Department for
Business, Energy
& Industrial Strategy

Contracts for Difference for Low Carbon Electricity Generation

Proposed changes to the Electricity Supplier Obligation Regulations in response to COVID-19: government response

June 2020

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Executive Summary

This document sets out the Government's response to the consultation published on 12 May that included proposals to mitigate the impact on electricity suppliers of the increased costs of the Contracts for Difference (CfD) scheme, as a result of measures introduced to reduce the spread of COVID-19.

The Government proposed deferring part of the amount of the increase in suppliers' obligations that would otherwise be collected by the Low Carbon Contracts Company (LCCC) for the current (the second) quarter of 2020 to the first quarter of 2021.

Following the consultation, the Government confirms that we will:

- protect suppliers from 80% of the increase in suppliers' obligations (up to the maximum loan amount of £100m) in the second quarter of 2020, higher than the 67% that we had proposed;
- amend the Contracts for Difference (Electricity Supplier Obligations) Regulations 2014 ("the ESO Regulations") to:
    - defer the increase in suppliers' obligations by an additional quarter, so that the total level of the obligation will be increased in Q2 2021 rather than in Q1;
    - calculate the reduction in suppliers' obligations for the current quarter based on their market share over this quarter;
    - calculate the increase in suppliers' obligations for the future quarter on the basis of their market share over that quarter;
    - enable the LCCC to repay the loan that BEIS is providing; and
    - allow the LCCC to consider anticipated receipt or repayment of a government loan when setting the interim levy rate (ILR) and/or the total reserve amount (TRA) for a quarter or making in-period adjustments.

The amended ESO Regulations were laid on 4 June in anticipation that Parliament can approve them before 9 July (the date on which we currently expect LCCC to carry out the reconciliation process for the current quarter). If Parliament does not approve them before the date on which LCCC carries out the reconciliation exercise, we would still provide the loan facility to LCCC, but suppliers' obligations for CfD payments in this quarter would be unchanged. Suppliers may therefore have to pay a higher lump sum to LCCC following the reconciliation process in July. Should it become clear that there is a short delay to the regulations coming into force, LCCC can delay the Q2 reconciliation process for a short time to accommodate this.

The LCCC has committed to provide a weekly update through the transparency tool on its website on the projected shortfall in levy payments collected from suppliers against payments to CfD generators.

List of acronyms

Acronym	
BEIS	Department for Business, Energy and Industrial Strategy
CfD	Contract for Difference
ESO	Electricity Supplier Obligations
ILR	Interim Levy Rate
LCCC	Low Carbon Contracts Company
Q1	1 January – 31 March
Q2	1 April – 30 June
Q3	1 July – 30 September
Q4	1 October – 31 December
TRA	Total Reserve Amount

Introduction

The Government published a consultation on 12 May setting out proposals to defer part of the amount of the increase in suppliers' obligations that would otherwise be collected by LCCC for the current (the second) quarter of 2020 to the first quarter of 2021.

The change would be implemented by amending the Contracts for Difference (Electricity Supplier Obligation) Regulations 2014 to change the way that suppliers' obligations are calculated and the ILR is set, to reflect and recover the government loan used by the LCCC to make CfD payments in the quarter.

The consultation closed on 19 May. BEIS held a webinar on 15 May to explain the proposals to stakeholders and how they could be implemented.

In total, 22 consultation responses were received from a range of interested parties including electricity suppliers and generators, business customers, consumer representatives and individuals. Respondents are listed in Annex A.

Determining the loan amount

The consultation explained that the Government intended to protect suppliers from around two thirds (67%) of the increase in CfD supplier obligation costs relating to Q2, up to a £100m cap. We estimated that this would allow us to provide 67% protection in the majority of possible shortfall or downside scenarios (i.e. up to 75 percentile). We considered that providing protection from only a proportion of these additional costs was appropriate, given that not all the additional costs can be directly attributed to the current situation. Some of the fall in wholesale prices preceded the measures introduced to combat COVID-19 and will have been related to more general patterns in global commodity prices as well as other factors.

Summary of responses

Although we did not seek views on it specifically, seven suppliers who responded to this part of the consultation suggested that Government should provide protection for a higher proportion of additional costs. Five of these argued that COVID-19 was responsible for 80-90% of the increase in costs, and two proposed that suppliers should be fully protected.

Government response

The Government remains of the view that suppliers should share some of the additional costs relating to COVID-19. However, we have considered the evidence presented by respondents, in conjunction with updated information from LCCC, and agree that around 80% of the additional costs expected could be related to measures taken to combat COVID-19.

At the time of writing, the LCCC is projecting[1] a gap between payments to CfD generators and ILR receipts from suppliers relating to Q2 2020 of c.£99m. As we are now in the last month of the quarter, there is increased certainty that the shortfall will fall at the lower end of previous probabilistic forecasts. This means that it is possible to protect suppliers from 80% of the forecast shortfall in the 'base case' scenario without hitting the £100m cap.

We have decided therefore to increase the level of protection from the 67% set out in the consultation to 80%.

We confirm that the LCCC will use the process set out in the consultation paper to determine the exact amount by which suppliers' obligations relating to Q2 will be reduced as part of the reconciliation exercise for Q2 2020, expected to be carried out in early July. See Annex B for a worked example.

The LCCC will continue to closely monitor demand and will publish updated online tracking as part of its CfD dashboards, which will include regularly updated actuals and forward estimates of the likely amount of the shortfall after the forecast loan amount has been applied and, where necessary, any potential reconciliation amounts due in July, as the quarter progresses.

[1] The LCCC has committed to provide a weekly update on the projected shortfall. See the "In-Period Tracking" dashboard on the LCCC website: www.lowcarboncontracts.uk/index.php/dashboards/cfd/levy-dashboards/in-period-tracking

Three respondents proposed that the Government should be prepared to also intervene in the next (third) quarter. However, we remain of the view, as set out in the consultation document, that the most significant pressure is expected to be in the current quarter, where the increase in costs was not forecast ahead of time. Furthermore, at the time of writing LCCC does not envisage that it will need to increase the ILR for Q3 2020 but will be monitoring this position very closely and the need for any changes will be clearly signalled to the market.

The Government reiterates, therefore, that the loan and deferral of the increase in suppliers' obligations relating to the current quarter (Q2 2020) is a one-off intervention, and we do not currently envisage providing similar support in future quarters.

The terms and conditions and arrangements for applying and managing the loan will be reflected in a separate agreement between BEIS and LCCC.

Proposed changes to Regulations

The Government's consultation set out proposals to amend the ESO Regulations to enable:

- a reduction in each supplier's obligations for the period in which government provides funding that can be used to pay CfD generators, by the amount of government funding provided in proportion to each supplier's market share over the quarter in which the funding was provided;
- an increase in all suppliers' obligations by the same amount three quarters later, to enable repayment of the government loan; the obligation for each supplier operating in that quarter would be increased in proportion to their market share over the quarter;
- LCCC to take into account anticipated receipt or repayment of government loan when setting the ILR for a quarter or making in-period adjustments; and
- LCCC to repay the government loan using monies collected from suppliers after the reconciliation process following the relevant period (the ESO Regulations currently only allow LCCC to use money collected from suppliers through the ILR or TRA to pay generators or suppliers).

Although the principal objective of the amendments was to reduce suppliers' obligations in Q2 2020 and increase them in Q1 2021, we proposed that they should be drafted in a way that the same mechanism could be used in future quarters if necessary. However, we also made clear that the loan was intended to be a one-off response to the current exceptional, unforeseen circumstances, and the fact that the amendments would remain in force should not be taken as any indication of the Government's intention to provide any additional support going forwards.

Summary of responses to the consultation

Reducing suppliers' obligations for CfD payments

We proposed that the level of each supplier's obligation relating to the quarter should be reduced in proportion to its market share (of eligible demand) over the quarter. This approach can be implemented using existing functionality in the LCCC's settlement system.

Consultation question

> **Do you agree with the proposed method for calculating the reduction in suppliers' obligations by the amount of the government loan provided to the LCCC to make CfD payments?**

Summary of responses

No responses disagreed with the proposal to reduce each supplier's obligation in the current quarter in proportion to its market share. Three responses noted that deferring the costs to a later quarter may reduce the risk of supplier failures in the short term but could materially increase the risk of suppliers failing at a later date meaning the remaining suppliers would face higher mutualisation costs as a result. Three responses suggested that Ofgem should monitor suppliers closely during this period. One response recommended that if a supplier exits the market before obligations are increased, that supplier's 'share' of the loan for the current quarter should not be mutualised across the other suppliers but should be covered by the Government.

Government response

The Government confirms that it will amend the ESO Regulations to implement the reduction in suppliers' obligations as proposed in the consultation.

Delaying payment to 2021 should reduce the risk of supplier insolvency by improving their longer-term financial position. For clarity, although each supplier will have its obligation for the current quarter reduced in proportion to its market share, individual suppliers will not be responsible or liable for repaying a 'share' of the government loan to the LCCC. Instead, the aggregate reduction in those obligations in the current quarter will be added to the total amount paid by suppliers in the later quarter. The mutualisation process will remain the same.

Increasing suppliers' future obligations for CfD payments

We proposed taking the same approach in calculating the increase in suppliers' obligations in a future quarter to allow repayment of the government loan. Suppliers' obligations would be increased for the third quarter after the quarter in which the obligations had been reduced, by the amount of the government loan used in the earlier quarter. The increased obligation would apply to all suppliers operating in the future quarter not just those operating during the quarter in which the obligation was reduced.

This approach would give suppliers a high level of confidence over the additional cost that they will incur for each MWh supplied in Q1 2021, as this amount will be determined and announced in July 2020, enabling them to price this into tariffs in advance with minimal cost risk.

Consultation question

Do you agree with the proposed method for calculating the increase in suppliers' future obligations to enable the LCCC to repay the government loan?

Summary of responses

Of the 15 responses that specifically commented on the method for calculating the increase in supplier's obligations, 12 said the obligation should be increased in line with the supplier's market share in the quarter when the loan is recovered, rather than the market share in the current quarter. Three responses disagreed, arguing that it would be more equitable and would not penalise small- and medium-sized suppliers who expect to grow their market shares if it was based on market share for the quarter in which suppliers' obligations were reduced. They argued that market shares for the current quarter will be known shortly, which avoids introducing uncertainty and gives suppliers time to adjust tariffs to repay a fixed amount. Two responses suggested that it should be paid back over several quarters, rather than in a single quarter.

Of the 17 responses that commented on the timing of the increase in supplier's obligations, nine argued that the increase should be deferred until (at least) Q2 2021, not Q1 2021 as we had proposed. Seven responses agreed it should be deferred to Q1 21. One response proposed including a review clause so the clawback of loan payments could be further deferred if the economic conditions were not suitable for this to take place in Q1 2021. Another suggested that the choice of quarter in which the loan repayment is to be made by the LCCC should be left as a matter for the Government's discretion. Several reasons were given for preferring Q2 21, but the main ones were that it could:

- Avoid the need for retailers to increase prices over the winter, in anticipation of the higher ILR that will include repayment of the loan, which would be better for customers.
- Put less pressure on suppliers' finances, as suppliers will be exiting the winter months in Q1 and may be in a weaker cash position than at other times in the year.
- Minimise the impact of seasonality distortions on market share and therefore be more equitable. Typically, domestic suppliers and customers see a greater increase in energy usage over the winter than business suppliers and customers, where usage tends to be less prone to seasonal variation. Displacing the incremental cost of the increase from Q2 volumes to Q1 volumes might lead inadvertently to a cross-subsidy between different market segments.
- Ensure the increased costs expected to be recovered through the ILR in future periods could be fully reflected in potential future energy retail price caps (as would be determined by Ofgem for 2021/22) according to existing price cap level calculation methodologies. Deferral until Q2 2021 (the first quarter of the next financial year) would ensure the reform was consistent with full recovery in the relevant financial year, and potentially reduce the potential for a disincentive for suppliers to act as a Supplier of Last Resort.
- Align with when the operational costs levy for 2021/22 comes into effect.

One response argued that suppliers should have sufficient time over the coming months to make appropriate provisions for the increased costs, and spreading the cost over the coming months and the higher-demand winter period (i.e. Q1 2021) would mean a lower unit rate uplift per consumer than if recouped by suppliers in lower demand quarters. Moreover, it suggested that delaying repayment beyond the proposed Q1 2021 timeframe could increase the risk of a shortfall in payments to LCCC because of supplier failures, leading to additional costs arising from mutualisation.

Government response

The Government recognises the value of greater alignment of the deferral with existing methodologies for calculating the level of retail energy price caps and confirms that it will amend the ESO Regulations to defer the increase in the suppliers' obligations by an extra quarter to Q2 2021. The obligation will now be increased in the fourth quarter after the one in which the Government funding was provided. In practice, this means that the reduction in the obligation for the current quarter (Q2 2020) will now be recovered from suppliers in Q2 2021 to align with when Ofgem will adjust the level of the price cap – in February, to apply from April, to reflect the estimated costs of supplying electricity in the six month summer period.

We also confirm that the increase in suppliers' obligations will otherwise be implemented as proposed, with the increase applying to all suppliers operating in the future quarter not just those whose obligations were previously reduced, and in proportion to their market share in that future quarter.

It is our view that it provides greater certainty and less market distortion if repayments are calculated based on future market shares, as this would mean all suppliers face the same £/MWh increase in costs and it allows them to reflect the increase in their pricing strategies.

Changes to the formula for setting the ILR

Proposal

We proposed amending the ESO Regulations to enable LCCC to consider anticipated receipt or repayment of a government loan when setting the ILR for a quarter or making in-period adjustments. This would enable LCCC to consider the increase to suppliers' obligations in Q2 2021 when setting the ILR for that quarter in December.

Consultation question

> **Do you agree with the proposal to enable LCCC to take account of anticipated receipt or repayment of a government loan when setting the ILR and when making in-period adjustments?**

Summary of responses

Of the 13 responses that commented on this part of the proposal, 11 agreed with the proposed approach. One respondent considered that, as the reason for the government loan is to prevent an in-period adjustment in the current quarter, the change should not apply to in-period adjustments in the future quarter.

While some of the responses did not comment specifically, 10 agreed with future proofing the regulations. One respondent noted that including the flexibility to respond to future market conditions in the regulations created a precedent and risked the government becoming stuck providing a rolling credit facility to bailout unsustainable suppliers. Removing the ability to repeat deferrals would mitigate against this risk, but at the expense of being able to respond in future.

Government response

The Government confirms that we will be implementing the proposal as described in the consultation paper. This means that LCCC will consider the need to collect the additional obligations offset by the loan in Q2 2020 when setting the ILR for Q2 2021. Increasing the ILR to collect the increased obligation from suppliers daily over Q2 2021 will reduce the likelihood of a higher lump sum payment at the end of the quarter. There is also value in retaining flexibility for the LCCC to take account of any future loan when setting the ILR or TRA. However, as the consultation paper also made clear, the loan is a one-off response to the current exceptional, unforeseen circumstances, and the fact that the amendments will remain in force should not be taken as any indication of the Government's intention to provide any additional support going forwards.

We have decided to amend the ESO Regulations to allow LCCC to consider anticipated receipt or repayment of a government loan when setting the TRA for a quarter or making in-period adjustments.

Other comments on the proposals

Consultation question

Do you have any other comments on the proposals?

Summary of responses

Some of the other comments on the proposals were:

- The Government, not suppliers, should cover the shortfall in supplier payments in the current quarter because of lower electricity demand, which itself is the direct result of the restrictions introduced to combat COVID-19.
- Domestic energy use has gone up since the start of lockdown, and many consumers will be facing increased energy bills and a reduced income. What impact will an increased supplier obligation have on consumers' electricity bills?
- Consideration should be given to further relief measures to protect energy intensive industries from the increase in costs when suppliers' obligations are increased in the future quarter.
- COVID-19 related bad debt because of households and business customers being unable to pay back credit that suppliers have extended to them over recent months will present a much greater pressure on suppliers.
- It only mitigates one impact of COVID-19 on the energy supply sector, and that the principle of deferral should be extended to other policy and system costs faced by

suppliers. Balancing Services Use of System (BSUoS) charges, Feed-in Tariffs (FiT), and the Capacity Market were all given as examples where suppliers' costs might be expected to increase because of COVID-19 but where suppliers would have limited ability to recover those increases from customers.

Government response

As set out in the consultation document, the Government has assessed that the impact of increased CfD costs for this period on consumer bills are likely to be very small (~0.1% of a typical domestic annual bill).

The provision of the loan to LCCC is a one-off intervention due to the unique nature of the CfD scheme, which is managed by a Government-owned counterparty that determines the levy rate in advance based on estimates of CfD generation and electricity demand.

BSUoS charges primarily relate to the balancing of Britain's electricity system and include the costs of constraining generation. These charges are for the system operator, National Grid ESO, and Ofgem as the independent regulator. We understand that the system operator has published a consultation on an urgent proposal recently raised by SSE Generation to defer the additional BSUoS costs arising from COVID-19. A final version of the proposal is scheduled to be sent in mid-June to Ofgem to decide whether it should be implemented.

In the FiT scheme, tariffs are fixed, which means overall supplier costs are mostly independent of wholesale electricity prices. Suppliers manage their own payments to generators, with the only externally administered part of the scheme being a quarterly levelisation process - which ensures that the cost of providing FiT tariffs is spread fairly between suppliers, and where some suppliers make payments and others receive payment. This means that the bulk of scheme costs has already been borne by some suppliers by the time other suppliers are required to contribute into the levelisation process. The Government does not consider that modifying this process at this stage would be practicable or desirable.

The Capacity Market (CM) is at the heart of the Government's plans for a secure and reliable electricity system. The cost of the CM is funded through the Capacity Market Supplier Charge, which is invoiced monthly to all electricity suppliers in GB according to their market share. The volume of capacity acquired in capacity auctions, and the price capacity providers are paid for their service, is known well in advance of the delivery year. Therefore, unlike CFD costs, the CM Supplier Charge is fixed and not affected by the lower wholesale electricity prices because of coronavirus.

Conclusion and next steps

BEIS has decided following the consultation to proceed with the proposals, with the limited modifications as described above.

We plan to lay amendments to the ESO Regulations in Parliament on 4 June to enable them to come into force, subject to the will of Parliament, before 9 July (the date on which we currently expect LCCC to carry out the Q2 reconciliation process). Should it become clear that there is a short delay to the regulations coming into force, LCCC can delay the Q2 reconciliation process for a short time to accommodate this.

Annex A: List of respondents

Bristol Energy

Bulb

Centrica

Citizen’s Advice

EDF

Energy UK

ENGIE

E.ON

Haven Power / Drax

Igloo Energy

Industrial and Commercial Shippers and Suppliers (ICoSS) group

Major Energy Users Council

Mineral Products Association

OVO Energy

Scottish and Southern Energy (SSE)

Scottish Power

Shell

Smartest Energy

Total Gas & Power

Welsh Government

Wessex Water

One member of the public also responded.

Annex B: Determining the loan amount - worked example

The process will operate as follows:

- The LCCC will utilise the government loan (up to the cap of £100m) to cover any shortfall in funding for CfD payments during Q2 and up to the day that reserve payments are received (in cleared funds) by LCCC in July.
- After the end of the quarter, the total loan amount that will be deemed to have been used to make CfD payments relating to the quarter (and by which suppliers' obligations would, in aggregate, be reduced), will be calculated according to the formula:
  - 0.80 x (total CfD payments in respect of Q2 minus total interim rate payments in respect of Q2)
  - Up to a maximum of £100m.

For example, at the time of writing the LCCC is projecting that CfD payments will exceed ILR payments from suppliers in respect of Q2 by c.£99.0m. Under the methodology described above, after the end of the quarter suppliers' obligations would be reduced by 0.80 x c.£99.0m = c.£79.2m, meaning they have an additional obligation of c.£19.8m (above ILR payments) for Q2. This would be deducted from the £78.3m in TRA already paid for Q2, meaning suppliers would be due a reconciliation payment of c.£58.5m in respect of Q2, which would be netted off the £77.0m TRA for Q3 (making a net payment from suppliers of c.£18.5m for Q3).

The final figure will be calculated by LCCC as part of the reconciliation process in July, at the start of Q3. It will be based on LCCC's estimates of the total CfD payments and interim rate payments in respect of the quarter (note that this will include payments due but not yet made) at the date the reconciliation process takes place, and will not be adjusted in future reconciliations for Q2 (although suppliers' individual obligations will continue to be adjusted as revised meter data becomes available, according to the process set out in the regulations).

This means that the total amount of government loan provided to the LCCC for the current quarter will be based in part on estimates, as final metered data for generation and supply will not be available for all days in the quarter at the date of reconciliation. However, we would not expect material changes in the overall level of CfD payments or interim rate payments because of further reconciliations.

The original consultation and this response are available from:

www.gov.uk/government/consultations/contracts-for-difference-proposed-changes-to-the-electricity-supplier-obligation-regulations-in-response-to-covid-19

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