increase to the budget relates to the estimated cost of software upgrades necessary to enable the settlement system to reflect planned policy and contractual changes to CFDs. This is different to the treatment of the one-off capital cost of developing and building a settlement system where, in accordance with HM Treasury guidance, BEIS's initial investment is being recovered through the inclusion of annual depreciation charges to the levy. Expensing rather than capitalising software upgrades will result in costs being recovered in one year rather than over five years, but the overall cost to suppliers will be the same.
31. Other than the settlement system software costs, LCCC's operational cost budget is lower than for 2016/17. The Company has achieved net efficiency savings of 4%, which include a 10% reduction in its settlement operations costs and other efficiency savings across its core support service functions, primarily IT. At the same time, partly offsetting these savings, professional services and technical support fees have increased. This is due to the support expected to be required to manage the Hinkley Point C nuclear CFD and renewables CFD activities, which is explained in more detail at paragraph 38. A breakdown of the total estimated operational costs for 2017/18 is provided in Table 1, together with comparative figures for the 2016/17 budget.

Table 1:

Description	Estimated costs - 2017/18	Budgeted costs - 2016/17
	£000s	
Premises costs	425	386
Payroll costs	5,862	5,465
Settlement costs	2,760	3,089
Settlement System - software upgrades	455	-
IT and telephony costs	672	1,066
Professional and legal fees	3,623	3,032
Contractors	467	475
Insurance	434	525
Other costs	1,064	1,282
Depreciation	654	794
Recharge to ESC	(1,628)	(1,707)
Total	14,788	14,407

Premises costs

32. Government policy is that, where possible, existing Government estate should be used by public sector bodies rather than entering into new leases for property. For this reason, LCCC continues to be based at Fleetbank House, Blackfriars, where it rents accommodation from BEIS. The total cost of the rental agreement is £35k per month, which is inclusive of rent, council tax and service charge (which includes heating, water and power supply). The cost of the rental agreement has increased from £32k per month in 2016/17, primarily due to increases in utility costs and an expected increase in rates resulting from the London rateable value review for businesses. Dilapidation costs were capitalised in 2014/15 and are being depreciated over the term of the lease. Depreciation is therefore charged over a five-year period from 2014/15 to 2019/20 with the annual depreciation charge being included within the operational costs levy.

Payroll costs

33. Based on an average of 53 employees plus 7 Board members, estimated payroll costs for 2017/18 are £5.862m. These costs include gross salary payments, National

Insurance contributions, pensions, bonuses, benefits, payroll outsourcing costs and recruitment costs, a breakdown of which is included in Table 2. Estimated payroll costs are £0.397m higher than those budgeted for in 2016/17, reflecting an increase of two employees and an increase in average payroll costs per employee. Whilst LCCC is classified as a public sector organisation, its staff are not Civil Servants and so they have separate terms and conditions, pay and benefit packages.

34. The Company's organisational structure has been designed to ensure that LCCC has the optimal structure for undertaking expected operational activities at least cost. Senior salaries have been benchmarked against organisations carrying out similar activities and against other relevant Government arm's length bodies. The salaries of senior executives are published in LCCC's annual report and accounts and, where those salaries are £150k and above, they will also be published online by the Cabinet Office in the interests of transparency. In accordance with Government rules, any pay that is above the Prime Minister's salary is cleared by BEIS Ministers and, where such pay relates to Ministerial Board appointments, it is cleared additionally by HM Treasury Ministers.

Table 2:

Description	Estimated costs - 2017/18 £000s
Gross salary costs ¹³	4,216
Employers' National Insurance	570
Employee benefits ¹⁴ , bonus ¹⁵ and pension ¹⁶	865
Recruitment costs	202
Payroll outsourcing	9
Total payroll costs	5,862

Settlement costs

35. The operational costs of the Settlement Service Provider have been estimated at £2.760m for 2017/18 and are set out in Table 3 below. These relate to the daily

¹³ Includes Board costs.

¹⁴ Includes life assurance, private medical cover, personal accident and income protection insurance.

¹⁵ The amount budgeted is based on bonuses of up to 20% salary for Executive Directors, up to 15% for senior managers and up to 10% for other staff, if all staff achieve a bonus. Bonus payments will be subject to staff meeting agreed performance criteria.

¹⁶ The pension employer contribution rate is 10%.

collection of the operational cost levy and principal supplier obligation and making payments to generators under CFDs. In addition, the audit and assurance costs outlined in the table include the costs for the provision of meter verification services for any private network generators that may be offered a CFD. Meter assurance services will be undertaken by the Settlement Services Provider as Metering Agent with their subcontractor, Siemens, as part of a new three-year service contract which was signed in August 2016.

Table 3:

Description	Estimated costs - 2017/18 £000s
Elxon support and related costs	1,070
Settlement operational costs (including infrastructure, licences and maintenance support)	1,395
Audit and assurance	295
Total settlement costs	2,760

Settlement system – software upgrades

36. The expenditure planned for 2017/18 is estimated at £0.455m and principally relates to software upgrades that will be needed to reflect planned policy changes. These changes are designed to improve the efficiency of the CFD supplier obligation mechanism and reduce costs to consumers, and have been subject to separate consultation¹⁷. The budget also includes a small provision for essential maintenance.

IT and telephony costs

37. Total IT and telephony costs for 2017/18 are estimated at £0.672m. Operational IT and telephony costs are incurred for the provision of web hosting, support and maintenance of IT infrastructure and end user equipment, as well as the ongoing running and support costs for fixed and mobile telephony. During 2016/17, LCCC migrated provision of its IT infrastructure to an independent service provider. The 2017/18 operational costs are based on the new service model (including new hosting infrastructure, storage and server rationalisation), which has resulted in substantial savings in the ongoing IT support and maintenance costs.

¹⁷ Available at: <https://www.gov.uk/government/consultations/contracts-for-difference-supplier-obligation-improving-efficiency-transparency>

Professional and legal fees and contractors

38. The total cost of professional and legal fees, together with contractor costs, has been estimated at £4.090m. Costs associated with professional services, legal fees and technical advice are incurred to support effective management of CFDs and other compliance activity (see Table 4). These estimated costs, which are greater than the £3.507m budgeted for in 2016/17, include the expected additional cost of undertaking compliance and reporting requirements relating to management of the Hinkley Point C nuclear CFD. In addition, as LCCC has gained further experience of managing individual and generic CFDs, it has increased its estimates of the resources required to manage them, with each project requiring a different level of project-specific analysis and, on occasion, specialist technology, technical, financial or other expertise. This expertise is essential in supporting decision-making which delivers value for money for consumers for e.g. avoiding making overpayment on CFDs. LCCC's current approach to procuring external technical and professional advice, instead of having more of its own in-house resources, allows it to access the required support only when it is needed. The Company will, however, continue to review its needs in this area and to assess whether it is more cost-effective to recruit some of this expertise in-house.
39. The audit, assurance and compliance costs include the costs of external auditors, third party quality assurance on LCCC's business critical systems and activities (such as the Supplier Obligation Forecasting Model) and costs to support fraud prevention activity.

Table 4:

Description	Estimated costs - 2017/18 £000s
Professional services	1,245
Legal fees	1,000
Technical advice	945
Audit, assurance and compliance	335
Fuel monitoring, sustainability, metering	98
Contractors	467
Total professional fees and contractor costs	4,090

Insurance

40. Insurance is procured on a commercial basis, using an insurance broker engaged under the Crown Procurement framework. The costs reflect the statutory insurances required by the Company as well as insurance that any commercial organisation

would typically have in place. The level of cover reflects the activity that LCCC expects to be undertaking in 2017/18.

Other costs

41. Other costs include stakeholder engagement and communications, training, travel and subsistence, printing and stationery.
42. As LCCC's operational cost levy is based on a £/MWh rate, its levy funding will vary with the amount of electricity actually supplied. A £0.5m contingency is therefore included (under 'other costs') to cover any reduction in volume of electricity supplied (e.g. due to warm weather). The contingency has been set, in monetary terms, at the same level as in the 2016/17 operational cost budget and will allow for a 3.5% reduction between forecast and actual electricity supplied. LCCC's utilisation of this contingency will be monitored by BEIS. Access to this contingency should avoid the need for any in-year operational cost levy rate increase relating to this specific risk or any other circumstances when an increase would otherwise have been justified.

Depreciation

43. BEIS will continue to provide grant-in-aid to LCCC to fund capital expenditure planned for 2017/18. This is estimated at £0.041m and relates to the replacement of IT hardware. Expected annual depreciation charges of £0.654m are included in the operational cost budget. These charges relate to the assets LCCC has purchased using funding initially provided by the Department, such as the IT hardware and the development and build of the settlement system for CFDs. The cash collected through the levy for depreciation will be repaid to BEIS in accordance with the relevant grant-in-aid arrangements.

Electricity Settlements Company cost recharge

44. To maximise efficiencies in the operation of LCCC and ESC, it was decided that ESC, rather than being developed independently, would contribute at cost for its use of shared facilities, back-office functions and the staff it requires for its corporate functions and operational activities. The contribution of £1.628m that LCCC expects to apportion to ESC is netted off against LCCC's estimated budget, see Table 1. The recharge agreement is explained in more detail under ESC costs (see paragraphs 52-54).

Low Carbon Contracts Company levy rate

45. LCCC's operational cost levy is calculated on the basis of a gross electricity demand projection. For 2017/18, LCCC expects to use a projected gross demand of 282.40 TWh to calculate the levy rate. This forecast of gross electricity demand is based on a dedicated forecast model developed by LCCC. The model uses statistical techniques taking into account trends in electricity demand and embedded generation¹⁸; it also considers the long-term variability of weather. As the basis of calculating gross demand has changed from the National Grid's Indicated Out-Turn (INDO) forecast with adjustments, to a forecast modelled by LCCC for levy-setting purposes, the

¹⁸ Embedded generation is generation that is connected to the distribution network rather than the transmission grid.

forecast is currently subject to independent assurance. If, as a result of that assurance, the forecast and resultant levy rate are revised, this will be explained in the Government response to this consultation.

46. Based on estimated costs of £14.788m and the forecast electricity supply of 282.40 TWh, the operational cost levy rate will be £0.0524/MWh for 2017/18.

Consultation questions	
1	Do you have any comments on LCCC's estimated operational costs as set out in this consultation document?
2	Do you have any comments on the forecast electricity demand from which the £/MWh levy rate for LCCC is derived?

Electricity Settlements Company

47. The total estimated operational costs budget for the Electricity Settlements Company for 2017/18 is £6.241m, which represents an increase of £1.958m on the 2016/17 budget of £4.283m. In a similar way to LCCC (see paragraph 30), the budget increase is due to the estimated cost of software upgrades necessary to enable the settlement system to deal with changes to the Capacity Market (see paragraphs 50-51). This is different to the treatment of the one-off capital cost of developing and building a settlement system where, in accordance with HM Treasury guidance, BEIS's initial investment is being recovered through the inclusion of annual depreciation charges included in the levy. Expensing rather than capitalising software upgrades will result in costs being recovered in one year rather than over five years, but the overall cost to suppliers will be the same.
48. Other than the settlement system programme costs, ESC's operational cost budget is lower than for 2016/17. ESC's operational costs budget includes a proportion of the total efficiency savings of 4% to be delivered by LCCC, which is reflected in the reduced recharge from LCCC. These efficiency savings are, partly offset by higher costs associated with increased meter assurance activity, which are charged by the Settlement Service Provider and included as 'settlement costs' in the budget. A breakdown of operational costs is shown in table 5.

Table 5:

Description	Estimated costs - 2017/18	Budgeted costs - 2016/17
	£000s	£000s
Settlement costs	1,702	1,552
Settlement system - software upgrades	2,045	-
Low Carbon Contracts Company cost recharge	1,628	1,707
Insurance	79	99
Other costs	280	365
Depreciation	507	560
Total	6,241	4,283

Settlement costs

49. The costs of the Settlement Service Provider, as set out in Table 6, reflect the estimated cost of:

- administering and monitoring bid bonds and collateral;
- making payments in respect of Transitional Arrangement auctions and Capacity Market auctions;
- collecting ESC's operational cost levy for 2017/18;
- audit and assurance, including the verification of meter arrangements for providers whose capacity agreements are conditional on ESC approving their metering configuration and external audit costs for the operational settlement services.

Meter assurance services will be undertaken by the Settlement Services Provider as Metering Agent with their subcontractor, Siemens, as part of a new three-year service contract which was signed in August 2016.

Table 6:

Description	Estimated costs - 2017/18 £000s
Elexon support staff and related costs	814
Settlement operational costs (including infrastructure, licences and maintenance support)	407
Audit and assurance	481
Total settlement costs	1,702

Settlement system – software upgrades

50. The budget includes £2.045m to fund software upgrades for the settlement system expected to be required for 2017/18. These upgrades include revisions to the system required to bring it in line with agreed changes to the Capacity Market regulatory framework such as volume reallocation, changes to monthly and annual penalty caps, additional credit cover requirements and component management for individual Capacity Market Units, as well as including essential maintenance updates. The regulatory changes¹⁹ have been made following separate BEIS consultations²⁰.

¹⁹ Capacity Market (Amendment) Rules 2016; Capacity Market (Amendment)(No. 2) Rules 2016; The Electricity Capacity (Amendment) Regulations 2016

²⁰ Copies of consultation documents and Government responses available at:
<https://www.gov.uk/government/consultations/2015-consultation-on-capacity-market-supplementary-design-proposals-and-changes-to-the-rules-and-regulations>
<https://www.gov.uk/government/consultations/consultation-on-reforms-to-the-capacity-market-march-2016>

51. In addition, BEIS is considering making further amendments to the Capacity Market regulatory framework in order to simplify it and provide further clarification and transparency in some key areas, such as state aid cumulation. If these changes, which are subject to consultation²¹, are taken forward it will cost an estimated £0.7m. These costs have been included within the 2017/18 budget. If the proposed changes are not taken forward in 2017/18, or the costs have been overestimated and the surplus levy is not required for other purposes, it will be repaid to suppliers in the normal course.

Low Carbon Contracts Company cost recharge

52. In order to reduce costs as far as possible, ESC will continue to share services and back-office functions with LCCC and so has no employees of its own. Under this arrangement, ESC pays LCCC to provide the functions it requires. This cost is based on an estimate of the time LCCC employees will spend on ESC activities during the levy year, together with an appropriate allocation of overhead costs (including rent, service charges, IT infrastructure and telephony support). For core systems which are shared between LCCC and ESC, and where the capital expenditure has been initially funded through LCCC, a charge for the use of these assets will be made to ESC based on a notional depreciation charge. The recharged costs also include a proportion of corporate service costs, legal and professional fees, and the salaries of the Board members (who divide their time between the two companies). Although LCCC undertakes corporate activities on behalf of ESC, the ESC Board retains responsibility and accountability for the quality and cost of services provided.
53. This approach avoids ESC replicating functions that LCCC already has in place. LCCC must therefore have sufficient capacity in 2017/18 to ensure ESC has the necessary resources to perform all of its functions in relation to the Capacity Market and fulfil its purpose and activities under the shareholder framework document and the relevant legislation.
54. For 2017/18 LCCC and ESC have agreed a recharge of £1.628m, which will be payable by ESC in monthly instalments. In general, this amount will remain fixed and will not be subject to amendment. However, if actual costs prove to be materially in excess of the estimated costs, LCCC will be entitled to amend the level of recharge accordingly. If costs prove to be materially less than estimated, resulting in actual cost savings to LCCC, the amount payable by ESC would be reduced accordingly.

Insurance

55. Insurance is procured on a commercial basis, using an insurance broker engaged under the Crown Procurement framework. The costs reflect the statutory insurances required by the Company as well as insurance that any commercial organisation

²¹ Consultation on state aid cumulation: <https://www.gov.uk/government/publications/selective-overcompensation-in-the-capacity-market>

A further consultation on the Capacity Market: proposals to simplify and improve accessibility in future capacity auctions, is expected to be launched by the end of October.

would typically have in place. The level of cover reflects the activity that ESC expects to be undertaking in 2017/18.

Other costs

56. In addition to the above, there are a number of other directly charged costs which ESC will incur. These relate primarily to the annual audit fee for the completion of the statutory annual report, stakeholder management and ESC-specific assurance activity.

Depreciation

57. Any levy that is collected to cover depreciation charges will be paid to BEIS in the year that it is collected. The levy proposed in this consultation includes £0.507m for ESC-specific depreciation, which relates to the development and build of the Capacity Market settlement system funded by BEIS in previous years.

Consultation question

- | | |
|---|---|
| 3 | Do you have any comments on ESC's estimated operational costs as set out in this consultation document? |
|---|---|

