EXPLANATORY MEMORANDUM TO

THE ELECTRICITY SUPPLIER PAYMENTS (AMENDMENT) REGULATIONS 2022

2022 No. [XXXX]

1. Introduction

1.1 This explanatory memorandum has been prepared by the Department for Business, Energy and Industrial Strategy ("BEIS") and is laid before Parliament by Command of Her Majesty.

2. Purpose of the instrument

2.1 These Regulations amend (a) the Contracts for Difference (Electricity Supplier Obligations) Regulations 2014 (S.I. 2014/2014, the "ESO Regulations") and (b) the Electricity Capacity (Supplier Payment etc.) Regulations 2014 (S.I. 2014/3354, the "Supplier Payment Regulations").

2.2 The ESO Regulations impose an obligation on electricity suppliers to pay an "operational costs levy" that funds the operational costs of the Contract for Difference ("CfD") Counterparty. The Supplier Payment Regulations impose an obligation on electricity suppliers to pay a "settlement costs levy" that funds the operational costs of the Settlement Body, which is responsible for financial transactions relating to the Capacity Market.

2.3 This instrument makes the following changes:

- regulation 2 sets new rates for the operational costs levy for the next three financial years in the ESO Regulations;
- regulation 3 sets new settlement costs levy rates for the next three financial years in the Supplier Payment Regulations; and
- in both cases, the levy set for the third financial year remains in place until next amended.

3. Matters of special interest to Parliament

Matters of special interest to the Joint Committee on Statutory Instruments.

3.1 None.

4. Extent and Territorial Application

4.1 The territorial extent of this instrument is the United Kingdom, except regulation 3 which extends to Great Britain only.

4.2 The territorial application of this instrument (except for regulation 3) is the UK, although the CfD scheme does not currently operate in Northern Ireland, so electricity suppliers in Northern Ireland are not subject to obligations to make payments to the CfD Counterparty. The territorial application of regulation 3 is Great Britain.

5. European Convention on Human Rights

5.1 Greg Hands MP has made the following statement regarding Human Rights:

"In my view the provisions of the Electricity Supplier Payment (Amendment) Regulations 2022 are compatible with the Convention rights."

6. Legislative Context

6.1 The Energy Act 2013 ("the Act") contains powers enabling the Secretary of State to implement measures to reform the electricity market to encourage low carbon electricity generation and to ensure security of supply.

6.2 The two main measures implemented using these powers are the Contracts for Difference ("CfD") scheme and the Capacity Market.

6.3 These mechanisms were implemented by a suite of secondary legislation and related documentation.

6.4 These Regulations set new operational costs levy rates to enable the CfD Counterparty to recover its operational costs and new settlement costs levy rates to enable the Settlement Body to recover its operational costs with respect to the Capacity Market, for the next three financial years.

7. Policy background

What is being done and why?

<u>*Operational costs levy for the CfD Counterparty*</u>

7.1 The CfD Counterparty enters into and manages CfDs with low carbon electricity generators. This includes managing the CfD portfolio to ensure pre-generation contractual milestones are met and compliance and reporting obligations are fulfilled. The CfD Counterparty also sets and collects the levy on electricity suppliers to pay for the cost of low-carbon generation under the CfD scheme. In addition, it contributes to CfD development and manages delivery of revisions to the CfD settlement system to reflect policy changes, to ensure continued correct processing of transactions.

7.2 The CfD Counterparty recovers its operational costs by a separate levy on electricity suppliers, which is set out in the ESO Regulations. These regulations amend regulation 23 of the ESO Regulations to revise the operational cost levy that liable electricity suppliers must pay.

7.3 The operational costs levy rate is calculated by dividing the CfD Counterparty's proposed annual budget by the total forecast electricity demand for the corresponding financial year. If demand is lower than forecast, the CfD Counterparty will not be able to raise enough income from the levy to meet their budgeted costs. Therefore, a robust forecast of electricity demand is needed for each financial year in order to set the CfD Counterparty's levy rate accurately.

7.4 Prior to 2017 there had been an annual process to consult on and amend the operational cost levy for the next financial year set out in the ESO Regulations. To offer stakeholders greater visibility of the estimated operational costs and to reduce the administrative burden on the CfD Counterparty and Parliament, in 2017 BEIS consulted on the operational cost budgets and resultant levy rates for the financial years 2018/19, 2019/20 and 2020/21 and corresponding levy rates for these years were set in regulations approved by Parliament in 2018.

7.5 In 2020, BEIS wished to consult on the operational cost budgets and resultant levy rates for the financial years 2021/22, 2022/23 and 2023/24. However, electricity demand had reduced significantly during the COVID-19 pandemic. Increased uncertainty with regards to a number of factors that are used to forecast electricity demand made it difficult to do so beyond the 2021/22 financial year. Consequently, the levies were set for the 2021/22 financial year only.

7.6 In 2021 BEIS has consulted on and seeks to amend the operational cost levy for the financial years 2022/23, 2023/24 and 2024/25, due to the benefits to stakeholders, the CfD Counterparty and Parliament set out at paragraph 7.4. Although the COVID-19 pandemic is ongoing, we are now confident that we can forecast electricity demand with sufficient accuracy to set the levy rate for more than one financial year.

7.7 The levy set for 2024/25 would continue to apply until next amended. BEIS intends to consult in advance of any subsequent operational cost period and to adjust the levy rate to ensure that it is set to recover the CfD Counterparty's expected operational costs.

7.8 The CfD Counterparty's operational costs budgets reflects the costs of its expected activity during the relevant financial year. The current operational budget for 2021/22 is £20.736m. The proposed budget in 2022/23 is £24.210m, representing an increase of £3.474m, £26.978m in 2023/24, representing a £2.768m increase and £29.051m in 2024/25, representing a £2.074m increase on the previous year's budget. These budget increases are due to a number of factors, including a significant increase in the number of CfDs being managed by the Counterparty over the budget period, work to develop new schemes such as Carbon Capture, Usage and Storage, preparatory work on how to enable Northern Irish projects to compete in future allocation rounds, and other cost increases beyond the CfD Counterparty's control, such as insurance premiums and inflation.

7.9 In the event that the total amount of levy collected exceeds the CfD Counterparty's actual operational costs, the surplus at year-end will be reimbursed to electricity suppliers.

Settlement costs levy for the Settlement Body

7.10 The Capacity Market aims to incentivise sufficient capacity to ensure security of electricity supply at minimum cost to consumers. Capacity payments made to capacity providers under capacity agreements are funded by electricity suppliers, with payments flowing via the Settlement Body. The Settlement Body is responsible for all financial transactions relating to the Capacity Market, including making capacity payments to capacity providers and managing credit cover for both suppliers and capacity providers. It also contributes to Capacity Market development and manages delivery of revisions to the Capacity Market settlement system to reflect policy and Capacity Market Rules changes, to ensure continued correct processing of transactions.

7.11 The Settlement Body recovers its operational costs by a separate levy on electricity suppliers, which is set out in the Supplier Payment Regulations. This draft instrument amends regulation 9(2) of the Supplier Payment Regulations to revise the total amount of the settlement costs levy that liable electricity suppliers must pay to fund the operational costs budget of the Settlement Body. The amount that suppliers are charged is proportionate to their share of total electricity supplied during the winter 'period of high demand'[1].

7.12 The Settlement Body's operational costs budget reflects expected activity during the relevant financial year. The current operational budget of the Settlement Body for 2021/22 is £7.472m. The proposed budget in 2022/23 is £6.954m, representing a decrease of £0.518m, £7.382m in 2023/24, representing a £0.428m increase and £7.734m in 2024/25, representing a £0.352m increase on the previous year's budget.

7.13 Despite a considerable growth in the size and complexity of the Capacity Market, Settlement Body costs have been held relatively steady to date. This reflects the fact that the Settlement Body is becoming more efficient as the number of capacity providers increases in the Capacity Market.

7.14 The period for which the settlement costs levy can be set is interdependent with the period for which the operational costs levy can be set because the Settlement Body and CfD Counterparty share resources (e.g. staff) and facilities (e.g. office space and IT systems) and costs are allocated between the two organisations accordingly. As BEIS believes it is prudent to set the operational levy for 2022/23, 2023/24 and 2024/25, the settlement costs levy will also have to be set for the same period.

7.15 In the event that the total amount of levy collected exceeds the Settlement Body's actual operational costs, the surplus at year-end will be reimbursed to electricity suppliers.

8. European Union (Withdrawal) and Future Relationship

8.1 This instrument does not relate to withdrawal from the European Union / trigger the statement requirements under the European Union (Withdrawal) Act.

9. Consolidation

9.1 BEIS does not intend to consolidate the relevant legislation at this time.

10. Consultation outcome

10.1 The levy rates required for the CfD Counterparty and the Settlement Body to recover their operational costs for the next three financial years have been subject to a four-week consultation[2]. As with prior consultations, a four-week consultation period was considered appropriate due to the limited and focussed nature of the material to be reviewed. Electricity generators, suppliers, and other stakeholders were alerted to the consultation launch. In addition, the consultation has been advertised on the website of the CfD Counterparty and Settlement Body and that of the Settlement Service Provider[3]. The consultation closed on 3 December 2021. The Government Response to this consultation was published on 7 February 2022 and is available on GOV.UK.

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[1] For any financial year, the amount suppliers are initially charged is proportionate to their share of total electricity supplied during the previous winter's 'period of high demand' (4pm to 7pm on working days between November and February inclusive). Suppliers' shares of the levy are then revised after 16 March to reflect actual supply data relating to the 'period of high demand' for that financial year.

[2] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1031311/lccc-esc-operational-costs-consultation-2022-2025.pdf

[3] EMR Settlement Ltd, a wholly-owned subsidiary of Elexon, which settles payments between electricity suppliers and generators for the CfD scheme and Capacity Market.

10.2 The devolved administrations of Scotland and Wales were notified of the department's intention to consult on the operational costs of the CfD Counterparty and Settlement Body in case they wished to provide a response.

10.3 In total, one response to the consultation was received. The respondent was generally supportive, noting the benefits of setting the companies operational costs over a longer period, and that increases in the budget of the CfD Counterparty, though significant (an increase of 40% between 2021/22 to 2024/25), reflected the additional costs required for the CfD Counterparty to deliver functions required to meet UK energy goals.

10.4 The respondent noted a number of cost items are associated with the CfD Counterparty providing support to BEIS in developing policy and processes associated with Power Carbon Capture Use and Storage (CCUS) projects, Biomass with CCUS and Northern Ireland CfDs. Given the uncertainties involved in some of these policies, the respondent strongly recommended the need for these budget lines to be kept under careful review. In addition, the respondent also noted their belief that the budgets use a relatively high assumption for inflation.

10.5 BEIS believes the budgets achieve the right balance between protecting consumers whilst ensuring the CfD Counterparty is adequately resourced to perform its role effectively. The increase in the CfD Counterparty's costs over the budget period is partly driven by an expected increase in delivering and managing CfDs in this period, which are an essential component of the Government's plans to deliver its legally binding net zero commitment. In addition, expanding the CfD Counterparty's remit to include other technologies, such as Power CCUS, could also play an important part in meeting the requirements of the government's Net Zero Strategy. Other cost increases are driven by factors outside the CfD Counterparty's control, such as increases in insurance costs.

10.6 An assumption of 5 per cent has been used for inflation in each year of the proposed budgets. The Department has considered the latest available inflation forecasts published by the Office for Budget Responsibility, which suggest inflation will peak at 4.4. per cent this year before reducing to 2 per cent at the end of the budget period. [4] However, these forecasts were published before the Omicron COVID variant was identified. Inflation reached 5.1 per cent in November 2021.[5] A survey of economists published in January 2022 suggests inflation could peak at above 6% next year.[6] On balance, taking into account these predictions and the inherent uncertainty in forecasting inflation, the Department believes it is prudent to retain an assumption of 5 per cent for inflation within the budgets.

10.7 The budgets will be kept under review over the budget period. If inflation is lower than 5 per cent or if funds assigned for the development of new policy and processes, such as preparatory work to potentially extend the CfD scheme to Northern Ireland, are not utilised for these purposes and the surplus levy is not required for other

[4] Economic and fiscal outlook – October 2021 (27 October 2021) OBR: https://obr.uk/efo/economic-and-fiscal-outlook-october-2021/

[5] Consumer price inflation, UK: November 2021 (15 December 2021), ONS: https://www.ons.gov.uk/economy/inflationandpriceindices/bulletins/consumerpriceinflation/november2021

[6] The Times Economic Survey: Inflation will rise but little to fear for UK's jobs market (4 January 2022), The Times: https://www.thetimes.co.uk/article/inflation-will-rise-but-little-to-fear-for-uks-jobs-market-sms7f7m7q

essential operational activity, they will be repaid to suppliers in accordance with regulations.

10.8 BEIS is satisfied that the operational cost budgets for the CfD Counterparty and Settlement Body should remain as consulted on.

10.9 Consequently, for the CfD Counterparty the budget will be £24.210m in 2022/23, £26.978m in 2023/24 and £29.051m in 2024/25. The forecast gross electricity demand for the 2022/23 financial year is confirmed as 275.38 terawatt hours (TWh), 271.46TWh for 2023/24 and 266.87TWh for 2024/25, resulting in levy rates to be included in regulations of £0.0879 per megawatt hour (MWh) for 2022/23, £0.0994MWh for 2023/24 and £0.1089MWh for 2024/25. For the Settlement Body the budget to be included in regulations is £6.954m for 2022/23, £7.382m for 2023/24 and £7.734m for 2024/25.

11. Guidance

11.1 Existing electricity suppliers are already aware of their obligation to pay levies to cover the operational costs of the CfD Counterparty and Settlement Body. They are provided with notice of changes to the levy rates through the consultation exercise and subsequent Government Response. When new levy rates are set in legislation the Settlement Service Provider writes to suppliers to inform them of the rates that will apply for the relevant financial year(s).

12. Impact

12.1 The impact on business, charities or voluntary bodies is limited. The operational costs budgets of the CfD Counterparty and Settlement Body are levied on electricity suppliers who pass costs through to electricity consumers. The estimated impact on electricity bills is described at paragraph 12.4 below.

12.2 The impact on the public sector is limited. The operational costs budgets of the CfD Counterparty and the Settlement Body are levied on electricity suppliers who pass costs through to electricity consumers. The estimated impact on electricity bills is described at paragraph 12.4 below.

12.3 A full Impact Assessment has not been prepared for this instrument because of the low-level impact on electricity consumers bills as described in paragraph 12.4 below.

12.4 BEIS estimates that the total impact of the combined operational cost budget of the CfD Counterparty and the Settlement Body on the average annual household electricity bill will be less that 50p for each of the periods 2022/23, 2023/24 and 2024/25 (2020/21 prices). This equates to less than 0.1% of an average household electricity bill for each year. For businesses, the annual impact is expected to be around 0.1% of the average electricity bill, equivalent to around £30 or £1,200 for a business that consumes around 250MWh or 10,000MWh of electricity a year, respectively.

13. Regulating small business

13.1 The legislation applies to activities that are undertaken by small businesses, as we expect some small electricity suppliers would be classified as small businesses.

13.2 No specific action is proposed to minimise regulatory burdens on small business.

13.3 The Regulations will not have a disproportionate effect on small business as the proposed operational costs levy rates will be charged in relation to the amount of electricity supplied daily by each electricity supplier. The settlement cost levy rates will also be charged to electricity suppliers in proportion to their share of total electricity supplied during the winter 'period of high demand'. The operational costs levy and settlement costs levy are expected to be passed through to electricity consumers rather than be borne directly by the electricity supplier. Electricity suppliers as consumers of electricity will therefore bear costs as outlined in paragraph 12.4 above.

14. Monitoring & review

14.1 The approach to monitoring of this legislation is to keep the operational budgets of the CfD Counterparty and the Settlement Body under review over the period concerned. In the event that, due to unforeseen circumstances, the operational costs were found to be higher than expected BEIS would consider amending the operational costs levy rates and settlement costs levies as necessary, following consultation.

14.2 In accordance with regulation 84 of the Electricity Capacity Regulations 2014 (as amended) the Settlement Body is required to produce an annual report on the performance of its functions in respect of each capacity year. The annual report must, no later than three months after the end of the capacity year to which it relates, be provided to the Secretary of State and published. The latest report is expected to be published in due course.

14.3 Section 66 of the Energy Act 2013, requires the Secretary of State to review a number of aspects of the operation of the Electricity Market Reform programme as soon as reasonably practical after the end of the period of 5 years beginning with the day on which the Act was passed (i.e. by the end of 2018). These aspects include the extent to which the original objectives have been met, whether these objectives are still appropriate and whether they could be delivered in a way that imposes less regulation. This requirement covers CfDs, the Capacity Market and the transitional arrangements from the Renewables Obligation. The Secretary of State's conclusions must be set out in a report laid before Parliament. There has been a delay in laying the report due to a range of factors, including the impact of the UKs departure from the European Union and the impact of the COVID-19 pandemic. However, the findings for the review are expected to be laid in Parliament shortly.

14.4 The Capacity Market implementing legislation is additionally required to be reviewed every five years by virtue of review requirements in the Electricity Capacity Regulations 2014, S.I. 2014/2043 and the Capacity Market Rules. The first Capacity Market five-year review was published in July 2019[7]. While the Supplier Payment Regulations do not contain a review requirement, the role and functions of the Settlement Body generally are reviewed through this five-year review process.

14.5 The instrument does not include a statutory review clause, and in line with the requirements of the Small Business, Enterprise and Employment Act 2015 Greg Hands MP, Minister of State for Business, Energy and Clean Growth, has made the following statement:

[7] https://www.gov.uk/government/publications/capacity-market-5-year-review-2014-to-2019

"Having regard to the Small Business, Enterprise and Employment Act 2015, I have decided that the Act does not apply to this instrument. The power being exercised via the instrument is to vary existing levies on electricity suppliers. Section 28 (3)(a)(i) of the Act states that the duty to review regulatory provisions in secondary legislation does not apply if or to the extent that the power or duty to be exercised is to amend provision varying any levy."

15. Contact

15.1 Ben Springhall at the Department for Business, Energy and Industrial Strategy Telephone: 0300 068 6840 or email: ben.springhall@beis.gov.uk can be contacted with any queries regarding the instrument.

15.2 Helena Charlton, Deputy Director for Renewable Electricity Support Schemes, at the Department for Business, Energy and Industrial Strategy can confirm that this Explanatory Memorandum meets the required standard.

15.3 Greg Hands MP at the Department for Business, Energy and Industrial Strategy can confirm that this Explanatory Memorandum meets the required standard.