



CFD counterparty and the supplier obligation

Institutional Frameworks team
Monday 11 February 2013

Introduction

CFD counterparty

- Overview of payment model process

- CFD counterparty design and set up timetable

- Q&A – CFD counterparty

Supplier obligation

- Overview, policy design and how the supplier obligation will work

- Q&A – Supplier obligation



CFD counterparty

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Why we are setting up a single CFD counterparty



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- May 2012 Draft Bill set out the legal framework for the Contracts for Difference and proposed a 'multiparty' payment model
- Both industry and the Energy and Climate Change Committee (ECC) had concerns over these proposals
- Moved to a single counterparty payment model in the Energy Bill:
 - CFD becomes a bilateral private law contract
 - Signed by the generator and the CFD counterparty
 - Supplier obligation in regulations

What the CFD counterparty will be



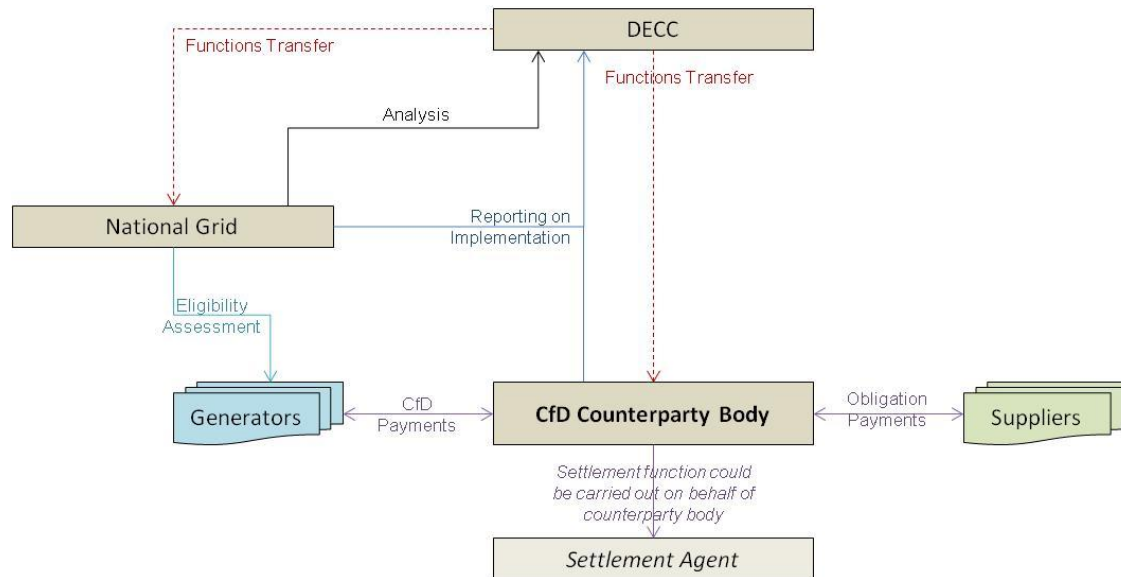
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- Government owned Companies Act company
 - HMG only shareholder
 - Appoints Chair and minority of the board
- Key features:
 - Not for profit
 - Single counterparty

Single counterparty payment model



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Key characteristics:

- Single CFD counterparty signs and manages bilateral contracts with suppliers
- Collects payments from suppliers through a Supplier Obligation (levy)
- Collects payments from generators through the contract when the reference price is above the strike price and passes these to suppliers
- Likely to have a settlement agent balancing payments between suppliers and generators- specialist function

SoS relationship with CFD counterparty:

- Seeking right balance between accountability of the CFD counterparty to the SoS and investor concern around political intervention
- SoS has significant control up front over design of contracts, agreeing strike prices and setting maximum costs. Once contract signed SoS would not be able to vary contract terms (a commercial contract)
- Company articles, framework document and regulations will set out relationship with SoS in detail.
- SoS will place legal obligations on the company to ensure that it governs the behaviour of the company, operates effectively and enforces its rights.

CfD Delivery and Counterparty Functions



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Delivery Body Responsibilities

Delivery Plan &
Annual Reporting

Qualification,
Application &
Allocation

Measurement &
Reporting

Counterparty Body Responsibilities

Contract Management

Contract Placement

Pre-commissioning Contract
Management

Post-commissioning Contract
Management

Contract Closure

Measurement & Reporting

Disputes Management

Money Management

Calculate, reconcile & Invoice

Collect & Manage Collateral

Payments to
Generators

Payments to
Suppliers

Receipts from
Generators

Receipts from
Suppliers

Measurement & Reporting

Disputes Management

Shared Responsibilities??

Manage LCF capacity & Reporting

Manage Stake-holders

Counterparty Design



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- Work has recently commenced on the detailed design of the counterparty body. Part of this work has involved scoping functions and decisions for which the counterparty will be responsible, with consideration of what controls or constraints might be needed in the exercise of these functions.
- Our aim is to provide transparency around how the counterparty makes decisions. We would expect to place these controls or constraints in secondary legislation, possibly supplemented by the company's constitutional documents.

Illustrative example of CFD counterparty discretion in decision-making



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Heads of Terms Clause 3.1 - Pre-Start Date Termination, states:

If:

the Generator fails or is unable to deliver the Milestone Certificate by the Milestone Delivery Date in accordance with Clause 6.1 (Milestone satisfaction);

- at any time prior to the Start Date, a Termination Event has occurred and is continuing; or
- subject to Clause 5.4(B) (Waiver), any of the Conditions Precedent is not fulfilled or waived by the Counterparty Body on or before the Longstop Date,

the CFD counterparty shall have the right, but not the obligation, to terminate the Agreement with immediate effect upon giving the Generator notice of the same specifying, in the case of Clause 3.1(B) (Pre-Start Date termination), the relevant Termination Event.

Governance and Accountability Framework



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- Under this clause there may be other objectives or factors we may want the CFD counterparty to take account of in taking the decision as to whether or not to terminate a given contract. We would set this out through the governance and accountability framework.
- Importantly, the Secretary of State will not have the power to alter contract terms once a contract has been signed. The Secretary of State will also not have the power to terminate a contract. However as part of the governance framework under development there may be requirements on the CFD counterparty to consult the Secretary of State under specific circumstances. For example, when settling claims or in the conduct of legal proceedings relating to contracts, there may be a need for the CFD counterparty to consult the Government on some matters.
- The Government intends to set out through regulations a transparent framework for the governance and accountability of the CFD counterparty to establish any necessary controls around how the CFD counterparty exercises discretion or makes decisions under the contract. Nothing in this framework will change the generator's rights under the contract. More information on the specific controls will be made available later this year.

2013 - Energy Bill in Parliament

- *ability to ask CPB to sign contracts on direction of HMG or National Grid*
- *Power to regulate CPB (to ensure fulfilling functions)*
- *Duty on SoS to make supplier obligation regulations and CPB to collect*
- *Ability to pro-rata payments should there be a temporary shortfall*
- *Powers for counterparty to enforce a debt against a supplier*
- *Ability to make payments back to suppliers*
- *Ability to raise monies from suppliers for operational costs*
- *Ability to specify what goes into the Consolidated Fund*

Autumn 2013 – Consult on relevant secondary legislation

- *Supplier obligation regulations; regulations governing the CFD counterparty*

2013 – Recruitments to company

Early 2014 – legislation introduced to Parliament

From Mid 2014 – legislation in force and company is designated

Questions?



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Q & A



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Supplier Obligation

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- Statutory obligation on suppliers to fund payments for CfDs
- Relevant requirement
- Design principles:
 - Ensuring the correct payments are made at the right time
 - Tax-raising principles
 - Using existing mechanisms and data



- Variable rate levy
- Monthly payment/settlement periods
- Existing data and mechanisms
- Payment Protection
- Energy Intensive Industry (EII) Exemption

How the supplier obligation will work



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- The cost of the supplier obligation will be based on:
 - generation data (actual)
 - supply data (estimated)
 - reference price
 - strike price
- Market share is based on volume
- The CFD counterparty will 'bill' for payments, collate funds and transfer to the CfD generator, or to suppliers when the strike price is above the reference price.



- Posting collateral will be a mandatory requirement
- Likely to be set to cover the upcoming payment period.
- Cash or a Letter of Credit from creditworthy counterparties.
- Balance between the cost of collateral to suppliers and the required stability of the regime.

- Mutualisation – the counterparty will be able to recover any unsecured sums from all of the other suppliers spread across market share through mutualisation.
 - Likely to start once a defaulting supplier's collateral has been exhausted and they further default on the next levy payment obligation.
- Supplier of Last Resort (SOLR) – allows Ofgem to revoke the failed supplier's licence and appoint another supplier
- Energy Supply Company Administration Scheme (ESCAS) – aimed at large supplier insolvency to ensure that customers continue to be supplied with energy until a resolution is found



- Preference for a fixed rate
- Variety of views on the settlement period
- Difficulties of hedging
- Impact of posting collateral
- Modelling and analysis

Questions?



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Q & A