



Department  
of Energy &  
Climate Change

# Supplier Obligation Institutions Expert group 16 January 2014

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# Aims

## **To seek views on:**

- The described approach to the industry proposal for a ‘fully fixed’ levy
- Alternative approaches to a fully fixed rate levy and their viability

## **Key questions:**

- Do you agree with the design principles for the industry proposed approach?
- Of the alternative options which offers the best solution?
- Are there any other alternatives that should be considered?
- Are any of these alternatives preferable to a variable rate levy?



# 'Fully' Fixed Proposal

## High level description

- Any surplus or deficit at year end is used to offset the reserve fund/levy rate the following year
- The tax for the year is the rate set by the counterparty
- Both levy and reserve fund monies are collected as a daily £/MWh rate

## Design principles/assumptions

- There would be no levy rate reconciliation – the rate is what the counterparty set (levy rate + RF rate), subject to any in-year adjustments
- Reserve payments are carried forward collectively and set against a standard rate charged to all suppliers the following year
- Data reconciliation would continue post year end and be adjusted on invoices, using the original levy rate
- Mechanism for in-year adjustments required
- RF rate would be based on estimate of closing balance rather than actual closing balance
- May need to collect early and/or need a lump sum to cover the first quarter for the first year
- If a supplier exits the market no RF money is returned and they remain liable for any future data reconciliation



# 'Fully' Fixed Proposal (2)

## Impacts

- Suppliers will be cross subsidising years – if a new supplier enters the market in Yr2 they would benefit from a reduced rate due to the reserve built up by suppliers in Yr1
- Breaches Government tax and accounting rules:
  - Cannot offset tax across years, without there being a fiscal impact and the approach increases likelihood that the RF is a tax
  - Surplus could be classified as belonging to the counterparty and could be transferred into the consolidated fund
  - Impacts on public borrowing measurements
- Size of reserve fund would need to increase to account for uncertainty over year end balance (estimated at least 4 months before year end)
- Rate likely to be set in regulations and consulted on each year

## Questions

- Is this how you envisaged the proposal working?
- What are the significant negative impacts of this design?
- How would suppliers cost this approach into tariffs? Would the whole cost of the RF be passed through to consumers?

# Alternative Option

## More frequent RF sizing

### High level description

- Counterparty forecasts the **maximum** required for the following 12 months and divides into quarterly payments
- Suppliers billed for RF amount for the next quarter only, with the counterparty reforecasting and billing for the next period 3 months in advance

### Design principles/assumptions

- Smaller payments are made as a lump sum at the start of each quarter
- Calculation of RF requirement is made using most up to date data
- Any surplus is offset between quarters, additional surplus (above what is needed in the next quarter) is paid back to suppliers in-year
- RF reconciliation is conducted between quarters rather than years
- Payment on Account rate remains constant (unless in-year adjustment needed)
- Levy reconciliation continues on a quarterly basis post year end (as generation data is trued up)

# Alternative Option

## More frequent RF sizing (2)

### Impacts

- Overall amount collected for RF would be smaller
- Less likelihood of unexpected in-year adjustments (more accurate forecasting)
- Potentially difficult to factor into tariffs and not very transparent as amounts likely to change
- Can adapt more swiftly to market entrants and exits

### Questions

- Is this uncertainty more manageable than a yearly sizing as amounts are smaller?
- 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?

# Alternative Option

## £/MWh yearly reserve fund reconciliation

### High level description

- The reserve fund is collected through a £/MWh rate
- Any surplus in individual reserve fund accounts at year end is used to offset the amount of RF owed by each individual supplier for the following year. The levy rate is not offset.

### Design principles/assumptions

- Total RF is calculated for the year as per current proposals and converted into a £/MWh rate
- This rate is applied to data reconciliation within year
- Mechanism for in-year adjustments required
- Any surplus at year end is only offset against reserve fund for the following year and not the levy rate. Any additional balance is paid back to suppliers.
- The POA rate is adjusted as data is reconciled post-year end until the final levy rate is determined. Suppliers are invoiced against adjusted rate on a quarterly basis

# Alternative Option

## £/MWh yearly reserve fund reconciliation (2)

### Impacts

- A £/MWh rate would lead to each supplier having a different reserve fund rate the following year
- Suppliers directly exposed to levy rate adjustments for previous years
- Harder to factor into tariffs and potentially less transparent because of different RF rates
- Any end of year surplus above what could be offset against the RF rate is returned to suppliers
- Adapts more easily to new market entrants and exits
- Increased likelihood of in-year adjustments due to possibility of shortfall
- Likely that full costs of RF would be passed through to consumers

### Questions

- How are suppliers likely to pass through the costs of the reserve fund?
- How would any returned surplus be passed through to consumers?
- Do the benefits of a £/MWh rate offset the increased possibility of in-year adjustments?



# Variable Rate

## High level description

- Levy rate is 100% variable – for each settlement, the total amount due to be paid to generators is split between suppliers based on their supply over that period
- Supplier obligation payments vary with reference price and generation changes

## Design principles/assumptions

- No reserve fund required – suppliers are responsible for funding total payments as and when required
- Data reconciliation continues following BSC runs
- To reduce volatility of payments, monthly settlement may be preferable to daily (for both suppliers and generators)
- Collateral requirements likely to increase:
  - Less frequent settlement more than doubles the requirement
  - Volatility of payments means previous SO invoices may be an unreliable predictor of supplier exposure leading to need for greater collateral cover



# Summary of Options

## Options

- Fully fixed
- Fixed with more frequent reserve fund sizing
- Fixed £/MWh rate with reserve fund rollover
- Variable rate

## Questions

- Is the fully fixed option as described the preferred approach?
- If the fully fixed option cannot be implemented, which is the preferred approach between the two alternative fixed options and the variable rate?