Department for
Business, Energy
& Industrial Strategy

Contracts for Difference for Low Carbon Electricity Generation

Consultation on proposed changes to the Electricity Supplier Obligation Regulations in response to COVID-19

Closing date: 19 May 2020

May 2020

Any enquiries regarding this publication should be sent to us at:
BEISContractsforDifference@beis.gov.uk

Contents

General information

Why we are consulting

The Low Carbon Contracts Company (LCCC) advised BEIS that as a result of lower electricity demand, resulting from measures introduced to reduce the spread of COVID-19, and higher payments to CfD generators because of lower wholesale electricity prices, electricity suppliers would have faced an unexpected increase in their obligations for the second quarter of 2020.

Therefore, in line with the Government's efforts to support the economy in the light of the COVID-19 national emergency, the Government announced on 24 April 2020 that it would provide a one-off loan to LCCC so that it can continue to pay generators without needing to increase the Interim Levy Rate at short notice. This is in response to the truly exceptional circumstances of COVID-19. It must be emphasised that we are committed to upholding the self-financing nature of levies in the energy system, and the Government cannot be relied upon to provide capital for consumer-funded energy levies in future.

The Government also announced that it intended to consult on deferring 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. This consultation seeks views from stakeholders and interested parties on this proposal.

The consultation period is shorter than usual because implementation is being taken forward as a matter of urgency. We need Parliament to approve changes to the Contracts for Difference (Electricity Supplier Obligation) Regulations 2014 ("the ESO Regulations") before 9 July (the date on which we currently expect LCCC to carry out the reconciliation process for the current quarter).

If BEIS is unable to or decides (following consultation) not to proceed with the proposal, we would still provide the loan facility to LCCC, but suppliers' obligations for CfD payments in this quarter would be unchanged. Suppliers would therefore have to pay a higher lump sum to LCCC following the reconciliation process in July. We would still amend the ESO Regulations to enable LCCC to repay the loan to BEIS.

Consultation details

Issued: 12 May 2020

Respond by: 19 May 2020

Enquiries to:

Email: BEISContractsforDifference@beis.gov.uk
Tel: 020 7215 5000

Consultation reference: Consultation on proposed changes to the Electricity Supplier Obligation Regulations in response to COVID-19

Audiences:

The Government welcomes responses from anyone with an interest in the policy area. We envisage that the consultation will be of interest to licensed electricity suppliers in Great Britain; generators; consumer groups; CfD delivery bodies and other stakeholders with an interest in the energy sector.

Territorial extent:

The CfD scheme applies to the UK but does not currently operate in Northern Ireland. This consultation therefore applies to Great Britain only.

How to respond

Respond online at: beisgovuk.citizenspace.com/clean-electricity/cfd-proposed-change-supplier-obligation-regs

or

Email to: BEISContractsforDifference@beis.gov.uk

When responding, please state whether you are responding as an individual or representing the views of an organisation. If you wish to respond but are unable to do so online because of difficulties with accessibility, please contact us on 020 7215 5000.

Your response will be most useful if it is framed in direct response to the questions posed, though further comments and evidence are also welcome.

Confidentiality and data protection

Information you provide in response to this consultation, including personal information, may be disclosed in accordance with UK legislation (the Freedom of Information Act 2000, the Data Protection Act 2018 and the Environmental Information Regulations 2004).

If you want the information that you provide to be treated as confidential please tell us but be aware that we cannot guarantee confidentiality in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not be regarded by us as a confidentiality request.

We will process your personal data in accordance with all applicable data protection laws. See our privacy policy.

We will summarise all responses and publish this summary on GOV.UK. The summary will include a list of names or organisations that responded, but not people's personal names, addresses or other contact details.

Quality assurance

This consultation has been carried out in accordance with the Government's consultation principles.

If you have any complaints about the way this consultation has been conducted, please email: beis.bru@beis.gov.uk.

List of acronyms

Acronym	
BEIS	Department for Business, Energy and Industrial Strategy
CfD	Contract for Difference
ESO	Electricity Supplier Obligation
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 CfD scheme and electricity supplier obligation

The Contracts for Difference (CfD) scheme was introduced in 2014 to incentivise renewable and low carbon electricity generation. A CfD is a private law contract between a low carbon electricity generator and the Low Carbon Contracts Company (LCCC) as the CfD Counterparty.

The LCCC is an arms-length body owned by the Secretary of State for Business, Energy and Industrial Strategy (BEIS), with an independent board. It manages the CfD contracts with generators and collects payments from licensed electricity suppliers (hereafter referred to as ’suppliers’) through an electricity supplier obligation that funds CfD payments.

Further information on the operation of the obligation is at Annex A.

Potential shortfall in funding for Quarter 2 2020

The LCCC faces a potential shortfall in the funding it has available to pay CfD generators in the current quarter. This is primarily driven by the unprecedented drop in electricity demand as result of the COVID-19 emergency, which has also contributed to a reduction in wholesale prices and therefore an increase in payments to CfD generators. This was not foreseen when the LCCC set the interim levy rate (ILR) and total reserve amount (TRA) for the current quarter in December 2019. Whilst the LCCC could, using its powers under the Contracts for Difference (Electricity Supplier Obligations) Regulations 2014 (“the ESO Regulations”), have made an ‘in period’ adjustment and increased the levy rate collected from suppliers during the quarter, this would have been a significant, unexpected cost to electricity suppliers who could not have anticipated the increase at the time retail tariffs were set.

Based on probabilistic forecasts provided by the LCCC (as of 25 April), in the absence of intervention, the shortfall in LCCC funding in period was projected to be in the region of £40-50m once the Total Reserve Amount (TRA) of £78m for the quarter had been utilised. If the Government had not decided to provide a one-off loan, the LCCC would have sought to meet this shortfall by increasing the interim levy rate during the quarter (an ‘in-period adjustment’). In total, the cost for suppliers relating to Q2 2020 was expected to be c.£90-150m (in reasonable low-high scenarios) above the level forecast by LCCC in December 2019. This would correspond to a 22-35% increase in the average costs of the CfD scheme for the quarter on a per MWh basis to suppliers from the pre-COVID-19 forecasts on which the initial Q2 ILR and TRA were set. Since suppliers generally set prices for customers in advance, this would have represented an unexpected cost to suppliers, to be absorbed by their margins.

Mitigating the impact of the potential shortfall in funding

In order to mitigate the short-term impact of this, BEIS[1] and LCCC[2] announced on 24 April that LCCC would not implement an in-period adjustment, and instead the Government would provide a one-off loan to the LCCC to ensure that it can continue to pay CfD generators in the current quarter. The loan will be interest free and capped at £100m.

Provision of the loan will ensure that suppliers have more time to prepare for a potential increase in payments under the supplier obligation.

At the same time, BEIS set out its intention to consult on a proposal to reduce suppliers' obligations for CfD payments this quarter, utilising the loan provided to LCCC, and to increase suppliers' obligations in Q1 2021 by the same amount. BEIS considers that giving suppliers this period of notice will substantially limit the negative short-term impact on supply businesses.

In particular, the approach will enable Ofgem to consider the value (small in the context of total supplier costs, corresponding to ~0.1% of a typical domestic annual bill) of deferred costs in the context of decisions regarding the setting of the Default Tariff Cap and Prepayment Meter cap for the relevant period (October 2020-March 2021) where appropriate, and give suppliers the ability to factor the same small change into their decisions relating to the setting of other variable, as well as new, fixed-price tariffs.

To implement these changes, BEIS intends, subject to the outcome of this consultation and the will of Parliament, to make and finalise changes to the ESO Regulations before 9 July 2020 (the date on which we currently expect LCCC to carry out the Q2 reconciliation process).

If BEIS is unable to or decides (following consultation) not to proceed with the proposal within the necessary timescales, we would still provide the loan facility to LCCC, but suppliers' obligations for CfD payments in this quarter would be unchanged. Suppliers would have to pay a higher lump sum to LCCC following the reconciliation process in July. We would still amend the ESO Regulations to enable LCCC to repay the loan to BEIS.

How BEIS will determine the loan amount

The objective of this intervention is (a) to ensure that the LCCC has sufficient funds to pay CfD generators this quarter without increasing the ILR in the middle of the quarter, and (b) to defer some of the increased costs facing suppliers this quarter as a result of the increase in CfD payments and reduced demand caused by measures introduced to combat the spread of COVID-19.

Based on the LCCC's probabilistic modelling, a loan of up to £100m will be sufficient to enable LCCC to make payments due to CfD generators relating to this quarter (i.e. cover any cash

[1] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/881305/cfd-stakeholder-bulletin-24-april-2020.pdf
[2] www.lowcarboncontracts.uk/sites/default/files/2020-04/Electricity%20Supplier-Bulletin%20CfD%20Loan%20Facility%20.pdf

shortfall) without needing to increase the ILR or TRA for the quarter up to a 'reasonable downside' scenario (modelled as a 'P75 scenario'[3]).

However, as we are only several weeks into Q2, there is still considerable uncertainty around what the eventual level of CfD payments and supplier revenue for the quarter will be. It is therefore not possible at this stage to determine by how much suppliers' obligations for the quarter should be reduced.

The Government has therefore decided to use a formula to determine the exact amount by which suppliers' obligations relating to Q2 will be reduced, based on outturn demand and CfD payments for the quarter. This will provide greater certainty to suppliers about the level of their obligations, whilst ensuring that the eventual amount of loan required from the Government reflects the actual circumstances experienced.

The Government intends to protect suppliers from around two thirds of the increase in CfD supplier obligation costs relating to Q2, up to the £100m cap. The Government considers that providing protection from around two thirds of these additional costs is proportionate, given that not all of the additional costs can be directly attributed to the current situation (in particular, 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).

The £100m cap would allow this protection up to the P75 'reasonable downside scenario' for CfD supplier obligation costs for this quarter. Even in a P75 downside scenario, the additional costs that suppliers would face following application of the government funding would be in line with the level of volatility in CfD supplier obligation costs over the past 12 months **(see Annex B for further details)**. It is important to note that if costs exceeded this P75 scenario, suppliers would face increased obligations and in an extreme scenario (e.g. P99) there would be a funding shortfall even after the full £100m had been drawn, so LCCC would need to consider an in-period increase in the ILR or TRA.

This process would operate as follows:

- The LCCC would 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 due to be received by LCCC in July 2020.
- 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 this formula:
    - 0.67 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 are projecting that CfD payments will exceed ILR payments from suppliers in respect of Q2 by c.£95.5m[4]. Under the methodology described above, after the end of the quarter suppliers' obligations would be reduced by 0.67 x c.£95.5m

[3] This is estimated based on probabilistic modelling drawing on historic volatility for weather and wholesale prices and using a range of assumptions around demand. The 'P' number represents the percentile (i.e. P75 is the 75th percentile).

[4] www.lowcarboncontracts.uk/dashboards/cfd/levy-dashboards/in-period-tracking, as of 12 May 2020. This amount is expected to vary as the quarter progresses.

= c.£64.0m, meaning they have an additional obligation of c.£31.5m (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.£46.8m in respect of Q2, which would be netted off the £77.0m TRA for Q3 (making a net payment from suppliers of c.£30.2m for Q3).

The final figure will be calculated by LCCC as part of the reconciliation process that takes place at the start of Q3 2020. 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 in line with regulations, including any amendments made following this consultation as described below).

We recognise that this means that the total amount of government loan provided in respect of the 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 as a result of further reconciliations, and consider that it is important to provide certainty over the amount of the government loan as early as possible.

Further information showing on an illustrative basis the potential value of government contributions to the funding gap under different scenarios is set out in **Annex B**.

We recognise that there is continued uncertainty over how electricity demand and wholesale prices will evolve over the rest of the year beyond this quarter, but we consider that suppliers should be in a better position to consider these risks when setting future tariffs (as will Ofgem in setting future Default Tariff and Prepayment Meter Cap levels). The most significant pressure is expected to be in this quarter, where the increase in costs resulting from measures introduced to reduce the spread of COVID-19 was not forecast ahead of time.

It should therefore be noted that what is proposed is a response to the unexpected impacts of COVID-19 in this specific instance and government should not be relied on to underwrite consumer-funded low carbon energy subsidies in future.

Purpose of consultation

This consultation sets out proposals for implementing the change through amendments to the ESO Regulations 2014. These would enable:

- a reduction in suppliers' obligations for the period in which government provides funding that can be used to pay CfD generators, by the amount of government loan provided;
- an increase in suppliers' obligations by the same amount three quarters later, to enable repayment of the government loan (this would apply to all suppliers operating in the future quarter not just those whose obligations were previously reduced);
- 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).

The proposal

We set out below proposals for how we intend to change the ESO Regulations to amend the way that suppliers' obligations are calculated and the ILR is set, to reflect and recover the amount of government loan deemed to have been used to make CfD payments in the quarter (as set out above).

Although the principal objective of the amendments is, as described above, to reduce suppliers' obligations in Q2 2020 and increase them in Q1 2021, they will be drafted in a way that the same mechanism could be used in future quarters if necessary. However, the loan is 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 future support going forwards.

How will suppliers' obligations for CfD payments be reduced?

There is no perfect way to adjust payments to exclude the precise impact of COVID-19, given the varying impacts of changes in electricity demand, wholesale prices and CfD generation across hours, days, and weeks.

We are proposing 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.

For example, if a supplier's unadjusted obligation for CfD payments for Q2 2020 is £1000 and it had a 10% share of eligible demand over that quarter, and the government loan amounted to £500, the supplier would see its obligation reduced by £50 (10% of £500) to £950.

This approach can be implemented using existing functionality in the LCCC's settlement system. LCCC and their settlement agent, EMR Settlement Ltd (EMRS), are therefore confident that they can calculate the reduction in suppliers' obligations in this way with minimal impact on their operational processes.

We recognise that there are alternative approaches that could in principle be taken to calculate the reduction in suppliers' obligations. However, these would require complex changes to the settlement system that could not be delivered in time, and / or would carry significant delivery risk and cost.

How and when will suppliers' future obligations be increased?

We are proposing to take 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. It should be noted that 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.

For example, if the above supplier's unadjusted obligation for CfD payments for Q1 2021 was £1500 and it had a 15% market share in that quarter, its obligation would be increased by £75 (15% of the £500 government loan) to £1575.

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.

An alternative approach would be to increase each supplier's obligation by the same amount that it was reduced by in Q2 2020 (in this example, by £50). However, whilst this might appear 'fairer', in practice it creates greater uncertainty for suppliers, as their market shares could change considerably between Q2 2020 and Q1 2021, significantly reducing their ability to incorporate the unexpected cost into their business plans. For example, a supplier whose market share shrinks would face a higher £/MWh payment in Q1 2021, and therefore be at a competitive disadvantage to suppliers who grow over the period. In the extreme case, suppliers may exit the market between Q2 2020 and Q1 2021, and their obligations could then have to be mutualised across other suppliers.

The proposed approach is also simpler to implement, as it would again use existing functionality in the settlement system.

Changes to the formula for setting the ILR

We are proposing changes to the ESO Regulations to enable LCCC to take into account 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 take into account the increase to suppliers' obligations in Q1 2021 when setting the ILR for that quarter in September 2020. It would also 'future proof' the regulations and ensure that if the Government decided to provide a loan in future, the LCCC is not forced to 'over-collect' through the ILR. However, as explained above, it is not the Government's intention to provide further support beyond that outlined in this consultation.

Changes to enable LCCC to repay the government loan

The ESO Regulations currently only allow LCCC to use money collected from suppliers through the ILR or TRA in limited circumstances – namely, to make payments due in respect of CfDs or connected agreements. We are proposing to amend the regulations to enable LCCC to repay government funding using monies collected from suppliers after the reconciliation process following the relevant period.

Consultation questions

1. **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?**

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

3. **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?**

4. **Do you have any other comments on the proposals?**

Next steps

We welcome views on the proposals set out in this consultation until it closes on 19 May.

Following this consultation, we plan to publish the Government Response and lay amendments to the ESO Regulations in Parliament in early 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).

If BEIS is unable to or decides (following consultation) not to proceed with the proposal, we would still provide the loan facility to LCCC, but suppliers' obligations for CfD payments in Q2 would be unchanged. Suppliers would therefore have to pay a higher lump sum to LCCC following the reconciliation process in July. We would still amend the ESO Regulations to enable LCCC to repay the loan to BEIS.

Annex A: How the electricity supplier obligation works

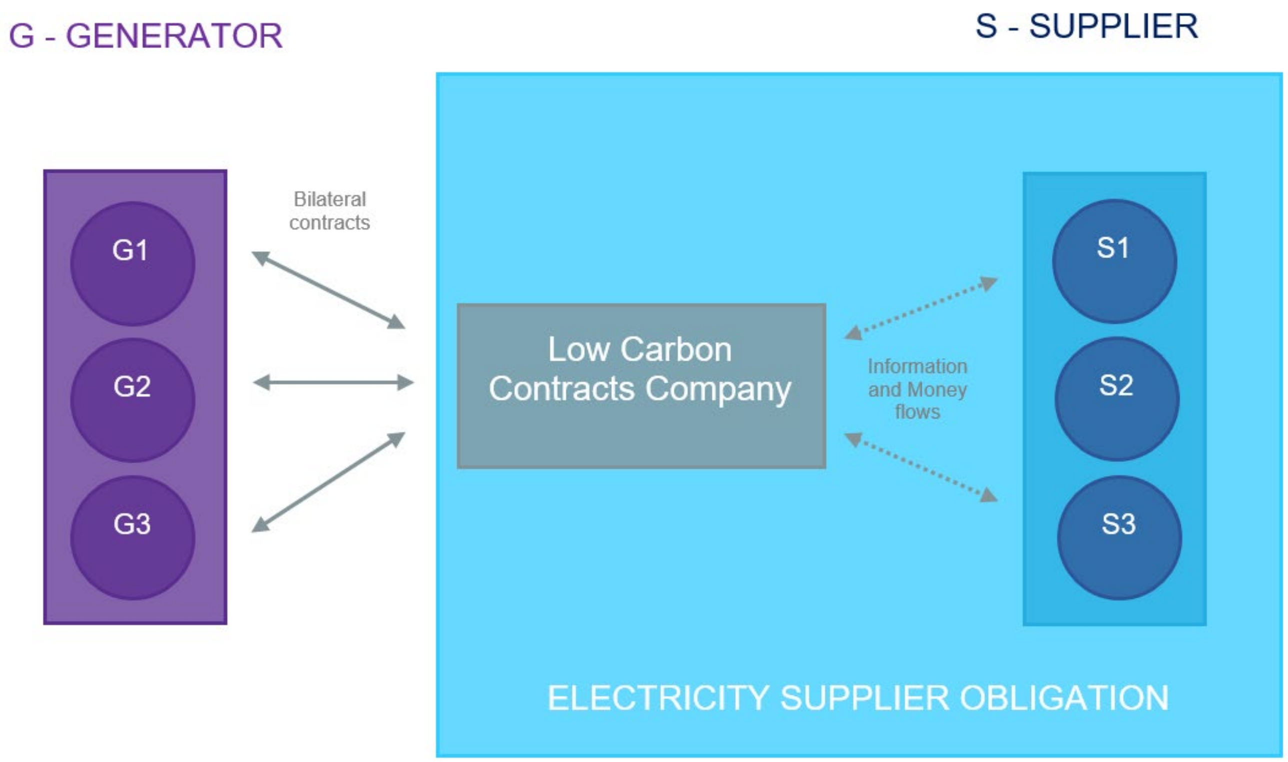

Figure 1: How the electricity supplier obligation works

The electricity supplier obligation is a compulsory levy on licensed electricity suppliers to meet the cost of CfDs. Obligation payments are collected by the LCCC who make payments to CfD generators. It is also the mechanism through which any payments back from CfD generators to LCCC are paid to electricity suppliers. It is expected that suppliers will pass on the net cost of the CfD levy to consumers through electricity bills.

The obligation consists of a series of prepayments from suppliers, and a reconciliation process. The prepayments comprise of:

- An Interim Levy Rate (ILR), which is determined by LCCC by reference to forecasts (of demand, generation, market prices, weather, etc.) and paid daily by suppliers on a £ per MWh supplied basis. It is intended to cover payments to CfD generators over a given calendar quarter (known as the 'rate period').
- A lump sum 'reserve' payment - the Total Reserve Amount (TRA) - paid at the start of each quarter (proportional to each supplier's share of the market in the preceding quarter). Reserve payments are intended to cover the risk that payments to CfD generators are higher than forecast or electricity demand is lower than forecast and to

ensure there is no shortfall between inward payments from suppliers and outward payments to generators in most scenarios (to a 95% level of confidence). Reserve payments help to manage unpredictability, volatility and cash flow timing mismatches that may arise.

The LCCC sets and notifies suppliers of the interim levy rate and total reserve amount around one calendar quarter in advance of the rate period; the amounts are based on the LCCC's forecast for generation, demand, and wholesale prices during the relevant levy period. LCCC must set the ILR at least a quarter in advance of the quarter to which it will apply, though they are able to change the rate with a minimum of 30 days' notice where they are of the opinion that there is a high degree of likelihood that they will be unable to make all CfD payments during a quarter.

At the end of every quarterly levy period, the LCCC undertakes a reconciliation of suppliers' interim payments against their share of actual payments to (or from) CfD generators during the period. Reconciliation payments to (or from) suppliers are netted off the following quarter's reserve payments.

The CfD supplier mechanism and LCCC's function in administering it are set in the Contracts for Difference (Electricity Supplier Obligation) Regulations 2014 (as amended).

Annex B: Illustration of potential value of government loan contributions to the funding gap required under different scenarios

LCCC's 'base case' from their probabilistic forecast (as of 25 April) was that there would be a £121m gap between levy receipts from suppliers in the quarter and payments to CfD generators (equivalent to a 25% increase in the £/MWh cost of the CfD scheme to suppliers in this period). This is due in part to the drop in demand following the COVID-19-related economic restrictions (£67m), but also to the fall in wholesale prices (£54m) which cannot be fully ascribed to factors related to the COVID-19 response (in particular, noting that price falls started before the lockdown). As the LCCC collected £78m in 'reserve payments' from suppliers at the beginning of the quarter, a £121m gap between CfD payments and levy receipts would leave them with a £43m shortfall in funding.

As we are only a few weeks into Q2, there is still considerable uncertainty around what the eventual level of CfD payments and supplier revenue for the quarter will be. LCCC therefore also modelled a range of potential outcomes: this showed that the gap between interim levy rate receipts and CfD payments ranged from £94–148m on a P25 to P75 basis, and £28–219m on a P01 to P99 basis. The funding shortfalls for the same ranges (after the £78m reserve payments have been used) were £16–70m and £0–£141m, respectively.

The table below shows the effective value of supplier and government loan contributions to the funding gap we estimate could arise under different scenarios. It assumes that the loan funding will be used to delay the pass through to suppliers of 67% of the funding gap, as set out in this consultation. The size of the loan available will be capped at £100m.

Percentile	**Total estimated gap between CfD payments and levy receipts for Q2 2020**	**Supplier contribution**	**Government contribution covered by loan**	**% of total gap covered by loan**
P:01	27	9	19	67%
P:25	94	31	63	67%
Base case	121	40	81	67%
P:75	148	49	99	67%
P:99	219	119	100	46%

This consultation is 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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