PARLIAMENTARY DEBATES

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OFFICIAL REPORT

Second Delegated Legislation Committee

DRAFT ELECTRICITY SUPPLIER PAYMENTS (AMENDMENT) REGULATIONS 2017

Monday 20 March 2017

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Friday 24 March 2017

The Committee consisted of the following Members:

Chair: Sir Alan Meale

† Brown, Alan *(Kilmarnock and Loudoun)* (SNP)
† Burns, Sir Simon *(Chelmsford)* (Con)
† Burrowes, Mr David *(Enfield, Southgate)* (Con)
Clwyd, Ann *(Cynon Valley)* (Lab)
† Costa, Alberto *(South Leicestershire)* (Con)
† Cunningham, Mr Jim *(Coventry South)* (Lab)
† Debbonaire, Thangam *(Bristol West)* (Lab)
† Evennett, David *(Lord Commissioner of Her Majesty's Treasury)*
Garnier, Sir Edward *(Harborough)* (Con)
† Goodman, Helen *(Bishop Auckland)* (Lab)
† Hart, Simon *(Carmarthen West and South Pembrokeshire)* (Con)
Hoey, Kate *(Vauxhall)* (Lab)
Kerevan, George *(East Lothian)* (SNP)
† Letwin, Sir Oliver *(West Dorset)* (Con)
† Morton, Wendy *(Aldridge-Brownhills)* (Con)
† Norman, Jesse *(Parliamentary Under-Secretary of State for Business, Energy and Industrial Strategy)*
† Whitehead, Dr Alan *(Southampton, Test)* (Lab)
† Wragg, William *(Hazel Grove)* (Con)

Ben Williams, *Committee Clerk*

† attended the Committee

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Monday 20 March 2017

[Sir Alan Meale *in the Chair*]

Draft Electricity Supplier Payments (Amendment) Regulations 2017

4.30 pm

The Parliamentary Under-Secretary of State for Business, Energy and Industrial Strategy (Jesse Norman): I beg to move,

That the Committee has considered the draft Electricity Supplier Payments (Amendment) Regulations 2017.

It is a pleasure to serve under your chairmanship, Sir Alan. This statutory instrument amends regulations concerning the contracts for difference scheme and the capacity market. Those schemes are designed to incentivise the significant investment required in our electricity infrastructure, keep costs affordable for consumers and help to meet our decarbonisation targets, while ensuring security of energy supply.

CfDs provide long-term price stabilisation to low-carbon generators, allowing investment to come forward at a lower cost of capital and therefore at a lower cost to consumers. The capacity market provides regular payments to reliable forms of generation or demand-side response in return for such capacity being available when needed, the purpose being to ensure that enough capacity is always in place to maintain the security of supply. In both schemes, participants bid for support via a competitive auction, which ensures that costs to consumers are minimised.

The next CfD auction, with a budget of £290 million, opens in April and will be available to less-established renewable technologies. That should result in enough renewable electricity to power 1 million homes and reduce carbon emissions by about 2.5 million tonnes per year from 2021-22 onwards. It will thus allow developers of innovative renewable technologies to come forward, while delivering the best deal for bill payers.

There have been three main capacity market auctions, held each December from 2014 to 2016, to secure capacity for four years ahead—that is, from 2018-19 to 2020-21. The latest of those secured 52.4 GW of capacity at a price of £22.50 per kilowatt per year. In January 2017, an early capacity auction was also held to secure capacity for winter 2017-18. That auction secured 54.4 GW of capacity at a clearing price of £6.95 per kilowatt per year.

The regulations will implement a second tranche of minor and technical amendments to improve the efficiency of the CfD supplier obligation—that is, the levy on suppliers that pays for the cost of CfDs. They build on a first tranche of changes that were approved by Parliament last year and became law in April 2016. These further changes are being implemented now to allow time for necessary changes to be made to the settlement system, which determines the way in which CfD payments are calculated and paid. The changes under consideration and those implemented last year were both the subject of public consultation and received a largely favourable response. The regulations also amend the levies that fund the companies established to deliver the CfD and capacity market schemes.

The supplier obligation is a compulsory levy on all Great Britain energy suppliers to meet the costs of clean electricity generation under CfDs. The levy is collected by a private company called the Low Carbon Contracts Company, of which the Government are the sole shareholder. The funds levied are paid to CfD generators for the electricity they have produced. The rates are set on a quarterly basis and consist of two payments: the first paid daily, based on every unit of supply; and the second a quarterly reserve amount, designed to ensure that the LCCC faces as little risk as possible in covering payments to generators. Both rates are set based on forecasts of payments to the CfD generators and levied on suppliers based on their market share. At the end of each quarter, the supplier payments are reconciled with actual payments to generators.

The changes made by the regulations will further improve the efficiency of the supplier obligation mechanism. The most significant changes will speed up reconciliation payments, so that over-collected funds are returned more quickly after the end of the quarter and suppliers face less onerous cash-flow risk. Secondly, they will allow the LCCC to reduce the reserve amount without notice when it has been overestimated, to ensure that suppliers do not overpay for renewable generation and to reduce the call on their cash flow. Thirdly, they will enable the LCCC to recover funds from suppliers when a compensation payment to generators is due in respect of generation that happened more than 10 quarters ago. Finally, they will prevent double counting of the green import exemption and the energy intensive industry exemption to avoid suppliers demonstrating a negative market share, thereby avoiding the payment of levies altogether.

Taking the regulations together with the changes introduced last year, we have estimated that the cost of CfDs to consumers will be reduced by £38 million between 2016 and 2020, which is a small reduction of 40p to 60p on consumer bills. The current set of changes alone is estimated to reduce bills by £22 million over the same period.

The second objective to be delivered through the statutory instrument is to set a revised operational cost levy for the LCCC and a revised settlement costs levy for the Electricity Settlements Company, which is the company responsible for collecting and making payments to capacity providers under the capacity market. Those companies play a critical role in delivering the CfDs in capacity market schemes, and it is important that they are sufficiently funded to perform their roles effectively. The Government closely scrutinise their operational cost budgets to ensure that they reflect the operational requirements and objectives for the companies and deliver value for money.

Both companies have performed well and the cost of their core activities is slightly down from 2016-17. The increase in both budgets is due to the cost of software upgrades to the settlement system, which are necessary to reflect policy changes that simplify and improve the overall effectiveness of the capacity market and CfD schemes. For example, the changes to the supplier obligation will need to be reflected in the settlement system.

The software upgrades are being treated as operational costs rather than as funded via capital, which means that they will be charged in full to the levy in 2017-18 rather than being recovered over the lifetime of the asset through a depreciation charge. Overall, there is no difference in costs to supplier.

The operational costs were also subject to consultation, which gave stakeholders the opportunity to comment, and they subsequently remain unchanged. The amendment revises the levies currently in place to reflect the operational cost requirements in 2017-18.

Subject to the will of Parliament, the settlement costs levy for the Electricity Settlements Company is due to come into force by 28 March 2017, the operational costs levy for the LCCC by 1 April 2017 and the changes to the CfD supplier obligation later this year.

Sir Simon Burns (Chelmsford) (Con): I am interested to know on what day the regulations will be made.

Jesse Norman: The regulations will be enacted today by a vote in the Committee and the settlement costs will come into force at the times indicated: the Electricity Settlements Company by 28 March; the operational costs levy for the LCCC by 1 April; and the changes to the CfD supplier obligation later this year.

Finally, I would like to assure right hon. and hon. Members that the Government will continue to evaluate and monitor the reforms following implementation, ensuring that the measures put in place remain effective and continue to represent value for money for the consumer.

4.38 pm

Dr Alan Whitehead (Southampton, Test) (Lab): It is a pleasure to serve under your chairmanship, Sir Alan. The regulations are, by and large, sensible, in that they clarify and extend provisions relating to the CfD counterparty that were originally set out, as the Minister has said, in regulations in 2014 and that have been further iterated since, including today.

The regulations change and make coherent references to settlement dates, set a new rate for the operational costs for the CfD counterparty and, interestingly—the Minister fleetingly mentioned this—introduce a new arrangement that allows the CfD counterparty to reduce the reserve fund if, in the opinion of the fund, it has too much in it. I would like to hear from the Minister about some issues relating to that particular provision.

In order to get to that position, we need to backtrack slightly in the narrative and establish why the CfD counterparty was set up in the first place. In effect, the issue arose during the passage of the Energy Act 2013, when it was acknowledged that a counterparty body was needed to hold the ring with regard to the operators, who would expect to receive regular payment for their possession of the CfD. That payment would cover the difference between the strike price at which they settled the CfD and the reference price or prevailing wholesale price of electricity. In order to invest, those operators would need to know that they would get paid from a fund containing the payments and a reserve fund levy paid in by electricity producers in general. The operators needed an assurance that they would get paid, and the other side also needed an assurance that money would go into a fund to enable that to happen. Both sides had to be fully assured.

The question that arose at the time was how to guarantee that transfer and ensure that the operators could be sure of receiving the payments, and that they could be made from a secure fund. The easiest option would have been for the Government simply to guarantee the transfer, but that was deemed not possible by the Treasury, because it would effectively have counted as public spending. A solution was found by the end of the legislation's passage through Parliament: a separate company, the Low Carbon Contracts Company, would be set up to be the receiving and payment agency, not backed by Government but with a high enough level of probability in its operation to satisfy investors that payments would be forthcoming. That meant that a linking mechanism was needed between payments in and payments out and payments in and the reserve fund, to ensure that payments would continue if there was a hiccup at the receiving end. That was implemented in the 2014 regulations.

A leading law company's brief synopsis of the LCCC states that

"the CfD will take the form of a bilateral private law contract between the generator and the CfD counterparty, a wholly owned subsidiary of the Government…the obligation of the CfD counterparty to make payments under the CfD is limited by the 'pay when paid' principle. This means that the CfD counterparty is channelling payments between generators and suppliers, but has no obligation to make payments if not previously received from suppliers or generator. There is no payment guarantee from the Government…the CFD counterparty will levy funds on a (likely) monthly basis from suppliers under the supplier obligation to cover the difference payments due to generators from the previous month and will transfer these funds to generators once received from suppliers."

That is the position with regard to this independent company, which is not backed by the Government but is a subsidiary of the Department in its operational life.

Interestingly—hon. Members might think that this is not very interesting, but I think it is—the 2014 regulations, which the regulations under discussion repeat and extend, use probability theory. It is the first time that I have seen defined in law what probability theory has to say about ability to pay and the necessary arrangements that a company should make. Regulation 7 states that the LCCC should work towards, essentially, a 95% probability of being able to pay. That transfers and slightly extends the probability theory statement in the 2014 regulations. As the explanatory memorandum helpfully emphasises, that means that payment will take place in 19 out of 20 scenarios. The regulations do not specify what those scenarios might be; the company itself has to think about them and act accordingly. In other words, at that point the company is the judge of its own probable solvency.

I did not like that formulation in the 2014 regulations and I do not particularly like it now. The scenarios that the company is supposed to consider can be unbalanced, because the law provides no direction. For example, according to the National Audit Office, offshore wind has recently turned out to be far more efficient than was previously thought, so it will require far more CfD payments and draw more from the fund than it might previously have done. That is just one scenario and the explanatory memorandum emphasises another, namely that the counterparty will need to make arrangements for the massive Hinkley Point CfDs when they start being produced.

As I have said, the regulations include a new provision that allows the CfD counterparty company to reduce its reserve fund without any notice, if it thinks it has been

[Dr Alan Whitehead]

oversubscribed, but it has to be in a position to make payment in 19 out of 20 scenarios. The reserve fund is there, among other reasons, to ensure that the payments are made even if there is a hiatus in the money coming in. Under the regulations, the company will decide for itself the sample points that will go into its initial calculation of its own likely solvency. It will then be able to make a further subjective determination of the solidity, or otherwise, of its own reserve fund. As I am sure the Minister will agree, that will add a further subjective factor to each sample point, because of the company's new ability to reduce its own reserve fund if it thinks it should do so.

All of that makes the provisions look a little wobbly. The regulations introduce a new factor that turns the probability position set out in the 2014 regulations into a further probability scenario of their own. In other words, what is the probability of a company reducing its own reserve fund without notice and therefore compromising its long-term likelihood of solvency?

I do not intend to divide the Committee, but will the Minister tell us whether he thinks that the arrangements proposed by the regulations, which are complicated by the new provision about reducing reserve funds, are a cause for concern with regard to the future solidity of the hard-worked arrangements set out in the 2013 Act, or does he think that everything is hunky-dory? I would assess the probability of getting a clear answer to that at a little over one in two, but of course I could be proved wrong by events, as all probability theory calculations have to acknowledge.

4.48 pm

Alan Brown (Kilmarnock and Loudoun) (SNP): It is a pleasure to serve under your chairmanship, Sir Alan. I will be very brief.

The amendments that the regulations make are mostly technical. Anything that improves legislation and ultimately helps to speed up reconciliation payments is to be welcomed. However, I have a few comments to make in passing. First, I note from paragraph 8.17 of the explanatory memorandum that professional and management fees are increasing because of Hinkley Point C. That seems to me another hidden cost of Hinkley. Secondly, the Minister mentioned forthcoming CfD auctions. I suggest to him that there is still time to reconsider allowing onshore wind to bid in future CfD auctions, given that it is now much cheaper. That would generate good value for the taxpayer. Thirdly, paragraph 8.14 of the explanatory memorandum states:

> "Three respondents disagreed with the proposal, arguing that it raised the possibility that a supplier could temporarily default and be excused of their share of mutualisation payments."

Do the Government have a response to that point?

4.49 pm

Jesse Norman: I am grateful to all hon. Members who have contributed for their comments and questions. If I may, I would like to correct something that I said earlier in response to my right hon. Friend the Member for Chelmsford. Officials have reminded me that regulations 1 and 19 will come into effect the day after the regulations are made. Regulation 14 will come into effect on 1 April, regulation 8 on 1 October, and all others on 1 July. I hope that that will comfort him. I apologise for misleading him earlier. I have been corrected on one other thing: it is not just the day, but the day after the day on which the regulations are made. I am doubly corrected

On the questions raised by the hon. Member for Kilmarnock and Loudoun, I hope he will correct me because I did not quite catch his final point about mutualisation. On onshore wind, as he is aware, the Government issued a consultation in November 2016 and continue to be heavily engaged in discussing the situation with the Scottish Government, developers, island communities and other Members. I hope that gives him comfort.

On the issue of costs, the hon. Gentleman will see that they have been included. We expect the costs for Hinkley Point to be in the region of £1.4 million for 2017-18. It is not at all clear why that should go up, but it is worth saying that Hinkley Point C is a complex contract and the Government's approach is based on a flexible outsourcing model of getting professional advice to fit the needs, so that may change. If there is an issue of mutualisation, I invite him to come back to me because I did not quite understand the point he made.

The hon. Member for Southampton, Test was right to separate out the fixed levy portion from the lump sum reserve payment, and to point out that the intention of the lump sum reserve payment is to give 95% confidence that that will be paid. In the past, the effect of the previous regulations meant that the LCCC over-collected. The purpose of the regulations under discussion is to allow it to remit more quickly those funds that may have been over-collected, rather than trap them in parallel with the faster settlement process that has been introduced. Therefore, the question whether the organisations are under-constrained does not arise. As I have said, their operating costs are scrutinised by the Government, and of course they are subject to mutualisation and are therefore undoubtedly subject to question by the suppliers who pay their costs.

Dr Whitehead: I am sure the Minister will agree that the existence of the reserve fund still has some salience in this process, in so much as it functions as a backstop when there have been hiatuses—if that word exists—in payment or collection. The reserve fund can, in such circumstances, be brought in to smooth the passage and allow for the continuation of business, even if there are problems at either end. The question of reducing the reserve fund unilaterally and with no notice, which is in the regulations, is not just a technical issue; it is a real issue that has a bearing on how the rest of the company works, and therefore the probability within which it works overall.

Jesse Norman: I take that point, but I think the hon. Gentleman has got the incentives the wrong way around. The incentives are to maintain a large reserve fund because that gives a degree of comfort and prevents challenge. The point of the provision is to create an inventive if it is perfectly clear that more money has been accumulated than is required to be paid out. In general, the companies concerned will have a tremendous incentive to retain what reserves they can, precisely for the reasons he suggests. In reality, I do not think there is any real danger.

Question put and agreed to.

4.54 pm

Committee rose.