DEPARTMENT OF
ENERGY
& CLIMATE CHANGE

Charles Hendry MP

Minister of State

Department of Energy & Climate Change
3 Whitehall Place
London
SW1A 2AW

www.decc.gov.uk

Tim Yeo Esq MP
Chair, Energy and Climate Change Committee
House of Commons
7 Millbank
SW1A 3JA

16 May 2012

Dear Tim,

Following my appearance on 15th May at the Energy and Climate Change Select Committee on *Building new nuclear: the challenges ahead*, I thought it would be helpful to set out how we see the payment and legal framework model for Contracts for Difference working under a reformed electricity market given that this is a key concern for industry.

I want to stress that our overriding objective is to design a system that gives investors confidence in the system such that they are willing to invest in low-carbon generation supported by CfDs. Alongside that, the design of the payment and legal framework and mechanics of the CfD also has to balance a number of considerations, as follows:

- Providing appropriate accountability to Ministers. In the near term, decisions on the low carbon supply mix will ultimately reflect the policy objectives of Government;
- Complying with EU guidelines on state aid;
- Ensuring no adverse liabilities are encountered by suppliers, low-carbon generators or Government and safeguarding the public finances;
- Administering the CfD in a practical and efficient manner, drawing on existing systems where possible.

My officials have been working with industry to understand the concerns that have been raised on the legal and payment framework. Whilst we believe that the model we will propose can meet them, we recognise the strength of feeling on this issue and wish to continue to take the thoughts of industry and yourselves on our proposals. You will be aware that we intend to publish more details on our proposals shortly, including a draft Energy Bill that will undergo pre-legislative scrutiny, and I welcome this as an opportunity to do so. I am therefore including detail on what we intend to publish below, and will expect to return to these issues with you over the coming weeks.

Background

Our proposed model is that the CfD will be an instrument created by statute, which sets out obligations of the parties to it. On one side is the generator, who has applied for a CfD. On the other side is all licensed suppliers, who will have obligations imposed upon them (which is similar to how the Renewables Obligation operates). The main obligation is expected to be to make payments on the basis of the difference between a reference price and a strike price; with other obligations to facilitate the administration of this.

Whilst the generic terms of the CFD will be set out in regulations, each project will be issued with a specific instrument by the System Operator (National Grid).

Once a CfD has been issued it will effectively require suppliers to meet their share of the obligations to the generator as set out under the CfD terms (or receive payments should the generator be 'paying-back'). A supplier's share of the obligations will be determined by their market share, defined by metered use. Suppliers are likely to be able to pass the costs of the mechanism through to consumers. Payments under the CfD will be administered by a settlement agent, likely to be Elexon. In effect, suppliers as a whole will act as counterparty, but the model is based on obligations put on suppliers through law rather than them being a signatory to a contract. Generators sign a CfD which is issued by the System Operator, in effect, on behalf of all suppliers.

A key risk for low carbon investors is that payments do not flow from suppliers (a form of credit risk). We believe that the credit risk under this model will be low. CfD payments flowing from suppliers to generators and vice versa will be facilitated by an agent settling payments in a manner similar to the settlement of payments under the Balancing and Settlement Code. We propose that Elexon, which is a well established and trusted organisation that manages payments under the Balancing and Settlement Code (BSC), would be able to perform this role.

To minimise credit risk for generators, payments will flow regularly and suppliers will be required to post collateral as under the Balancing and Settlement Code. This system has been highly effective in minimising the impact of supplier default. The proposed Energy Supply Company Administration Scheme will address the credit risks to generators resulting from a large supplier going into administration. Whilst the scale of any unsecured losses are therefore expected to be very low, these losses would be spread across all suppliers.

This model will also ensure accountability, as Government will retain responsibility for setting out the policy approach and objectives, and for taking final decisions on the key parameters for the System Operator [National Grid] in administering the system.

Do contact me if you or your secretariat would like any further detail on any aspects of the Electricity Market Reform programme.

Yours ever, Charles

CHARLES HENDRY