Department of Energy & Climate Change

Electricity Market Reform:

Consultation on Low Carbon Contracts Company's and Electricity Settlements Company's operational costs 2015/16

Government Response

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Introduction

Purpose of this document

1. This document sets out the Government's response to feedback received from the consultation on the proposed 2015/16 operational costs and resulting levies for the Low Carbon Contracts Company (LCCC) and the Electricity Settlements Company (ESC)[1]. It sets out the key issues raised by organisations responding to the consultation and Government's response on these points. It also provides a summary of the consultation outcome and outlines the next steps in the amendment of levy rates for the LCCC and ESC.

Consultation overview

2. The LCCC as counterparty to Contracts for Difference (CfDs), including Investment Contracts which have been transferred to them[2], manages the contracts and is responsible for payments thereunder; and the ESC is responsible for payment flows under the Capacity Market, including making capacity payments to capacity providers, and managing credit cover. The operational costs of both the LCCC and the ESC are to be funded by levies on electricity suppliers. As the amount of these levies will be revised through the amendment of secondary legislation, made under Part 2 of the Energy Act 2013, DECC is required to publicly consult on them.

3. The consultation document explained that the total operating costs (including applicable depreciation on capital expenditure) proposed to be recovered through the levies for 2015/16 are **£12,007,000** for the LCCC and **£3,891,000** for the ESC.

4. The LCCC's cost estimates presented in the consultation document are underpinned by a number of assumptions. For example, the number of CfD contracts that LCCC will manage in 2015/16 will depend on the number of successful generators coming forward in the first CfD allocation round which commenced in October 2014. The proposed budget for the LCCC was set to resource the company to manage a reasonable range of outcomes, enable efficient operation of its key activities and ensure regulatory compliance notwithstanding the volume of contracts.

5. Major elements of the LCCC's budget include payroll costs relating to the organisational structure developed to support expected operational activities and the costs of professional

[1] See https://www.gov.uk/government/consultations/low-carbon-contracts-company-and-electricity-settlements-company-operational-costs-201516

[2] Investment Contracts which have been transferred to the LCCC are treated, by virtue of the regulation Contracts for Difference (Supplier Obligation) 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.

services, legal fees and contractors required for the effective management of contracts. Another major element of the LCCC's budget is costs relating to the operational costs of the Settlement Service Provider[3], which include managing payment flows under CfDs and the provision of meter assurance activities.

6. In setting the budget for the LCCC, a balance needs to be struck between ensuring that the company has sufficient resources to perform its role effectively, whilst minimising the risk of over-collection of the operational cost levy (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 within year.

7. The ESC's operational costs include the costs of the Settlement Service Provider administering and monitoring bid bonds and collateral in advance of the Capacity Market auction and conducting meter checks for Demand Side Response. The other main element of ESC costs is the recharge that the company pays to the LCCC for activities undertaken by LCCC employees on behalf of the ESC and an appropriate allocation of overhead costs.

Publication and dissemination of the consultation

8. The consultation ran from 5 November to 3 December 2014 with the consultation document published on the Government website. On the day of publication, a news bulletin including a link to the consultation document was sent to c. 750 stakeholders, including electricity generators, suppliers and consumer groups.

9. In total, five responses were received to the consultation. Respondents included three integrated energy companies, an electricity supplier and a trade association in the energy sector: a list of organisations that responded is included at Annex A.

Outcome of the consultation

10. Three of the responses were generally supportive of the proposed budgets for the LCCC and ESC and recognised the need for the companies to be sufficiently resourced to carry out their activities effectively. The other two responses raised questions regarding specific costs, with one querying the overall level of contingency built into the budgets. Most of the responses emphasised the need for the LCCC and ESC to ensure robust processes are in place to monitor and control expenditure.

11. In considering these responses, Government has recognised that LCCC is in the process of becoming operational and that there will still be a level of uncertainty over the optimal cost base once it reaches a state of 'business as usual'. Therefore there will continue to be a need for the company to seek to deliver organisational activities as efficiently as possible. The budgets for LCCC and ESC have been prepared on a best endeavours basis and have

[3] EMR Settlement Ltd

been formally approved by the independent boards of both companies, which include members with experience across the energy sector and other commercial organisations. The Guiding Principles of the companies include a requirement to minimise costs to consumers and this is already reflected in the sharing of common resource between the LCCC and ESC. The 2015/16 budgets and resultant levy rates for the companies have been set using best available information, recognising that the forecasting of some costs will improve over time.

12. Following analysis of the responses to this consultation (see Section 1) the budgets of the LCCC and ESC will remain unchanged although the operational cost levy for the LCCC has been recalculated.

13. As set out in the consultation document, the LCCC's operational costs for 2015/16 (and the CFD Supplier Obligation) will be collected on the basis of gross electricity demand, which is a new definition that captures total demand rather than demand net of embedded generation. As the projected gross demand figure for 2015/16 was not available to allow the calculation of a levy rate on this basis for inclusion in the consultation document, a projected net demand for 2015/16 of 304,765,716[4] MWh was used to calculate the levy rate for that purpose.

14. The consultation document proposed that if updated forecasts for net demand, gross demand or a robust proxy for gross demand were available during or following the consultation, we would use the latest available projections to set the levy rate and confirm this in the Government Response to the consultation. As the LCCC has now informed us that a forecast for gross demand will not be available in time to set the 2015/16 levy rate, we have decided to set this using a proxy for gross demand to reduce the risk of over-collecting the levy. We are also using a different data source for the electricity demand forecast, which was unavailable prior to consultation, on which the levy rate will be calculated in order to be consistent with the demand data on which the supplier obligation is being calculated.

15. The updated forecast of net electricity demand is 298,800,000 MWh[5]. This is then uplifted by 4%, which is an estimate of the expected difference between gross and net demand[6], giving a proxy for gross demand of 310,752,000 MWh. The estimated demand from Electricity Intensive Industries[7] is then deducted to give the gross demand (302,252,000 MWh) used to calculate the levy rate. The resulting levy rate that will be included in regulations is **£0.0397/MWh.**

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[4] Using National Grid's 'Gone Green' scenario.
[5] This forecast electricity demand figure is based on a National Grid's Indicated Out-Turn forecast for 2015/16.
[6] Based on a study showing that historically gross demand was estimated to be 4-7% higher than the Indicated Out-Turn forecast. In the absence of a definitive alternative measurement of gross demand, the outputs of the report were considered and agreed by an industry expert group established by LCCC.
[7] To take account of expected Electricity Intensive Industry (EII) exemptions from operational cost levy payments, accessible from October 2015, a reduction has been made to the demand forecast based on estimated EII electricity usage for October 2015 - March 2016. The Department for Business, Innovation and Skills (BIS) currently estimate that 20TWh of electricity per annum will be eligible for exemption at a rate of 85%.

16. The total amount per financial year charged to electricity suppliers to fund the ESC will be specified in regulations as **£3,891,000**.

17. We anticipate the total impact of the LCCC and ESC operational costs on household electricity bills to be around £0.18 in 2015/16 (at 2014 prices) which equates to less than a 0.05% increase in average household electricity bills. We would expect similar percentage impacts for medium-sized businesses and for electricity-intensive users (except any that become exempt during 2015/16).

Structure of the Government response

18. Section One of this document summarises feedback received on each of the consultation questions and sets out Government's response to the points raised. The consultation included three questions on the operational costs of the LCCC and ESC and the resulting levies on electricity suppliers.

19. Section Two briefly addresses issues that were raised by respondents but which are outside the scope of the consultation.

20. In each section the summary of responses focuses on the key issues and themes raised. Although it does not list or comment on every point made, all of them have been analysed by Government.

Next steps

21. The Energy Act 2013[8] provides that Regulations setting the operational cost levies are subject to the 'affirmative' Parliamentary procedure, which means that any amending Regulations have to be debated and approved by Parliament before they are made. Legislation to amend the Regulations to reflect the outcome of this consultation has now been laid before Parliament along with amendments to other Electricity Market Reform regulations. The intention is that the amended Regulations will come into effect on 1 April 2015. However, if it is not possible to complete the parliamentary process for amending the Regulations before the dissolution of Parliament prior to the general election, the levies that are in force as at 1 April 2015 will continue to apply until such time as the Regulations are amended to include the new 2015/16 levies.

[8] The Energy Act (2013) http://www.legislation.gov.uk/ukpga/2013/32/pdfs/ukpga_20130032_en.pdf

Section 1: Questions and Responses

Operational costs of the Low Carbon Contracts Company

Consultation question		3 responses
1	Do you have any comments on the LCCC costs outlined?	

Summary of responses

22. One respondent questioned whether the LCCC's budget was too cautious and included greater contingency than required, including the £500k contingency proposed to ensure the company's operational costs are recovered even if electricity demand is below that forecast. There was a concern that a higher budget would lead to the LCCC's costs being higher. One respondent said that they believed the costs were proportionate and another welcomed the steps taken to promote a cost minimisation culture within the companies. One respondent commented that it was important that the budgets are sufficient to ensure the companies are able to carry out their activities effectively.

23. One respondent queried the staffing levels of LCCC for 2015/16 and the basis on which bonuses would be paid in relation to delivery of the company's functions. Another respondent thought that DECC had changed its position on whether depreciation costs relating to capital expenditure would be recovered through the operational cost levy of the LCCC.

Government response

24. The LCCC's Board has agreed that the company will operate in accordance with its Guiding Principle as set out in its Framework Document[9] . The Guiding Principle requires LCCC, in carrying out its functions (as set out in the Framework Document), to seek to maintain investor confidence in the CfD regime and minimise costs to consumers.

25. To comply with the Guiding Principle the company needs to find a balance between ensuring that it is adequately resourced through its operational budget to carry out its functions effectively, whilst not over-estimating its costs. Particularly, when forecasting its resource needs for its first full operational year, this is not simple to achieve.

26. If the company were to under-estimate its operating costs this could result in the operational cost levy rate initially being set too low and then needing to be increased in-year, causing

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[9] See https://lowcarboncontracts.uk/system/files/Low%20Carbon%20Contracts%20Company%20Framework%20Document%20-%20August%202014%20-%20Signed.pdf

uncertainty over costs for electricity suppliers. The Board of the LCCC considers that, in the circumstances, it has achieved the right balance.

27. The LCCC is already taking action to minimise costs to consumers. Where possible use of facilities, resources and common costs (e.g. IT infrastructure) are being shared by both LCCC and ESC and the companies are using Government estate premises and existing infrastructure. The LCCC has put in place rigorous internal spending controls. Public procurement frameworks are also used where appropriate to minimise third party costs and the companies have reassessed the split of in-house activity versus use of third party consultancy providers to support internal projects and making the processes of the companies operational.

28. The £500k contingency included in the LCCC budget will be ring-fenced and only be used by the company to deal with a deficit in levy income caused by electricity supplied being lower than estimated. This will be reflected in relevant agreements between DECC and the Company. At year-end, surplus funds from the contingency will be returned to suppliers by the company in the same way as any other underspend against the LCCC's operational budget.

29. The organisational structure of the LCCC has been developed to support its expected operational activities at least cost. Whilst the company expects to procure additional resources during the year, for example, for professional services (such as audit, assurance and compliance) and legal services it does require some in-house resource in the relevant areas to undertake regular and routine work, and to commission and quality assure the bought-in expertise required.

30. Similarly, although the Settlement Service Provider will undertake billing and invoicing activities relating to payment and settlement under the CfD regime, the LCCC requires in-house forecasting and analyst resources to undertake work such as setting of the interim Supplier Obligation rate and the reserve fund rates and providing on-going cash flow management and monitoring. Regardless of the number of CfDs that LCCC does manage in 2015/16 there is a base level of staff resources that will be required to support the company's operational processes and to ensure regulatory compliance.

31. The 41 staff expected to be in post during 2015/16 will undertake activities relating to both the LCCC and ESC with an estimate of time that employees spend on ESC activities and an appropriate allocation of overhead costs included in the LCCC recharge to ESC.

32. A priority for both the LCCC and ESC has been to recruit and retain key individuals with the right skills at the level that is required to deliver both companies' functions, which include, amongst other things:

- forecasting the levy rate and reserve fund;
- managing Investment Contracts and CfDs worth tens of billions of pounds;

- managing payment flows under both the CfD and Capacity Market regimes, including making capacity payments to capacity providers, providing investment funding for low carbon generators, and managing credit cover.

33. Senior staff remuneration packages have been benchmarked against current competitive market rates and are consistent with packages provided by comparable organisations.

34. The bonus framework has also been approved by the independent board of directors of both companies. It is important to note that bonuses will only be awarded on the basis of targeted performance criteria being achieved. A Remuneration Committee (to be chaired by a Non-Executive Director) will oversee all salary and bonus awards and judge the award of bonuses against Key Performance Indicators. These performance indicators will be approved by the Board on which Government is represented.

35. The consultation document for the LCCC's and ESC's 2014/15 operational costs stated that DECC would fund all costs of the LCCC[10] up to 1 August 2014 and the set-up costs of the LCCC's CfD settlement system to 31 March 2015. DECC has maintained this position, which means depreciation charges are not being recovered through the levy for capital expenditure incurred on LCCC's settlement system in 2014/15. Capital expenditure (including settlement system updates or changes to the system in response to policy development) will continue to be funded by DECC as a grant in aid capital loan, but will be recovered through the levy, with amounts received being repayable to DECC in accordance with HM Treasury's policies on managing public money.

36. The 2015-16 operational cost budget for LCCC includes £499k for depreciation, of which £107k relates to capital expenditure in 2015/16 and the remainder to non-settlement system capital expenditure in 2014/15 (e.g. for IT systems and premises costs).

Consultation question		**3 responses**
2	Do you have any comments on the forecast electricity demand from which the £/MWh levy rate is derived?	

Summary of responses

37. One respondent suggested that the forecast net electricity demand figure used in the consultation document to calculate the LCCC's operational cost levy rate represented the lower end of possible forecasts. They commented that this would result in an inflated £/MWh levy rate, given that the levy rate is calculated by dividing the total operational cost budget by forecast electricity demand in MWh. The respondent queried the use of National Grid's 'Gone Green' scenario as the basis for the forecast and the amount deducted from the forecast to take account of expected Electricity Intensive Industry exemptions from

[10] Then referred to as the CFD Counterparty.

operational costs, accessible from October 2015. Another respondent, while supportive of using net demand data, queried whether the £500k contingency for differences in supply in addition to using net demand resulted in excess contingency.

Government response

38. Following consideration of the consultation responses, the Government is using National Grid's Indicated Out-Turn (INDO) forecast rather than its 'Gone Green' scenario to provide the forecast of net electricity demand needed to calculate a proxy of gross electricity demand for calculating the LCCC's operational levy rate (see paragraph 40). Using the INDO forecast means that the operational cost levy for the LCCC is set using the same data that is used to set the Supplier Obligation interim levy rate, which provides a consistent approach to levy calculation.

39. The Government is aiming to commence the exemption of Electricity Intensive Industries from the indirect costs of CfDs from October 2015, subject to state aid approval. While there may be some staggering of certificates, we would expect that the majority of certificates will be in place shortly after the commencement of the scheme.

40. In order to address the risk of over-collection of the operational cost levy as a result of using net demand data and as there is a proxy for demand data available, we have concluded that it would be appropriate to base the levy rate on a proxy of gross demand. The proxy is an updated forecast for net electricity demand of 298,800,000[11],[12] MWh uplifted by 4% (an estimate of the expected difference between gross and net demand), from which a deduction has been made for estimated demand from eligible Electricity Intensive Industries.

41. As set out at paragraph 28, the LCCC will only use the £500k contingency funds it needs to deal with a levy income deficit caused by electricity supplied being lower than estimated, and any surplus at the year-end will be returned to suppliers.

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[11] This forecast electricity demand figure is based on a National Grid's Indicated Out-Turn forecast for 2015/16.
[12] To take account of expected EII exemptions from operational cost levy payments, accessible from October 2015, a reduction has been made to the demand forecast based on estimated EII electricity usage for October 2015 - March 2016. BIS currently estimate that 20 TWh of electricity per annum will be eligible for exemption at a rate of 85%, so the gross demand figure has been reduced by 8,500,000 MWh (85% of 10 TWh) to take this into account.

Operational costs of the Electricity Settlements Company

Consultation question		3 responses
3	Do you have any comments on the ESC costs outlined?	

Summary of Responses

42. One respondent raised similar concerns for the ESC as were raised for LCCC on the budget being too cautious and including greater contingency than required. Another respondent supported ESC sharing common resources with LCCC and the steps being taken to promote a cost minimisation culture in the companies. One respondent commented that it was important to ensure that the budgets are sufficient to ensure the companies are able to carry out their activities effectively.

Government response

43. As outlined in response to Question 1, the ESC's Board has agreed that the company will operate in accordance with its Guiding Principle as set out in its Framework Document[13] which includes minimising costs to consumers. In addition, the approach of LCCC providing services to ESC results in efficient use of common resources, therefore minimising costs.

[13] See https://electricitysettlementscompany.uk/sites/intranet2/files/general/Electricity%20Settlements%20Company%20Framework%20Document%20-%20August%202014%20-%20Signe....pdf

Section 2: Issues raised which fall outside the scope of this consultation

Summary of responses

44. Two respondents noted their expectation that the LCCC and ESC would develop robust processes, including appropriate performance indicators, to measure the effective delivery of their functions. Another respondent welcomed the transparent approach taken to the LCCC's costs. One respondent supported the development of robust processes to control and monitor the companies' expenditure.

Government response

45. Both the LCCC and ESC will report on the delivery of their functions in their annual reports. For the LCCC, key deliverables in 2015/16 will relate to management of CfDs, setting the Supplier Obligation interim rate and reserve fund payments, and managing payment and settlement of CfDs. The ESC's key deliverables will relate to conducting metering tests on capacity providers, holding and monitoring credit cover from auction applicants and finalising settlement system modules being delivered by the Settlement Service Provider in time to make the first capacity payments (from September 2016).

46. LCCC's staff will have their individual performance assessed against indicators linked to LCCC's delivery performance and, where they have undertaken activities for the ESC, additionally against that company's delivery.

Annex A: List of organisations that responded to the consultation

The following organisations responded to this consultation:

EDF Energy

E.ON

Renewable Energy Association (REA)

Scottish Power

Spark Energy

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3 Whitehall Place
London SW1A 2AW
www.gov.uk/decc
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