

This paper is for discussion and does not represent government policy or policy intent

Offtaker of Last Resort Advisory Group Discussion Paper 5.2: LEVELISATION

Overview

Headlines:

- As a 'last resort' we expect the OLR to be used rarely, if ever. However, if it is used, costs (or benefits) will fall unevenly upon offtakers. We propose to levelise the costs (or benefits) for offtakers by placing an obligation to fund the OLR on suppliers, spreading the costs evenly across the retail market.
- Levelisation and cost-sharing is a feature of several other DECC policies. We will seek to build on these established approaches where appropriate.
- Under the OLR, we propose that:
 - All licensed suppliers, not just those mandatorily or voluntarily offering Backstop PPAs, are obligated to participate in the levelisation process
 - The costs (or benefits) that are levelised will comprise of the costs (or benefits) associated with each Backstop PPA; and potentially both Ofgem's administration costs and a fixed payment to cover the fixed costs of each supplier.
 - Each supplier's share of the levelisation fund would be based on the volume of electricity that they have supplied over the levelisation period
 - Costs (or benefits) would be levelised quarterly
 - Mutualisation provisions would be included to guard against a shortfall in the levelisation fund. This would be subject to a collar and a cap, set at 10% and 1% of the levelisation fund respectively.
- We do not intend to require collateral to be posted by suppliers or offtakers, or to put in place additional arrangements in the event that a supplier goes insolvent and is unable to make its contribution to the levelisation pot. Suppliers acting as backstop offtakers would be expected to carry any losses arising from a shortfall in the levelisation pot until they are made good through the mutualisation process (subject to the collar and cap, above).

Key Questions:

- Q1 - Do you agree that all licensed suppliers should be obligated to participate in the levelisation process?
- Q2 - Should a fixed payment to each offtaker be included to cover administration and other fixed costs associated with being a backstop offtaker? How should such a sum be calculated?
- Q3 - Should Ofgem's costs be recovered from the OLR levelisation fund?
- Q4 - Do you agree that costs (and profits) should initially be levelised quarterly, and reviewed if there is high utilisation of the OLR mechanism?
- Q5 - Do you agree that mutualisation provisions are included, with a cap and collar? If the cap is breached, should we allow payment in instalments?
- Q6 - Do you agree that we should not require suppliers or offtakers to post collateral?

Introduction

Under the OLR, mandatory offtakers will be required (and voluntary offtaker will be able) to offer Backstop PPAs to eligible generators. There will be a cost (or a benefit) to providing these contracts.

We propose to levy a payment on (or recycle profits to) suppliers to cover these costs (or benefits) since they are best placed to pass these onto consumers tariffs in a way that will least distort the retail market. If, as may be the case, a backstop offtaker is also a supplier with an obligation to fund the OLR, it will be required to pay less (or be due a net payment) to account for the fact that it has already incurred a loss under the backstop PPAs to which it is a party.

This paper is primarily concerned with the question of *how* the levelisation process works. It assumes that the cost to backstop offtakers of providing the Backstop PPAs has been calculated, through competitive bids or through regulated cost assessment. As such the questions being asked here are *how should those costs be recovered from the market (or profits redistributed across it)?*

Assessment Criteria

Criteria	Description
Availability of financeable routes to market for independents	N/A <i>[The Backstop PPA terms should ensure that Generators are paid; they should be agnostic to the levelisation process]</i>
Minimise system costs	<ul style="list-style-type: none"> Levelisation should incentivise offtakers to compete for backstop PPAs (where competitive allocation is used)
Impact on suppliers	<ul style="list-style-type: none"> Levelisation should be designed to minimise credit rating / balance sheet impact on suppliers Levelisation should provide sufficient certainty to suppliers to enable them to efficiently price it into their retail tariffs
Potential for market distortions	<ul style="list-style-type: none"> Levelisation should not affect retail market competition / discourage new entrants, e.g. through disproportionate impacts on small or large suppliers
Practicality and cost of implementation and administration	<ul style="list-style-type: none"> Reporting obligations and payment metrics should, to the extent possible, be consistent with other levy payment process Levelisation process should be efficient and minimise administrative costs
Legal risk and potential compliance cost	<ul style="list-style-type: none"> Levelisation should spread the cost of the OLR fairly across all suppliers

Review of levelisation and cost sharing

There are several electricity policies, existing and in development, where the costs and benefits to individual suppliers are shared across the all suppliers to avoid distorting the retail market. The processes involved for three of these policies – the small scale Feed-in-Tariff, the Renewables Obligation, and the CfD - are summarised below, and tabulated in Annex 1.

(1) Feed-in-Tariff

The small-scale Feed-in-Tariff (ssFiT) levelises the costs incurred by FiT Licensees (mandated and voluntary suppliers) in making FiT payments to FiT generators that have signed up with the licensee (the supplier's "FiT contribution"). These costs are levelised across all electricity suppliers.

There are two distinct types of costs that are levelised. 'Qualifying FiT costs' are the fixed costs deemed to have been incurred by suppliers in connection with each FiT generator that signs up with that supplier, expressed in £/generator per year. The remainder of the costs are the FiT payments to generators, which includes the p/kWh figure for each kWh generated that is paid according to the tariffs set by Government, the p/kWh figure for each kWh *exported*, minus the assumed value of exported electricity to the supplier.

Levelisation payments are based on a 'market share FiT contribution', calculated based on the total FiT costs and suppliers' market share based on electricity supplied. Ofgem maintains a 'levelisation fund': if a supplier's individual FiT contribution is below its 'market share FiT contribution', it is required to make a levelisation payment to make up the difference; conversely if a supplier's FiT contribution is *above* its market share FiT contribution, it is entitled to receive a levelisation payment equal to the difference.

This levelisation is undertaken on a quarterly basis and takes 30 working days to complete. In addition, an annual levelisation takes place that reconciles the quarterly data, taking two months to complete.

Suppliers who have made FiT payment are protected against being under-recompensed in the event of a supplier default through a mutualisation process. This requires all suppliers to contribute to a shortfall in the levelisation fund in proportion to their market share, with payments made to those owed monies within 30 days of the initial payment deadline.

The mutualisation volume is subject to a cap and collar¹, currently set as a percentage of the most recent levelisation fund value. Shortfalls in the levelisation fund that are below the collar (currently 1%) and any sum in excess of the cap (10%) are not mutualised, and are absorbed by suppliers that are owed funds.

The process is administered by Ofgem in accordance with the FITs Order. However, Government is responsible for setting some levelisation detail each year: the proportion of electricity deemed to be

¹ The *collar* sets a *de minimis* limit, below which the sums involved are not sufficient to warrant the administrative cost of mutualising. The *cap* limits the maximum sum that can be mutualised in order to avoid a domino effect, such as in the unlikely scenario whereby one or two large suppliers default. In such a scenario the mutualisation sum falling on the remaining suppliers could be so great that they were themselves placed under financial stress.

exported and the value of that electricity; the additional qualifying FIT costs; and the mutualisation trigger range.

(2) Renewables Obligation

Under the RO, suppliers pay into the buy-out fund to cover for any ROCs that they do not present towards their total obligation. This buy-out fund is then recycled to suppliers in proportion to the total number of ROCs that each has presented, increasing the 'value' of each ROC. This process is undertaken annually.

Suppliers that do not meet their obligation by the 1st September must make a payment into a late payment fund (with interest), which is collected and redistributed in the same way as the buy-out fund.

Mutualisation provisions apply when a supplier cannot meet its RO, for example due to a default, resulting in a shortfall in the buy-out fund. All suppliers are required to make additional payments to make up the shortfall in proportion to their RO.

As with the ssFiT, there is a cap and collar to the mutualisation sum. The cap for the RO is England and Wales was set at £200m in 2005, and increases with RPI each year. It was set at this amount such that it would only be breached if at least one major supplier failed. The collar, used to determine a 'relevant shortfall', is specified in legislation – the Renewables Obligation Order 2009 – and broadly represents £1m for every percentage point of the Obligation (as originally envisaged). In the current financial year it is £13.4m.

Again, the process is administered by Ofgem, with the scheme set out by Government in legislation.

(3) CfD

A Supplier Obligation will control payments from suppliers to the counterparty body under the CfD. All licensed suppliers will be required to make these payments, based on their market share (volume of electricity supplied). Invoices, as with the BSC, are proposed to be settled daily.

To protect the CfD Counterparty Body (and, therefore, generators) from a shortfall in payments, several measures are being proposed: collateral will need to be posted, an insolvency reserve fund is being considered, and a mutualisation process would recover outstanding monies from suppliers in proportion to their market share.

Levelisation under the OLR

Below we set out our initial view on the OLR levelisation principles:

(1) Parties to levelisation

Smaller licensed suppliers are exempted from participating in some Government policies. However, these tend to be energy efficiency policies with significant fixed costs that would disproportionately impact upon a smaller supplier. Such exemptions have not extended to levelising costs of policies.

Whilst we would expect the OLR to be used by generators rarely, if at all, in the event that it was used widely, there could be a large cost to those suppliers bearing the cost; leaving some suppliers outside of this process would risk a significant distortion of the retail market. Since the small-scale

FiT, RO (and soon the CfD) encompass all suppliers in levelising costs, requiring smaller suppliers to levelise OLR payments should not involve a significant additional fixed cost.

Therefore, we propose that all licensed suppliers, not just those mandatorily or voluntarily offering Backstop PPAs, are obligated to participate in the levelisation process.

Q1 - Do you agree that all licensed suppliers should be obligated to participate in the levelisation process?

(2) Cost calculation

The total cost (or benefit) of the OLR scheme will be levelised across the market. The elements of this will comprise:

- The net cost or benefit to offtakers for each MWh generated under each Backstop PPA over the levelisation period in question, as determined by regulatory cost assessment or a competitive process (see accompanying paper; under a competitive process, this would be the amount bid by the successful bidder), multiplied by the volume of electricity generated under each backstop PPA.
- (Potentially) A fixed payment to each offtaker to cover administration and other fixed costs associated with being a backstop offtaker over the levelisation period.
- (Potentially) Costs incurred by Ofgem in connection with the administration of the scheme.

Q2 - Should a fixed payment to each offtaker be included to cover administration and other fixed costs associated with being a backstop offtaker? How should such a sum be calculated?

Q3 - Should Ofgem's costs be recovered from the OLR levelisation fund?

(3) Market share

We propose that the costs (or benefits) incurred by offtakers are split between suppliers on the basis of the volume of electricity supplied over the levelisation period, as in the case with the ssFiT.

At the end of the levelisation period, Ofgem would determine the volume of electricity generated by each generator under a Backstop PPA. This data would be matched with Ofgem's record of the management fee bid, or the regulated cost assessment, to give the total levelisation fund needing to be borne by all licensed suppliers.

Each supplier's share of the levelisation fund would then be established based on the volume of electricity that they have supplied over the period. Payments due would be netted off against any payments already made to generators through providing Backstop PPAs as is the case under the ssFiT.

(4) Payment timetable

At the outset of the OLR, we propose that the levelisation would occur quarterly. This would be subject to the annual review, which would consider the current and projected volume of generation within Backstop PPAs, and adjust the frequency of levelisation as necessary – the intention would be to reduce the levelisation period and increase the frequency of levelisation payments in the event that the OLR was widely used. This would reduce the working capital requirements of backstop offtakers and therefore reduce barrier to entry.

As with the ssFiT, we propose that suppliers make their levelisation payment as one lump sum.

An annual reconciliation would account for changes in measured data across the quarterly periods.

Q4 - Do you agree that costs (and profits) should initially be levelised quarterly, and reviewed if there is high utilisation of the OLR mechanism?

(5) Mutualisation

We propose that mutualisation provisions are included within the levelisation process to guard against a shortfall in the levelisation fund. As with the ssFiT, suppliers will have 10 working days to make mutualisation payments once they are issued with a mutualisation notice. However, if the shortfall is greater than the mid-point of the range of amounts that may trigger a mutualisation (see cap and collar below), that payment period may be extended to 20 working days.

We propose to include both a collar and a cap on the amount of shortfall that can be mutualised. The collar reduces the administrative burden by only mutualising if the shortfall is proportionally significant. The cap helps preserve the integrity of the retail market by avoiding a domino effect; the cap would only be exceeded in the unlikely event that one or more large suppliers had become insolvent, and the mutualisation payments could put remaining suppliers under stress. Amounts below the collar would not be mutualised; mutualisation of sums greater than the cap would be limited to this amount.

We propose to set the cap such that it would only be breached in the event that one or more large suppliers became insolvent. In this case, where the mutualisation sum is equal to the cap, we would consider allowing payment in four quarterly instalments.

In the event that there is a shortfall after mutualisation, offtakers would be paid in proportion to the total sum that they are owed.

Q5 - Do you agree that mutualisation provisions are included, with a cap and collar? If the cap is breached, should we allow payment in instalments?

(6) Collateral

As is the case with the RO and the ssFiT, we do not propose to require collateral to be posted under the OLR. Posting collateral can be expensive; since we do not expect the OLR to be used frequently, posting collateral would be a disproportionate requirement.

In the CfD Supplier Obligation, collateral serves a specific purpose in assuring generators that they will be paid by the Counterparty Body under the pay-when-paid principle. However, generators require no such assurance under the OLR since offtakers will be contractually obliged to make payments under the terms of the Backstop PPAs, regardless of the levelisation mechanism. To ensure that there is enough money in the levelisation fund to pay backstop offtakers, Ofgem can use their licence enforcement powers against those suppliers that do not contribute what they owe. Whilst provision of collateral could reduce the chance of the levelisation fund being 'short' in the event of a supplier becoming insolvent, we consider that the negative impact of requiring collateral provision would outweigh the reduction in what is already a low probability event.

Q6 - Do you agree that we should not require collateral to be posted?

Annex 1 - Learning from experience

Policy	Cost Sharing	Frequency	Who/Market Share	Protections from default	How managed
RO	Payments into buy-out fund	RO is an annual obligation. Buy-out fund is recycled annually. Mutualisation payments are in four instalments and redistributed by Ofgem after each instalment.	Suppliers pay into the buy-out fund to cover for ROC that they do not present for compliance towards their total obligation. The buy-out funds (and late payment funds) are then redistributed to suppliers in proportion to the total number of ROCs that each has presented	Suppliers that do not meet their obligation by the end of 1 September must make a payment into a late payment fund (with interest), which is collected and redistributed in the same way as the buy-out fund. Mutualisation: Where a supplier cannot meet its RO, there is a shortfall in the buy-out fund. There is a de minimis limit, below which the shortfall isn't considered sufficient to trigger mutualisation. All suppliers who have discharged their RO and/or ROS (in whole or in part) will be required to make additional payments to make up the „relevant shortfall'. The sum owed is calculated by assessing that supplier's obligation as a proportion of the total Obligation for the shortfall period, taking into account the fact that the failed supplier cannot make any payment. The whole of the shortfall will be recovered, up to the mutualisation ceiling.	Government (and DAs) set out legislation (Renewables Obligation Order 2009 (as amended), the Renewables Obligation (Scotland) Order 2009 (as amended) and the Renewables Obligation Order (Northern Ireland) 2009 (as amended)). Ofgem administer the scheme directly in Great Britain and on behalf of the Northern Ireland Authority for Utility Regulation (NIAUR) in Northern Ireland. Responsibilities include: <ul style="list-style-type: none"> - monitoring and administering compliance of suppliers - calculating, the buy-out price per ROC and mutualisation ceiling, reflecting RPI - receiving ROCs from suppliers - receiving buy-out payments and redistributing the fund to suppliers - receiving late payments and redistributing
ssFIT	Generation payments, Export payments (minus value), Qualifying FiT costs.	Periodic levelisation: - Quarterly process, takes 30 working days to complete. Data submitted by suppliers via Central FIT Register Annual levelisation:	Licensed Electricity Suppliers > 250,000 domestic customers are required to join the FIT scheme Other licensed electricity suppliers can elect to join the scheme and become Voluntary FIT Licensees. All licensed suppliers are obligated to participate in the levelisation process. FIT costs are split by market share: the	Those owed monies are protected through a mutualisation process. These payments are made within 30 days of the initial payment deadline. The mutualisation volume is subject to a cap and collar, currently set as a percentage of the most recent levelisation fund. Shortfalls in the levelisation fund that are below the collar (currently 1%) are not be mutualised, and are absorbed by those who are owed funds. Shortfalls are only mutualised up to the cap (10%) – amounts above this are absorbed by those who are owed	The FITs scheme is based on two separate pieces of legislation, the FITs Order (which tells Ofgem how to administer the scheme), which is a negative resolution secondary regulation and the modification to the standard conditions of electricity supply which is licence condition. Ofgem issue a supplier guidance document to explain their interpretation of Government legislation and are the authority on all aspects of the scheme .

		<ul style="list-style-type: none"> - Reconciles all quarterly data. Uses supply and FIT payment data plus generation and export data; takes 2 months. 	amount of electricity supplied, expressed as a percentage of the electricity supply market of Great Britain. The “electricity supply market of Great Britain” is the electricity supplied to all customers less the amount of any electricity sourced from renewable sources and generated outside the United Kingdom;	funds.	<p>Under the legal structure DECC cannot intervene in Ofgem decisions.</p> <p>Some detail is left for the SoS to decide:</p> <ul style="list-style-type: none"> - Proportion of electricity deemed to be exported - Value of the exported electricity - Administrative (qualifying FIT) costs - The mutualisation trigger range <p>These can be changed annually (though might need consultation)</p>
CfD	Supplier Obligation	Billing period TBC, but proposed as daily.	All licensed suppliers, based on market share; the volume of eligible energy supplied	<p>Collateral, mutualisation, and the existing supplier of last resort.</p> <p>All suppliers (and generators when the payment flow is reversed) will be required to post collateral to cover their upcoming liabilities in the form of cash or Letters of Credit (LoCs), and is likely to cover the expected supplier obligation debts that will accrue over the period from the settlement date to the time that the associated invoice is due to be paid.</p> <p>Consideration of an insolvency reserve fund.</p> <p>The mutualisation process would allow outstanding monies owed by a supplier to be recovered from the remaining suppliers based on market share at the time of mutualisation.</p>	<p>Powers to make regulations to create the supplier obligation are within the Energy Bill. The Bill states that the Secretary of State when making regulations must make provision for suppliers to pay the Counterparty, and that the Counterparty can recover sums owed to it as a debt.</p>