Department of Energy & Climate Change

Government response to the CFD Counterparty and Electricity Settlements Company operational costs 2014/15 consultation

Consultation on the operational cost levies

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Introduction

The Government's Electricity Market Reform (EMR) programme aims to secure the significant investment required to replace the generation capacity closing this decade and deliver a low-carbon electricity system whilst guaranteeing security of supply. Integral to this is the introduction of Contracts for Difference (CfDs) and the Capacity Market (CM). The implementation of these two regimes will be made possible by the creation of a CFD Counterparty (the Low Carbon Contracts Company[1]) and a Capacity Market Settlement Body (the Electricity Settlements Company).

The Low Carbon Contracts Company will manage CfDs (including Investment Contracts) with generators and manage payments between suppliers and generators. The Electricity Settlements Company will be responsible for payment flows under the Capacity Market, including making capacity payments to capacity providers, controlling collateral draw-down and managing auction bid bonds and collateral.

Issues and costs consulted upon

1. Both the Low Carbon Contracts Company and the Electricity Settlements Company are to be funded by levies on electricity suppliers. As the amount of these levies[2] will be included in annually amended secondary legislation (regulations) DECC is required to publicly consult on them.
2. The consultation that this document is responding to explained and sought views on the estimated operational costs of the two companies for the period 1 August 2014 to 31 March 2015. A separate consultation will be carried out later this year before setting the budgets for 2015/16, and annually thereafter. In the future we expect to consult in autumn each year prior to asking Parliament to approve updated operational cost levies to be applied in the next levy period (April to March). This process will provide early sight to electricity suppliers of the anticipated costs for the coming year.
3. For the Low Carbon Contracts Company the operational costs proposed in the consultation were **£6,485,000** resulting in a levy rate of £0.08/MWh. For the Electricity Settlements Company operational costs proposed in the consultation document were **£1,374,000**.

[1] The name of the CFD Counterparty Company was changed on 29 April 2014 to the Low Carbon Contracts Company. For the remainder of this document and in all future publications the new name will be used.

[2] The Low Carbon Contracts Company will be using a £/MWh levy rate. The Electricity Settlements Company's operational costs budget will appear in the regulations and will be divided amongst suppliers based on their entire net demand across the levy period for the first levy period, after which it is intended to be divided according to each supplier's share of net demand between 4pm & 7pm on weekdays between November and February (inclusive) to reflect the charging methodology for the principle capacity market charge. Both operational cost levies will be charged for the period from 1 August 2014 to 31 March 2015 and collected in March 2015. The Settlement Service Provider will administer the collection process.

4. These budgets cover the periods from the respective dates of the designation of the Low Carbon Contracts Company as CFD Counterparty and the appointment of the Electricity Settlements Company as Capacity Market Settlement Body to the end of financial year 2014/15.
5. The Low Carbon Contracts Company's budget was based on assumptions and estimates as well as predetermined costs for an operating model. A large proportion of the budget is allocated to contractors, staffing and professional advice. The estimated spend within these categories relates to the complex nature of CfDs and the specialist knowledge required for minor and necessary amendments, signing, settling and administering the contracts (including setting and raising the supplier obligation levy).
6. The Electricity Settlements Company's estimated operating costs are based on the proportion of the Low Carbon Contract's Company's resources it is expected to consume. This will be funded through a cost recharge which will be collected through a separate levy. This structure is designed to ensure that costs are shared wherever possible and that the overall running costs of the two companies are reduced as far as possible.
7. In setting the budget, a balance was struck between ensuring the companies had sufficient resources to effectively perform and develop their roles as they transfer to the enduring regime, while minimising the risk of over-collecting the levies (notwithstanding that any surpluses will be reimbursed to suppliers).

Outcome of consultation

8. Following analysis of the responses to this consultation, the 2014/15 budgets for the Low Carbon Contracts Company and the Electricity Settlements Company will remain unchanged. The operational cost levy rate for the Low Carbon Contracts Company has been recalculated to take account of an updated electricity demand figure provided by National Grid and the levy rate for the Low Carbon Contracts Company that will be included in regulations will be **£0.0790/MWh**. The budget for the Electricity Settlements Company that will be included in regulations will be **£1,374,000**.
9. Bill impacts are calculated on calendar years and we anticipate the impact of both levies on household electricity bills to be around £0.05 in 2014 (August – December). The levy is only set as part of this budget until end March 2015. If we assume the costs in the remainder of 2015 are similar to the first quarter (included in the current estimate for 14/15) the annual bill impact would be around £0.15 at 2012 prices, which is less than 0.05% of average household electricity bills. We would expect similar percentage impacts for medium-sized businesses and energy-intensive users[3].

[3] The Government recently consulted on the proposal to exempt suppliers of Energy Intensive Industries from some of the costs of CfDs. The Government is considering the responses and expects to respond formally to the consultation shortly (see https://www.gov.uk/government/consultations/electricity-market-reform-contracts-for-difference-costs-exemption-eligibility).

Consultation Process

Publication and dissemination of the consultation

10. This consultation was open between 27 March 2014 and 24 April 2014 and was published on the Government website (www.gov.uk)[4]. A link to the consultation was sent to 1,543 EMR stakeholders on the day of publication including electricity generators, suppliers and consumer groups.

11. In total, nine responses were received to the consultation. Respondents included integrated energy providers, companies involved in the energy sector and major energy consumers.

Structure of the Government response

12. This Government response summarises answers to the consultation questions and sets out Government's response to them. There is also a short section that addresses other issues that were raised by respondents but which are outside the scope of the consultation.

13. The consultation included four questions on the operational costs of the Companies and the resulting levies on electricity suppliers.

14. The summary of responses focuses on the key issues and themes raised and although it does not list or comment on all of the individual points made, all of them have been analysed by Government.

[4] Whilst the consultation has now closed the consultation document is still available online here

Questions and Responses

Operational costs of the Low Carbon Contracts Company

Consultation question	5 Responses
CfD1	Do you have any comments on the costs outlined?

Summary of responses

15. Three respondents raised concerns about the levels of spend on salaries and on professional and legal fees, expressing concern that these may be too high. However, there was a shared expectation that there would be a reduction in these costs as the enduring regime settled into business as usual. Another respondent supported DECC's use of flexible resource contracts for professional services but emphasised that these would need to be balanced with the employment of permanent staff to ensure value for money. There were questions raised over how depreciation is calculated and what period capital expenditure was to be recovered over. There was one question about the new settlement systems, what they will do, why they are required and when they will come into force.

Government Response

16. The roles and responsibilities of the Low Carbon Contracts Company are outlined on page 123 of *Electricity Market Reform: Consultation on Proposals for Implementation*[5]. Information on the roles and responsibilities of the Electricity Settlements Company can be found on page 206 of the same document. The roles and responsibilities of both companies are also summarised on page 10 of the *CFD Counterparty and Electricity Settlements Company operational costs 2014/15 consultation*[6] and at sections 2.4.1.1 and 3.4.6.1 of *Implementing Electricity Market Reform: Finalised policy positions for implementation of EMR*[7].

17. As outlined in the consultation, the two companies are likely to require legal advice on different issues at different times, and as this could result in a need for fluctuating levels of legal resource, it is considered appropriate to plan to have flexible resource contracts rather than permanent staff. This will be in addition to some legal provision within the companies. DECC is aware of the importance of ensuring there is an appropriate balance between in-house and bought-in resources, and although this is a difficult area to estimate, especially because this is a start-up phase, DECC and the companies are confident the budget strikes the right balance.

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5 https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/255254/emr_consultation_implementation_proposals.pdf

6 https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/298354/CFD_Counterparty_and_Electricity_Settlements_Company_operational_costs.pdf

7 [Insert link to Implementing Electricity Market Reform: Finalised policy positions for implementation of EMR]

18. DECC also anticipates that the cost per CfD and the cost per Capacity Market participant will reduce as the enduring regime progresses. This is through the realisation of greater economies of scale and the companies becoming increasingly experienced and efficient in the delivery of their functions. However, because of increased activity and general increases in the underlying costs we expect that in the medium term the overall costs of both companies will increase in future years.

19. The current electricity settlement system cannot carry out the more complex settlement functions required for CfDs or the Capacity Market and new systems were therefore required. It was deemed more cost effective to procure the Capacity Market and CfD systems together.

20. Depreciation has been estimated in respect of assets that are expected to be purchased and used by the Low Carbon Contracts Company in the period up to 31 March 2015. Depreciation is applied on a straight line basis according to the assets' historic cost and expected life.

21. Capital Expenditure will be recovered through the operational levy over a period of time consistent with the depreciation charges applied to the relevant class of asset (expected lives will range from 3 years to 10 years).

Consultation question	5 responses
CfD2	Do you have any comments on the forecast electricity demand from which £/MWh is derived?

Summary of responses

22. The majority of respondents supported the forecast of electricity demand used to calculate the £/MWH levy rate proposed for the Low Carbon Company. However, two respondents were concerned that the estimate may be too low given their estimates show it is 4% below the lowest demands over the previous five years and 6.7% lower than the average for the same period.

Government response

23. DECC welcomes the support received for the electricity demand forecast used in calculating the £/MWh rate for the Low Carbon Contracts Company. This forecast was based on National Grid's projections of the daily electricity transmitted through their network for an equivalent period of demand.

24. The original electricity demand forecast provided by National Grid reflects ten years of growth in non-BMU, embedded generation[8] and the increase in domestic and commercial energy efficiency since 2005. Following the consultation, National Grid has provided an updated electricity demand forecast using the latest available data which has resulted in a revised forecast of **82,108,398 MWh[9]**. This is following the downward revision of next winter's underlying demand levels.

25. The levy rate for 2014/15 that will be included in Regulations will be £0.0790/MWh rather than £0.08/MWh. DECC has decided that the rate should be set to four decimal places rather than two to reduce the likelihood of significant under or over collection of levy payments from suppliers. This change in the levy rate does not alter the estimated

[8] This includes solar PV, small-scale wind generation and conventional biofuel plant.

[9] Previous supply estimate was **82,929,166 MWh**

impact on bills referred to in paragraph 4 and the Settlement Service Provider has confirmed that this can be implemented. The Electricity Settlement Company's levy is not affected by the revised electricity demand forecast because the agreed budget will be divided amongst suppliers based on their annualised market share of peak demand.

26. If for any reason the levy collected is less than budgeted (such as if demand is lower) Government would expect the companies to manage the budget pressure themselves. However, as we recognise that this may not always be possible we are putting appropriate arrangements in place to ensure the companies remain solvent. These include the companies' ability to request financial assistance from DECC and the access they will have to short-term working capital. Subject to parliamentary approval, Government may also increase the levy in-year should there be a material discrepancy between the expected levy income and the companies' forecast of expenditure.

Operational costs of the Electricity Settlements Company

Consultation question	5 responses
Electricity Settlements Company 1	Do you have any comments on the costs outlined?

Summary of responses

27. Respondents were content with the proposal for the two companies to share resources as outlined in the consultation document, agreeing that it was a sensible approach to minimise the overall cost of the two companies. One respondent requested greater transparency on what was included in the Settlement Service Provider costs.

28. Two respondents questioned the tasks and responsibilities of the two companies and how these would be apportioned between them.

Government response

29. All the resources required by the Electricity Settlements Company including staffing, accommodation, operating systems and back office functions will be shared with the Low Carbon Contracts Company. However, both companies will operate independently of one another with the costs being apportioned or charged to the Electricity Settlements Company by the Low Carbon Contracts Company under a cost recharge (so that they will not be collected under the CfD operational costs levy).

30. As outlined in the consultation document, transparency and scrutiny around the allocation of operational costs between the two companies will be achieved through the annual consultation, parliamentary approval process (in setting the resulting levy rates) and the publication of each company's audited annual accounts. As Government-owned companies both will also be subject to Government's framework for managing public money[10]. Additionally, the companies' operations and costs may be subjected to value for money reviews by the National Audit Office (NAO) and Public Accounts Committee (PAC).

31. The Low Carbon Contracts Company and Electricity Settlements Company will rigorously scrutinise the performance and value for money offered by all contractors and service

[10] Available at: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/212123/Managing_Public_Money_AA_v2_-_chapters_annex_web.pdf

providers that they use. The anticipated Settlement Service Provider costs in the operational cost levy include costs related to changes to the BSC and the collection of the 2014/15 levy.

Consultation question	5 responses
Electricity Settlements Company 2	Do you have any comments on the apportionment of the Electricity Settlements Company's operational costs based on market share?

Summary of responses

32. Four respondents suggested that the operational cost levies for both companies should be calculated using the same charging methodology. Three respondents recommended that both companies adopt a £/MWh model, whilst one other suggested the market-share model should be adopted by both companies.

Government response

33. The operational cost levies for both companies have been designed to mirror the main levies that they will collect for CfDs and the Capacity Market, which themselves differ. Mirroring the main levies allows the operational costs for each regime to be more easily collected, thereby streamlining the process for suppliers.

Other issues raised

Summary of responses

34. One respondent requested clarity in terms of when the Low Carbon Contracts Company's levy would be calculated and collected. The majority of respondents agreed that the levy for both companies for the 8 months to March 2015 should be collected through a single payment in March. One respondent raised the issue of whether there was sufficient clarity around the settlement systems requirements to allow these systems to be developed in time. The publication of key performance indicators relating to management by the companies of their operational costs was requested by one respondent. One respondent raised concerns regarding the companies' incentives to reduce costs.

Government response

35. The Low Carbon Contracts Company is expected to be operational from 1 August 2014 and so the operating cost levy for 2014/15 has been calculated to fund costs estimated to be incurred from that date. However, the actual levy rate has been calculated on the basis of forecast electricity demand in the 3 months to 31 March 2015, and suppliers will be obligated to pay it based on their electricity supply in this period only. This method of collection is unique to the first financial year (first operational cost period) in which the company will operate. It was designed this way to minimise the financial impact of any delays to the date at which it becomes operational.

36. System development is still underway, with ELEXON running a number of stakeholder events in conjunction with DECC and National Grid in order to confirm the requirements and design of the settlement systems.

37. The Low Carbon Contracts Company is incentivised to forecast the operational costs as accurately as possible and the Board will be held to account by the shareholder (DECC) for their accuracy for this and other areas of their performance. Government will look to the Company to manage its costs from within its levy income, including re-prioritising spend where necessary. We recognise that this may not always be possible and where appropriate Government may agree to provide the Company with additional funding, and it will be able to access working capital if necessary. Government may also increase the levy in-year if there is a significant discrepancy between the levy income and costs, but we would consult on this and seek Parliamentary approval prior to any change. If the Company's operational costs are less than income from the levy or other sources any surplus at year-end will be refunded to suppliers. As these actions could have an impact on suppliers, the company will be managed by a board whose guiding principle is expected to include the requirement to minimise costs to consumers, and its operational costs will be monitored by DECC with the Secretary of State empowered to approve or refuse the companies' budgets.

Annexes

Annex A - List of organisations that responded to the consultation

This consultation received nine responses from eight respondents, five of whom consented to the publication of their organisations' names.

EDF Energy

Elexon

Energy UK

Rail Delivery Group

RWE Npower

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