



National Audit Office

Report

by the Comptroller
and Auditor General

Department of Energy & Climate Change

The Levy Control Framework

Key facts

£2bn

the level of the cap on spending under the Levy Control Framework in 2011-12, covering the **Renewables Obligation, Feed-in Tariffs and Warm Home Discount**

£7.6bn

the level of the cap on spending on electricity policy schemes under the Levy Control Framework in 2020-21 (in 2011-12 prices), covering the **Renewables Obligation, Feed-in Tariffs and Contracts for Difference**

33%

the proportion of electricity which the Department would expect from renewable sources in 2020-21 under its central assumptions

£1,458 million the cost of the **Renewables Obligation** in 2011-12 to support investment in renewable generation

£151 million the cost of **Feed-in Tariffs** in 2011-12 to support small-scale renewable energy generators

£238 million the cost of the **Warm Home Discount** in 2011-12 to help vulnerable consumers with their electricity bills

£247 million the amount by which the Framework cap exceeded combined spending on the **Renewables Obligation, Feed-in Tariffs and Warm Home Discount** in 2011-12

£2,534 million the forecast cost of the **Contracts for Difference** scheme in 2020-21 (in 2011-12 prices) to provide support to new low carbon generators

Summary

1 The Department of Energy & Climate Change (the Department) has responsibility for UK energy policy and has overall responsibility within government for delivery to meet UK climate change commitments. The Department has three overarching energy policy objectives: to deliver secure, low carbon and affordable energy for consumers. The Department has used a range of policies and regulatory requirements for the energy market to achieve its objectives. Some of the Department's interventions involve levies on electricity suppliers.

2 Levy-funded expenditure is analogous to government spending. Levy schemes are approved by Parliament and require electricity suppliers to meet their costs. Electricity suppliers seek to recover these costs from consumers through bills rather than the government funding the schemes directly through general taxation. In 2011, the Department and HM Treasury established the Levy Control Framework (the Framework) to cap the cost of levy-funded schemes to ensure the Department:

“achieves its fuel poverty, energy and climate change goals in a way that is consistent with economic recovery and minimising the impact on consumer bills.”¹

The Framework specifies arrangements for monitoring the costs of levy-funded schemes, and requires early action to keep costs within the caps.

Scope of our report

3 We reviewed the operation of the Framework to assess its effectiveness for providing control and accountability to Parliament for levies and levy-funded expenditure. We used five criteria derived from the model we use for assessing the maturity of the government's financial management of public expenditure (**Figure 1** overleaf).²

¹ HM Treasury, *Control framework for DECC levy-funded spending*, March 2011.

² National Audit Office, *Financial management maturity model*, January 2012.

Figure 1

Criteria for evaluating the Levy Control Framework

Coverage	Framework coverage has a clear rationale, which gives investors confidence and fits with the Department's main financial control regime, without duplication or unjustifiable gaps.
Governance	The Department's and HM Treasury's governance arrangements for the Framework adequately engage skilled and empowered people in decision-making.
Forecasts	Forecasts used by the Department to set annual Framework spending caps are based on a sound understanding of the factors influencing costs and outcomes, and reasonable assumptions regarding future levels of those factors.
Controls	The Department has effective controls for costs of, and outcomes from, schemes covered by the Framework and uses them appropriately.
Reporting	The Department reports actual and forecast costs and outcomes from Framework measures transparently, promptly and accurately to ministers, Parliament and the public.

Source: National Audit Office

4 This report is organised in three parts:

- Part One describes the Framework.
- Part Two assesses the effectiveness of the Framework so far.
- Part Three assesses risks to the future effectiveness of the Framework.

Key findings

5 The Framework is a valuable tool supporting control of the costs to consumers from pursuing energy policy objectives. The Department delivers a number of its energy schemes through levies on energy suppliers, which suppliers seek to recover through consumers' bills. This levy-funded spending is not subject to the controls routinely applied to departmental spending funded by general taxation. By setting a cap on levy-funded spending, the Framework should encourage the Department to control the burden on consumers and ensure that spending is subject to appropriate oversight by HM Treasury equivalent to spending from general taxation. It should encourage consideration of the trade-offs between schemes that may be needed to achieve the government's goals while minimising impacts on consumer bills. And, by enabling reporting of the overall cost of levy-funded schemes for consumers, the Framework should enable greater transparency and more effective public and parliamentary scrutiny (paragraphs 2.7 to 2.15).

Coverage

6 The Framework does not currently cover all consumer-funded energy schemes. The Department and HM Treasury decided the Framework's current scope on the basis of actual or anticipated decisions by the Office for National Statistics on which schemes should be classified as levies. The Office for National Statistics has not reached a classification decision on the Energy Companies Obligation, a consumer-funded scheme, which could reasonably be regarded as a levy. The Department and HM Treasury consider that the Energy Companies Obligation is a regulation and not a levy, and have therefore not included it in the Framework. The Department monitors the costs and outcomes of the Energy Companies Obligation outside the Framework, and has reported publicly on the impact of this scheme on consumer bills (paragraphs 2.2 to 2.4).

7 By establishing the level of support available through the Framework for certain levy-funded schemes to 2020-21, the Department has provided greater certainty for investors. The Department has yet, however, to clearly define the future scope of the Framework. The Department has announced upper limits on the levies raised to fund electricity policies, covering the Renewables Obligation, Feed-in Tariffs and Contracts for Difference to 2020-21. It has stated too that these caps do not include the new Capacity Market scheme or non-electricity policies that are levy-funded, such as the Warm Home Discount. But it has yet to finalise cost control arrangements for the Capacity Market scheme and, within it, the Electricity Demand Reduction measures. The Department has also stated that these caps are intended to cover electricity policy in general, and would therefore apply equally to any future levy-funded electricity policy. Investors seek transparency over the scope and scale of any caps on funding to give them confidence in the support available for potential investments (paragraphs 3.2 to 3.5).

Governance

8 A levy control board has enabled joint HM Treasury and departmental oversight of the operation of the Framework but the board has focused on cost control and not the associated impacts on energy policy outcomes. The Department considers that its policy teams consider outcomes and potential trade-offs between levy-funded schemes when developing policy advice for ministers. Contrary to its terms of reference, the levy control board's monitoring has therefore focused on costs compared with Framework caps and on providing HM Treasury with assurance that the costs of levy-funded schemes are subject to appropriate controls. The Department and HM Treasury have not taken the opportunity to use the board to jointly consider costs and outcomes in aggregate across all levy-funded schemes. They are currently considering how the board should operate in future (paragraphs 2.5 to 2.6).

9 The governance arrangements for the Framework will need to be updated when new delivery bodies take up their responsibilities for new forms of levy-funded spending under the Energy Bill 2012-13 to 2013-14. National Grid will assess applications and allocate contracts under the Contracts for Difference scheme in accordance with an allocation framework agreed by government. A government-owned counterparty body will then award and administer those contracts. The Framework's governance arrangements will need to be revised to ensure all major stakeholders in the operation of the Framework can coordinate their activities to keep within the Framework cap (paragraphs 3.6 to 3.9).

Forecasting

10 The Department's decisions on the Framework's cap are informed by substantial and detailed modelling of the electricity market as well as consultation with industry and market intelligence gathering. We examined the Department's dynamic dispatch model (DDM) as part of our study of infrastructure investment.³ We concluded that design decisions in the DDM about how to model investor and generator behaviour appear reasonable and that overall it performs well in many areas. However, we also identified weaknesses, for example in the Department's quality assurance of the model, which prevent us having the highest degree of confidence in the model forecasts. The Department has stated that it is working to address these issues, and has commissioned an independent professional services firm to review the underlying formulae used in the model (paragraphs 3.10 to 3.16).

11 The Department expects to achieve its ambition of 30 per cent renewable electricity by 2020 within the cost caps it has set for the Framework. The Department has published scenarios illustrating how it expects to remain within the cap and achieve its ambition for renewable electricity in a range of circumstances. The Department has undertaken but not published further scenario analysis including some scenarios where Framework caps would be breached. However, the Department's scenario analysis does not systematically show the effects of varying individual input assumptions in the model or the relative probability of different scenarios. The Department's analysis does not give an indication of the probability that the Department's current policies will achieve the ambition for 30 per cent renewable electricity by 2020 within Framework caps (paragraphs 3.14 to 3.15).

³ Comptroller and Auditor General, *Infrastructure investment: the impact on consumer bills*, Session 2013-14, HC 812-I, National Audit Office, November 2013.

Controls

12 The Department has improved its cost controls for schemes currently covered by the Framework. The Department expects levy-funded spending to exceed the Framework cap in three out of four years over the spending review period to 2015, but it has introduced controls to limit spending so that it comes within the agreed 20 per cent headroom, on top of the cap. It expects to come within the £5.3 billion cap (in nominal prices) set for the Framework for 2015-16 by £300 million. To achieve this, the Department has refined its controls over the Renewables Obligation by adjusting the support levels for individual technologies and providing flexibility for further control of support for biomass plant to prevent cost escalation. The Department also introduced a method to automatically reduce tariffs available under the Feed-in Tariff scheme if take-up exceeds its expectations (paragraphs 2.7 to 2.15).

13 The Contracts for Difference scheme introduces a new risk of levy costs escalating if energy market prices fall below expected levels. The cost of levy-funded schemes is set to rise from £1.8 billion in 2011-12 to up to £7.6 billion in 2020-21 (in 2011-12 prices), with the inclusion of the Contracts for Difference scheme. The principle control for the Department will be the number of contracts awarded and their strike prices. The levy cost arising will depend on the difference between the strike prices in the contracts and the prevailing wholesale electricity price and how much of the contracted generating capacity comes on stream. To achieve its objectives of providing certainty over support for decarbonisation while minimising costs to consumers, the Department will need to work with its Framework partners to provide up-to-date and transparent forecasts of levy costs and outcomes (paragraphs 3.17 to 3.23).

Reporting

14 Ofgem publishes separate reports on each of the schemes currently included in the Framework, and the Department has also published information on the impact of its policies on prices and bills. However, the Department has not reported aggregate actual expenditure against the Framework cap, limiting proper public and parliamentary scrutiny of costs to consumers. When the Framework was published, the Department intended that actual and forecast revenues and expenditure under the Framework schemes would be reported through its Annual Accounts. The Department subsequently was unable to report the scheme revenues and expenditure in this way because they did not meet the conditions for inclusion in financial statements under International Financial Reporting Standards. Ofgem publishes expenditure and outcomes for each scheme up to 11 months after year-end in line with legal requirements, although preliminary data from suppliers is available earlier, within six months of year-end, and could be published earlier. The Department has not defined how current arrangements for enforcement of compliance with the schemes could support assurance on its own reporting of scheme spending (paragraphs 2.16 to 2.21).

15 Public reporting of Framework costs together with outcomes is fundamental to providing confidence in the support regime. Reporting outcomes alongside costs supports transparency on the relative merits of spending on different schemes. The Department currently regularly publishes data on the level of renewable generation achieved as a result of the Renewables Obligation and the Feed-in Tariff schemes, but does not report these outcomes alongside costs. It has also published data on the impact of energy schemes on consumer bills. In the future, because of the interaction between government interventions and market prices, the Department will need to report levy costs alongside outcomes and impacts on energy bills to consumers to provide a complete picture of overall impact. In addition, reporting of the Framework will need to be consistent with the other public reporting of the administration of the schemes, including the reporting by the proposed new Contracts for Difference counterparty body (paragraphs 3.24 to 3.26).

Overall conclusion

16 In establishing the Framework, the government has rightly recognised the importance of monitoring and controlling the considerable cost of energy schemes that consumers fund through their energy bills. The Framework has prompted the Department to monitor actual and expected costs closely and consider its response to unexpected increases in costs of schemes charged to consumers.

17 However, the operation of the Framework has not been fully effective in some key areas. The joint Treasury and departmental governance board for the Framework has not strongly linked spending and outcomes in its deliberations. Reporting on Framework schemes has not supported effective public and parliamentary scrutiny of the overall costs and outcomes from levy-funded spending. The Framework does not cover the consumer-funded Energy Companies Obligation scheme and it is not yet clear whether it will cover the new Capacity Market scheme, including Electricity Demand Reduction measures. As consumer-funded spending increases and new schemes are introduced, the Department needs to assure Parliament and the public that it has robust arrangements to monitor, control and report on all consumer-funded spending, and the outcomes it is intended to secure.

Recommendations

Coverage

18 The Department and HM Treasury should keep in mind the underlying objective of the Framework and aim for transparency and accountability when deciding which schemes to include within the Framework. The Department has processes in place to monitor costs to consumers of the Energy Companies Obligation and is considering measures to control the cost of the Capacity Market scheme. If these schemes are not covered by the Framework, the Department should explain how it will control the aggregate costs of consumer-funded schemes and assess whether together these schemes are achieving the outcomes needed to meet its objectives.

Forecasts

19 The Department should develop its testing of the modelling results used to inform the Framework and develop the capability to allow more sophisticated analysis of the probability of different scenarios. The Department should continue to address weaknesses in its quality assurance of the forecasting model. This should include a review of the outputs from the most recent version of the model to gauge its accuracy against known outcomes and explain any discrepancies.

Controls

20 The Department must ensure that it monitors the risk of under- or over-allocating available budgets for Contracts for Difference. In particular, it will need to consider:

- how to allocate budgets over time so that best value is achieved from the available budget; and
- the continuing risk of breaching its spending cap if the wholesale price falls.

Reporting

21 The Department and HM Treasury are proposing to supplement existing public reporting on individual Framework schemes by reporting routinely to Parliament on spending on levy-funded schemes. These reports should cover past and future spending across all the schemes within the Framework and the outcomes achieved or expected. This reporting should also provide appropriate independent assurance on reported figures and the effective operation of controls. In particular, the Department should do the following:

- Establish a bespoke process allowing Parliament to scrutinise actual and forecast committed levy-funded spending, since it falls outside the established financial accounting and reporting framework for the Department.
- Conduct or commission appropriate independent assurance of the robustness of data on actual and forecast Framework spending and outcomes.
- Indicate how and when controls have been applied and the impact on outcomes and costs.
- Ensure that any costs reported under the Framework can be reconciled with those reported by government-owned counterparty or settlement bodies for the same schemes.