LOW CARBON
CONTRACTS COMPANY

# Annual Report 2016/17
## CFD Scheme Delivery

**Low Carbon Contracts Company Ltd**
Registered No. 08818711

**Our vision…**

is to be at the heart of the delivery of the UK's goals for secure, affordable and sustainable electricity

LCCC's Guiding Principle is **to maintain investor confidence** in the CFD scheme and **minimise costs to consumers**.[1]

The **Low Carbon Contracts Company** (LCCC) is an independent, non-profit private company owned by the Secretary of State for Business, Energy and Industrial Strategy (BEIS). We were established to be the counterparty to Contracts for Difference (CFDs) for large scale, low carbon electricity generation under the CFD scheme. As the counterparty to CFDs, our role is crucial to delivering the government's objective of "ensuring that the country has secure energy supplies that are reliable, affordable and clean".[2]

This is reinforced by our role in managing payments to reliable capacity providers under the Capacity Market scheme on behalf of our sister company, Electricity Settlements Company (ESC).

**LCCC is providing:**

- strong independent governance
- commercial skills and industry knowledge
- a close working relationship with government, industry and other key stakeholders
- a focus on delivering better outcomes for the UK.

[1] Low Carbon Contracts Company Framework Document, available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/338353/FINAL_LOC_Co_FWD__2_.pdf

[2] DECC, Single departmental plan: 2015 to 2020: https://www.gov.uk/government/publications/decc-single-departmental-plan-2015-to-2020

# Contents

# Our Portfolio

## CFD

Portfolio Power: MW per technology*

**Offshore Wind**
4,270MW
44%

**Nuclear**
3,200MW
33%

**Biomass Conversion**
1,065MW
11%

**Onshore Wind**
687MW
7%

**Dedicated Biomass with CHP**
299MW
3%

**Energy from waste with CHP**
94.75MW
1%

**Advanced Conversion Technology**
59.4MW
0.6%

**Solar PV**
21.84MW
0.2%

**Total: 10GW**

## CM†

Portfolio Power: MW per technology**

**CCGT**
22,062MW
41%

**Coal/biomass**
10,480MW
19%

**Nuclear**
7,878MW
15%

**CHP and autogeneration**
4,604MW
9%

**OCGT and Reciprocating Engines**
3,400MW
6%

**Storage**
2,710MW
5%

**Interconnector**
2,362MW
4%

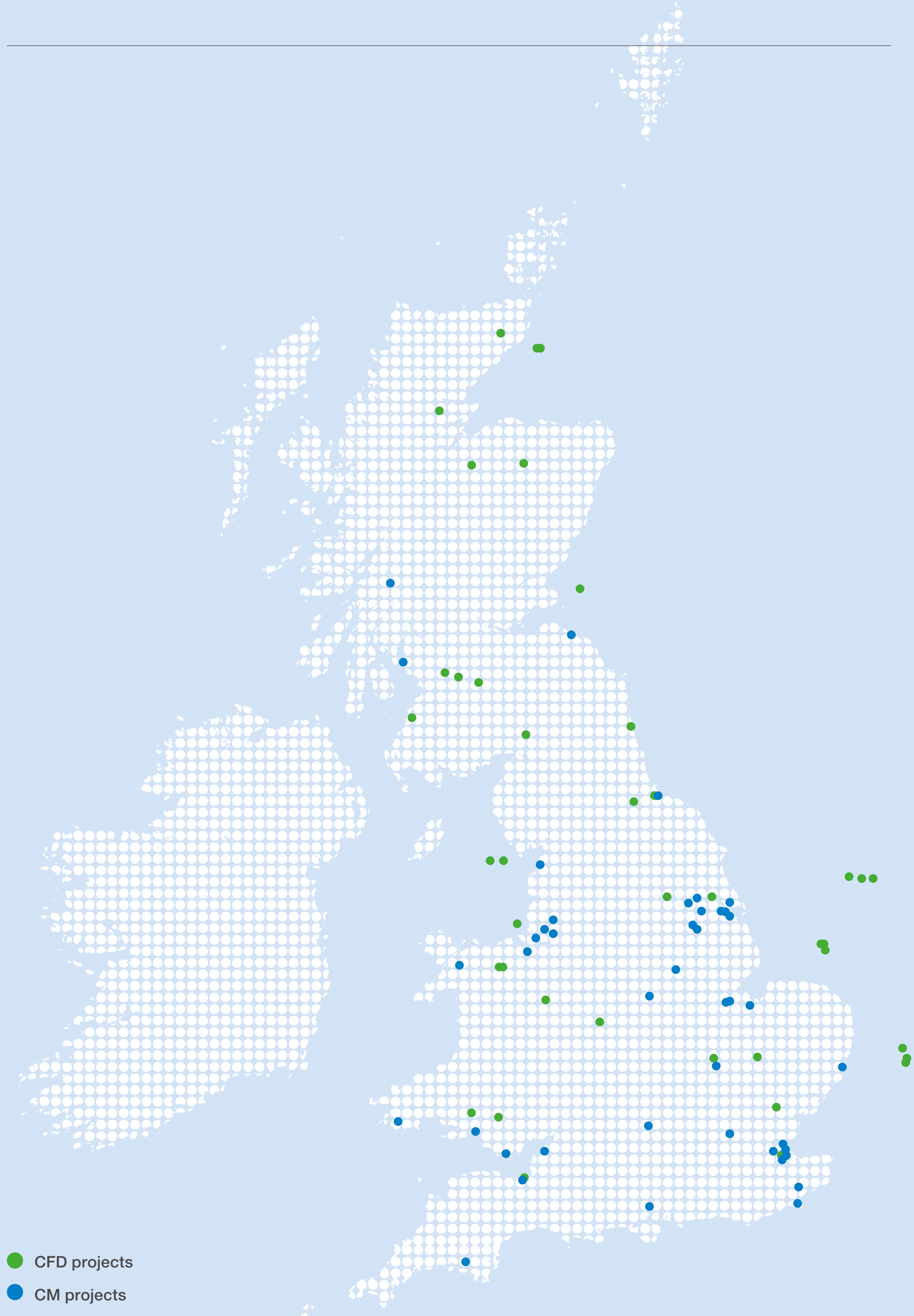
**Hydro**
679MW
1.3%

**DSR**
209MW
0.4%

**Oil-fired steam generators**
17MW
0.03%

**Total: 54.43GW**

*Installed capacity estimates or final installed capacities (Drax and Charity Farm) from the CFD register on 31 March 2017
**CM MWs per technology from National Grid, Early Auction Capacity Market Auction for 2017/18, p6: https://www.emrdeliverybody.com/Capacity%20Markets%20Document%20Library/Early%20Auction%2017-18%20Provisional%20Results.pdf
†locations for CM facilities shown on the map (opposite) represent generation of 290MW and above



CFD projects
CM projects

Chairman's foreword

# A new phase

This year has seen a marked change in the focus of LCCC and its sister company, ESC, all of whose activities are undertaken by LCCC.

The organisations are now fully operational, with payments commencing to both low carbon generators and capacity providers. It has been pleasing to see how the two companies have matured as we have moved into this new phase of activity.

LCCC is working closely with our counterparties as their enterprises approach the commissioning phase, including engaging with investors to enable projects to secure finance. We have become "the" specialists in CFDs, advising our shareholder on revision to the Standard Terms.

We have also been very active in the Capacity Market. We have been involved in three auctions this year, all on different timescales, as well as managing the first payments to the capacity providers successful in last year's Transitional Arrangements. This is against a backdrop of ongoing changes to the payment mechanism as a result of Ofgem's annual consultation process.

## Gaining momentum

The CFD projects we are managing are now valued at around £60bn. They include one of the largest infrastructure projects in the UK, Hinkley Point C, which transferred to LCCC in September 2016. We have worked hard to assist our CFD counterparties to deliver against their obligations and to ensure that generation is delivered on time.

We have also been busy looking after consumers' interests. In managing our CFDs, we have a duty to maintain the balance of risks, benefits and liabilities between the generator and, ultimately, the consumer. This is central to our management approach. We apply our discretion in accordance with our Guiding Principle which is to maintain investor confidence in the scheme and minimise costs to consumers. Now that projects are starting to generate low carbon electricity, they are contributing to the decarbonisation of the electricity sector and ultimately helping the UK to meet its carbon reduction targets for 2030 and 2050.

We have had many interactions with Demand Side Response providers as a result of the Capacity Market Auctions. We have worked hard to enable the Capacity Market to operate effectively, through coordination across multiple delivery bodies.

Despite the scale and complexity of the activities we are managing, we have consistently met all our operational targets, delivering new capabilities successfully and within agreed timescales.

## Our people

We have an experienced board which is adding tangible value to the work of the companies as they have worked through a variety of demanding issues. I am grateful to my colleagues for their insights and commitment. I should also like to thank all of our staff for their hard work and dedication during a time of considerable challenge and their success in meeting all our deadlines. Talent is key to maintaining delivery excellence. We are, therefore, working closely with other BEIS partner organisations to provide opportunities for our people to learn from others and gain new experiences.

## Looking ahead

Our vision is to be at the heart of the delivery of the UK's goals for secure, affordable and sustainable electricity. We are constantly looking for opportunities to add value in the achievement of these goals.

We are particularly focused on seeking simplifications and further efficiencies in the delivery of the schemes we manage. For example, we advised BEIS on how to streamline the CFD settlement processes to ensure that we can return suppliers' funds more quickly when they are no longer needed.

As the market evolves, we are increasingly working with the regulator, Ofgem, alongside our core delivery partners BEIS, National Grid and EMRS. We stand ready to collaborate further to respond to technological change across the energy sector. We are particularly mindful of the growing importance of electricity storage and the increasing appetite for decentralised and smarter energy solutions that give communities a personal stake and greater control. We also see cross sector innovation and the electrification of heat and transport as important drivers of change in the future. All this will undoubtedly impact on electricity suppliers and affect the way the market operates.

In the year ahead, we will continue to deliver the CFD and Capacity Market schemes effectively and efficiently and to assist BEIS by advising on how to futureproof them. We look forward to achieving further success and to supporting the government's objectives of ensuring security of supply, reduced costs to consumers and decarbonisation.

**Dr Martin Read CBE**
Chairman

©DONG Energy
Installing the world's biggest wind turbine. The windfarm began generating in early 2017. It can generate enough electricity to power over 230,000 homes.

# Chief Executive's foreword

## Making it happen

This year has been about making things happen. Although we moved into a business as usual phase, we have still been doing some things for the very first time.

CFD projects from the first Allocation Round in 2014 are progressing through the next stage following successful completion of the Milestone Requirement, with two projects commencing operation after fulfilling their "Operational Conditions Precedent" (OCP). The OCP process requires projects to satisfy certain commissioning and other tests ahead of qualifying for CFD difference payments. One of the projects commencing operations was the DRAX biomass conversion facility, which received European Commission State Aid clearance and started generating under its CFD in December 2016. LCCC made its first CFD difference payment to the project (28 days later) in January 2017.

In September 2016, we signed the Hinkley Point C contract, our biggest contract to date. Hinkley Point C is a 3.2GW nuclear power station. When you compare this with the smallest project we are managing, which is a 6.15MW onshore wind facility, it becomes clear that we are managing a diverse and interesting portfolio. Looking ahead to the second Allocation Round which is currently under way, we can expect contracts to be allocated to projects with start dates in the early 2020s. As these projects progress, by the mid-2020s, CFD generation could represent a considerable proportion of the market – providing electricity for perhaps up to a third of total demand.

With the successful conclusion of both settlement system modules, we were ready to start making payments to counterparties during the year in line with our regulatory and contractual requirements. Charity Farm, a solar project, was our first CFD project to move into operation in June 2016 and received the first CFD payment from our new system. This was followed by payments to capacity providers in October 2016, who were successful in the first Transitional Arrangements Auction. We achieved these key milestones thanks to the dedicated hard work of our people in LCCC and the team in EMRS.

During the year, LCCC collected just under £15.6m from suppliers under the operational cost levy, but spent around £11.7m, which means that we are returning over £3.8m to suppliers. We are pleased that we have been able to deliver our operational role not only within budget, but in such a way that we can return monies to suppliers, with a significant amount of these monies resulting from savings and the recovery of a sum from the sub-contractor retained to provide the original settlement system.

Our operational costs levy for 2017/18 has been set at around 5 pence per MWh of electricity (which represents an expected budget for operational costs of just under £15m, based on the estimated gross volume of electricity demand in Great Britain in the financial year).

### Our people

I would like to extend my thanks to our highly experienced and supportive board of directors who have brought their expertise to both companies addressing several interesting issues that have arisen as we embarked, over the course of the year, on our next phase of operations. And, of course, thanks go to the tireless commitment and hard work of our teams, without whom we could not have met all our operational milestones.

Moving into business as usual, our organisation has been maturing as our contract management function has been growing and we've needed to adapt our resources, people and infrastructure to accommodate the needs of the business. This has meant having independent IT arrangements (originally we were fully reliant on government IT systems), which has enabled us to save almost 4% of our total operational costs. We have taken the opportunity to invest in and grow our commercial team in order to build the expertise we require to manage the growing numbers of CFDs and, as projects move into construction and operations, we have sought to make the best use of professional and technical advisers to support our work.

## Building for the future

Occupying a space between government, developers, investors and industry, with a key role in delivering the CFD and Capacity Market schemes, our Guiding Principle is to maintain investor confidence and minimise costs to consumers. This means that we must continue to build close working relationships with government, our key delivery partners (including National Grid and EMRS), stakeholders (including BEIS and Ofgem) and the energy industry to evolve, influence, support and improve the environment within which we all deliver energy policy and the associated low carbon infrastructure.

We have learnt a huge amount about the diverse nature of our projects, how to manage them as a portfolio and the sort of issues that will arise in the early phase of projects. Our growing knowledge and experience has brought us to a position where we can also take a more consultative and advisory role in the energy delivery field. For example, working with BEIS, we have improved the CFD standard template, secured changes to the regulations to better align the settlement processes under the CFD and Capacity Market schemes and implemented these changes into our settlement system. In this way, we have continued to find ways to ensure that we minimise the burden of the schemes on electricity suppliers, and ultimately consumers.

## Looking ahead

The world and the energy markets are changing and we have to be ready to respond. Our strategy has been to focus on delivery first and this is serving us well, but we are also committed to proactively influencing and supporting change as the CFD and Capacity Market schemes and our business will undoubtedly need to adapt to the evolving market.

Our vision to be at the heart of the delivery of the UK's goals for secure, affordable and sustainable energy has not changed. And in conjunction, we continue to pursue our mission to build confidence in the schemes through effective commercial delivery and continuous improvement. That means we must become resilient and ensure that our current delivery standards are sustainable going forward. It's an exciting time ahead!

N McDermott.

**Neil McDermott**
Chief Executive

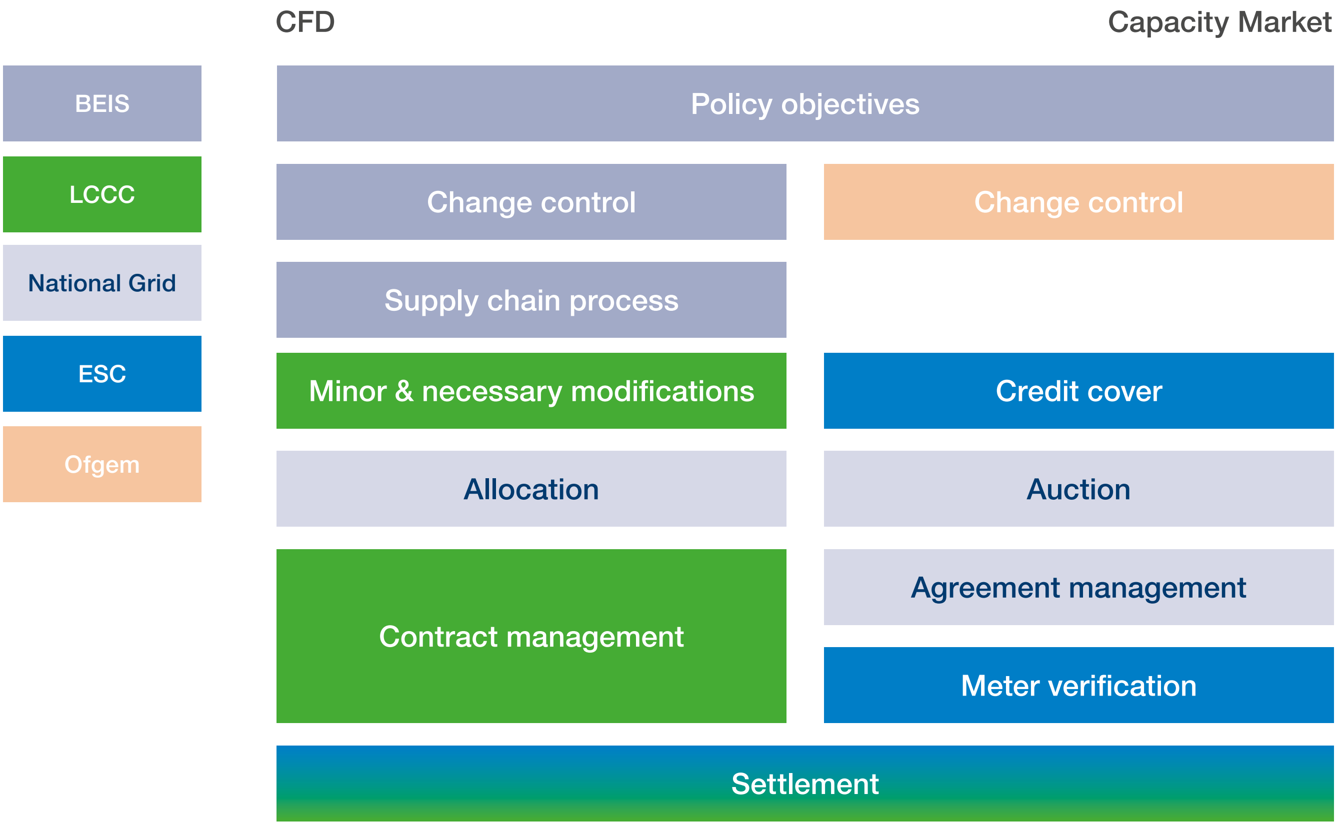
©Drax
A Drax biomass conversion facility started generating under the CFD scheme in December 2016, after it received European Commission State Aid clearance.

# Corporate report

## Our role

Our primary responsibility is to act as the counterparty to CFDs and manage them throughout their lifetime, ensuring that all our low carbon generators meet their obligations under the CFDs. This also involves managing the Supplier Obligation Levy that funds CFD payments, which we forecast using sophisticated forecasting and power price models. In addition, we manage Capacity Market payments on behalf of our sister company, ESC, as well as holding credit cover for Capacity Auction participants and conducting meter assurance which is required before the successful applicants can start receiving payments.

### Roles across the two schemes to deliver clean, reliable, affordable electricity



# Highlights for 2016/17

**CFD scheme**[3]
**33 facilities**
**(2 generated in 2016/17)**

**Capacity Market scheme**[4]
**133 participating companies**
**(46 were active in 2016/17)**

## Managing payments

**first CFD payments**
made to a solar farm in June 2016

**109 meters tested**
for capacity providers successful in 2015 Transitional Arrangement Auction

**first Capacity Market payments**
commenced in October 2016

## Managing CFDs

**nuclear CFD signed**
for Hinkley Point C power station in September 2016

**657MWnet**
of CFD capacity became operational

**Quality Assurance**
for Allocation Round 2 CFD standard template contract

## Delivering excellence

**built Nostradamus**
a new demand forecasting model during July to December 2016

**advised BEIS**
on changes to Capacity Market and CFD Supplier Obligation regulations

**IT system migration**
onto an independent platform in October 2016

Legend:

CFD
Capacity Market
CFD & Capacity Market

[3] 33 facilities, of which 5 are phased projects, resulting in a total of 41 contracts under management with commissioning dates between 2016/17 and 2025/26
[4] 133 companies, holding between them a total of 1,585 valid capacity agreements across future delivery years, of which 46 were receiving capacity payments in 2016/17

## The schemes

Both the CFD and Capacity Market schemes have become fully operational this year, with LCCC now managing payments under both schemes. The schemes are beginning to produce results in support of the electricity market objectives set by the government:

- **reliable, affordable and clean[5]**
- **attracting new sources of investment in the UK infrastructure**
- **making the market fairer.**

"There's a lot of transformation in the energy market and governance system. LCCC is administering two of the most critical tools that will guarantee our security of supply and decarbonisation going forward."

**Alex Coulton**
CFD Policy and Strategy Manager

©Dudgeon
Installation vessel Sea Challenger and first turbine installed at Dudgeon field. Dudgeon offshore wind farm began generating power to 6,000 homes in early 2017. When fully operational, later in the year, it will provide electricity to over 400,000 homes.

"We are moving from early stage contract management of the initial milestones to projects that are now in construction or are nearing operation. Some are already generating or are going to start generating in the next few years. There's a fundamental shift in the maturity of our business and the portfolio."

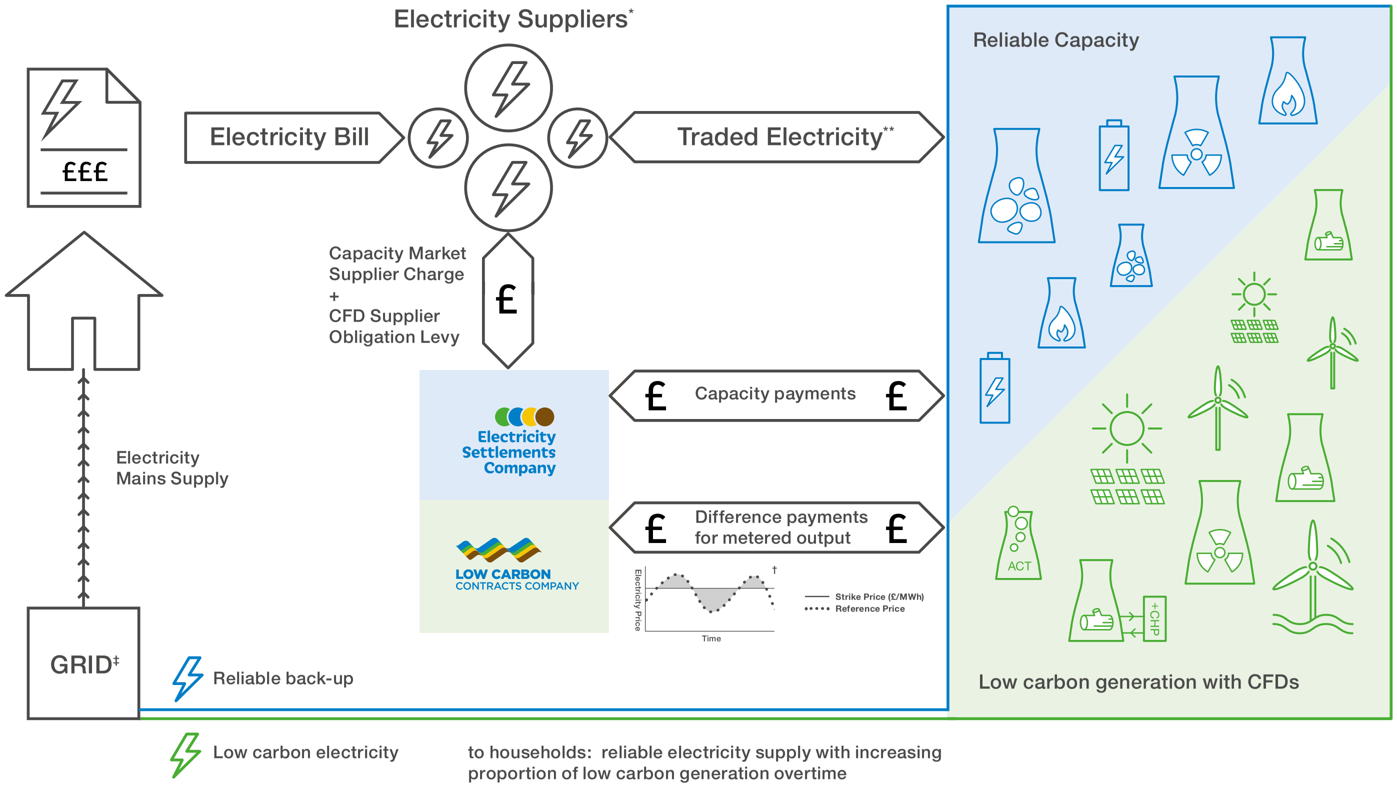
**James Rushton**
Head of Commercial

[5] https://www.gov.uk/government/organisations/department-for-business-energy-and-industrial-strategy/about

## How the CFD & Capacity Market schemes work

Households pay suppliers for electricity. These suppliers trade in the electricity market with generators.

The suppliers pay money to LCCC and ESC, which we pass on to electricity generators through the CFD scheme in exchange for low carbon electricity and to capacity providers through the Capacity Market scheme in exchange for reliable capacity (including Demand Side Response).




The Capacity Market scheme aims to ensure a reliable supply of electricity, which helps to manage the intermittency of some renewable generation (e.g. wind and solar). Under this scheme, ESC makes "capacity payments" to capacity providers who commit to making their generation capacity available or reduce their demand at times of system stress.

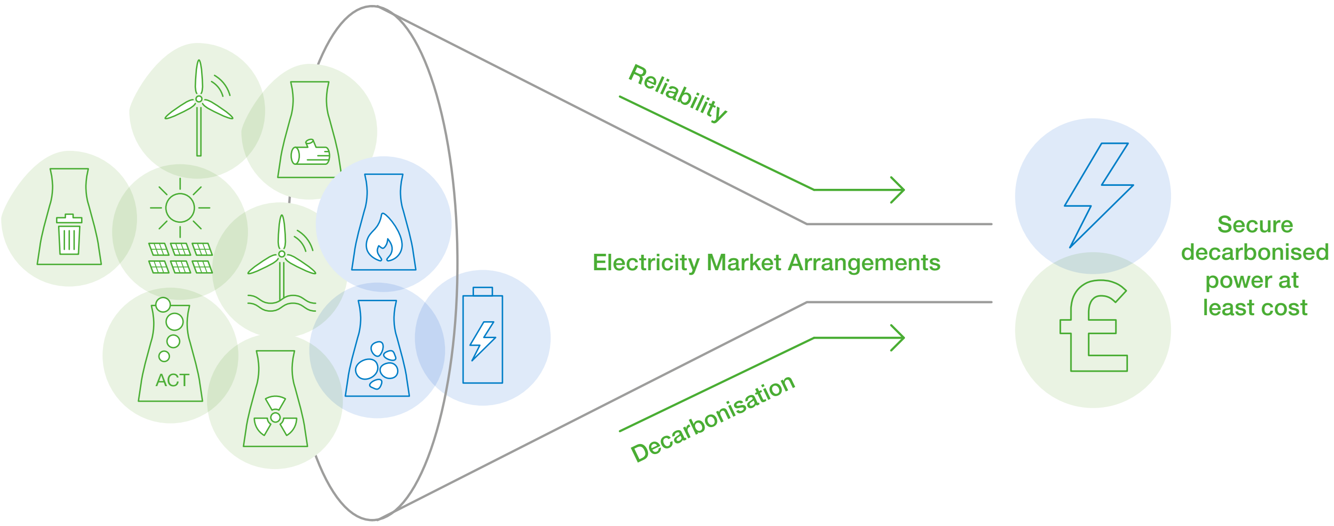
The CFD scheme provides future price certainty aimed at enabling investment in the new build low carbon generation needed to power the country for years to come. Households (and businesses) receive power from those generating assets, which are increasing the percentage of electricity provided by renewable sources.

*All GB licensed electricity suppliers
**Wholesale electricity market
†CFD payments are a two-way process. Where the "reference price" is less than the "strike price", LCCC makes a "difference payment" to the CFD generator (see LCCC Annual Report 2015/16, p10).
‡National Grid system operator manages the balancing of electricity supply and demand, drawing down on reliable capacity when needed.

## reliable, affordable and clean

The CFD and Capacity Market schemes were designed by the government as "market based" incentives that would work within the structure of the existing electricity market to contribute to the government's objective of **clean** and **reliable** electricity, using competition to deliver **affordability.**

Creating a market fit for the future

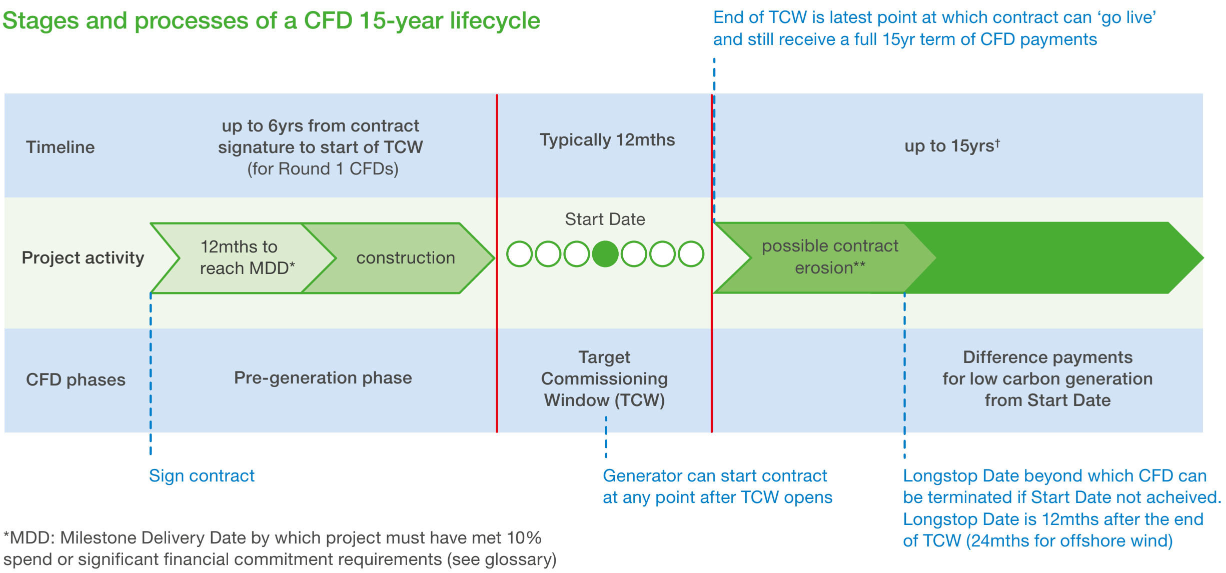



This year both schemes have become fully operational, with LCCC making payments to operational CFD generators and, on behalf of ESC, to capacity providers across Great Britain. Outcomes in support of policy objectives are beginning to emerge:

Table: outcomes in 2016/17

| Scheme | Outcomes | Net payments to facilities under the scheme in 2016/17 | Total operational cost (to nearest £100k) |
|---|---|---|---|
| CFD | 649MW of low carbon capacity | £92.1m | £11.7m |
| Capacity Market | 620MW of reliable capacity available | £9.2m | £2.9m |

## Stages and processes of a CFD 15-year lifecycle




*MDD: Milestone Delivery Date by which project must have met 10% spend or significant financial commitment requirements (see glossary)
**contract erosion is possible if Start Date is after end of TCW
†CFD expires 15yrs after the earlier of Start Date and end of TCW

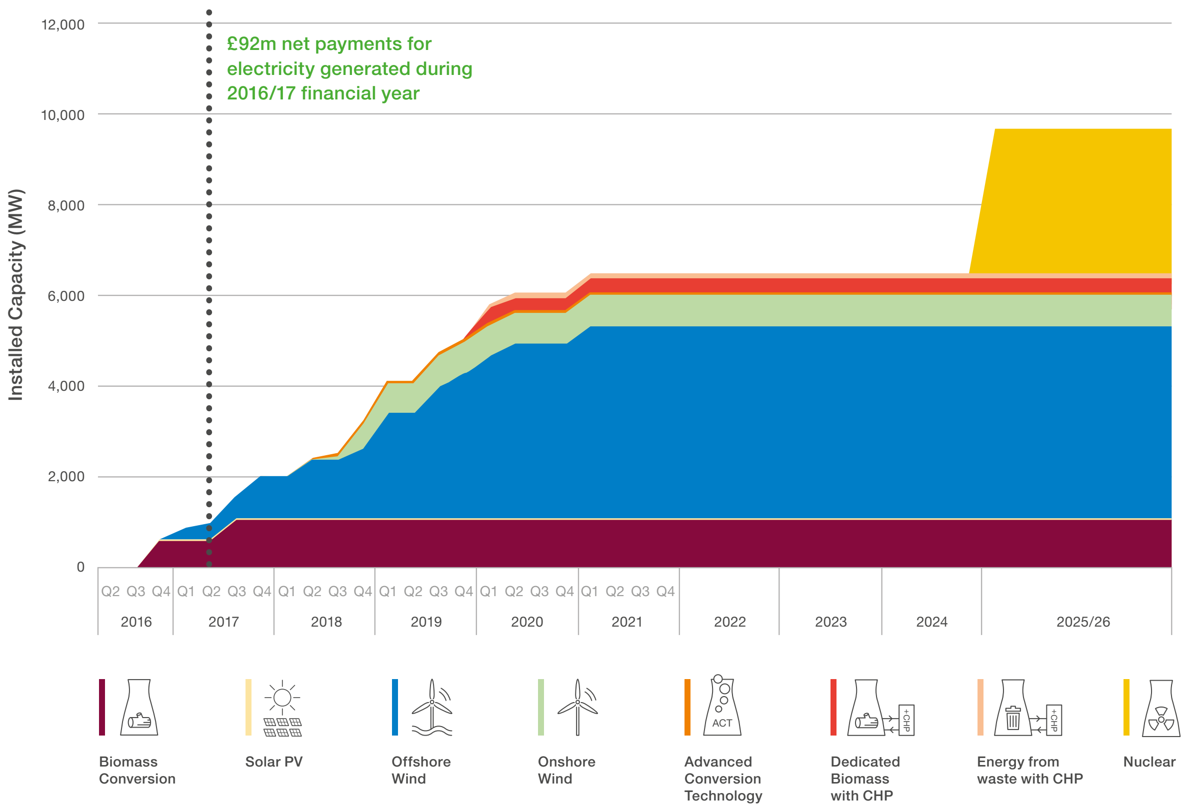
## Commissioning low carbon capacity

Commissioning was a key focus of our contract management activity this year, as some CFDs approached their expected start dates.

For a CFD generator to commission its plant and be eligible for payments, it must satisfy LCCC that it has complied with the Operational Conditions Precedent set out in the CFD. This includes demonstrating that it can meet the requirement to generate at 80% of its capacity estimate.

A set of technology specific commissioning conditions need to be met by generators to evidence that they have met this 80% requirement. To help the process LCCC has set out its evidential guidance requirements for certain technologies (e.g. offshore wind) and published guidance on the definition of "Installed Capacity" within the CFD. Between June 2016 through to March 2017, we had two renewable projects which qualified for CFD payments by fulfilling their Operational Conditions Precedent. We expect several other projects to commence generation in 2017/18.

## Installed Capacity under the CFD by Fuel Type*



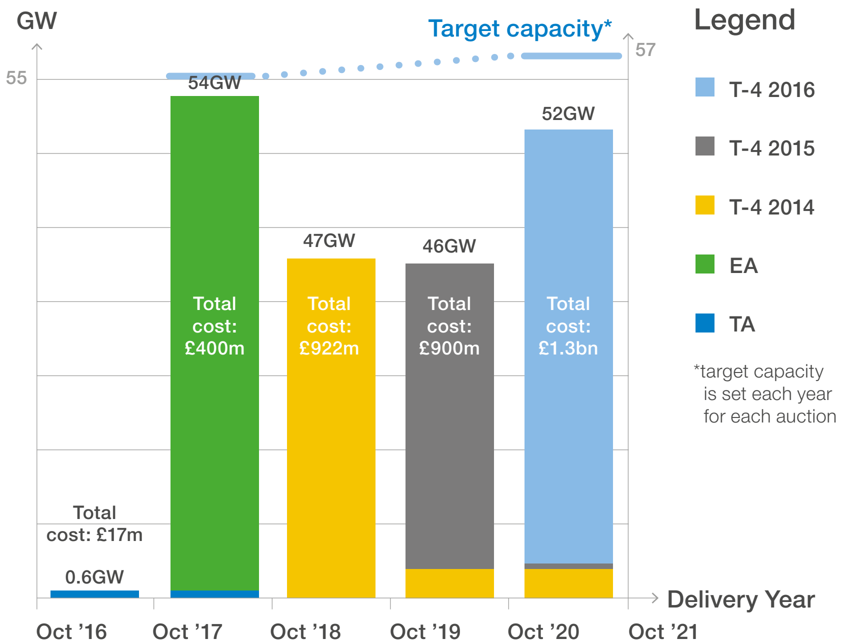

*Installed capacity estimates or final installed capacities from the CFD register on 31 March 2017

## Making a success of the Capacity Market

From 1 October 2016, small scale generation generators and Demand Side Response participants received payments to provide security of supply, in many cases for the first time, having secured an agreement a year earlier under the 2015 Transitional Arrangements Auction. In accordance with the Capacity Market rules, LCCC delivered 109 meter tests and made payments of £9.2m in exchange for 620MW of reliable capacity to be made available to National Grid as system operator. In addition, we advised BEIS on how the scheme might be extended further to build on this success. Alongside this new activity we continued to manage credit cover for Transitional Arrangements and Capacity Auctions, with the total credit cover managed this year being £211m.

©UKPowerNetworks
Leighton Buzzard – inside a battery storage facility that received capacity payments in 2016/17.

Chart: total cost of capacity agreements by auction and year[5]




[6] LCCC estimate based on input data sources taken from www.emrdeliverybody.com and assuming that electricity suppliers pass on the full costs of the Capacity Market charge and operational costs levy equally to all consumers. Note this does not include operational costs of other delivery partners such as BEIS or National Grid.

## attracting new sources of investment

The CFD was designed specifically to attract the new sources of investment required for electricity generation in the period to 2030, for example pension funds or other institutional investors, as policy-makers recognised the scale of investment needed to replace the UK's ageing assets within a decade.[7]

CFDs provide long term price certainty to low carbon plant, designed with the aim of enabling investment to come forward at a lower cost of capital.

Projects may change hands and/or new investors can come on board during the life of a CFD, which may involve contract management matters that LCCC needs to manage. In 2016/17, several CFD projects announced the involvement of new investors.

### Allocation Round 2

From December 2016 onwards, as part of our role as CFD implementation coordinator, we worked to prepare for the second CFD Allocation Round. This included the creation of the Allocation Round 2 Implementation Plan and, working in collaboration with National Grid, who administers the application and allocation of the CFDs, provision of stakeholder events and FAQs to engage with potential applicants. In addition to this, we assisted BEIS by drafting certain amendments as well as undertaking quality assurance of the standard CFD template contract to be used in the Allocation Round.

"The £290m budget pot for the second allocation round will enable our world-leading industry to deliver significant investment to the UK. The competitive auction process is continuing to drive down the cost of offshore wind energy at an unprecedented speed."

**Hugh McNeal**
RenewableUK Chief Executive

©Banks Renewables
Banks Renewables is investing £237m in the construction of three onshore wind farms. Once in operation they will generate over 418GWh of low carbon energy, powering more than 101,000 homes.

[7] The UK operates a liberalised energy market, in which the private sector finances and delivers most infrastructure", National Infrastructure Delivery Plan 2016–2021, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/520086/2904569_nidp_deliveryplan.pdf

# Hinkley Point C: investment in new build generation

LCCC is involved in one of the biggest new nuclear projects in the UK for more than a generation.

LCCC signed the CFD for Hinkley Point C on 29 September 2016. A dedicated LCCC team is managing the CFD which, at 3.2GW capacity, is the largest project in our portfolio. It is expected to commission in 2025.

The developer has stated that, during construction, the project is expected to create 25,000 jobs and 1,000 apprenticeships, as well as estimating projected economic benefits to the local area in the region of £1.5bn during construction and £2.4bn once the project is in operation.

Once in operation, two UK reactors at the plant are expected to generate enough low carbon energy to power almost 6 million homes and to provide up to 7% of the UK's electricity needs over the facility's 60 year lifespan. Generated electricity is estimated by the developer to avoid 9 million tonnes of carbon dioxide emissions per year; that is 600 million tonnes over the facility's 60 year lifespan.

©EDF Energy
First concrete pour at Hinkley Point C took place in March 2017.

## Project timeline

**15 Sept 2016**
UK government confirms agreement for the construction of Hinkley Point C

**29 Sept 2016**
LCCC signs Hinkley Point C CFD – marking the end of the of the project's development phase and formally relaunches new nuclear construction

**March 2017**
First Nuclear Safety Concrete Pour using high performance, heavy density concrete with special attributes that improves reaction shielding efficiency, structural integrity and durability

**2025**
Hinkley Point C generation start date

"Hinkley unleashes a long overdue new wave of investment in nuclear engineering in the UK, creating 26,000 jobs and apprenticeships and providing a huge boost to the economy, not only in the South West, but in every part of the country through the supply chains of firms, big and small, that will benefit from investment."

**Greg Clark**
Secretary of State for Business, Energy and Industrial Strategy
15 Sept 2016

## making the market fairer

The schemes were intended to make the market fairer by ensuring consumers do not pay "over the odds" for their electricity and providing greater access for new entrants.[8]

### Enabling new entrants

The Capacity Market Transitional Arrangements Auctions in January 2016 and January 2017 were aimed at new entrants. This year we have engaged extensively with Demand Side Response providers, who made up around 50% of those awarded capacity agreements in 2016, as well as small scale generators (2MW-50MW),[9] to enable them to provide the required meter data in order to qualify for Capacity Market payments.

### A better deal for consumers

#### Difference payments

CFDs have an inbuilt safeguard in that the "difference payment" is a two-way mechanism. While LCCC pays a difference payment to low carbon generators where the wholesale electricity price is lower than the strike price, the generator pays LCCC a difference payment when wholesale electricity prices rise higher than the strike price. This protects consumers from overpaying for new generation capacity.

#### Benefits of competitive allocation

The competitive allocation of CFDs in the first Allocation Round (2014-15) has been independently analysed as being expected to reduce costs and deliver savings for consumers of £0.4bn as compared with the projected costs for the same volume of generation had it been supported under the Renewables Obligation.[10] The second Allocation Round is currently underway and will determine the strike prices for CFDs commissioning in 2021/22 and 2022/23.

"As advocates of the schemes, we must continue to propose ideas on how things can be improved to ensure that the CFD acts as an enabler to new innovative low carbon projects; and that the Capacity Market continues to work well as it evolves."

**Ruth Herbert**
Head of Strategy and External Relations

#### Operational efficiency

LCCC has a responsibility to deliver the CFD and Capacity Market schemes in a way that minimises costs to consumers in line with our Guiding Principle. Examples of this include:

- setting the CFD Supplier Obligation Levy as accurately as possible (see case study on p18)
- acting quickly to revise the Levy by in-period adjustments where there are material changes to the underlying assumptions made when the Levy was set
- simplifying our processes to reduce operational costs – for example, we have advised BEIS on changes to the Supplier Obligation Regulations[11] to speed up the process of issuing refunds to electricity suppliers where the Levy is "over collected" in any quarter, which should ultimately benefit both suppliers and consumers.

[8] BEIS, Planning our electric future: a White Paper for secure, affordable and low-carbon electricity, July 2011, Ministerial Foreword, p3, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/48129/2176-emr-white-paper.pdf
[9] National Grid, Final Auction Results: Transitional Capacity Market Auction for 2016/17, Appendix A – results by CMU, January 2016, pp9-10: https://www.emrdeliverybody.com/Capacity%20Markets%20Document%20Library/Transitional%20Auction%202016%20-%20Final%20Results.pdf
[10] Grant Thornton UK LLP, Independent evaluation of the Electricity Market Reform, 2015, Cost of subsidy per unit of demand 2020/21,Figure 25, pp113, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/468257/Independent_evaluation_of_Electricity_Market_Reform_-_Final_report_-_14_....pdf
[11] the proposed changes to the regulations are subject to Parliamentary approval

# Nostradamus: Setting the Supplier Obligation Levy accurately

**Jack Barber**
Senior Modeller

It is important for CFD generators, suppliers and consumers that LCCC sets the quarterly Supplier Obligation Levy as accurately as possible. This is not only because the Levy ensures that we pay CFD generators on time, but also because it is levied on all licensed electricity suppliers, who may pass the costs through to their customers. The Supplier Obligation Forecasting Model (SOFM) is used to create the forecasts to set the Interim Levy Rate and Total Reserve Amount that underpin payments to CFD generators. SOFM relies on a number of key input datasets, one of which is a forecast of electricity demand. An in-house demand forecasting system, called Nostradamus, was developed by our forecasting team to enable LCCC to try to produce more accurate demand forecasts than are currently available with the aim of increasing the accuracy of our Supplier Obligation Levy forecasts.

"Nostradamus is a dedicated electricity demand forecasting system that provides the input that SOFM needs in order to make more accurate supplier obligation calculations. It is based on gross demand,* which is a unique measure of electricity demand in the UK. We specifically created Nostradamus for the CFD.

We needed something that was bespoke and took account of embedded generation (wind and solar, biomass and incinerator waste) as National Grid's demand forecasts do not.

It took six months to put Nostradamus together, and although it's early days, we now we have a forecasting model that is customised to our needs.

Though primarily a demand forecasting system, Nostradamus can potentially do a lot more. We can use it to correlate solar power generation with local weather observations in the area of our CFD projects in order to optimise the operation of our forecasting models. We can do the same thing with wind. Therefore, we should be able to improve our forecasts of power generation for all our weather dependent CFD generators. It means we have a more tailored forecast of how much each plant will generate over a period of time."

*gross demand: total view of demand including electricity provided by embedded generation

## How does Nostradamus work?

Electricity demand is driven by human behaviour and the level of demand at any point in time depends on many factors, such as weather and calendar data (e.g. on weekends and bank holidays there is low demand, as there is less commercial usage, whereas on weekdays there is high demand as there is more commercial usage). The effects on demand are numerous, complex and often interwoven, and a large volume of data is required. Nostradamus, as an automated data processing system, runs in the background, collecting all input information (such as solar radiation and temperature), and running the forecasting algorithms. We are able to monitor forecasts that are generated through live dashboards. This information feeds into the SOFM "determination runs" which calculate the Supplier Obligation Levy.

# Our people

As a company that's growing, our people are integral to our development. Key areas of focus for the year included evolving our employer brand, valuing our talent, investing in our people and living our core values.

**Investing in our people**

Our people are specialists, primarily from within the energy, financial, legal and IT sectors, who since joining LCCC have developed a knowledge base that is unique around the delivery of the schemes.

**Our current focus is on improving our continuous professional development offering by identifying the talent and helping our people to develop their futures:**

- recruitment (of high calibre permanent and interim staff) to build on our resource base and capability; a growth from 8 to 13 in the commercial team
- training across the business focusing on technical expertise, cross training, leadership skills and team development to enable greater overall resilience
- introduction of a new HR portal which allows people to manage their own employee data, including remotely, which has empowered our people and helped the organisation run more efficiently and smoothly.

"… people recognise, we're doing something meaningful, that has an impact on the environment, an impact on the UK, reduces emissions and is helping to make the planet a better place."

**Cynthia Duodu**
Head of Corporate Services

## Moving within the company

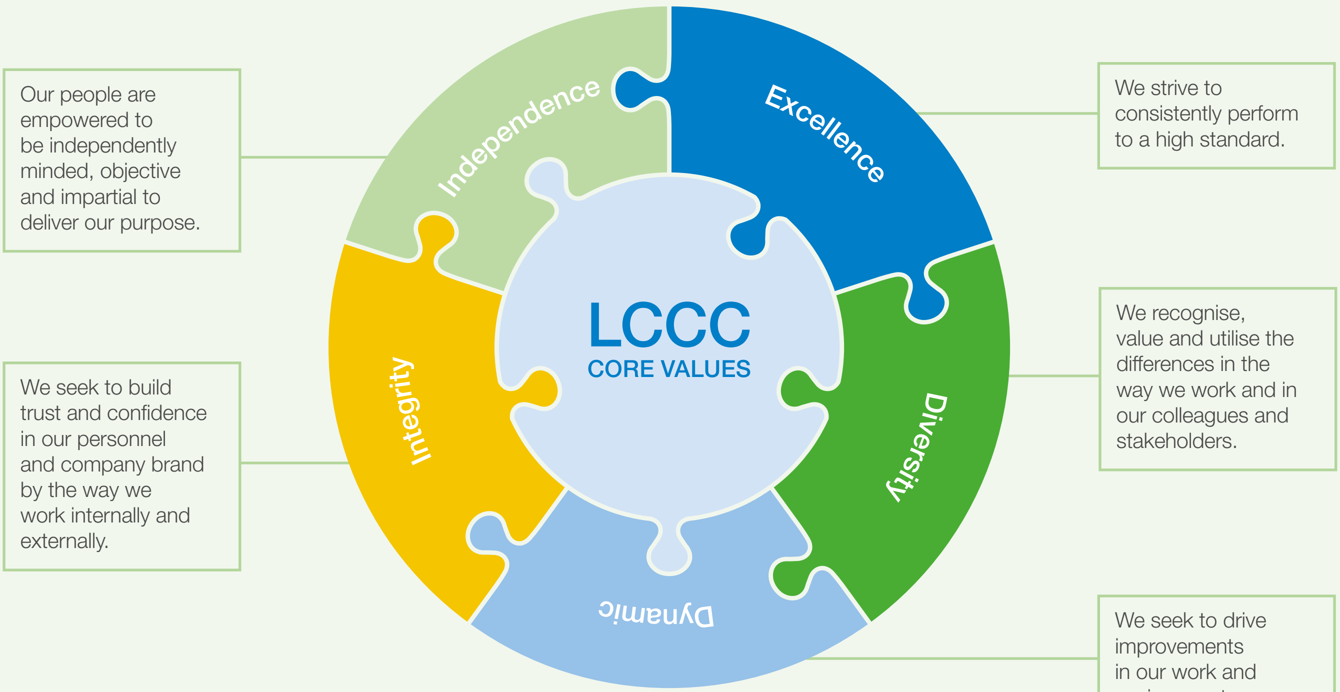
**Maris Koivastik**
Junior Commercial Manager
Degree: BSC Environmental Management
Joined LCCC: September 2014

"I was working in the HR and internal operations department as an admin assistant. From there I got involved with the communications team and after that I moved to the commercial team in October 2015 – they were short staffed as some of the work was beginning to ramp up.

Commercial started me off in an admin role for the contract management team… I progressed from there into managing projects directly. I had to hit the ground running, but I had good project supervisors and so I was training on the job. Now as the same projects are approaching commissioning, it's got even busier and everything is dynamic and ever-changing… I feel like I'm still learning something different every day, as we go into operations which is still quite new… I find it hugely intense and interesting. It's exciting as it feels like the team is making history."

### Our values

We created our values and behaviours to reflect the kind of culture we want in our organisation. Our people demonstrate these values and behaviours. We aim to live and work by these values now and in the future.



# Environment report

### LCCC's impact overall on UK $CO_2$ emissions

Through bringing forward the investment needed to deliver an increase in low carbon electricity generation, CFDs are facilitating a reduction in the UK's greenhouse gas emissions.

The latest figures for UK Greenhouse Gas Emissions[12] shows that energy supply was the largest emitting sector of UK greenhouse gas emissions, responsible for 31% of UK emissions in 2014. The main source of emissions for the energy supply sector was the use of coal and natural gas in electricity generation from power stations.

©Lightsource
Charity Farm solar project across 86 acres with up to 54,349 solar panels with an installed capacity of 11.9MW.

As the energy sector is responsible for nearly a third of the UK's greenhouse gas emissions, the opportunity to decarbonise our energy supply, and in turn reduce the UK's greenhouse gas emissions, is significant. The Digest of United Kingdom Energy Statistics (DUKES) 2016 outlines that renewables' share of electricity generation increased from 19.1% in 2014 to a record 24.6% in 2015, as a result of increased capacity. Low carbon electricity's share of generation increased from 39% to a record 46%.[13]

CFD generation in 2016/17, from LCCC projects such as Charity Farm (solar) and Drax (biomass), and in 2017/18 from projects such as Dudgeon (offshore wind) and Burbo (offshore wind), is supporting the transition to a low carbon economy. This will facilitate a reduction in the UK's greenhouse gas emissions and support the decarbonisation targets as set out in the Climate Change Act 2008.

We estimate that the total carbon emissions that have been offset through generation from Charity Farm and Drax in 2016/17 is expected to be approximately 1.28m tonnes of $CO_2$.[14]

[12] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/496942/2014_Final_Emissions_Statistics_Release.pdf
[13] https://www.gov.uk/government/statistics/electricity-chapter-5-digest-of-united-kingdom-energy-statistics-dukes
[14] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/542570/Fuelmixdisclosurewebpage2016__3_.pdf; assumes: CO2 emissions counterfactual is coal generation. The value is derived from: 910g/kWh

### LCCC's impact on its own operations

LCCC is committed to minimising the environmental impact of its own operations through the adoption of sustainable practices and continuous environmental performance. The focus for 2016/17 has been to establish a baseline for the business, via our carbon reporting tool, to which environmental targets can be benchmarked. This has included the monitoring and recording of energy, water, waste and transport data resulting from LCCC operations. Reporting of LCCC's greenhouse gas (GHG) emissions is in line with the mandatory carbon reporting format which measures scopes 1, 2 and 3 GHG emissions.

| **Greenhouse gas emissions (Total $tCO_2e$[15])** | **2015/16 Apr – Mar (12 months)** | **2016/17 Apr – Mar (12 months)** |
|---|---|---|
| Scope 1: direct emissions | 20.68 | 20.36 |
| Scope 2: indirect emissions | 101.56 | 92.66 |
| Total Scope 1 & 2 emissions | 122.24 | 113.02 |
| Scope 3: other indirect emissions Water & Waste Water | 0.65 | 0.63 |
| Waste[16] | 0.12 | 0.11 |
| Total Scope 1, 2 & 3 emissions | 123.00 | 113.76 |

As shown in the table above, there have been improvements across all emission scopes. Gas, electricity and water consumption data continues to be provided by the landlord and equally divided across the nine floors of the tenanted site. While sub-metering of the tenanted floors has yet to be implemented, which would allow a more accurate breakdown between the floors. The overall reduction in emissions is the result of the improvement in building operation by the landlord, including effective implementation of energy, water and waste efficiency measures as well improved employee awareness of our environmental policy and sustainability programmes.

[15] Tonnes of $CO_2$ equivalent
[16] The capturing of waste data for 2016/17 is still in development

# Strategic report

LCCC plays an integral role in the delivery of the CFD and the Capacity Market schemes.

Its operations include its responsibilities as CFD implementation coordinator, and as CFD counterparty in the management of CFDs over their life and CFD levy forecasting, collection and settlement operations. It also, on behalf of ESC, delivers ESC's metering assurance, credit cover, levy collection and settlement functions for the Capacity Market.

The company's strategy is to focus on delivery first, given its crucial operational role in the delivery of the CFD and Capacity Market schemes, while also being committed to proactively influencing and supporting change as the schemes adapt to the needs of the evolving market. The company's mission is to build confidence in the CFD and Capacity Market schemes through effective commercial delivery and continuous improvement.

This mission reflects the company's Guiding Principle to maintain investor confidence in the CFD scheme and minimise costs to consumers as well as ESC's Guiding Principle to seek to maintain market participants' confidence in the Capacity Market settlement process and minimise costs to consumers.

These Guiding Principles and LCCC's role as an operationally independent company are fundamental to its work and align with its strategy to focus on delivery first, given LCCC's critical operational role and the importance of its offering to the electricity sector.

The principal activities of the company are described on pages 2 to 21.

During the year the company increased its staff through recruitment, with staff numbers reaching 53 at the year end. The company's highly skilled workforce is one of its key strengths, which will help the company to deliver against its core strategic objectives over the long term.

The company monitors its progress against its strategic objectives through key performance indicators ("KPIs"). The company's KPIs have been defined by reference to the key milestones or targets required to perform its role and achieve its strategic objectives. The KPIs for 2016/17 are set out below.

| Key performance indicator | Description of performance |
|---|---|
| **Financial and budget performance** | The financial and budget performance of the company was well managed with:<br>• LCCC has successfully delivered within its and ESC's operational and capital budgets. As a result LCCC will be returning £3.8m to suppliers and ESC will be returning £1.4m to suppliers<br>• no 'material issues' were identified in the "period 9" and year end financial audits of LCCC and ESC<br>• effective controls in place to identify, monitor and manage strategic risks, with the mitigating actions for strategic risks being completed in a timely manner and with >90% of mitigating actions being completed by their target date. |

**Management of CFDs**

LCCC has effectively and efficiently managed its CFDs in respect of all relevant contractual milestones. In particular,

- LCCC successfully fulfilled its role and contractual responsibilities in relation to contract milestones e.g. Milestone Requirement/Milestone Delivery Date, Operational Conditions Precedent and Start Date. CFDs were managed through the Milestone Requirement process, two projects were managed through their Operational Conditions Precedent and have started CFD operations and several other projects are in the process of being managed through the Operational Conditions Precedent process
- an independent survey of CFD counterparties, suppliers and other stakeholders was undertaken and outputs are being used to develop baseline measures for 2017/18 and contribute to the management of future CFDs.

**Delivery of CFD settlement system**

LCCC has successfully and efficiently delivered a fully effective and functioning CFD settlement system, including:

- the timely delivery of CFD settlement system functionality enabling company to accurately settle CFD generator payments, the Supplier Obligation Levy collections and payments and operational cost levies in accordance with the company's CFD and regulatory obligations
- the first CFD payment was successfully made to a CFD generator in June 2016, with the system also operating effectively, accurately and in a timely manner in relation to subsequent CFD generator payments.

**CFD Supplier Obligation Levy**

LCCC has forecast, set, published and notified the Supplier Obligation Levy in accordance with the company's regulatory requirements.

LCCC also monitored its quarterly and annual forecast accuracy figures (full and adjusted for changes to expected start date assumptions). The accuracy figures achieved, taking into account the relevant assumptions, were at the projected level and standard.

**Capacity Market settlement systems**

LCCC effectively and efficiently delivered and managed the Capacity Market settlement operations. This included:

- the delivery of a functioning Capacity Market settlement system enabling capacity provider payments to be made in accordance with the Capacity Market rules and regulatory requirements
- subject to externalities, the collection of 100% of credit cover from eligible Capacity Market applicants in accordance with the requirements relating to Capacity Auctions and Transitional Auctions
- that the cost per capacity agreement showed a year on year improvement (adjusted for external factors such as the termination of capacity agreements or limited Capacity Market agreement volume)
- subject to externalities, achieving that >/=95% of issued invoices, notifications and payments were accurate and that </=2% of invoices and notifications were issued late by more than two business days.

| | |
|---|---|
| **CFD and Capacity Market metering assurance** | LCCC delivered its metering assurance responsibilities effectively, efficiently and on time, including by:<br>• awarding a meter assurance contract to a reputable supplier;<br>• implementing a meter assurance framework that enables LCCC and ESC to achieve their ongoing metering assurance regulatory requirements<br>• agreeing with BEIS, National Grid and Ofgem processes for the more efficient and effective management of Capacity Market metering assurance. |
| **Corporate governance and strategy – including leadership of company, organisational vision and structure** | LCCC has implemented good and effective corporate governance processes including:<br>• ensuring that both business and workforce planning is aligned with the delivery of the company's mission, vision and strategy<br>• effective external communications with stakeholders – ensuring that stakeholders confidence is increased through the delivery of communications and engagement with sector (as measured by rolling improvement in feedback from stakeholder events and other engagement activity such as webinars and conducting a stakeholder survey)<br>• monitoring staff engagement levels putting in place strategies are in place to manage turnover, including:<br>- ensuring alignment of people strategy and business planning<br>- developing the workforce plan to mitigate the potential risk to the business from staff turnover<br>- undertaking an employee survey to obtain staff feedback and measure staff engagement.<br>• the refreshing of the strategy and business plan on an annual basis, with the business plan being aligned to and supporting the implementation of the strategy.<br>The successful delivery of the first limb of the strategy of "delivery first" is demonstrated by the effective, efficient, timely and within budget delivery of CFD management, CFD settlement operations, Capacity Market administration, Capacity Market settlement operations and the other matters referred to on pages 2 to 21 of this report.<br>The second limb of the strategy of "influencing and supporting change" is demonstrated by matters including LCCC's input into aligning the Capacity Market and CFD settlement processes, providing input into BEIS consultations, undertaking the drafting of certain provisions in the CFD standard template to be used in the second Allocation Round, undertaking the quality assurance review of the CFD standard templates for the second Allocation Round and the other matters referred to in pages 2 to 21 of this report. |

## Financial overview

The company is the CFD counterparty to a large number of long term CFDs and is responsible for managing the collection of levies from suppliers and the settlement of payments to generators. The company's own operational costs are also funded by a levy on suppliers. The company shares resources with ESC. These are paid for by LCCC, with the proportion of costs relating to the Capacity Market being recharged to ESC as set out in note 2.5 of the financial statements.

### Generator payments

The company pays CFD generators when the market reference price for electricity is lower than the strike price applicable to the relevant generator ("**generator payments**").[17] On occasions when the reference price is higher than the strike price, CFD generators pay the difference to the company. The first payment to generators was made for generation which took place on 30 June 2016. The total value of payments for electricity generated in the financial year was £92.1m.

The company obtains the funds it needs to make generator payments from a levy it collects from electricity suppliers. The company forecasts how much money it will need to make the generator payments, and then levies suppliers for these funds under the CFD (Electricity Supplier Obligations) Regulations 2014 (as amended) (**"Supplier Obligation Regulations"**).

The source of funds for generator payments is the daily "Interim Levy Rate". Suppliers are obliged to pay the Interim Levy Rate within five working days of receipt of a notice to pay. The company, on the other hand, has 28 calendar days to make the generator payments due to generators (thereby helping to insulate the company against cashflow timing mismatches).

Further, in addition to the Interim Levy Rate, the company collects a quarterly reserve (the "Total Reserve Amount"). The reserve helps to provide reassurance that the company will have sufficient cash to make timely generator payments to the generators.

At the end of each quarter the company calculates the difference between the amount of the net payments to generators with the amount collected from suppliers from the Interim Levy Rate and the Total Reserve Amount. As at 31 March 2017, £49.3m was due to be returned to suppliers which included £14.9m of Interim Levy Rate and £34.4m of Total Reserve Amount.

The company collects credit cover from suppliers for 21 days of Interim Levy Rate payments to protect against supplier default. As at 31 March 2017, the company held £4.3m of credit cover.

In addition, if a supplier fails to pay a levy for which it is liable and has insufficient credit cover, this failure is "mutualised" between the remaining suppliers (i.e. the remaining suppliers have to make up the "shortfall" between them). There were no mutualisations in the financial year.

### Operational costs

The day to day operational costs of the company are funded by suppliers under its "operational costs levy" by the Supplier Obligation Regulations. The operational costs levy for 2016/17 was set in the Supplier Obligation Regulations at £0.0509 per MWh (which represented an expected budget for operational costs of £14.4m based on the estimated volume of gross electricity demand in Great Britain in the financial year).

The operational costs levy for 2017/18 has been set at £0.0524 per MWh (which represents an expected budget for operational costs of £14.8m).

The actual total levy amount collected depends on the actual volume of gross electricity demand, the outturn for 2016/17 was £15.5m (2015/16: £12.2m). This compares with a net operating cost of £11.7m (2015/16: £9.5m). As a result of this strong financial performance the company will return £3.8m to suppliers for 2016/17 (2015/16: £2.6m).

The company has delivered all operational requirements within the budgeted levels of operational costs set by Parliament after public consultation.

The company applies robust financial management in order to ensure that its commitments are accommodated within the timing of its collection of the levies.

There have been a number of contributory factors to the company's positive financial performance, including changing the provider for the IT infrastructure, lower professional fees due to the projected date for signing of the Hinkley Point C CFD being postponed and lower than expected insurance costs. In total savings account for £1.7m of the 2016/17 being refunded to suppliers.

[17] The "strike price" is the generator's guaranteed level of revenue per £/MWh. It is designed to reflect the estimated cost of the generator's investment in low carbon technology. The "reference price" is essentially the average market price for the electricity sold by the generator.

At the same time, there has also been a contribution to the lower cost base due to not needing to utilise the MWh electricity volume contingency which amounted to £0.5m. This contingency protects the company against falling volumes of electricity supplied in the year (i.e. against the volume of gross demand being less than the estimate). As the operational cost budgets are collected on a fixed £/MWh basis, if MWh volumes of electricity supplied fall, then the level of operational costs levy income collected also falls.

A further reason for our lower cost base is a reduced depreciation charge of £0.2m. This lower charge reflects a delay in the commissioning of the fully automated settlement system.

In addition, as a result of the delay in the build and testing of the original planned system, the contract between EMRS, as settlement services provider, and its then principal subcontractor was terminated on 9 November 2015. Following an agreement between the parties involved, £1.6m was received by LCCC as its share of the settlement.

In 2015/16, the company terminated the CFD for the Neart Na Gaoithe ("NnG") wind farm. The developer of the windfarm disagreed with the decision, which then went to arbitration in accordance with the processes set out in the CFD and, subsequently, the CFD has now been re-instated. The company's own costs in dealing with the arbitration have been absorbed within its operating costs.

Through grant funding from BEIS, ELEXON Limited and its subsidiary, EMRS, have invested a further £0.4m (2015/16: £0.7m) in the settlement system functionality required to deliver CFD settlement operations.

## Significant accounting matters and key judgements in the financial statements

The key accounting issues, matters and judgements in relation to the company's financial statements and disclosures relates to the valuation of the CFDs (including the Hinkley Point C contract) and additional costs expected to be paid relating to NnG.

## Valuation of CFDs (excluding Hinkley Point C)

The estimated discounted value of payments which the company may be required to pay out over the life of these (minimum 15 year) contracts is £31.4bn. The figure for 2015/16 was £27.8bn. The increase is mainly due to the transfer to the company of an investment contract (Drax) from BEIS in late 2016, subsequent to this project receiving state aid approval (£2.6m), the re-instatement of the NnG contract (£1.6m). The increase in valuation is partially offset against the difference in fair value due to changes to the forecast of wholesale electricity prices. The actual cash payments made to generators over the life of the contracts will vary, depending on a number of key matters such as projected wholesale electricity prices, commissioning dates for generation, and the average load factor of the generator. Further details relating to the treatment of the valuation of CFDs are set out in note 26 of the financial statements.

## Valuation of Hinkley Point C CFD

The CFD for Hinkley Point C (HPC) was signed on 29 September 2016. As detailed in note 28 to the financial statements, it has not been possible for the company to satisfactorily verify whether a single point fair value estimate for the HPC CFD is complete, neutral and free from error. The company has therefore concluded that for the time being the HPC CFD fails to meet the recognition criteria. Therefore, the HPC CFD has not been recognised as a transaction in these primary statements.

The company has nonetheless in note 28 of the financial statements set out its best estimation of the fair value of the contract, and the assumptions which have been considered in its valuation, in the interests of transparency.

## Costs of payments related to NnG

Following the result of the arbitration relating to NnG, the company is due to pay a proportion of the generator's costs relating to the arbitration. This amount has yet to be agreed, and will be recovered under the Interim Levy Rate.

There are no post balance sheet events to be recognised or disclosed.

## Viability statement

The directors have assessed the company's prospects, taking into account the company's current position and the principal risks faced by it over a business plan period of three years. The period of three years has been chosen as this is the time period over which the company has reasonable visibility of its strategy implementation and business planning and is the period for which BEIS has, for the period going forward, requested a three year business plan and budget.

The financial arrangements relating to the company minimises the risk of the company being unable to meet its liabilities. As set out in the preceding Financial Overview, the company is not obliged to make payments to generators and suppliers unless and until it has the funds to do so. The company also applies prudent financial management to ensure that its operating costs are covered by the operational costs levy.

As part of the strategic planning process and in assessing viability, the directors have considered the regulatory and legal environment within which the company operates and do not foresee any changes that will significantly affect the finances of the company within the period of the three year plan. The directors have also carefully considered the way in which the company manages its principal risks, which are set out on pages 29 to 31. They do not believe these risks will bring into question the company's viability.

Based on their assessment, the directors have a reasonable expectation that the company will be able to continue in operation and meet its liabilities as they fall due.

## Risk management – principal risks and uncertainties

The board formally reviews the material risks facing the company and ensures that they are appropriately managed by the executive team. The board retains ultimate responsibility for the company's risk management framework, with oversight of the overall effectiveness of the risk management programme being delegated to the audit, risk and assurance committee. The company's internal audit function provides further assurance on the effectiveness of the internal controls relating to risk.

Risk management is embedded within the company's operational activities. The company's approach to risk management is further detailed in the Corporate Governance Report on page 45.

The board considers the matters outlined below are, as at the date of this report, the principal risks and uncertainties that could adversely impact the company's reputation and operations and thus its ability to deliver against its strategic objectives.

| Risk or uncertainty | Risk brief description | Main mitigating actions |
|---|---|---|
| **Settlement services** | There is a risk that the newly built system and processes will not effectively deliver settlement services and that the increasing level of settlements will place an unanticipated strain on the system. There is also a risk that delays occur in the delivery of ongoing changes to the settlement system or that key processes are not fully designed, documented and fit for purpose or are delayed. | • Good project governance is in place<br>• Discussions take place with BEIS to agree an implementation plan for policy changes to avoid delivery risk to implementation of system change<br>• All changes relating to the change programme agreed with BEIS are impact assessed and implemented on agreed timelines<br>• There is an interim agreement on roles and responsibilities in relation to Capacity Market settlement interfaces with BEIS and National Grid<br>• A proposal for a longer term framework to support the Capacity Market (including the definition of roles and responsibilities across delivery partners) has been produced<br>• Working level and executive level meetings are in place to co-ordinate deliverables involving delivery partners<br>• A controls workshop is held with the settlement system delivery partner to obtain system and controls assurance<br>• Controls assurance performance reporting is in place. |
| **CFD contract lifecycle management** | There is a risk that the operating model for CFDs assumes a more stable workflow than eventuates, resulting in budget or resourcing issues and/or changes to the profile of issues affecting the company. Assumptions have been made as to the number of CFDs likely to result from the second Allocation Round. | • Commercial team size has increased to ensure the function is adequately resourcing and to improve the resilience of the team<br>• Commercial team's organisational structure provides strength and depth and reduces key person dependencies<br>• Contract knowledge system has been reviewed to ensure data retention and sharing, including of lessons learned and issues<br>• Early generator engagement to identify issues and identify solutions<br>• Governance structure is in place and documented for key contract decision making<br>• Long term call down contracts are in place for specialised advice. |
| **Nuclear CFD** | This contract, while a CFD, involves more complex and detailed requirements than other CFDs. There is a risk relating to the assumptions as to the level of resourcing required and the nature of any contract management issues over time. | • Extra resource recruited and temporary secondee in place as an interim additional resource<br>• Contract management materials and guides in place<br>• Team worked with BEIS and advisors prior to the company signing the contract in order to identify key areas that needed process documentation<br>• Memorandum of Understanding agreed with BEIS for ongoing governance and reporting in relation to the contract<br>• Appropriate advisory resource is available<br>• Regular working level and senior level meetings with the generator are in place to manage the relationship and assist in the resolution of any issues. |

| | | |
|---|---|---|
| **Operational coordination** | The company's structure involves cross functional teams with overlapping workloads and inter-dependency. This creates a risk if cross-functional interfaces are not fully streamlined and effective. | • Operational owners have identified core processes and interfaces (including cross-functional interfaces)<br>• Critical processes and interfaces are being documented<br>• Accountabilities have been allocated for these processes and monitoring and reporting mechanisms have been introduced<br>• A governance model for projects, project planning support and portfolio board is in place<br>• An IT change assessment board considers the impact across the IT portfolio of proposed changes<br>• IT release management controls are in place. |
| **Policy and market change** | There is a risk of policy and market change which impacts the strategy or operations of the company or require additional operational activity for which the company has not been given the time to fully prepare. | • Regular shareholder meetings and liaison with government is in place<br>• Staff members attend various government forums<br>• There is ongoing industry engagement<br>• The impact of potential policy and market change is assessed, including in relation to matters such as Brexit<br>• Monitoring of policy and industry issues and consultations is ongoing<br>• Company strategy is annually refreshed. |
| **Workforce management** | There is a risk that LCCC is inadequately resourced to meet its business needs. | • A workforce plan that anticipates business requirements and skill needs is reviewed annually<br>• Short term additional staffing business needs can be met by contractors<br>• Recruitment partners are in place to identify specialised resource at short notice<br>• Critical processes are being documented and knowledge transfer processes are being developed<br>• Succession plan is reviewed 6 monthly<br>• The requirement to use the CRM system is being refreshed<br>• Cross-training of staff is reviewed<br>• Retention strategies are in place<br>• Staff feedback loops and surveys are in place. |
| **Scheme fraud risk** | There is a risk of fraudulent activity from individuals or third parties. | • Key finance controls and fraud controls are in place and monitored, including embedded segregation of duties in finance processes and systems access controls<br>• Control environment assurance report on settlement system controls has been obtained from an external adviser<br>• A company fraud prevention officer is in place<br>• "Know your client checks" on generators are in place<br>• Annual credit-worthiness checks for capacity providers as part of risk-based sampling approach are in place<br>• Fraud awareness and anti-money laundering training has been provided to the settlement services delivery partner<br>• Internal audit function is in place and internal audit checks are being undertaken. |

| | | |
|---|---|---|
| **Scheme fraud risk continued** | There is a risk of fraudulent activity from individuals or third parties. | • Compliance and checking processes have been developed against a fraud control matrix<br>• Metering assurance and inspection regime is in place<br>• IT security is in place<br>• A risk framework is being developed with the settlement services delivery partner<br>• A data analytics tool is in place to flag potential frauds or discrepancies<br>• Meetings and liaison with key individuals within partner organisations and managers of other schemes are taking place. |
| **Change management** | There is a risk that proposals for change initiated by other bodies (e.g. BEIS, Ofgem or National Grid) may not be identified or responded to at a sufficiently early stage to enable the company to address the proposals appropriately. | • Company business design authority is in place to approve, monitor and assess change<br>• Resource is in place to monitor, review and respond to consultations<br>• Regular change board meetings take place with the relevant bodies and delivery partners<br>• IT change assessment board is in place<br>• Governance is in place for project delivery and management. |
| **Strategic delivery** | There is a risk of insufficient focus on the development and implementation of the company's strategy and how it fits within the broader developments within the energy sector. | • Board strategy sessions are in place<br>• Strategy sessions with senior management are in place<br>• Company wide strategy communication is in place<br>• Strategy is aligned with the business plan<br>• Strategy delivery is a company key performance indicator<br>• Engagement with BEIS and government is in place, including regular scheduled meetings<br>• Engagement with the wider sector is being expanded. |
| **Litigation and dispute process** | There is a risk of disputes or claims in relation to operational matters leading to additional costs, impacting resources and staff time and potentially industry and stakeholder confidence. | • Strong governance and compliance processes are in place<br>• Competent and experienced staff are in place<br>• In-house legal department is integrally involved in operations and processes<br>• External legal advice is available, with long term relationships in place as required<br>• Guidances on key CFD milestones and operation matters have been produced. |

Signed on behalf of the Board

N McDermott.

**Neil McDermott**
Chief Executive

31 July 2017

# Board of Directors

**LCCC is providing:**

- strong independent governance
- commercial skills and industry knowledge
- a close working relationship with government, industry and other key stakeholders
- a focus on delivering better outcomes for the UK.

**Martin Read**
Chairman

**Jim Keohane**
Senior Independent Director

**Neil McDermott**
Chief Executive

**Catherine Gan**
Chief Finance Officer

**Anne Baldock**
non-executive director

**Tony Bickerstaff**
non-executive director

**Simon Elliston**
shareholder nominated director

**Simon Orebi Gann**
non-executive director

**Marion King**
non-executive director

**David Long**
shareholder nominated director

**Tony White**
non-executive director

# Directors’ report

The directors present their annual report on the affairs of the company, together with the financial statements and auditors’ report for the year ended 31 March 2017. The company’s registered number is 08818711.

## Board

The board is responsible for the overall strategy and direction of the company. Details of the board’s composition are set out on page 43.

## Directors and corporate governance

Full details of the directors and corporate governance matters are set out on pages 36 to 50.

## Position of the company

Information relating to the strategy and to the development, performance and the future prospects of the company are set out in the Strategic Report and on pages 2 to 21.

## Employees

The company recognises that the commitment of its highly skilled and experienced workforce is key to the efficient and effective delivery of the company’s functions and the achievement of its strategic objectives.

The company is a fair, honest and considerate employer. It is committed to treating its employees with dignity and respect, and values diversity. The company lives its values and is committed to equal treatment and opportunities for all present and potential employees and does not discriminate on the grounds of colour, ethnic origin, gender, age, religion, political or other opinion, disability, marital status or sexual orientation. Applications for employment by all persons are fully considered, bearing in mind the aptitudes of the applicant concerned. The company provides training opportunities to staff and encourages career and personal development and the building of skills and expertise.

If employees should become disabled, every reasonable effort will be made to continue to provide suitable employment either in the same job or, by training, in an alternative job. Disabled persons are given equal consideration for training, career development and opportunities for promotion within the company.

There are a number of communication and discussion channels in place to enable employee engagement. These channels include team meetings and regular company-wide briefings. The company encourages open and frank communication between employees and senior management, including providing feedback sessions, focus groups and opportunities for employees to express their views and generate ideas. The company conducted an annual staff survey in 2016/17 (its second since August 2014, when it commenced operations). While not the only source of staff feedback, the survey has provided a method of reaching a broader range of staff and giving them an opportunity to feedback on a wide range of matter. The survey results have provided useful insights which will allow the company to both build on its areas of strength (e.g. staff have good teamwork and a clear understanding of the company’s strategy) and be responsive to suggestions for improvement.

The company’s employee numbers (including executive directors but excluding non-executive directors and secondees) as at 31 March 2017 were 53.

## Environment

Details are set out on pages 21 to 22 in the Environment Report.

## Payment to suppliers

The company pays its suppliers in accordance with the provisions of its contracts with suppliers, subject to compliance by the suppliers with their obligations.

## Charitable and political contributions

During the year, the company made no charitable or political contributions.

## Results and dividends

The company has prepared its 2016/17 financial statements in accordance with International Financial Reporting Standards (IFRS). The audited financial statements for the year ended 31 March 2017 are set out on pages 57 to 85.

The company is a not-for-profit company, with the settlement activity it performs ensuring that the CFD payments it is required to make to generators are matched with the Supplier Obligation Levy it collects from suppliers. In addition, the company's costs are funded by the operational cost levy referred to on page 26. Any operational costs levy collected that exceeds the company's requirement is refunded to suppliers. This refund is recognised through the financial statements and matched with the income collected. On this basis the financial results for the year reflect a neutral profit position, i.e. nil profit-nil loss. Consequently, the company does not pay a dividend.

For a more detailed review of the results for the year and a more detailed explanation of the accounting profit, see the financial statements on pages 57 to 85, and the Strategic Report on pages 23 to 31.

## Directors' third party indemnity provisions

The directors have been granted an indemnity against liability in respect of proceedings brought by third parties, subject to the conditions set out in the Companies Act 2006. Such qualifying third party indemnity remains in force as at the date of approving this Directors' Report.

## Going concern

The directors have a reasonable expectation that the company has adequate resources to continue to operate for the foreseeable future. The financial statements therefore continue to be prepared on a going concern basis. The basis of this view is outlined in more detail in note 2.2 to the financial statements.

## Directors' responsibilities statement

The directors are responsible for preparing the annual report and financial statements in accordance with applicable law and regulations.

Company law requires the directors to prepare financial statements for each financial year. Under that law the directors have elected to prepare the company financial statements in accordance with IFRS, as adopted by the European Union, and in accordance with applicable law. Under company law the directors must not approve the financial statements unless they are satisfied that they give a true and fair view of the state of affairs and profit or loss of the company for that period.

In preparing these financial statements, the directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgements and accounting estimates that are reasonable and prudent;
- state whether applicable IFRS have been followed, subject to any material departures disclosed and explained in the financial statements; and
- prepare the financial statements on the going concern basis unless it is inappropriate to presume that the company will continue in business.

The directors are responsible for keeping adequate accounting records that are sufficient to show and explain the company's transactions and disclose with reasonable accuracy at any time the financial position of the company and enable them to ensure that the financial statements comply with the Companies Act 2006. They are also responsible for safeguarding the assets of the company and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

Each of the directors, whose names and functions are described herein, confirms that to the best of his or her knowledge:

- the financial statements, which have been prepared in accordance with IFRS as adopted by the European Union, give a true and fair view of the assets and liabilities, financial position and the profit or loss of the company; and
- the Directors' Report and Strategic Report include a review of the development and performance of the business and the position of the company, together with a description of the principal risks and uncertainties that it faces.

The directors are responsible for the maintenance and integrity of the corporate and financial information included on the company's website. Legislation in the United Kingdom governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

The directors consider that the annual report and financial statements, taken as a whole, are fair, balanced and understandable and provide the information necessary for the shareholder to assess the company's position, performance, business model and strategy.

## Auditors

So far as each person who was a director at the date of approving this report is aware, there is no relevant audit information, being information needed by the auditor in connection with preparing its report, of which the auditor is unaware. Having made enquiries of fellow directors and the company's auditor, each director has taken all the steps that he/she is obliged to take as a director in order to make himself/herself aware of any relevant audit information and to establish that the auditor is aware of that information.

The company's auditors have expressed a willingness to continue in office. A resolution to reappoint them will be proposed at the relevant time.

By order of the board

Claire Williams

**Claire Williams**
Company Secretary

31 July 2017

# Corporate Governance report

The company was established by the Secretary of State for Business, Energy and Industrial Strategy as an independent private law company.

However, it is also a governmental arm's length body which is funded by and manages compulsory levies, with the Secretary of State being its sole shareholder. Compulsory levies are normally classified as taxation, which effectively means that the company is managing public monies.

The company accordingly, both as an independent private company and as an entity having responsibilities for the administration of public monies, adopts the highest standards of governance and works to the highest standards of probity. The company recognises the importance of operating with regularity and propriety, the need for effectiveness and prudence in the administration of public resources and the need to secure value for public money.

This Corporate Governance Report outlines the company's governance structure and demonstrates how its arrangements align with the guidelines and principles set out in the UK Corporate Governance Code. An explanation is given below where any aspect of the Code has not been fully applied.

The company's activities in the year are described in pages 2 to 21 and in the Strategic Report at pages 23 to 31.

## Framework Document

The company's main governing documents are its Articles of Association and its Framework Document. The Framework Document, which establishes the fundamental relationship between the shareholder and the company, is published on the company's website to provide transparency of the relationship.

The Framework Document reflects the basic tenet that functional independence is compatible with financial oversight of an arm's length body by its parent department. The Framework Document makes it clear that the company has day-to-day operational independence, subject to certain limited exceptions set out in legislation, the company's Articles of Association and in the Framework Document itself. The limitations on the company's independence are those which are either:

- common to government owned entities and necessary to satisfy government and Parliamentary budgeting and accountability requirements; or

- provide the shareholder with specific controls in respect of policy implementation matters relating to CFDs. Essentially, these specific controls are matters for which shareholder consent is required, mainly in relation to material change to the CFDs.

The Framework Document recognises that the company is a separate corporate entity and that its governance, and decision-making processes, flow through its board, with its executives reporting to that board.

The Framework Document establishes that in carrying out its functions, activities and role the company shall seek to maintain investor confidence in the CFD scheme and minimise costs to consumers. This is known as the "Guiding Principle". The company recognises the importance of this Guiding Principle.

## UK Corporate Governance Code

The company is required by the Framework Document to comply with the UK Corporate Governance Code as it applies to small quoted companies (other than Section E relating to relations with shareholders) or specify and explain any non-compliance in its annual report.

The company additionally believes that the adoption of the UK Corporate Governance Code is important as a means of recognising and embedding best practice in corporate governance. The board considers that the company has complied in full with the Code, otherwise than as explained in this Corporate Governance Report. Any non-compliance is due to the requirements of the company's shareholder as reflected in company's Articles of Association and the Framework Document.

## Role of the board

The board is committed to ensuring high standards of corporate governance. It accepts that good governance is based on the underlying principles of accountability, transparency, probity and focus on the sustainable success of the company over the longer term.

The board is collectively responsible for the long term success of the company and is ultimately responsible for its strategy, management, direction and performance. The board sets the company's strategic aims, ensures that the necessary financial and human resources are in place for the company to meet its objectives, reviews progress towards the achievement of objectives and reviews the performance of management.

The board establishes the values, culture, ethics and standards of the company and sets the framework for prudent and effective controls which enables risk to be assessed and managed.

The board has delegated authority to its committees to carry out the tasks defined in the committees' terms of reference. There are three committees, being (i) the audit, risk and assurance committee; (ii) the remuneration committee; and (iii) the nomination committee. The written terms of reference of each committee are available on the company's website. The board has delegated the day-to-day management of the company to the Chief Executive.

## Composition of the board

The Framework Document and the Articles of Association provide that the shareholder's approval is required for all board appointments. The Framework Document and the Articles of Association also state that the shareholder has the right to appoint the Chairman, the Senior Independent Director and two shareholder nominated directors.

Martin Read was appointed as Chairman designate in early 2014 and as Chairman on 2 May 2014. Jim Keohane was appointed in early 2014 as Senior Independent Director designate and, on 2 May 2014, as Senior Independent Director. Both Martin Read and Jim Keohane were re-appointed to these roles in March 2017. The two shareholder nominated directors are currently David Long (appointed on 27 October 2015) and Simon Elliston (appointed on 16 December 2015).

After obtaining the consent of the shareholder in accordance with the Framework Document and the Articles of Association, the board, on 11 November 2014, appointed an additional five independent non-executive directors (Anne Baldock, Tony Bickerstaff, Marion King, Simon Orebi Gann and Tony White).

Neil McDermott, the Chief Executive, was appointed as a director on 22 July 2014 and Catherine Gan the Chief Finance Officer was appointed as director effective on 24 April 2017 (replacing Helen Turner, the previous Chief Finance Officer, who resigned her roles as both CFO and director on 7 December 2016).

The details of all board members, any changes in the year and attendance at board meetings are listed on pages 43 to 44. All directors, with the exception of the two shareholder nominated directors have written terms of appointment. These terms of appointment are available for inspection at the company's registered office during normal business hours. The shareholder nominated directors are, respectively, a civil servant employed by central government and a public servant employed by a government wholly owned company.

The Chairman was independent on appointment. The board considers all non-executive directors to be independent of the company, with the exception of David Long and Simon Elliston who have been appointed by the shareholder as its nominated directors.

The independent non-executive directors are appointed for a term of three years as set out in the Framework Document, subject to statutory and appropriate other provisions relating to the cessation of their appointment. The shareholder nominated directors are appointed for the period required by the shareholder.

The board and its committees have an appropriate, effective and broad balance of skills, experience, independence and knowledge which enables them to discharge their respective duties and responsibilities effectively.

New directors receive an induction programme that is tailored to their individual needs.

The company maintains a register of directors' interests.

## Board changes

Helen Turner, the Chief Finance Officer stepped down from the board and her role as Chief Finance Officer on 7 December 2016. She was replaced in both roles in April 2017 by Catherine Gan.

## Board governance

The board meets sufficiently regularly to discharge its duties effectively, generally meeting eight times per year (with ad hoc meetings as required). The board met nine times in 2016/17 and also held a separate strategy meeting.

The Chairman has held a meeting with the non-executive directors without the executives being present. The non-executive directors, led by the Senior Independent Director, have met without the Chairman and executive directors being present.

Details of the directors' interests are recorded in the register maintained by the company and reviewed at least annually by the board. The company has procedures in place to ensure any actual or potential conflicts of interest are appropriately declared and managed. Directors are required to declare any actual or potential conflict of interest to the board and to the Company Secretary.

The board is supplied in a timely manner with the appropriate information of the required quality to enable it to discharge its duties effectively and properly. The Chairman, executive directors and Company Secretary have review processes in place to ensure the quality of the information provided to the board and its committees. The board and committees have concluded, after assessing the question as part of their annual evaluation processes, that they were being provided in a timely manner with appropriate information of the required quality. Board members have access to the Company Secretary and also to independent legal advice if appropriately required.

There is a formal schedule of matters specifically reserved to the board. In high level terms, the day to day management of the company is delegated to the Chief Executive and senior management with the matters reserved to the board including:

- setting and approving the company's strategy
- responsibility for the leadership of the company
- approving the financial statements
- approving (subject to shareholder consent) the annual business plan and budget
- monitoring and overseeing risk management, financial reporting and the system of internal control
- deciding Supplier Obligation Levy
- oversight of the company's operations
- approving of financial commitments over specified monetary thresholds
- setting the terms of reference for the board committees.

The main roles and responsibilities of the Chairman, Chief Executive, Senior Independent Director and non-executive directors are summarised in high level terms below. There is a document which sets out the division of responsibilities between the Chairman and the Chief Executive which has been approved by the board.

**The Chairman:**

- provides clear and effective leadership to the board
- is responsible for maintaining high standards of operation and governance
- is responsible for promoting a culture of openness and constructive debate by facilitating the effective contribution of the non-executive directors
- facilitates the effective contribution and encourages the active engagement of all members of the board
- ensures the annual evaluation of the performance of the board, its members and its committees
- ensures constructive relations between the executive and non-executive directors
- speaks on behalf of the board and represents the board to the shareholder
- manages the business of the board, including the board's agenda and ensuring that adequate time is available for the discussion of all agenda items, in particular, strategic issues
- is responsible for ensuring that the directors receive accurate, timely and clear information.

**The Chief Executive:**

- fulfils his responsibilities as Accounting Officer[18]
- leads the executive team in the day-to-day running of the company
- makes and executes operational decisions
- implements the strategy agreed by the board
- ensures delivery within the annual budget
- ensures appropriate internal controls and risk management processes are in place
- maintains the appropriate dialogue with the Chairman and the board
- facilitates effective communication to the shareholder and external stakeholders, including service providers, industry parties, regulatory bodies and governmental authorities
- ensures the values of the company are embedded within its operations and staff culture.

**The Senior Independent Director:**

- works alongside the Chairman and provides a sounding board for the Chairman
- is available as an intermediary to other directors when necessary
- leads the meeting(s) with the other non-executive directors without the Chairman being present, including to appraise the performance of the Chairman.

**Non-executive directors:**

- Non-executive directors (including via their activities in relevant committees) ensure that the board fulfils its responsibilities, including in relation to strategy, monitoring the performance of management and satisfying themselves as to the integrity of financial information and that there is in place robust internal controls and a sound system of risk management.

## Board evaluation

The board has undertaken a formal and rigorous annual evaluation of its own performance and that of its committees and individual directors. The committees also each separately undertake an annual evaluation process. The Chairman has, with the input and assistance from the other directors and the executive management, undertaken an objective and thorough evaluation of the performance of the Senior Independent Director. The non-executive directors, led by the Senior Independent Director, have undertaken an objective and thorough performance evaluation of the Chairman, taking into account the views of executive directors.

These evaluations have concluded that the board and the committees are working effectively, they are performing their role in a proper, good and appropriate manner and there is strong corporate governance in place.

The Chairman also regularly reviews and agrees with each director their training and development needs, including as part of the evaluation process.

[18] The responsibilities of an Accounting Officer are described in HM Treasury guidance "Managing Public Money". They include accountability for the activities of the company, the stewardship of public funds and the extent to which key performance targets and objectives are met. https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/212123/Managing_Public_Money_AA_v2_-_chapters_annex_web.pdf

# Tony Bickerstaff

chair of audit, risk and assurance committee

## Audit, Risk & Assurance Committee

This committee was established by the board on 16 December 2014.

During the year and at the year end the membership of this committee comprised five non-executive directors, namely Tony Bickerstaff (chairman), Jim Keohane, Marion King, Simon Elliston and Simon Orebi Gann.

The chairman of the committee is a qualified accountant with recent and relevant financial experience. The committee is composed of four independent non-executive directors and one shareholder nominated non-executive director. The Framework Document, as permitted by the Articles of Association, requires the committee to include a director nominated by the shareholder.

The committee met three times in the financial year 2016/17, with meetings in May 2016, September 2016 and in January 2017. The company's external auditor attends committee meetings.

The Chief Executive (as Accounting Officer), Chief Finance Officer (or Acting Chief Finance Officer), Head of Internal Audit, Company Secretary and external auditors are invited to attend each meeting. The Accounting Officer, Chief Finance Officer (or Acting Chief Finance Officer), Head of Internal Audit and the external auditors have access to the chairman of the committee outside formal committee meetings. The Head of Internal Audit and the external auditors each separately meet informally with the committee after every scheduled committee meeting.

The main responsibilities of the committee include:

- monitoring the assurance needs of the company in relation to risk, governance and the control framework
- reviewing the company's internal controls (including financial controls) and risk management systems
- monitoring the integrity of the company's financial statements and reviewing and reporting to the board on significant financial reporting issues and judgements
- monitoring the effectiveness of the company's internal audit function
- making recommendations to the board in relation to the appointment, re-appointment and removal of the external auditor and approving the remuneration and terms of engagement of the external auditor
- reviewing external auditor independence and objectivity and the effectiveness of the audit process, taking into consideration relevant UK professional and regulatory requirements
- reporting to the board, identifying any matters in respect of which it considers that action or improvement is needed and making recommendations as to the steps to be taken
- reporting to the board on how it has discharged its responsibilities
- undertaking an evaluation of its own performance.

The committee has reviewed arrangements by which employees are able, in confidence, to raise concerns about possible improprieties in matters of financial reporting or other matters.

The committee applies an external auditor independence policy to safeguard auditor objectivity and independence where the company's auditors have provided non-audit services. The external auditor has not provided any non-audit services in the financial year.

In the financial year, the committee discussed the following matters:

- Review of Financial Performance
- Risk Register Review
- Deep Dive on Contract Lifecycle Management Risk
- Internal Audit Activity Update
- Status of Significant Accounting Estimates, Judgements and Special Issues
- Annual Report Update: Going Concern & Viability Statement
- External Auditors Report for 2015/16
- Letters of Representation for 2015/16

- Recommendation of Annual Report and Accounts for 2015/16
- Committee Annual Report to the Board
- Review of Procedures for Handling Reporting Errors or Irregularities
- Lessons Learnt on 2015/16 External Audit
- Re-Appointment of External Auditors for 2016/17
- Approval of External Audit Fee for 2016/17
- Annual Evaluation of Committee
- Risk Deep Dive on Organisation Co-ordination
- Risk Management and Internal Control Framework
- Annual Report Process for 2016/17
- External Audit Plan and Update on Period 9 Work 2016/17
- External Audit Letter of Engagement
- Assessment of Committee Training Requirements
- Internal Audit Plan, Objectives and Updates on Internal Audit Activity
- Business Continuity Planning for IT Infrastructure Support Provider Failure
- Deep Dive on Fraud Risk.

The minutes of the meeting are circulated to the board.

The significant issues considered by the committee in relation to the financial statements relate to the (i) valuation of CFDs and the accounting treatment for the Hinkley Point C CFD; (ii) the settlement system; and (iii) the NnG contract. These matters are further referred to on page 27 of the Strategic Report and, respectively, notes 6, 12, 26 and 28 of the financial statements.

The company's main risks and related mitigating actions are set out on pages 29 to 31 of the Strategic Report. There have been no lapses in data security (other than possibly trivial lapses).

The re-appointment of the external auditor was approved by the board in November 2016 upon the recommendation of the committee. The committee in recommending the re-appointment, and the board in approving the re-appointment, took into account the fact that the Framework Document stated the strong presumption that the company would appoint the National Audit Office (NAO) as its auditor and also that shareholder consent was required for the appointment of any external auditor. They also noted the significant benefits of appointing the NAO based on value for money, the potential synergies with BEIS's audit requirements and the NAO's understanding of both the complex environment within which the company would operate and the wider government and public sector context.

The committee assessed the effectiveness of the external audit process and provided its comments on the effectiveness to the external auditor.

# Martin Read

chair of nomination committee

## Nomination Committee

During the year and at the year end the committee comprised Martin Read (chairman), Anne Baldock, Marion King, Simon Orebi Gann and Tony White. A majority of members of the nomination committee are independent non-executive directors.

The committee met twice during the year, in May 2016 and September 2016, in order to discuss the re-appointment of the Chairman and Senior Independent Director. The committee was chaired by Mr Orebi Gann in place of the committee chair (Mr Read) who was not present as the question of his re-appointment as board chair was being discussed. During the course of the meetings the committee also discussed the composition of the board and matters relating to the timing for directors to be appointed or re-appointed. The committee recommended the re-appointment of the Chairman and the Senior Independent Director to the shareholder.

Under the Articles of Association and the Framework Agreement, the shareholder has reserved the right to appoint the board chair, the Senior Independent Director and up to two shareholder nominated directors. The shareholder has also reserved the right to approve the appointment of the other directors of the company.

The committee did not lead the process for board appointments as it was not established until December 2014, shortly after the appointment of the majority of board members which took place in November 2014.

The shareholder in early 2014 appointed the Chairman and Senior Independent Director for a three year term (effective in each case from 1 March 2014), and has re-appointed the Chairman for a further three year term (effective from 1 March 2017) and the Senior Independent Director for a further two year term (effective from 1 March 2017). The nomination committee recommended the reappointment of both the Chairman and Senior Independent Director to the shareholder.

The Chairman and the Senior Independent Director led the process in 2014 for appointing the Chief Executive and the independent non-executive directors and recommended the proposed appointments to the shareholder. The shareholder consented to these appointments. The shareholder appointed the two original shareholder nominated directors in early 2014 and appointed replacement shareholder nominated directors in late 2015.

An external recruitment consultancy, Odgers Berndtson, was used in the appointment of the Chairman, the Senior Independent Director, Chief Executive and the independent non-executive directors. The shareholder nominated directors are civil servants selected by the shareholder. Odgers Berndtson does not have any other connection with the company.

An external recruitment consultancy, Sartori Executive Search, was used in the search for the replacement Chief Finance Officer. Catherine Gan was appointed as Chief Finance Officer and as a director effective on 24 April 2017. Sartori Executive Search does not have any other connections with the company.

The search process for the appointment of the Chairman, Senior Independent Director, Chief Executive, Chief Finance Officer and other directors was formal, rigorous and transparent and the searches were conducted, and appointments made, on merit, against objective criteria and with due regard for the benefits of diversity on the board.

The committee's responsibilities include:

- regularly reviewing the structure, size and composition of the board including skills, knowledge, diversity and experience
- reviewing plans for the orderly succession for appointments to the board and to senior management, so as to maintain an appropriate balance of skills and experience within the company and on the board and to ensure progressive refreshing of the board
- undertaking an evaluation of its own performance.

The minutes of meetings are circulated to the board.

## Remuneration Committee

The membership and responsibilities of this committee are described in the Remuneration Report at pages 47 to 50.

## Board and committee membership

The table below sets out the dates of appointment of the members to the board and the committees and details of those board members who resigned in year.

| Director | Role | Board | Audit, Risk & Assurance Committee | Nomination Committee | Remuneration Committee |
|---|---|---|---|---|---|
| Anne Baldock | non-executive director | App. 11/11/2014 | | App. 16/12/2014 | App. 16/12/2014 |
| Tony Bickerstaff | non-executive director | App. 11/11/2014 | App. 16/12/2014 | | |
| Simon Elliston | non-executive director | App. 16/12/2015 | App. 16/12/2015 | | |
| Catherine Gan | Chief Finance Officer | App.24/04/2017 | | | |
| Jim Keohane | non-executive director | App. 22/07/2014 | App. 16/12/2014 | | App. 16/12/2014 |
| Marion King | non-executive director | App. 11/11/2014 | App. 16/12/2014 | App. 16/12/2014 | |
| David Long | non-executive director | App. 27/10/2015 | | | App. 27/10/2015 |
| Neil McDermott | Chief Executive | App. 22/07/2014 | | | |
| Simon Orebi Gann | non-executive director | App. 11/11/2014 | App. 16/12/2014 | App. 16/12/2014 | |
| Martin Read | Chairman | App. 22/07/2014 | | App. 16/12/2014 | App.16/12/2014 |
| Helen Turner | Chief Finance Officer | App. 22/07/2014<br>Res. 07/12/2016 | | | |
| Tony White | non-executive director | App. 11/11/2014 | | App. 16/12/2014 | App. 16/12/2014 |

## Board and committee meetings

The table below shows the number of board and committee meetings of the company held during the year ended 31 March 2017, and the attendance of the individual directors. All directors are expected to attend all board meetings and all members of committees are expected to attend all committee meetings.

It should be emphasised that the table does not fully reflect the contribution made to the company's business by many of the directors who have also attended other meetings (including with senior managers and/or for briefings on various matters) addressing matters raised ex-committee and attending events relating to the company's business and activities during the year.

## Member attendance record

| | Board | Audit, Risk & Assurance Committee | Nomination Committee | Remuneration Committee |
|---|---|---|---|---|
| Number of meetings | 9 | 3 | 3 | 2 |
| Anne Baldock | 9 | | 3 | 2 |
| Tony Bickerstaff | 8 | 3 | | |
| Simon Elliston | 9 | 3 | | |
| Catherine Gan* | N/A | | | |
| Jim Keohane | 8 | 2 | | 2 |
| Marion King | 8 | 3 | 2 | |
| David Long | 7 | | | 2 |
| Neil McDermott | 9 | (attends but not a member) | | |
| Simon Orebi Gann | 8 | 2 | 2 | |
| Martin Read | 9 | | 2† | 2 |
| Helen Turner** | 5 | (attends but not a member) | | |
| Tony White | 9 | | 3 | 2 |

*Appointed after year end
**Resigned part way through the year
†interested in subject matter of the meeting (which related to his reappointment) and therefore did not attend that meeting

## Relations with shareholder and other stakeholders

The company in accordance with its Framework Document maintains an appropriately regular dialogue with its shareholder. The shareholder has appointed two shareholder nominated directors.

The company has also engaged in regular communication with industry and other stakeholders, including by stakeholder engagement events, annual survey and via its website.

As a non-traded entity the company does not propose to have an annual general meeting.

## Maintenance of a sound system of internal control

The board has overall responsibility for the company's risk management and system of internal controls and for reviewing their effectiveness. While retaining overall responsibility, the board has delegated responsibility for more regular and granular review of the effectiveness of the company's risk management framework to the audit, assurance and risk committee.

The key elements and procedures established to provide effective risk management and internal controls have been established. The systems in place are monitored and embedded and are as set out on pages 45 to 46.

### Control and assurance environment

- The board is responsible for the company's system of internal control and for reviewing its effectiveness. The company's system of internal control is designed to manage and where possible to mitigate the risks facing the company, safeguard the assets and provide reasonable (although not absolute) assurance against material financial misstatement or loss. The audit, risk and assurance committee assists the board in discharging its responsibilities (as further described below and in the section headed Audit, Risk and Assurance Committee on pages 40 to 41).
- The board, with the assistance of the audit, risk and assurance committee, has reviewed and is satisfied with the effectiveness of the company's systems of risk management and internal control. There have been no significant lapses in protective security.
- There is an appropriate quality assurance framework in place and applied to all business critical models.[19]

### Risk management framework

- The identification, mitigation and continual monitoring of significant business risks is the responsibility of senior management. Each functional department of the company maintains a risk register identifying the business risks and allocating responsibility for appropriate monitoring and the implementation of mitigating controls. Departmental risk registers and the company's strategic risk register are kept under regular review by the senior management team and reported to the board and audit, risk and assurance committee, with the top strategic risks receiving particular attention. A risk workshop attended by senior employees was held during the year. Risk management processes are incorporated into the company's management and governance systems at all levels and form a part of the company's day to day operations.
- The audit, risk and assurance committee formally reviews the risk position at each scheduled meeting (in 2016/17, in May and September 2016 and in January 2017) and is updated on any significant risk matter which falls outside its formal review cycle. The committee also undertakes a "deep dive" into selected risk. The committee considers the risk appetite of the company in relation to the principal risks.
- The board reviews the strategic risk register twice per year (in 2016/17, in June and December 2016). The reports to the audit, risk and assurance committee and the board include a report from management on the status of the risk management and internal control, any significant failings or weaknesses identified during the period and actions taken to remedy any significant weaknesses.
- The board has reviewed, with the assistance of the audit, risk and assurance committee, and is satisfied that a comprehensive and robust process for identifying, assessing and managing the company's principal risks is in place, including in respect of those risks that would threaten its business model, future performance, solvency or liquidity. Reference is made to the more detailed risk report on pages 29 to 31.

### Internal audit

- There is a comprehensive strategic planning, budgeting and forecasting process within the company, with the business plan (including the annual budget) being approved by the board.
- The company's operational costs are set out in the annual budget. The process for establishing the annual budget involves a number of stages which provide challenge and accountability to ensure that a robust and prudent annual budget is prepared which also ensures cost control and value for money for consumers. The draft budget is reviewed by the board, subsequent to which it is submitted to the shareholder for further review. The shareholder then undertakes a public consultation on the proposed budget. Subsequently the operational costs levy which funds the company's budget is laid before Parliament in the form of regulations.
- The company operates robust financial management processes to ensure that it manages within its budget so as not to exceed the operational costs levy.
- An update on the company's progress, forecasts and results is reported in the management information report submitted to each board meeting.
- Senior management meet regularly with the Chief Executive and Chief Finance Officer to discuss business progress and review management accounts.

[19] The company takes into account the MacPherson Review, HM Treasury Review of Quality assurance of government analytical models: Final Report, March 2013: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/220745/tax_pay_appointees_review_230512.pdf

- There is shareholder oversight of financial management as set out in the Framework Document and the Finance and Reporting Letter from the shareholder to the company dated 1 August 2014, including monthly reporting.

- The company is required to comply with the requirements set out in the Framework Document and the Finance and Reporting Letter, including the requirement to comply with the relevant requirements in HM Treasury guidance entitled "Managing Public Money".[20]

### Operational

- The senior management team meets on a weekly basis to review the operations of the company, its delivery, progress, issues and challenges. The Chief Executive has regular meetings with each member of the senior executive team.
- The Chief Executive and the executive team meet with appropriate regularity with the shareholder and other stakeholders.
- The commercial team, legal and other functional teams (including settlement) work closely together to ensure the appropriate interfaces and communication in relation to CFD management, with the governance, internal decision making and critical processes being documented.
- The company reports on its significant matters relating to its operational activities at each board meeting, including CFD management matters.
- The board decides on matters falling within the schedule of reserved matters (e.g. the Supplier Obligation Levy and financial commitments over the specified threshold) or otherwise raised to it for decision.

### Procurement

- The company has in place an effective procurement policy and is required to procure all goods and services in compliance with the relevant requirements in Managing Public Money, Cabinet Office controls and the public procurement regulations.
- The company is required to carry out procurement and project appraisal objectively and fairly, using cost benefit analysis and generally seeking good value for money.

### Legal and compliance

- There is a system for monitoring and embedding compliance, including by company policies and procedures as well as training and guidance to support compliance (e.g. relating to anti-bribery, whistle-blowing, anti-money laundering, health & safety and other legislative and good practice requirements). External obligations are driven primarily by key legal, statutory and regulatory requirements.
- The company expects the highest standards from all employees and delivery partners.
- The company considers and implements the requirements of the Alexander Tax Review in relation to the retention of consultants.[21]

### Treasury management

- The finance department:
  - operates within policies agreed by the audit, risk and assurance committee
  - uses its resources efficiently, economically and effectively, avoiding waste and extravagance
  - uses management information systems to gain assurance about value for money and the quality of delivery and so make timely adjustments
  - uses internal and external audit to improve its internal controls and performance.

### Insurance

- Appropriate insurance is in place, with insurance cover being reviewed annually by the board.

Signed

**Neil McDermott**
Chief Executive and Accounting Officer

[20] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/454191/Managing_Public_Money_AA_v2_-jan15.pdf

[21] HM Treasury, Review of tax arrangements of public sector appointees, May 2012: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/220745/tax_pay_appointees_review_230512.pdf

# Remuneration report

The company's registered number is 08818711.

## Jim Keohane

chair of committee

### Remuneration committee

During 2016/17 and at year end this committee comprised Jim Keohane (chairman), Anne Baldock, David Long, Martin Read and Tony White. The Framework Document requires that one shareholder nominated director should be a member of the committee. The committee consists of a majority of independent non-executive directors, the board Chairman and the shareholder nominated director.

The responsibilities of the committee include:

- setting the overall remuneration policy for the company
- setting the conditions of employment, including levels of salary and pension arrangements for executive directors and senior management, but subject to the shareholder's consent being necessary to the remuneration or material variation to the remuneration of any executive director or employee whose salary is equal to or higher than the threshold set in Cabinet Office guidance in respect of senior pay
- recommending the level of remuneration of the non-executive directors to the board, but subject to the shareholder's consent being necessary to the remuneration or material variation to the remuneration of any director
- ensuring that the remuneration package for employees and salary levels are appropriately benchmarked
- undertaking an evaluation of its own performance.

During the period the committee met twice times and discussed the following matters:

- 2015/16 – Company Performance Report and Staff Incentive Scheme Award
- 2015/16 – Proposal for Senior Team Staff Incentive Scheme Award
- 2015/16 – CFO Award for 2015/16
- 2015/16 – CEO Award for 2015/16 and Objectives for 2016/17
- Company Annual Pay Review
- Staff Incentive Scheme Proposal 2016/17
- Recruitment – Commercial Update
- Approval of Specific Appointment
- Report on Benefits Package Review
- Company Pension Overview
- Death in Service Benefit
- Interim Company Performance Report
- Committee Terms of Reference
- Annual Evaluation of Committee.

The minutes of each meeting are circulated to the board.

## Directors and senior management remuneration

In 2014, prior to the establishment of the committee, the then board of the company met to approve the appropriate remuneration for incoming executive directors.

Advice on remuneration for the executive directors and senior management team was obtained in 2014 from Odgers Berndtson. In 2016 advice on the appropriate remuneration for the Chief Finance Officer post was received from Satori. During the course of early 2016 and subsequently further remuneration advice was obtained from the Hay Group in respect of the senior management team and in respect of staff below senior management level. The Hay Group has no other connection with the company.

No director is involved in deciding his or her own individual remuneration.

Public sector reporting bodies are required to disclose the relationship between the remuneration of the highest paid director in their organisation and the median remuneration of the organisation's workforce. An annualised figure has been used to better reflect contractual salary. The annual remuneration of the highest paid director is £263,292 (2015/16: £248,684).[22] This is 4.2 (2015/16: 4.1) times the median remuneration of the company's workforce, which is £61,122 (2015/16: £60,779).[23] No employees receive salary in excess of the highest paid director.

Levels of remuneration for the "non-governmental" non-executive directors reflect the time commitment and responsibilities of the role and reflect the advice on remuneration for directors and benchmarking information provided in 2014 by Odgers Berndtson (an independent recruitment consultancy). The shareholder nominated (or "governmental") directors are not paid by the company.

## Procedures for developing policy and determining remuneration

The committee has responsibility for setting the compensation arrangements for the board and the executive directors. It also sets the broad framework for employee remuneration and benefits. The committee has access to the information it requires and has the authority to obtain the advice of external advisers.

The committee assesses where to position the company in respect of remuneration matters relative to other companies and the requirements of the company's business and operations. The company undertakes an annual benchmarking of employee salaries.

The committee is required under its Framework Document to comply with Cabinet Office rules relating to the level of director and staff remuneration. The shareholder's consent is required to any increase in excess of the level specified in the Cabinet Office rules.

## Statement of remuneration policy

The remuneration policy is to:

- provide a compensation package to attract, motivate and retain high quality employees in furtherance of the mission and strategy of the company
- assess remuneration relative to other arm's length bodies and other organisations (including in the private sector) engaged in functions or operations of similar size and complexity
- set the performance targets to incentivise and reward sustainable business performance while not encouraging inappropriate business risks to be taken.

A range of methods are used to ensure that the levels of compensation are appropriately benchmarked against external organisations.

## Pay review

After carefully considering the performance of the executive directors and other staff, the range of salaries offered to other staff and relevant market reference points, the committee approved a general pay review increase of 1.5% effective from 1 July 2015, with the specific amount to be awarded dependant on the company's remuneration policy.

The company obtains the consent of the shareholder prior to the implementation of any increase which would be above the level specified in the Cabinet Office rules.

[22] The total remuneration figure includes salary, non-consolidated performance related pay and benefits-in-kind. It does not include severance payments, employer pension contributions, cash payments in lieu of pension contributions and the cash equivalent transfer value of pensions.

[23] Salary increases took effect on 1 April 2016. It should be noted that while the median calculation for 2016/17 includes all salary, performance bonuses and benefits payable to staff members, not all staff members will receive a bonus. The reason for this is that a number of staff members may not have been with the company for the qualifying period.

## Executive directors

The executive directors' remuneration has been designed to promote the long term success of the company. Their respective earnings consist of a base salary plus taxable benefits (permanent health insurance, private medical cover and life assurance); a defined contribution pension scheme; and an incentive bonus. The bonus links corporate and individual performance with an appropriate focus on delivery targets and the balance between short and long term elements. The committee, based on an assessment of individual and company performance against key objectives, has agreed the bonuses to the two executive directors for 2015/16 as set out below.

Neil McDermott (Chief Executive) and Helen Turner (CFO) are the relevant executive directors for the period. Helen Turner resigned her post on 7 December 2016, and therefore the figures below reflect payments to 31 December 2016. Pension benefits disclosed relate to cash paid in lieu of pension contributions (for Neil McDermott and Helen Turner) in accordance with their respective employment contract arrangements.

| Name | 2016/17 Salary £ | 2016/7 Performance Related Pay (Bonus) | 2016/17 Taxable Benefits | 2016/17 Pension Payments | 2016/17 Total |
|---|---|---|---|---|---|
| **Neil McDermott** | 2016/17: £216, 347<br>(2015/16: £212,363) | 2016/17: £41,411<br>(2015/16: £30,827) | 2016/17: £5,534<br>(2015/16: £5,495) | 2016/17: £21,634<br>(2015/16: £21,236) | 2016/17: £284,926<br>(2015/16: £269,921) |
| **Helen Turner** | 2016/17: £117,980<br>(2015/16: £151,688) | 2016/17: £27,304<br>(2015/16: £19,833) | 2016/17: £1,998<br>(2015/16: £2,626) | 2016/17: £11,798<br>(2015/16: £15,169) | 2016/17: £158,713<br>(2015/16: £189,316) |

*The performance related incentive bonuses only become receivable in the year following the year to which they related as they, in accordance with the remuneration committee and other applicable approval processes, are not determined or approved for payment until after the end of the financial year. As a result, bonuses relating to 2015/16 were not approved and paid until early in 2016/17. They were, however, noted as being payable in the 2015/16 Annual Report and as being £41,411 and £27,304 respectively. The performance incentive bonus for Neil McDermott relating to 2016/17 was approved in 2017/18 and will be paid in 2017/18, being £42,404. Helen Turner was not eligible for a bonus as she left the company prior to year end.*

The executive director payments for 2016/17 reflect that the executive directors received a 1.5% pay increase in line with the general pay review applicable to all company employees referred to above.

## Director fees

Fees are payable to all non-executive directors, except the shareholder nominated directors. The company provides services to ESC and, for reasons of synergy, operational efficiency and cost effectiveness, the board of directors of the company and ESC are identical. The fees paid to directors therefore relate to work for both companies. The fees are paid by the company, with the appropriate amount relating to ESC being recovered under the "recharge" arrangements described in note 2.5 to the financial statements.

The level of remuneration paid by the company to the "non-governmental" non-executive directors reflects the time commitment and responsibilities of the role and accords with the advice on remuneration for directors and benchmarking information provided by Odgers Berndtson (an independent recruitment consultancy). The company does not pay any remuneration to the shareholder nominated directors.

| Name | 2016/17 Fees £ | Principal positions held elsewhere at 31 March 2017 |
|---|---|---|
| Anne Baldock | £25,000<br>2015/16: £25,000 | • ESC – non-executive director<br>• Hydrogen Group plc – non-executive director<br>• Thames Tideway Limited – non-executive director<br>• 375 Greyhound Residents Ltd – director/shareholder |
| Tony Bickerstaff | £31,000<br>2015/16: £31,000 | • Costain Group Plc – Group Finance Director<br>• CBI Economic Growth Board – member<br>• ESC – non-executive director |
| Simon Elliston | 0 (shareholder nominated director – civil servant) | • BEIS – Director of Finance and Commercial<br>• ESC – non-executive director |
| Catherine Gan | 0 (employed after year end) | • ESC – Chief Finance Officer and director |
| Jim Keohane | £40,000<br>2015/16: £40,000 | • Gas & Electricity Marketing Authority – non-executive member<br>• Harwich Haven Authority – chairman<br>• ESC – non-executive director |
| Marion King | £25,000<br>2015/16: £25,000 | • Royal Bank of Scotland – Group Director of Payments<br>• ESC – non-executive director<br>• Payments UK – director |
| David Long | 0 (shareholder nominated director – public servant) | • UK Government Investments – Executive Director<br>• ESC – non-executive director |
| Neil McDermott | N/A – see above | • ESC – Chief Executive and director |
| Simon Orebi Gann | £25,000<br>2015/16: £25,000 | • ESC – non-executive director<br>• Aspen Technology Inc (NASDAQ: 'AZPN), USA – non-executive director |
| Martin Read | £120,000<br>2015/16: £120,000 | • Laird plc – chairman<br>• Remuneration Consultants Group – chairman<br>• ESC – chairman<br>• UK Government Senior Salaries Review Body – chairman<br>• Lloyds of London (Franchise Board) – non-executive director |
| Helen Turner | N/A – see above | • ESC – Chief Finance Officer and director |
| Tony White | £25,000<br>2015/16: £25,000 | • ESC non-executive director<br>• Association for Decentralised Energy – Vice President<br>• Green Energy Options – non-executive director<br>• BW Energy Ltd – director<br>• The Ecofin Research Foundation – trustee director<br>• First Utility Trust – trustee |

*The above is the only form of remuneration that each non-executive director receives from LCCC. LCCC receives 20% of the directors' fees from ESC under its re-charge arrangements with ESC – see note 2.5.

# Independent Auditor's Report to the sole shareholder of the Low Carbon Contracts Company Ltd

## Opinion on financial statements

In my opinion the financial statements:

- give a true and fair view of the state of the company's affairs as at 31 March 2017 and of the profit for the year then ended;
- have been properly prepared in accordance with International Financial Reporting Standards as adopted by the European Union; and
- have been prepared in accordance with the Companies Act 2006.

## Emphasis of matter – Contracts for Difference ("CFD") derivative and associated supplier obligation asset

Without modifying my opinion, I draw attention to the disclosures made in note 26 to the financial statements concerning the measurement of liabilities relating to CFDs. As this note describes, the fair value of these liabilities is highly sensitive to assumptions regarding future prices and volumes, particularly in view of the long timescales involved. This sensitivity also applies to the measurement of these liabilities recognised in the Statement of Financial Position (which are adjusted in respect of the difference between fair value and transaction price on initial recognition) and the matching Supplier Obligation Levy asset. As disclosed in note 28, the Low Carbon Contracts Company has concluded that the uncertainty over the estimate of the valuation of the CFD for Hinkley Point C is such that the liability does not meet the recognition criteria set out in the Conceptual Framework for Financial Reporting.

## Opinion on regularity

In my opinion, in all material respects the expenditure and income recorded in the financial statements have been applied by the purposes intended by Parliament and the financial transactions recorded in the financial statements conform to the authorities which govern them.

## Basis of opinions

I have audited the financial statements of the Low Carbon Contracts Company Ltd ("the company") for the year ended 31 March 2017 which comprise:

- the Statement of Comprehensive Income;
- the Statement of Financial Position;
- the Statement of Cash Flows;
- the Statement of Changes in Equity; and
- the related notes.

The financial reporting framework that has been applied in their preparation is applicable law and International Financial Reporting Standards as adopted by the European Union and as applied in accordance with the provisions of the Companies Act 2006. I have also audited the information in the Directors' Remuneration Report that is described as having been audited.

The regularity framework that has been applied is the Companies Act 2006; the articles of association of the company; the Framework Document between the Secretary of State and the company; and HM Treasury authorities and other relevant legislation to the extent they are applicable to the company.

## Overview of my audit approach

### Key audit matters

Key audit matters are those matters that, in the auditor's professional judgement, were of most significance in the audit of the financial statements for the year ended 31 March 2017 and include the most significant assessed risks of material misstatement (whether or not due to fraud) identified by the auditor, including those which had the greatest effect on the overall audit strategy; the allocation of resources in the audit; and directing the efforts of the engagement team.

These matters were addressed in the context of the audit of the financial statements as a whole, and in forming the auditor's opinion thereon, the auditor does not provide a separate opinion on these matters.

This is not a complete list of all risks identified by my audit but only those areas that had the greatest effect on my overall audit strategy, allocation of resources and direction of effort. I have not, for example, included information relating to the work I have performed around the risk of litigation, an area where my work has not identified any matters to report.

The areas of focus were discussed with the Audit, Risk and Assurance Committee; their report on matters that they considered to be significant to the financial statements is set out on page 41.

### Fair value of CFDs (excluding Hinkley Point C)

#### Risk

The fair value of the CFD was assessed to be a significant risk of material misstatement as the liability is derived using significant judgements that are complex and subjective and could individually lead to a material misstatement in the accounts.

A key driver to determining the fair value of the CFD financial instrument is the company's forecast of wholesale electricity prices over the life of the signed contracts. This forecast is generated by the Department for Business, Energy and Industrial Strategy using an in-house model.

The uncertainties inherent in determining the fair value of CFDs are further discussed in the disclosures made in note 26 to the financial statements.

#### My response and findings

I assessed the company's controls over the valuation of the CFD liability.

To gain substantive assurance over management's estimate of the CFD fair value, I constructed my own range as a point of comparison. In constructing the auditor's range, I assessed the reasonableness of the inputs used by the company underpinning assumptions of both future electricity volumes and future market prices, and considered the plausibility of possible alternatives. In doing so, I considered the principles of fair value, which includes the concept of an exit price for the asset or liability being valued, and wherever possible based my auditor's range on data sources which would be consulted by counterparties in a theoretical exit transaction (for instance, by using forecast price series from reputable third parties).

As required by auditing standards, I narrowed the auditor's range to the point where I considered all outcomes within it to represent reasonable estimates of fair value. Management's point valuation fell within my constructed range, on the basis of which I judge it to be a reasonable estimate. The span of my constructed range reflects the significant degree of uncertainty inherent in estimating fair value for these instruments.

### Hinkley Point 'C' accounting

#### Risk

The CFD contract for Hinkley Point 'C (HPC)' contains a number of bespoke contractual elements which required special consideration. The additional length of the contract compounds the risk of material misstatement, as valuation requires forecasts of wholesale electricity prices out to the 2050s and beyond. Assumptions concerning prices over this period are complex and subjective, and small changes can have considerable impact upon the entire valuation.

The uncertainties inherent in determining the fair value of the HPC contract is further discussed in the disclosures made in note 28 to the financial statements.

#### My response and findings

I read all HPC contractual documents to understand those requiring special consideration when assessing managements accounting treatment and valuation. In many respects, the HPC contract is similar to existing contracts for difference held by the company, but the timescale for payment runs to 2061 (at least 20 years longer than existing contracts).

As disclosed in note 28, management has, following its own investigations, concluded that – for the time being – HPC fails to meet the criteria for recognition in these accounts. This is as a result of the difficulty preparing an estimate which is complete, neutral and free from error in respect of the cash flows in the later years of the HPC contract. We have directed significant audit effort towards assessing the estimation uncertainty in respect of HPC, and have ultimately evaluated management's judgement on non-recognition as reasonable, and their disclosures properly prepared.

***My assessment of the estimation uncertainty connected with the HPC contract***

As with all CFDs, I engaged with auditor's experts and obtained third party price series, for the period to 2040. As the HPC CFD is expected to continue generating cash flows until 2061, the third party price series available did not provide sufficient evidence to support a reliable fair value estimate over the life of the contract.

In the absence of these third party price series, I sought to gain assurance over the post 2040 element of management's internally generated price series fair value estimate by reviewing management's own quality control procedures, and by consulting alternative external sources.

Despite directing significant audit effort towards these alternative assurance methods, I was ultimately unsuccessful in finding a source of evidence on price series sufficiently robust to support the construction of a range estimate.

This was a result of:

i) management's quality assurance methodology and assumptions being primarily geared towards the relevant model's use for economic and policy appraisal purposes, rather than fair value estimation; and

ii) the level of development in post 2040 views expressed by external parties.

Management has disclosed in note 28 the value that would have been recognised if their internal estimate of price series had been used.

***My assessment of management's key judgement on the non-recognition of HPC liabilities***

As a result of my efforts and my conclusions, I judge as reasonable management's assertion in note 28 that the HPC CFD should not be recognised in order to avoid the introduction of excessive reliability issues into the financial statements.

***My assessment of the truth and fairness of related disclosures***

I have nevertheless reviewed the adequacy of disclosures around management's fair value estimate for HPC, presented in note 28, and found these to be properly prepared, and a fair reflection of the estimation uncertainty inherent to this contract.

### Application of materiality

I applied the concept of materiality in both planning and performing my audit, and in evaluating the effect of misstatements on my audit and on the financial statements. This approach recognises that financial statements are rarely absolutely correct and that an audit is designed to provide reasonable, rather than absolute, assurance that the financial statements are free from material misstatement or irregularity. A matter is material if its omission or misstatement would, in the judgement of the auditor, reasonably influence the decisions of users of the financial statements.

| Audited Area | Basis | Materiality |
|---|---|---|
| Account balances or transaction streams not related to contracts for difference and to support my opinion on regularity | 2% of gross expenditure (excluding movements relating to contracts for difference). I determined that for financial statement components unconnected with CFDs, misstatements of a lesser amount than overall materiality could influence the decisions of users of the accounts given the additional user interest in the cost of the company's activities. | £305,000 |
| Overall Financial Statement Materiality (applying to all audited areas with the exception of those listed above) | 2% of the disclosed fair value of the CFD liability, excluding Hinkley Point C which does not meet the criteria to be recognised within the financial statements. I chose this benchmark given that I consider it to be of principal interest to users of the financial statements as one of the company's primary objectives is to manage CFDs. | £628m |

As well as quantitative materiality, there are certain matters that, by their very nature, would if not corrected influence the decisions of users, for example, any errors reported in Directors' Remuneration. Assessment of such matters would need to have regard to the nature of the misstatement and the applicable legal and reporting framework, as well as the size of the misstatement.

I applied the same concept of materiality to my audit of regularity. In planning and performing audit work in support of my opinion on regularity, and evaluating the impact of any irregular transactions, I took into account both quantitative and qualitative aspects that I consider would reasonably influence the decisions of users of the financial statements.

I agreed with the Audit, Risk and Assurance Committee that I would report to it all uncorrected misstatements identified through my audit in excess of £250,000 relating to CFDs, £5,000 for financial statement components unconnected with CFDs and differences below that threshold that, in my view, warranted reporting on qualitative grounds.

There were no unadjusted errors to report to the Audit, Risk and Assurance Committee.

### Scope of my audit

An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of:

- whether the accounting policies are appropriate to the group and parent company's circumstances and have been consistently applied and adequately disclosed;
- the reasonableness of significant accounting estimates made by the directors; and
- the overall presentation of the financial statements.

In addition, I read all the information and non-financial information in the Annual Report to identify material inconsistencies with the audited financial statements and to identify any information that is apparently materially incorrect based on, or materially inconsistent with, the knowledge acquired by me in the course of performing the audit. If I become aware of any apparent material misstatements or inconsistencies I consider the implications for my report.

I am also required to obtain evidence sufficient to give reasonable assurance that the expenditure and income recorded in the financial statements have been applied to the purposes intended by Parliament and the financial transactions recorded in the financial statements conform to the authorities which govern them.

## Other matters on which I report under the Companies Act

### Directors' remuneration

In my opinion, the part of the part of the Remuneration Report to be audited has been properly prepared in accordance with the Companies Act.

I also report to you if, in my opinion, certain disclosures of directors' remuneration required have not been made. I have nothing to report arising from this duty.

### The strategic and directors' reports

In my opinion, based on the work undertaken in the course of the audit, the information given in the strategic and directors' reports for the financial year are consistent with the financial statements and have been prepared in accordance with applicable law.

Based on my knowledge and understanding of the company and its environment obtained during the course of the audit, I have identified no material misstatements in these reports.

### The corporate governance statement

In my opinion, based on the work undertaken in the course of the audit, the information given in the corporate governance statement in respect of internal control and risk management systems in relation to financial reporting processes, and about share capital structures, is consistent with the accounts and has been prepared in accordance with applicable law.

Based on my knowledge and understanding of the company and its environment obtained during the course of the audit, I have identified no material misstatements in this information.

## Matters on which I report by exception

**Adequacy of accounting records information and explanations received**

I report to you if, in my opinion:

- adequate accounting records have not been kept;
- the financial statements and the part of the Remuneration Report to be audited are not in agreement with the accounting records and returns; or
- I have not received all of the information and explanations I require for my audit.

I have nothing to report arising from this duty.

**Consistency of information in the Annual Report**

Under International Standards on Auditing (UK & Ireland), I am required to report to you if, in my opinion, information in the annual report is:

- materially inconsistent with the information in the audited financial statements; or
- apparently materially incorrect based on, or materially inconsistent with, the knowledge of the company that I acquired in the course of performing my audit; or
- otherwise misleading.

In particular, I am required to consider:

- whether I have identified any inconsistencies between the knowledge that I acquired during the audit and the directors' statement that they consider the annual report is fair, balanced and understandable; and
- whether the Annual Report appropriately discloses those matters that I communicated to the Audit, Risk and Assurance Committee which I consider should have been disclosed.

I have nothing to report arising from this duty.

**The directors' assessment of principal risks and future prospects**

Under International Standards on Auditing (UK & Ireland), I am required to report to you if I have anything material to add, or to draw attention to, in relation to the directors' disclosures in the annual report and financial statements:

- confirming that they have carried out a robust assessment of principal risks facing the company, including those that would threaten its business model, future performance, solvency or liquidity;
- describing those risks and explaining how they are being managed or mitigated;
- on whether they considered it appropriate to adopt the going concern basis, and their identification of any material uncertainties to the entity's ability to continue over a period of at least twelve months from the date of approval of the financial statements; and
- explaining how they have assessed the prospects of the entity, over what period they have done so and why they consider that period to be appropriate, and their statement as to whether they have a reasonable expectation that the company will be able to continue in operation and meet its liabilities as they fall due over the period of their assessment, including any related disclosures drawing attention to any necessary qualifications or assumptions.

I have nothing material to add, or to draw attention to, on these matters.

## Respective responsibilities of the directors and the auditor

As explained more fully in the Statement of Directors' Responsibilities, the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view. My responsibility is to audit and express an opinion on the financial statements in accordance with applicable law and with International Standards on Auditing (UK & Ireland). Those standards require me and my staff to comply with the Auditing Practices Board's Ethical Standards for Auditors.

**Matthew Kay**
Senior Statutory Auditor

For and on behalf of the Comptroller and Auditor General (Statutory Auditor)

National Audit Office
157–197 Buckingham Palace Road
London, SW1W 9SP

11 September 2017

# Financial statement and notes to the accounts

# Contents

# Statement of comprehensive income for the year ended 31 March

| | Note | 2017 £'000 | 2016 £'000 |
|---|---|---|---|
| Other income | 6 | 15,266 | 11,749 |
| Supplier Obligation Levy | 27 | 1,064,055 | 9,281,975 |
| Fair value movement of CFDs | 26 | (1,064,055) | (9,281,975) |
| Staff costs | 7 | (5,336) | (5,049) |
| Depreciation | 9 | (168) | (166) |
| Amortisation | 10 | (505) | (233) |
| Other operating costs | 8 | (9,257) | (6,301) |
| **Profit for the year** | | – | – |
| **Other comprehensive income for the year** | | – | – |
| **Total comprehensive income for the year** | | – | – |

All operations are continuing operations.

The notes on pages 63 to 85 form part of these accounts.

# Statement of financial position as at 31 March

| | Note | 2017 £'000 | 2016 £'000 |
|---|---|---|---|
| **Non-current assets** | | | |
| Property, plant and equipment | 9 | 384 | 450 |
| Intangible assets | 10 | 2,328 | 2,341 |
| Supplier Obligation Levy | 27 | 12,333,869 | 11,269,814 |
| **Total non-current assets** | | **12,336,581** | **11,272,605** |
| **Current assets** | | | |
| Operational costs levy receivable | 11 | 1,394 | 1,255 |
| Supplier Obligation Levy receivable | 12 | 42,553 | – |
| Trade and other receivables | 13 | 285 | 187 |
| Cash and cash equivalents | 14 | 40,266 | 18,911 |
| **Total current assets** | | **84,498** | **20,353** |
| **Total assets** | | **12,421,079** | **11,292,958** |
| **Current liabilities** | | | |
| Operational costs levy payable | 15 | (3,835) | (2,675) |
| Supplier Obligation Levy and generators payments payable | 16 | (71,999) | (15,513) |
| Trade and other payables | 17 | (7,131) | (2,063) |
| Borrowings | 18 | (402) | (378) |
| Finance Lease Obligations | 19 | (220) | (124) |
| Provisions | 20 | (1,500) | – |
| **Total current liabilities** | | **(85,087)** | **(20,753)** |
| **Non-current liabilities** | | | |
| Contracts for Difference | 26 | (12,333,869) | (11,269,814) |
| Trade and other payables | 17 | (620) | (798) |
| Borrowings | 18 | (727) | (1,028) |
| Finance Lease Obligations | 19 | (709) | (498) |
| Provisions | 20 | (67) | (67) |
| **Total non-current liabilities** | | **(12,335,992)** | **(11,272,205)** |
| **Total liabilities** | | **(12,421,079)** | **(11,292,958)** |
| **Net assets** | | **–** | **–** |
| **Shareholders' equity and other reserves** | | | |
| Share capital | 21 | – | – |
| Retained earnings | | – | – |
| **Total equity** | | **–** | **–** |

The notes on pages 63 to 85 form part of these accounts.
The financial statements were approved by the board of directors on 31 July 2017 and signed on its behalf on 31 July 2017 by:

**Neil McDermott**
Chief Executive Officer

N McDermott.

**Catherine Gan**
Chief Finance Officer

Catherine Gan

# Statement of changes in equity for the year ended 31 March

| | Share capital | Retained earnings | Total equity |
|---|---|---|---|
| | £'000 | £'000 | £'000 |
| **As at 1 April 2015** | **–** | **–** | **–** |
| Share capital issued | – | – | – |
| Total comprehensive income for the year | – | – | – |
| **As at 31 March 2016** | **–** | **–** | **–** |
| Share capital issued | – | – | – |
| Total comprehensive income for the year | – | – | – |
| **As at 31 March 2017** | **–** | **–** | **–** |

As at 31 March 2017 the company has one authorised ordinary share, issued and fully paid.
The notes on pages 63 to 85 form part of these accounts.

# Statement of cash flows for the year ended 31 March

| | Note | 2017<br>£'000 | 2016<br>£'000 |
|---|---|---|---|
| **Cash flows from operating activities** | | | |
| Profit for the year | | – | – |
| Adjustments to reconcile profit before tax to net cash flows: | | | |
| Depreciation of property, plant and equipment | 9 | 168 | 166 |
| Amortisation of intangible assets | 10 | 505 | 233 |
| Amortisation of government grant liability | 22 | (155) | (26) |
| Loss on disposal | 9 | 1 | – |
| Working capital adjustments: | | | |
| (Increase)/decrease in operational costs levy receivable | 11 | (139) | 5,592 |
| (Increase)/decrease in Supplier Obligation Levy receivable | 12 | (41,053) | 1,010 |
| (Increase)/decrease in trade and other receivables | 13 | (98) | 263 |
| Increase in operational costs levy payable | 15 | 1,160 | 1,396 |
| Increase in Supplier Obligation Levy and generators payments payable | 16 | 56,486 | 14,452 |
| Increase/(decrease) in trade and other payables | 17 | 5,026 | (1,239) |
| Net cash inflow from operating activities | | 21,901 | 21,847 |
| **Cash flows from investing activities** | | | |
| Purchase of property, plant and equipment | 9 | (103) | (14) |
| Purchase of intangible assets | 10 | (40) | (228) |
| Net cash outflow from investing activities | | (143) | (242) |
| **Cash flows from financing activities** | | | |
| Decrease in borrowings | 18 | (277) | (3,100) |
| Finance Lease obligations payment | 19 | (126) | – |
| Net cash outflow from investing activities | | (403) | (3,100) |
| **Net increase in cash and cash equivalents in the year** | | **21,355** | **18,505** |
| Cash and cash equivalents at the beginning of the year | | 18,911 | 406 |
| **Cash and cash equivalents at the end of the year** | **14** | **40,266** | **18,911** |

The notes on pages 63 to 85 form part of these accounts.

# Notes to the financial statements for the year ended 31 March 2017

## 1. Authorisation of financial statements

The financial statements of Low Carbon Contracts Company Ltd (the "company'') for the year ended 31 March 2017 were approved and authorised for issue in accordance with a resolution of the board on 31 July 2017.

The company is a company limited by shares, incorporated and domiciled in the UK. The company's registered office is at Fleetbank House, 2-6 Salisbury Square, EC4Y 8JX. The company is unlisted and wholly owned by the Secretary of State for Business, Energy and Industrial Strategy (the "shareholder") making it the company's ultimate controlling party.

In last year's financial statements the company was stated as owned by the Secretary of the State for Department of Energy & Climate Change. In July 2016 the Department of Energy & Climate Change became part of the new Department for Business, Energy & Industrial Strategy.

### 1.1 Principal activities

The company has been established to act as the counterparty for Contracts for Difference (CFDs). The company will also undertake such other activities that the board considers to be consistent with the company's functions, duties, obligations and constitution.

The company and the Electricity Settlements Company Ltd (ESC) currently share a number of common resources to minimise overall costs, but they remain legally separate entities. At present all administrative functions of ESC are provided by the company, with the cost of these functions being recovered by the company through a recharge to ESC (note 2.5).

## 2. Accounting policies

### 2.1 Basis of preparation

These financial statements are presented in pounds sterling and all values are rounded to the nearest thousand pounds (£'000).

The financial statements of the company have been prepared in accordance with International Financial Reporting Standards (IFRS) as adopted by the European Union and applied in accordance with the provisions of the Companies Act 2006 applicable to companies reporting under IFRS.

These accounts have been prepared under the historical cost convention as modified for the treatment of financial instruments.

The Contracts for Difference regulations as outlined below are defined hereafter as the "Regulations":

i. The Contracts for Difference (Electricity Supplier Obligations) Regulations 2014; as amended.

### 2.2 Going concern

The directors have a reasonable expectation that the company has adequate resources to continue to operate for the foreseeable future. The financial statements are, therefore, prepared on a going concern basis.

In forming this view, the directors note that the company:

i. applies prudent financial management in order to ensure that its commitments are accommodated within the timing of its collection of its operational costs levy and the Supplier Obligation Levy;

ii. undertakes a robust and detailed annual business planning and budgeting process to establish its operational cost requirements for each financial year; and

iii. has considered the potential impact of credit risk and liquidity risk detailed in note 3.

The day to day operational costs of the company are funded by electricity suppliers under the operational costs levy which is set by the Regulations.

The operational costs levy is currently set annually by new regulations. The directors note the low risk that regulations resetting the annual rate may not be made (resulting in the operational costs levy set out in relation to the previous year continuing to apply) or may not be made until after the commencement of the relevant financial year (which could result in the company experiencing a timing mismatch in its funding requirements). The directors are of the view that there is no reason to believe that future regulations will not be forthcoming,

The directors also note the low risk that the total operational costs levy set for a year may be insufficient or that a timing mismatch might arise between the time when monies are raised by the levy and the time when monies are required to meet a spend commitment made by the company.

During the course of a year, the company may, where it identifies that there is likely to be a shortfall in the collection of the operational costs levy against its requirements, request BEIS to support an in-year adjustment to the applicable levy rate. Such an adjustment would be subject to public consultation and the making of new regulations in accordance with the same process that applies to the setting of the annual operational costs levy. The company can also request a working capital loan from BEIS if there is a shortfall in its operating cash flow.

Payments to CFD generators are funded by suppliers under the Regulations. The terms of the CFD state that the company's obligation is to pay when paid (i.e. the company has no obligation to pay the generators until it receives adequate funds from suppliers to perform its obligation).

**2.3 Operational costs levy income**

Under the Regulations, the company is entitled to recover its operational costs through the operational costs levy on suppliers referred to above. The levy rate charged is based on the company's budget and the total forecast electricity demand for the financial year. The rate set for 2016/17 after public consultation was £0.0509 per MWh (2015/16: £0.0397 per MWh), which is apportioned to suppliers based on the amount of electricity they supply in a levy year (which runs from 1 April to 31 March). For 2017/18 the operational costs levy has been set at £0.0524 per MWh and will be apportioned to suppliers based on the actual electricity they supply in the levy year from 1 April 2017 to 31 March 2018.

As the levy rate is based on estimates of the company's expenses for the financial year and recovery is based on the estimated overall amount of electricity supplied over the levy year, the amount collected is unlikely to match actual expenditure. As set out in the Regulations, any surplus at the end of the financial year will be reimbursed to suppliers and is classified as an operational costs levy payable under current liabilities.

The operational costs levy is recognised as 'other income' in the financial year to which it relates and is presented net of any operational costs levy repayable to suppliers.

The operational costs levy is recognised on an accrued basis and is collected alongside the principal Supplier Obligation Levy (relating to payments to CFD generators) in the same daily invoice using the same settlement systems. The company's settlement service provider, EMRS, administers the collection process.

**2.4 Total Reserve Amount and Interim Levy Rate payment**

As required by the Regulations, the company collects Supplier Obligation Levy payments from electricity suppliers which are comprised of two key elements:

(a) an Interim Levy Rate, charged on a daily basis at a fixed £/MWh rate on electricity supplied each day across each levy quarter; and

(b) a Total Reserve Amount which is a lump sum 'reserve' payment made in respect of each levy quarter at the start of the quarter.

The Total Reserve Amount is the amount the company determines is needed for there to be a 19 in 20 (i.e. 95%) probability of being able to make all the CFD generation payments required during that quarter, having regard to:

(a) the amount of Interim Levy Rate payments which it expects to collect from suppliers during the quarter;

(b) the likelihood of any supplier failing to make payments during the quarter;

(c) the estimated income to be received by the company from CFD generators in the quarter;

(d) the estimated amount of electricity to be supplied by suppliers in the quarter; and

(e) the estimated amount the company will need in the quarter to pay CFD generators.

At the end of every quarterly levy period, the company undertakes a reconciliation of suppliers' payments (i.e. Total Reserve Amount and Interim Levy Rate payment) against suppliers' CFD liabilities. The amount of the reconciliation payment to be paid to, or by, a supplier in respect of the quarter is:

(a) the total amount payable to the generators, less

(b) the Total Reserve Amount and Interim Levy Rate payment for that period.

Reconciliation payments become due 90 days (5 days from 1 July 2017) after the reconciliation notice is issued, on the same day as the next quarter's reserve payment becomes due. The reconciliation payment is recognised as repayable to suppliers and is classified as a Supplier Obligation Levy and generators payments payable under "current liabilities".

### 2.5 Recharges

ESC is a sister company also owned by the Secretary of State for Business, Energy and Industrial Strategy, which is responsible for managing the Capacity Market settlement process. In order to maximise operational cost efficiency, the company provides certain services to ESC and makes certain payments on its behalf. Typically this includes common costs such as staff costs, shared IT infrastructure and the use of shared resources and facilities. The recharge includes costs incurred on those activities which allow ESC to perform its functions in relation to the Capacity Market.

This recharge is based on an estimate of the time the company's employees will spend on ESC activities during the relevant financial year, together with an appropriate allocation of overhead costs (including rent, service charges, IT infrastructure support and telephony) and a use of asset charge. It also includes a proportion of the salaries of the board members who divide their time between the two companies. The company undertakes these activities on behalf of ESC and the ESC board retains responsibility and accountability for the quality and cost of services provided by the company.

The company and ESC are part of the same VAT group, therefore no VAT is charged on recharge income. The company's income is outside the scope of VAT, so it will be unable to recover its input VAT on any of its expenditure.

### 2.6 Government grants

Grants from the Government are recognised at their fair value where there is a reasonable assurance that the grant will be received and the company will comply with all the attached conditions.

The company has received a capital loan from BEIS, which is repayable in line with the depreciation over the useful life of the asset. The loan is interest free and is recognised under borrowings. The benefit of a below market rate of interest on the capital loan for capital expenditure, if material, is recognised in the statement of comprehensive income over the period of the loan.

### 2.7 Financial assets

#### *2.7.1 Classification*

The classification depends on the nature and purpose of the financial assets and is determined at the time of initial recognition. Management determines the categorisation of financial assets at initial recognition and re-evaluates this designation at each reporting date.

***Loans and receivables***

These are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. Loans and receivables comprise cash and cash equivalents and trade and other receivables. There are no loans receivable held by the company.

#### *2.7.2 Recognition and measurement*

Trade and other receivables are initially measured at fair value inclusive of transaction costs. After initial recognition, they are carried at amortised cost, using the effective interest method, less any impairment in accordance with IAS 39. Short term receivables have not been discounted to their net present value as it is management's view that the recognition of interest would not be material.

The carrying amount of the trade and other receivables approximates to their fair value.

#### *2.7.3 Impairment of financial assets*

#### *2.7.3.1 Assets carried at amortised cost*

The company must assess at the end of each reporting period whether its financial assets or group of financial assets require impairment. Financial assets are impaired where there is objective evidence that, as a result of one or more events that occurred after the initial recognition of the financial asset, the estimated future cash flows of the asset have been adversely impacted and the impact can be reliably estimated. Gains or losses arising when the asset is impaired or derecognised are recognised in the statement of comprehensive income.

Financial assets are derecognised when the rights to receive future cash flows have expired or are transferred and the company has transferred substantially all the risks and rewards of ownership.

### 2.8 Determination of fair value of financial instruments

The fair value of a financial instrument is the price that would be received to sell, or paid to transfer, a particular asset or liability in an orderly transaction between market participants at the measurement date.

The fair value of financial instruments is determined using appropriate valuation techniques. These valuation techniques are applied using, where possible:

- quoted prices in an active market for identical assets or liabilities (level 1);
- inputs other than quoted market prices that are observable for the asset or liability (level 2);
- unobservable inputs for the asset or liability (level 3).

**2.9 Financial liabilities**
The company classifies financial liabilities into the following categories:

- financial liabilities at fair value through profit or loss (FVTPL);

- other financial liabilities.

The categorisation of financial liabilities depends on the purpose for which the financial liability is held or acquired. Management determines the categorisation of financial liabilities at initial recognition and re-evaluates this designation at each reporting date.

***2.9.1 Recognition and measurement***
***2.9.1.1 Financial liabilities at fair value through profit or loss (FVTPL)***
Financial liabilities are classified as FVTPL where the financial liability is designated as FVTPL upon initial recognition.

***Contracts for Difference (CFDs)***
CFDs are a mechanism introduced to support new investment in low carbon generation. They have been established as private law contracts between the generator and the company.

CFDs have been designated as FVTPL and are stated at fair value, with any resultant gain or loss recognised in the statement of comprehensive income.

The fair value of the CFDs has been calculated using the income approach based on level 3 inputs, which reflects the present value of future cash flows that are expected to occur over the contract term of the CFD.

The difference between the fair value of the liability at initial recognition (day one) and the transaction price, is deferred unless the calculation can be based on observable inputs which at this point in time is not the case for CFDs.

The deferred difference between the fair value of the liability on day one and the transaction price is amortised over the contract life of the CFDs, which commences from the earlier of i) the actual start date of generation or ii) the end of the Target Commissioning Window (TCW) identified in the CFD, as this is the point at which the contractual liability will start to unwind (i.e. it is the point at which the potential payment period under the CFD commences).

The significance of these two dates is that they are the part of the contractual provisions which determine when the right to potential CFD payments starts. The contract payment period is typically for 15 years, although contracts relating to biomass conversion have an expiration date in 2027. CFDs may be signed many years in advance of actual generation. The main benefit to generators is the fact that they can derive economic benefit from these contracts over the payment period life of the contract.

Typically, if generators start generating within their TCW (which is specified in the contract) then the generation period starts from the date of generation and subject to all conditions being met, the generator can extract benefit for the full term of the contract. If generators miss the end of their TCW (and it is not extended under the terms of the contract) then the payment life period commences at the end of their TCW even if the generator is not in a position to generate. If the generator does not achieve the required minimum generation capacity by the contractual Longstop Date, the company has a right to terminate the CFD.

After initial recognition, the company recognises the deferred difference as a gain or loss only to the extent that it arises from a change in a factor (including time) that market participants would take into account when pricing the asset or liability.

Changes in fair value arising after day one, are recognised in the reporting period that they occur and are accounted for in the statement of comprehensive income and in the statement of financial position as they arise.

CFDs which were initially signed by the Secretary of State and subsequently transferred to the company have been recognised at BEIS's CFD carrying value at the date of transfer. Any day one difference is calculated at the point the CFD was signed by the Secretary of State and is treated in line with the company's policy as stated above. Subsequent revaluations of these contracts will also be treated in line with company policy.

The CFD is not recognised on the accounts when a reasonable estimate of the value of that CFD cannot be measured with reliability. As explained in note 28, the company has not recognised HPC CFD in the accounts.

***2.9.1.2 Other financial liabilities***
Other financial liabilities are initially measured at fair value, net of transaction costs and are subsequently measured at amortised cost using the effective interest rate method, with interest expense recognised on an effective yield basis.

***2.9.2 Derecognition of financial liabilities***
Financial liabilities are derecognised when, and only when, the obligations are discharged, cancelled or they expire.

**2.10 Property, plant and equipment**
Property, plant and equipment is stated at cost, net of accumulated depreciation and impairment losses, if any. The company's capitalisation threshold for property, plant and equipment is

£2,000, except where an individual asset is part of a group of assets that in aggregate exceed £2,000.

Property, plant and equipment are depreciated at rates calculated to write them down to their estimated residual value on a straight line basis over their estimated useful lives. The depreciation expense is charged to the statement of comprehensive income.

Assets are depreciated over the following periods:

| | Years |
|---|---|
| Leasehold improvements | 5 |
| IT equipment | 3 |
| Furniture and fittings | 10 |

Leasehold items will be depreciated over the shorter of their useful life and the lease term.

Residual values and useful lives are reviewed, and adjusted if appropriate, at each reporting date.

**2.11 Intangible assets**

Intangible assets are measured on initial recognition at cost. Following initial recognition, intangible assets are carried at cost less any accumulated amortisation and impairment losses, if any.

Intangible assets have finite lives and are amortised over their useful economic life, assessed for impairment whenever there is an indication that the intangible asset may be impaired. The amortisation period and the amortisation method for an intangible asset with a finite useful life are reviewed at least at the end of each reporting period.

Changes in the expected useful life or the expected pattern of consumption of future economic benefits embodied in the asset are considered to modify the amortisation period or method, as appropriate, and are treated as changes in accounting estimates. The amortisation expense on intangible assets with finite lives is recognised in the statement of comprehensive income in the expense category that is consistent with the function of the intangible assets.

Intangible assets are amortised over the following periods:

| | Years |
|---|---|
| Settlement System | 5 |
| Other IT software | 5 |

Gains or losses arising from derecognition of an intangible asset are measured as the difference between the net disposal proceeds and the carrying amount of the asset and are recognised in the statement of comprehensive income when the asset is derecognised.

**2.12 Impairment of non-financial assets**

Intangible assets are only subject to amortisation to the extent that they are available for use. Intangible assets which are not available for use are tested annually for impairment. Assets that are subject to amortisation are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable.

At each reporting date, the company reviews the carrying amounts of its property, plant and equipment to determine whether there is any indication that those assets have suffered an impairment loss. If any such indication exists, the recoverable amount of the asset is estimated in order to determine the extent of any impairment loss.

An impairment loss is recognised for the amount by which the asset's carrying amount exceeds its recoverable amount. The recoverable amount is the higher of an asset's fair value less costs of disposal and value in use. For the purposes of assessing impairment, assets are grouped at the lowest levels for which there are largely independent cash inflows (cash-generating units). Impairment losses are charged to the statement of comprehensive income and prior impairments of non-financial assets are reviewed for possible reversal at each reporting date.

**2.13 Leases**

Determination of whether an arrangement is, or contains, a lease is based on the substance of the arrangement at the inception of the lease. The arrangement is, or contains, a lease if fulfilment of the arrangement is dependent on the use of a specific asset or assets and the arrangement conveys a right to use the asset or assets, even if that right is not explicitly specified in an arrangement.

A lease is classified at the inception date as a finance lease or an operating lease. Leases are classified as finance leases whenever the terms of the lease transfer substantially all the risks and rewards of ownership to the lessee. All other leases are classified as operating leases.

***2.13.1 Finance leases***

***Company as a lessee***

Lease of the settlement system where the company has substantially all the risks and rewards of ownership is classified as a finance lease. Finance leases are capitalised at commencement of the lease at the lower of the fair value of the leased asset and the present value of the minimum lease payments. The present value of the minimum lease payments of the settlement system approximates to its fair value.

The settlement system acquired under a finance lease is depreciated over the shorter of the useful life of the asset and the lease term. The useful life of the settlement system is equivalent to the lease term.

*2.13.2 Operating leases*
Lease rentals relating to office premises are charged to the statement of comprehensive income on a straight line basis over the term of the lease. The rent free period received as an incentive to enter into the property operating lease has been spread on a straight line basis over the lease term.

**2.14 Staff Costs**
Under IAS 19, Employee Benefits, all staff costs are recorded as an expense as the company is obligated to pay them; this includes the cost of any untaken leave as at the reporting date.

**2.15 Pensions**
The company operates a defined contribution pension scheme for eligible employees. Under the defined contribution scheme the company pays fixed contributions into a fund separate from the company's assets. Contributions are charged in the statement of comprehensive income when they become payable.

**2.16 Provisions**
Provisions are recognised when the company has a present obligation (legal or constructive) as a result of a past event, that can be reliably measured, and it is probable that an outflow of economic benefits will be required to settle that obligation.

Provisions are measured at the present value of the expenditures expected to be required to settle the obligation. The accounting policy allows for an increase in the provision due to the passage of time (time value of money) which would be recognised as an interest expense.

**2.17 Segmental reporting**
The company operates solely within the UK and within one business segment; hence no segmental reporting is required. This is consistent with the internal reporting provided to the directors of the company, who are considered the company's chief operating decision makers.

**2.18 Borrowings**
Borrowings represent a grant in aid capital loan from BEIS. Borrowings are recognised initially at fair value, net of transaction costs incurred. Borrowings are subsequently carried at amortised cost; any difference between the proceeds (net of transaction costs, if any) and the redemption value is recognised in the statement of comprehensive income over the period of the borrowings using the effective interest method.

**2.19 Supplier Obligation Levy recognition**
The statement of financial position reflects three separately reported elements of the Supplier Obligation Levy which are as follows:

i) Supplier Obligation Levy (reported as a non-current asset i.e. receivable in more than one year);

ii) Supplier Obligation Levy receivable (reported as a current asset i.e. receivable in less than one year); and

iii) Supplier Obligation Levy payable (reported as a current liability i.e. payable within one year).

Supplier Obligation levy balances are not treated as financial assets or liabilities as they arise from statutory provisions, rather than contractual. Each of the separately reported elements is described in more detail below.

*2.19.1 Supplier Obligation Levy*
The Supplier Obligation Levy reported as a non-current asset is recognised in the statement of financial position to reflect the company's right to benefit from the obligations of electricity suppliers under the Regulations to make payments to the company in order for the company to then settle the related CFDs. The other side of this asset entry is recognised as other income and is classified as Supplier Obligation Levy in the statement of comprehensive income. This receivable is measured as equal and opposite to the CFD fair value movement recognised in the statement of financial position as a non-current liability under the heading 'Contracts for Difference' (the corresponding entry to the CFD fair value movement also being to the statement of comprehensive income). This results in the company's statement of comprehensive income remaining neutral to the impact of the CFD valuation movements and remaining consistent with the company's role as defined by the Regulations.

*2.19.2 Supplier Obligation Levy receivable*
The Supplier Obligation Levy receivable reported as a current asset is recognised in the statement of financial position to reflect the actual amount of Interim Levy Rate and Total Reserve Amount payments owed by suppliers at the reporting date, in respect of the levies for those quarterly obligation periods which have been set up to the reporting date.

*2.19.3 Supplier Obligation Levy payable*
The Supplier Obligation Levy payable reported as a current liability is recognised in the statement of financial position to reflect the actual amounts owed to suppliers in respect of over-collection of the Interim Levy Rate and Total Reserve Amount at the reporting date. This situation occurs where the estimated payments to be made by suppliers under the Regulations

in respect of the Interim Levy Rate and Total Reserve Amount are reconciled to the actual payments which should have been made by suppliers and a difference arises. The over-collection will be returned to suppliers through issuing a credit note after the reporting date which will then be used to offset any subsequent collection of the Total Reserve Amount for future quarterly obligation periods. To the extent that the subsequent quarterly payments owed by suppliers are below the level of the credit note issued then a cash refund will be made by the company.

***2.19.4 Generators payments payable***

The Generators payments payable is the amount owed to the electricity generators in response to the supply of low carbon electricity in accordance with CFDs and is classified under current liability in the statement of financial position.

## 3. Financial risk management

### 3.1 Financial risk management and financial risk factors

CFDs potentially expose the company to a variety of financial risks: market risk, credit risk and liquidity risk. However, in practice the financial risk is minimal given the Supplier Obligation Levy funding arrangements with licensed suppliers (described above and set out in more detail below).

***3.1.1 Market risk***

Market risk is the risk that the fair value of future cash flows of the CFDs will fluctuate because of changes in market prices. Market risk comprises three types of risk:

i. price risk;

ii. inflation risk; and

iii. interest rate risk.

***i. Price risk***

Amounts payable under CFDs are exposed to price risk through the fluctuation in future wholesale electricity prices, specifically, on how such prices will differ in the future from the prices used to fair value the liability. However, the company is not financially exposed to this risk because the liability is funded through a levy on suppliers.

***ii. Inflation risk***

Amounts payable under CFDs are affected by the indexation of strike prices to reflect actual inflation. As such, inflation risk arises from the impact of change in indexation on the Interim Levy Rate determined by the Supplier Obligation Forecasting Model (SOFM) and in the actual contracts. Inflation rates may not continue at the relatively low levels experienced in recent years. However, the company is not financially exposed to this risk because the liability is funded through a levy on suppliers.

***iii. Interest rate risk***

The company does not have any borrowings that are subject to interest rate risk.

***3.1.2 Credit and Liquidity risk***

Under the Regulations there is an obligation placed on licensed suppliers to fund in advance, via payment through the Interim Levy Rate and Total Reserve Amount, the company's CFD payment liabilities as they crystallise. The Interim Levy Rate (£/MWh) is set quarterly and is based on the forecast of the amount expected to be paid to CFD parties under every CFD or connected agreement to which the company is, or is likely to become, a party to during the relevant quarter, having regard to the:

(a) estimated payments that the company will need to make to CFD generators in relation to generation during the quarter;

(b) estimated income expected to be received by the company from CFD generators during the quarter; and

(c) estimated amount of electricity to be supplied by suppliers during the quarter.

The key trigger for the collection and recognition of levy payments from suppliers is the date of expected generation of low carbon electricity which will result in the company's payment to generators under the CFDs.

As the levy payments made by suppliers to the company are in advance of the required payments by the company to generators, the company's liability is only to "pay when paid" and additionally 21 days of collateral cover is also required from suppliers, the credit and liquidity risks are minimal.

***3.1.3 Maturity profiles***

Maturities of finance liabilities are provided in the following table:

| CFDs exc. HPC | <1 year £000 | 2-5 years £000 | 5 years £000 | Total £000 |
|---|---|---|---|---|
| As at 31 March 2016 | 1,375 | 2,236,366 | 9,032,073 | 11,269,814 |
| **As at 31 March 2017** | **295,283** | **3,612,883** | **8,425,703** | **12,333,869** |

These amounts are based on the carrying values of CFD financial liabilities. Note 26 provides disclosures relating to the fair value of the CFD excluding HPC CFD.

## 4. Critical accounting judgements, estimates and assumptions

The preparation of the company's financial statements requires management to make judgements, estimates and assumptions that affect the application of policies and reported amounts of assets and liabilities, income and expenses. The estimates and associated assumptions are based on historical experience and other factors, including expectations or future events that are believed to be reasonable under the circumstances. The results form the basis of making judgements about the carrying values of assets and liabilities that are not readily apparent from other sources.

Revisions to accounting estimates are recognised in the period in which the estimate is revised if the revision affects only that period or, in the period of the revision and future periods, if the revision affects both current and future periods.

### 4.1 Estimates

The key assumptions concerning the future and other key sources of estimation uncertainty at the reporting date, that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year, are described below. The company based its assumptions and estimates on parameters available when the financial statements were prepared. Existing circumstances and assumptions about future developments, however, may change due to market changes or circumstances arising that are beyond the control of the company. Such changes are reflected in the assumptions when they occur.

#### *4.1.1 Estimating useful lives and residual values of property, plant, and equipment and intangible assets*

At each reporting date, the useful lives and residual values of property, plant, and equipment and intangible assets are reviewed. Assessing the appropriateness of useful life and residual value estimates requires the company to consider a number of factors such as the physical condition of the asset, technological advancement, expected period of use of the asset by the company, and expected disposal proceeds (if any) from the future sale of the asset. An incorrect estimate of the useful life or residual value will affect the depreciation/amortisation expense recognised in the statement of comprehensive income and the asset's carrying amount.

#### *4.1.2 Provisions*

Judgement and estimation techniques are employed in the calculation of the best estimate of the amount required to settle obligations, including determining how likely it is that expenditure will be required by the company. This can be very complex, especially when there is a wide range of possible outcomes.

As of 31 March 2017, the company has dilapidation and other provisions. The other provision relates to the generator related cost and will be recovered through the Supplier Obligation Levy.

The dilapidation provision relates to a future liability for dilapidation costs for its leased premises at Fleetbank House. The company is required, at the expiry of the lease term, to return the premises to their previous state and condition, including removing any furniture and fittings installed by the company. In accordance with IAS 37 an undiscounted provision has been created for these future costs based on a dilapidation liability report issued by an independent surveyor. However, due to the immaterial impact of discounting over the lease period discounting has not been applied.

### 4.2 Significant judgement

#### *4.2.1 Fair value measurement of CFDs excluding HPC CFD*

The fair value of the CFDs, disclosed in note 26, is derived at initial recognition based on the valuation technique that uses data other than from observable sources. In accordance with

IAS 39 paragraph AG 76, the measurement of CFDs on the statement of financial position therefore includes an adjustment to defer the difference between the fair value at initial recognition and the transaction price of nil.

The fair value is calculated using the income approach and represents the company's best estimate of the payments which the company will be committed to make, if and when the generators supply low carbon electricity in accordance with their contractual terms. Significant inputs used in the valuation technique are detailed in note 26.

Management believes it is reasonable to amortise the difference between the fair value at initial recognition and the transaction price over the same period as the actual contract life reflects the obligation under the contract to make payments and the right to receive monies from suppliers to make those payments. Financial instrument standards require the "deferred difference" to be recognised only to the extent that it arises from a change in factor (including time) that market participants would take into account.

***4.2.2 Fair value measurement of HPC CFD***

As explained in Strategic report on page 23 and note 28, a reasonable estimate of the value of HPC CFD cannot be measured with reliability and on that basis the company has not recognised HPC CFD in the accounts.

***4.2.3 Supplier Obligation Levy***

The accounting treatment of CFDs as a financial liability would result in a charge to the statement of comprehensive income in subsequent periods due to the amortisation of the day one deferred difference, between the fair value of the liability and the transaction price, and the movement in fair value of CFDs.

In substance the Supplier Obligation Levy and the CFD obligation to make payments to generators are linked transactions. The company's reason for existence is to facilitate the settlement of CFDs to generate low carbon electricity with funding raised via the Supplier Obligation Levy.

The company's right to receive payments is laid out in the statutory obligations on licensed electricity suppliers as outlined in the Regulations. The company can only make payments related to the CFDs once it has received sufficient funding through the Supplier Obligation Levy. Therefore, any payments related to the CFDs are covered through the Supplier Obligation Levy.

However, there is a timing difference between the point at which changes in the fair value of the CFDs liability are recognised in the financial statements, and the point at which the related obligations give rise to mature levy obligations under the Regulations.

The timing difference is analogous to the timing differences discussed in IAS 12 (Income Taxes). It is highly probable that the company will receive future funding to pay for the CFDs through the Supplier Obligation Levy, and management believe it is appropriate to recognise an asset for the timing difference therefore a Supplier Obligation Levy non-current asset is recognised in the statement of financial position to match the timing difference with a corresponding entry in the statement of comprehensive income. For the purposes of fair presentation, this recognition is capped at the amount at which the CFDs are measured on the statement of financial position. This would result in the company's statement of comprehensive income remaining neutral to the impact of the CFD valuation movements and remain consistent with the company's role as defined by the Regulations.

A different treatment is taken by BEIS in its accounts because it uses the adaptations in the Financial Reporting Manual which prevent the recognition of any assets related to taxes payable to the Consolidated Fund, generally taken to extend to taxes and levies more generally. The company applies IFRS in full so as to comply with the Companies Act 2006 so the directors have not applied this adaptation.

## 5. New standards, amendments and interpretations not yet adopted

The standards and interpretations that are issued, but not yet effective, up to the date of issuance of the company's financial statements are disclosed below. The company intends to adopt these standards, if applicable, when they become effective. The company has not sought early adoption of any standards or amendments. None of these standards, except IFRS 16: Leases, are expected to have a significant effect on the financial statements of the company. Once IFRS 16 is adopted, the operating lease for the office rental will be capitalised.

***IFRS 9: Financial instruments***

IFRS 9, "Financial instruments", addresses the classification, measurement and recognition of financial assets and financial liabilities.

The complete version of IFRS 9 was issued in July 2014. It replaces the guidance in IAS 39 that relates to the classification and measurement of financial instruments. The standard is effective for accounting periods beginning on or after 1 January 2018.

***IFRS 15: Revenue from Contracts with Customers***

IFRS 15 was issued in May 2014 and establishes a new five-step model that will apply to revenue arising from contracts with customers. Under IFRS 15 revenue is recognised at an amount that reflects the consideration to which an entity expects to be entitled in exchange for transferring goods or services to a customer.

The principles in IFRS 15 provide a more structured approach to measuring and recognising revenue. The new revenue standard is applicable to all entities and will supersede all current revenue recognition requirements under IFRS. Either a full or modified retrospective application is required for annual periods beginning on or after 1 January 2018 with early adoption permitted.

***IFRS 16: Leases***

IFRS 16 was issued in January 2016 and establishes principles for the recognition, measurement, presentation and disclosure of leases.

The standard provides a single lessee accounting model, requiring lessees to recognise assets and liabilities for all leases unless the lease term is 12 months or less, or the underlying asset has a low value. The standard is effective for accounting periods beginning on or after 1 January 2019.

***Amendments to IAS 7 Disclosure Initiative***

The amendments require an entity to provide disclosures that enable users of financial statements to evaluate changes in liabilities arising from financing activities, including both changes arising from cash flows and non-cash changes. The amendments do not prescribe a specific format to disclose financing activities; however, an entity may fulfil the disclosure objective by providing a reconciliation between the opening and closing balances in the statement of financial position for liabilities arising from financing activities.

The amendments apply prospectively for annual periods beginning on or after 1 January 2017 with earlier application permitted. Entities are not required to present comparative information for earlier periods.

There are no other IFRS or IFRIC interpretations that are not yet effective that would be expected to have a material impact on the company.

## 6. Other income

The following is an analysis of the company's other income from continuing operations:

| | 2017 | 2016 |
|---|---|---|
| | £'000 | £'000 |
| Operational costs levy income | 15,530 | 12,178 |
| Less: expected refund to suppliers | (3,802) | (2,652) |
| Net operational costs levy income | 11,728 | 9,526 |
| Recharges to related parties | 1,707 | 1,263 |
| Settlement of a dispute | 1,676 | – |
| Amortisation of deferred government grant liability | 155 | 26 |
| Release of deferred government grant liability | – | 883 |
| Reversal of finance lease obligation | – | 51 |
| **Other income** | **15,266** | **11,749** |

As a result of the delay in the build and testing of the original planned system, the contract between EMRS and its then principal subcontractor was terminated on 9 November 2015. Following an agreement between the parties involved, £1.676m was received by LCCC as its share of the settlement.

The release of the deferred government grant liability and the reversal of finance lease obligations, in 2015/16, relates to the impairment of the settlement system.

Recharges to related parties represents £1.7m (2015/16: £1.2m) charged to ESC.

## 7. Staff costs

| | 2017 | 2016 |
|---|---|---|
| | £'000 | £'000 |
| Wages and salaries (including secondees) | 4,024 | 3,588 |
| Agency and contracted staff costs | 691 | 927 |
| Social security costs | 443 | 378 |
| Contributions to defined contribution plans | 178 | 156 |
| **Staff costs** | **5,336** | **5,049** |

The average number of staff employed by the company (including executive directors):

| | 2017 | 2016 |
|---|---|---|
| | £'000 | £'000 |
| Permanent staff | 48 | 40 |
| BEIS's secondees | 2 | 3 |
| Agency and Contracted staff | 5 | 6 |
| **Total** | **55** | **49** |

The remuneration of directors and the disclosure of the highest paid director are included in the Remuneration Report on pages 47 to 50.

## 8. Other operating costs

| | 2017 | 2016 |
|---|---|---|
| | £'000 | £'000 |
| Operational settlement costs | 3,142 | 3,027 |
| Legal, professional and consultancy | 4,251 | 767 |
| IT support, telephony and maintenance | 859 | 738 |
| Premises costs | 381 | 361 |
| Insurance | 267 | 289 |
| Auditor's remuneration | 94 | 90 |
| Impairment of settlement system asset | – | 934 |
| Miscellaneous costs | 263 | 95 |
| **Other operating costs** | **9,257** | **6,301** |

Miscellaneous costs mainly include training costs, stationery & printing, repairs & maintenance and bank charges.

Premises costs for the year include operating lease rental expenses of £0.191m (2015/16: £0.186m).

## 9. Property, plant and equipment

| | Leasehold improvements | IT equipment | Furniture and Fittings | Total |
|---|---|---|---|---|
| | £'000 | £'000 | £'000 | £'000 |
| **Cost** | | | | |
| As at 1 April 2015 | 425 | 206 | 67 | 698 |
| Additions during the year | – | 25 | – | 25 |
| **As at 31 March 2016** | **425** | **231** | **67** | **723** |
| Additions during the year | 33 | 58 | 12 | 103 |
| Disposals during the year | – | – | (1) | (1) |
| **As at 31 March 2017** | **458** | **289** | **78** | **825** |
| **Depreciation** | | | | |
| As at 1 April 2015 | 85 | 19 | 3 | 107 |
| Charge for the year | 85 | 74 | 7 | 166 |
| **As at 31 March 2016** | **170** | **93** | **10** | **273** |
| Charge for the year | 79 | 82 | 7 | 168 |
| Disposals during the year | – | – | – | – |
| **As at 31 March 2017** | **249** | **175** | **17** | **441** |
| Net book value as at 31 March 2016 | 255 | 138 | 57 | 450 |
| **Net book value as at 31 March 2017** | **209** | **114** | **61** | **384** |

## 10. Intangible assets

| | Settlement System | Other IT Software | Total |
|---|---|---|---|
| | £'000 | £'000 | £'000 |
| **Cost** | | | |
| As at 1 April 2015 | 2,402 | 971 | 3,373 |
| Additions during the year | 700 | 230 | 930 |
| Impairment | (934) | – | (934) |
| Derecognition of capital accruals | (743) | – | (743) |
| **As at 31 March 2016** | **1,425** | **1,201** | **2,626** |
| Additions during the year | 452 | 40 | 492 |
| **As at 31 March 2017** | **1,877** | **1,241** | **3,118** |
| **Amortisation** | | | |
| As at 1 April 2015 | – | 52 | 52 |
| Charge for the year | 44 | 189 | 233 |
| **As at 31 March 2016** | **44** | **241** | **285** |
| Charge for the year | 291 | 214 | 505 |
| **As at 31 March 2017** | **335** | **455** | **790** |
| Net book value as at 31 March 2016 | 1,381 | 960 | 2,341 |
| **Net book value as at 31 March 2017** | **1,542** | **786** | **2,328** |

Carrying value of the settlement system includes asset created against deferred government grant liability and finance lease. The settlement system is recognised as a finance lease as economic rights rest with the company. The settlement system went live in April 2017.

The impairment and the derecognition of capital accruals, in 2015/16, is associated with the impairment of the settlement system asset as a result of the termination of the original development contract. The settlement system was impaired equivalent to the amount by which the carrying value of the settlement system exceeded it recoverable amount (after reflecting the derecognition of capital costs). An amount equivalent to the impairment expense was recognised as income by releasing the deferred government grant liability and reducing the finance lease obligation to match the impairment expense so the net impact in the statement of comprehensive income was neutral (see note 6 and note 8).

No impairment is charged in the current year. The lease term is 5 years which is the period over which the asset is being depreciated as management has assessed this to be the useful life of the asset.

## 11. Operational costs levy receivable

| | 2017 | 2016 |
|---|---|---|
| | £'000 | £'000 |
| Operational costs levy receivable | 350 | 258 |
| Operational costs levy accrued | 1,044 | 997 |
| **Total operational costs levy receivable** | **1,394** | **1,255** |

The operational costs levy receivable reflects the amounts owed by suppliers to fund the operational costs of the company.

## 12. Supplier Obligation Levy receivable

| | 2017 | 2016 |
|---|---|---|
| | £'000 | £'000 |
| Total Reserve Amount receivable | 26,188 | – |
| Interim Levy Rate receivable | 7,603 | – |
| Interim Levy Rate accruals | 7,262 | – |
| Supplier obligation accruals | 1,500 | – |
| **Total Supplier Obligation Levy receivable** | **42,553** | **–** |

The Supplier Obligation Levy is made up of two components: the Interim Levy Rate and the Total Reserve Amount. The receivable reflects the amounts owed by suppliers relating to each of these components to fund the necessary payments to generators under the CFDs.

## 13. Trade and other receivables

| | 2017 | 2016 |
|---|---|---|
| | £'000 | £'000 |
| Due from related parties | – | 9 |
| Staff receivables | 22 | 17 |
| Prepayments | 263 | 161 |
| **Total trade and other receivables** | **285** | **187** |

## 14. Cash and cash equivalents

| | 2017 £'000 | 2016 £'000 |
|---|---|---|
| Cash at bank | 35,943 | 18,532 |
| Suppliers' credit cover | 4,323 | 379 |
| **Total cash and cash equivalents** | **40,266** | **18,911** |

For the purpose of the statement of cash flows, cash and cash equivalents comprise the cash at bank and suppliers' credit cover as stated above. Cash at bank includes cash of £31.047m (2015/16: £15.513m) received from suppliers in respect of the Supplier Obligation Levy which can only be used to pay generators. Suppliers credit cover is a restricted cash balance and relates to credit cover provided by the electricity suppliers.

## 15. Operational costs levy payable

| | 2017 £'000 | 2016 £'000 |
|---|---|---|
| **Operational costs levy payable** | **3,835** | **2,675** |

To the extent that the company spends less than the annual budget set for operational costs, as approved through public consultation and Parliament, the difference between the amount collected under the operational costs levy and the actual expenditure of the company for the year, is refunded to suppliers. The refund is made as soon as practicable in the following financial year and as a result there is an amount owed to suppliers at the year end which is reflected as a liability in the statement of financial position.

## 16. Supplier Obligation Levy and Generators payments payable

| | 2017 £'000 | 2016 £'000 |
|---|---|---|
| Interim Levy Rate payable | 14,904 | 6,652 |
| Total Reserve Amount payable | 34,440 | 8,861 |
| Generators payment payable | 14,228 | – |
| Generators payment accrual | 8,427 | – |
| **Total Supplier Obligation Levy and Generators payment payable** | **71,999** | **15,513** |

The Supplier Obligation Levy is made up of two components: the Interim Levy Rate and the Total Reserve Amount. The payable reflects the amounts owed to suppliers for each component as a result of over collection of these amounts compared to the actual payments to be made to generators under the CFDs.

The generators payments payable reflects the amount owed to the electricity generators in response to the supply of low carbon electricity in accordance with the CFDs.

## 17. Trade and other payables

| | 2017 £'000 | 2016 £'000 |
|---|---|---|
| **Current:** | | |
| Supplier collateral payable | 4,321 | 379 |
| Accruals | 1,850 | 937 |
| Amounts owed to ESC | 766 | 177 |
| Capital creditors | 42 | 51 |
| Accruals for lease incentives | 13 | 13 |
| Trade payables | 4 | 353 |
| Other taxation and social security | 135 | 111 |
| VAT payable | – | 42 |
| | **7,131** | **2,063** |
| **Non-current:** | | |
| Deferred government grant liability (see note 22) | 595 | 750 |
| Discounting of grant in aid capital loan | 12 | 21 |
| Accruals for lease incentives | 13 | 27 |
| | **620** | **798** |
| **Total trade and other payables** | **7,751** | **2,861** |

The carrying value of trade and other payables approximates to their fair value. The deferred government grant liability which relates to the settlement system asset received from BEIS is a non-cash transaction for the purposes of disclosure in the statement of cash flows. The accrual for lease incentives relates to the rent free period received on the leasehold premises at Fleetbank House which is spread evenly over the term of the lease.

## 18. Borrowings

| | 2017 £'000 | 2016 £'000 |
|---|---|---|
| **Current:** | | |
| Grant in aid capital loan | 402 | 378 |
| **Non-current:** | | |
| Grant in aid capital loan | 727 | 1,028 |
| **Total borrowings** | **1,129** | **1,406** |

The grant in aid capital loan is interest free and repayable to BEIS from funding received through the operational costs levy collected from suppliers. The actual loan outstanding as of 31 March 2017 was £1.141m (2015/16: £1.427m) with the difference of £0.012m (2015/16: £0.021m) reflecting the impact of discounting (see note 17). The timing of the repayment of the loan is in line with the depreciation charged on the assets funded via the loan.

## 19. Finance lease obligations

| | £'000 |
|---|---|
| As at 1 April 2015 | – |
| Finance lease acquired during the year | 673 |
| Finance lease obligations paid | (51) |
| **As at 31 March 2016** | **622** |
| Finance lease acquired during the year | 433 |
| Finance lease obligations paid | (126) |
| **As at 31 March 2017** | **929** |

| | 2017 | 2016 |
|---|---|---|
| | £'000 | £'000 |
| Less than 1 year | 220 | 124 |
| Between 1 and 5 years | 709 | 498 |
| **As at 31 March** | **929** | **622** |

The finance lease obligation is held in respect of the additions made during the year for the settlement system asset. Additions are funded by BEIS through EMRS, a wholly owned subsidiary of ELEXON Limited.

## 20. Provisions

| | Dilapidation | Other | Total |
|---|---|---|---|
| | £'000 | £'000 | £'000 |
| As at 1 April 2015 | 67 | – | 67 |
| Movement in provision | – | – | – |
| **As at 31 March 2017** | **67** | **–** | **67** |
| Non-current | – | 1,500 | 1,500 |
| **Total provisions** | **67** | **1,500** | **1,567** |
| Current | – | 1,500 | 1,500 |
| Non-current | 67 | – | 67 |
| **Total provisions** | **67** | **1,500** | **1,567** |

Under IAS 16.16 the value of a fixed asset should include the initial estimate of the costs of dismantling and removing items and restoring the site to its original state. As a result the company is required to set up a provision for the estimated costs of this reinstatement work. Refer to note 4.1.2 for further detail on above mentioned provision.

The other provision relates to generator related costs and will be recovered through the Supplier Obligation Levy. An equivalent amount is recognised as Supplier Obligation accruals in note 12.

## 21. Share capital

| | Number |
|---|---|
| **Authorised shares** | |
| Ordinary share capital £1 each | 1 |
| | **£** |
| **Ordinary share capital issued and fully paid:** | |
| As at 1 April 2015 | 1 |
| Share capital issued during the year | – |
| **As at 31 March 2016** | **1** |
| Share capital issued during the year | – |
| **As at 31 March 2017** | **1** |

## 22. Deferred government grant liability

| | £'000 |
|---|---|
| As at 1 April 2015 | 2,402 |
| Recognised in the statement of comprehensive income | (883) |
| Derecognition of capital accruals | (743) |
| Amortisation | (26) |
| **As at 31 March 2016** | **750** |
| Amortisation | (155) |
| **As at 31 March 2017** | **595** |

The derecognition of capital accruals and deferred government grant liability recognised in the statement of comprehensive income, in 2015/16, relates to the impairment of the settlement system asset (see note 10 and note 9).

## 23. Commitments under operating leases

Future minimum lease payments under non-cancellable operating leases are outlined in the table below:

| | 2017 | 2016 |
|---|---|---|
| | £'000 | £'000 |
| **Commitments under operating leases:** | | |
| **Buildings** | | |
| Within one year | 390 | 217 |
| After one year but not more than five years | 405 | 452 |
| **Total commitments under operating leases** | **795** | **669** |

## 24. Related party transactions

The following table provides the total amount of transactions that have been entered into with related parties for the relevant financial period:

| | Services to related parties | Services from related parties | Amounts owed by related parties | Amounts owed to related parties |
|---|---|---|---|---|
| | £'000 | £'000 | £'000 | £'000 |
| **Entities with significant influence:** | | | | |
| **2016** | | | | |
| BEIS | 86 | 1,034 | 9 | 2,312 |
| ESC | 1,177 | – | – | 177 |
| **2017** | | | | |
| BEIS | – | 645 | – | 2,263 |
| ESC | 1,707 | – | – | 766 |

Services to ESC comprise of shared costs of premises, staff and directors' payroll costs, IT infrastructure and depreciation which are incurred in the first instance by the company but are then recharged at an agreed percentage to ESC based on an estimated usage of those services.

The services supplied to BEIS relate primarily to the charges for the secondment of staff. The services from BEIS include staff costs associated with secondments, settlement system additions during the year and charges for the rental of premises and associated service costs of the 6th Floor, Fleetbank House. Amounts owed to BEIS include the grant in aid capital loan, obligations under the finance lease relating to the settlement system asset and rental of premises and associated services received during the year.

### 24.1 Compensation of key management personnel of the company

Key management personnel include executive directors and their compensation is disclosed in the Remuneration Report on pages 47 to 50.

## 25. Financial assets and liabilities

### Financial assets

| | Note | 2017<br>£'000 | 2016<br>£'000 |
|---|---|---|---|
| Other receivables | 13 | 22 | 26 |
| Cash and cash equivalents | 14 | 40,266 | 18,911 |
| **Total financial assets** | | **40,288** | **18,937** |
| **Total current** | | **40,288** | **18,937** |
| **Total non-current** | | **–** | **–** |
| **Total financial assets** | | **40,288** | **18,937** |

### Financial liabilities

| | Note | 2017<br>£'000 | 2016<br>£'000 |
|---|---|---|---|
| Contracts for Difference | 26 | 12,333,869 | 11,269,814 |
| Trade and other payables | 17 | 6,983 | 1,939 |
| Borrowings | 18 | 1,129 | 1,406 |
| Finance lease obligations | 19 | 929 | 622 |
| **Total financial liabilities** | | **12,342,910** | **11,273,781** |
| **Total current** | | **7,605** | **2,441** |
| **Total non-current** | | **12,335,305** | **11,271,340** |
| **Total financial liabilities** | | **12,342,910** | **11,273,781** |

## 26. CFDs exc. HPC

Note 26 and 27 only relates to CFDs other than Hinkley Point C which is disclosed in note 28. As at 31 March 2016 the company was counterparty to 38 contracts of which 14 contracts were for 8 CFD projects under the government's "Final Investment Decisions enabling Renewables" programme (FIDeR). Subsequently, an additional FIDeR contract relating to Drax was transferred to the company in December 2016. The Drax biomass project has a capacity of 637MW of low carbon generation. In addition, in March 2017, a previously terminated CFD contract was reinstated following the results of a tribunal decision.

Under the legislation there is an obligation placed on licensed electricity suppliers to fund the CFD liabilities as they crystallise through the Supplier Obligation Levy. The future levy amounts which will be received from the licensed suppliers will be accounted for within the company and will be triggered by the generation and supply of low carbon electricity.

### 26.1 Measurement differences relating to day one recognition

The transaction price for CFDs differs from the fair value at initial recognition measured using a valuation model, mainly because the transaction price is not established in an active market. If there are significant unobservable inputs used in the valuation technique (level 3), the financial instrument is recognised at the transaction price and any difference between the transaction price and fair value at initial recognition measured using a valuation model is deferred.

The following table represents the difference between the CFD liability at initial recognition and at the reporting date:

| | CFDs exc. HPC |
|---|---|
| | £'000 |
| CFD liability as at 1 April 2015 recognised on the statement of financial position | 1,987,839 |
| CFD liability transferred from BEIS during the year | 896,170 |
| Remeasurement of the CFD liability | 8,964,044 |
| CFD liability released during the year | (578,239) |
| **CFD liability as at 31 March 2016 recognised on the statement of financial position** | **11,269,814** |
| CFD liability transferred from BEIS during the year | 1,111,253 |
| CFD reinstated during the year | 575,187 |
| Remeasurement of the CFD liability | (570,802) |
| Payments to the CFD generators | (92,148) |
| Deferred difference recognised during the year | 40,565 |
| **CFD liability as at 31 March 2017 recognised on the statement of financial position** | **12,333,869** |

During the year the net movement in the fair value of CFDs amounting to £1,064m (2015/16: £9,282m) is recognised in the statement of comprehensive income.

### 26.2 Movement in deferred measurement differences

| | CFDs exc. HPC |
|---|---|
| | £'000 |
| Deferred measurement differences as at 1 April 2015 | 16,807,315 |
| Measurement differences deferred on contracts transferred from BEIS | 816,301 |
| Measurement differences recognised in respect of terminated CFDs | (1,087,413) |
| **Deferred measurement differences as at 31 March 2016** | **16,536,203** |
| Measurement differences deferred relating to a reinstated CFD | 1,084,094 |
| Measurement differences deferred on contract transferred from BEIS | 1,499,017 |
| Measurement differences deferred during the year | – |
| Deferred measurement differences recognised during the year | (40,565) |
| **Deferred measurement differences as at 31 March 2017** | **19,078,749** |

### 26.3 Fair value measurement of CFDs

The fair value of CFDs represents the company's best estimate of the payments which the company will be committed to make, if and when the generators supply low carbon electricity in accordance with their contractual terms. They are based upon the estimates of future electricity prices using the Dynamic Dispatch Model (DDM) owned by BEIS.

Should no low carbon electricity be supplied in accordance with the contractual terms, then the company is not under any obligation to make these payments.

#### *26.3.1 Fair value of CFDs (financial liabilities at fair value through profit and loss)*

The following table provides an analysis of financial instruments which are measured subsequent to initial recognition at fair value and grouped into input levels 1 to 3 within the fair value hierarchy based on the degree to which the fair value is observable:

| | Level 1 | Level 2 | Level 3 | Total |
|---|---|---|---|---|
| | £'000 | £'000 | £'000 | £'000 |
| As at 31 March 2016 | – | – | 27,806,017 | 27,806,017 |
| **As at 31 March 2017** | **–** | **–** | **31,412,618** | **31,412,618** |

#### *26.3.2 Reconciliation of CFDs*

The following table shows the impact on the fair value of CFDs, classified under level 3, by using the assumption described below:

| | CFDs exc. HPC |
|---|---|
| | £'000 |
| As at 1 April 2015 | 18,795,154 |
| Transferred from BEIS | 1,712,471 |
| Change in fair value during the year | 8,964,044 |
| CFD Terminated during the year | (1,665,652) |
| **As at 31 March 2016** | **27,806,017** |
| Additions during the year | – |
| CFD reinstated during the year | 1,659,281 |
| Transferred from BEIS | 2,610,270 |
| Change in fair value during the year | (570,802) |
| Payments to the CFD generators | (92,148) |
| **As at 31 March 2017** | **31,412,618** |

The fair value of the unquoted contracts has been estimated using a discounted cash flow model. This method involved the projection of a series of cash flows and application of a discount rate to establish the present value of the expenses associated with the liability. The valuation requires management to make certain assumptions about the model inputs, including cash flows, the discount rate, credit risk and volatility. Further information relating to the assumptions is included below under key inputs and underlying assumptions.

The probabilities of the various estimates within the range can be reasonably assessed and are used in management's estimate of fair value for these unquoted contracts.

Annual cash flow is estimated as reference price less strike price multiplied by estimated capacity delivered. The series of periodic net operating expense is then discounted using the HM Treasury discount rate of 0.7% (2015/16: 0.7%).

**26.4 Key inputs and underlying assumptions for CFDs other than Hinkley Point C**
For the key inputs into the model, the underlying assumptions are set out below.

***26.4.1 Transmission Loss Multiplier (TLM)***
TLM reflects the fact that electricity is lost as it passes through the transmission system from generators to suppliers. If the TLM is incorrect, this will have implications for the volume of electricity subject to CFD payments. Any change in TLM will be corrected through adjustments in strike prices although the change in TLM is expected to be immaterial.

***26.4.2 Start date***
Generators nominate a Target Commissioning Date (TCD) in their binding application form for a CFD, and this date is specified in their CFD following contract award. However, the generator is free to commission at any time within their Target Commissioning Window (TCW), a period of one year from the start of the TCW for most technologies, with no penalty, or after the end of the TCW and up to their "Longstop Date" (one to two years after the end of the TCW depending on technology) with a penalty in the form of reduction of contract length for each day they are late in commissioning after the end of the TCW. The contract can be terminated if the generator has not commissioned 95% (or 85% for offshore wind) of their revised installed capacity estimate by the end of the Longstop Date. Any change to the start date will change the timing of future cash flows and impact on the discounted fair value.

***26.4.3 Strike price***
The strike price is an agreed price which determines the payments made to the generator under the contract with reference to its low carbon output and the market reference price. The relevant strike price is specified in each CFD and is not intended to change for the duration of the project, other than through indexation to CPI and certain network charges, or in the event of certain qualifying changes in law.

***26.4.4 Future forecast wholesale electricity prices***
Forecast wholesale electricity prices are derived from the Dynamic Dispatch Model (DDM) which has been developed by BEIS to facilitate/inform policy decisions by modelling investor behaviour in response to fuel and carbon prices and policy environment. The DDM estimates the wholesale price by:

- using the Short Run Marginal Cost (SRMC) for each plant;
- daily demand for electricity taken into account wind profiles, interconnector flaws, pumped storage, auto-generation and wind generation; and
- using a mark-up on the price derived from historic data and the difference between marginal price and cost affected by reduced capacity.

Economic, climate, policy, generation and demand assumptions are external inputs to the model including demand load curves for both business and non-business days and seasonal impacts. Specific assumptions can also be modelled for domestic and non-domestic sectors and smart meter usage.

***26.4.5 Installed Capacity***
The figure for the maximum installed capacity was provided by the generator in its application for a CFD and specified in its CFD contract following allocation. The installed capacity cannot be increased after contract signature, but can be reduced by the generator by no more than 25% with no penalty between contract signature and the completion of the first contractual milestone by its contractual deadline (i.e. the Milestone Requirement which must be completed 12 months after contract award). Thereafter the installed capacity figure can only be reduced by the generator for a permitted contractual construction event (which is a narrowly defined concept) or by the difference by which the relevant project has an installed capacity of 95% (or 85% in the case of offshore wind) of its current contractual installed capacity figure and 100%. The actual output of the generator will depend on the load factor.

*26.4.6 Load Factor*

Load Factor is defined as the actual power output of a project as a proportion of its rated installed capacity. It is a percentage figure which is used to transform installed capacity into actual power output (generation). Load factor assumptions are based on reference factors for given technology types; however, actual power outputs are sensitive to technological and environmental factors which may impact actual cash flows for given technology types; however, actual power outputs are sensitive to technological and environmental factors which may impact actual cash flows.

### 26.5 Sensitivity analysis

The following table shows the impact on the fair value of CFDs, classified under level 3, by using reasonably possible alternative assumptions:

| | Favourable changes | Unfavourable changes |
|---|---|---|
| | £'000 | £'000 |
| **Change in fair value of CFDs exc. HPC if:** | | |
| Electricity prices decrease by 10% | – | 1,857,633 |
| Electricity prices increase by 10% | 1,857,633 | – |
| 10% more load factor | – | 3,141,262 |
| 10% less load factor | 3,141,262 | – |
| Estimated Commissioning Date moves backward by one year | 552,723 | – |
| Generation starts at the earliest possible date | – | 358,728 |

The fair value is highly dependent upon the actual capacity generated once the plant is built and the electricity prices which will prevail at the time of generation. The favourable and unfavourable changes show how the impact of changes in capacity and prevailing electricity prices will affect the fair value of CFDs due to the change in the level of cash flows.

### 26.6 Significant unobservable inputs

The following table discloses the valuation techniques and significant unobservable inputs for CFDs recognised at fair value and classified as level 3 along with the range of values used for these significant unobservable inputs.

| | Fair value of CFDs (£'000) | Valuation technique | Significant unobservable input | Range Min-Max | Units |
|---|---|---|---|---|---|
| 2016 | 27,806,017 | DCF | Electricity prices | 37.6-54.0 | £/MWh |
| **2017** | **31,412,618** | **DCF** | **Electricity prices** | **35.2-53.4** | **£/MWh** |

## 27. Supplier Obligation Levy

| | £'000 |
|---|---|
| As at 1 April 2015 | 1,987,839 |
| Levy receivable recognised against remeasurement CFD liability | 8,964,044 |
| Levy receivable recognised against transfer of a CFD from BEIS | 896,170 |
| Levy receivable derecognised against terminated CFDs | (578,239) |
| **As at 31 March 2016** | **11,269,814** |
| Levy receivable recognised against remeasurement of CFD liability | 4,385 |
| Levy receivable recognised against transfer of a CFD from BEIS | 1,111,253 |
| Supplier obligation levy received during the year, net of repayable | (92,148) |
| Amortisation charge during the year | 40,565 |
| **As at 31 March 2017** | **12,333,869** |

A non-current Supplier Obligation Levy asset is recognised in the statement of financial position to match the timing difference between the point at which changes in the fair value of the CFDs liability are recognised in the financial statements and the point at which the related obligations give rise to mature levy obligations under the Regulations. A corresponding entry is made in the statement of comprehensive income.

There is no Supplier Obligation Levy asset for the HPC CFD as no matching HPC CFD liability recognised in the accounts. Non recognition of the HPC CFD is discussed in note 28. The Supplier Obligation Levy asset recognised in the statement of financial position only relates to the CFDs other than HPC.

## 28. Hinkley Point C CFD

The company entered into the Hinkley Point C (HPC) CFD on 29 September 2016. This project has a maximum lifetime generation cap of 910,000,000 MWh. The HPC contract will expire at the earlier of 35 years after the start date of the second reactor or when the total CFD payments made have reached the generation gap.

The valuation of Hinkley Point C (HPC) Contract for Difference (CFD) would require that an assumption be made of wholesale electricity prices in each year out to 2060. The company uses BEIS's DDM to provide estimates of future wholesale electricity prices. This model currently extends only as far as 2050 and the company has therefore assumed flat wholesale prices for the ten years 2050-2060. Moreover there is an inherent limitation in accurate estimation beyond 2040 because there is a paucity of independent third-party information beyond this point from which to validate the company's assumptions.

The unavoidable uncertainty over possible scenarios so far into the future extend to a variety of factors including electricity demand, fossil fuel prices, generation mix, carbon prices and technology.

Under International Financial Reporting Standards (IFRS) the Conceptual Framework sets out the concepts which underlie the preparation and presentation of financial statements. The Conceptual Framework deals with, amongst other things, the definition, recognition and measurement of the elements from which financial statements are constructed. Paragraph 4.38 of the Conceptual Framework states that an element should be recognised in the accounts if:

a) it is probable that any future economic benefit associated with the item will flow to or from the entity; and

b) the item has a cost or value that can be measured with reliability [defined as: using information that is complete, neutral and free from error].

In comparison to other CFDs the company considers the CFD for HPC to be unique. The European Pressurised Reactor is a much more complex asset than the wind turbines or bio-mass generators associated with our other CFDs. It has very high levels of safety, reinforcement and containment incorporated into the design, which make it more expensive and complex to build and result in a significant lead time before generation commences (planned for 2025). Until these challenges are overcome and the asset is built, no payments will be made by the company under the CFD.

The HPC CFD duration is also more than double (35 years) the length of other CFDs (15 years) so far entered into by the company. This makes it considerably more challenging to provide a single point fair value estimate, as required for accounting purposes, as that requires estimation of future wholesale electricity prices in every year out to 2060. This means that there are considerable but unavoidable uncertainties in creating a fair value estimate for the HPC CFD because of the unusually long time period involved.

Uncertainty increases with time and so the choice of discount rate plays a significant part in determining how much uncertainty is weighted into a present value calculation; a higher discount rate places less weight on increasingly more uncertain later years of a present value calculation. For example, in conducting the economic appraisal for the HPC project BEIS used the social discount rate of 3.5% per year, as required by the HM Treasury Green Book. However for valuing financial instruments like CFDs the company is obliged to use the financial instrument discount rate of 0.7%, as required by the HM Treasury Financial Reporting Manual. Therefore, compared to an economic appraisal, a present value estimate for a financial instrument includes progressively more weight from the less certain later years of the appraisal period. For comparison, using the social discount rate leads to a valuation of £15.6bn compared to £28.8bn using the financial instrument discount rate of 0.7%.

This is particularly relevant to the HPC CFD fair value because external forecasts for wholesale electricity prices are not currently readily available beyond 2040. It has not been possible for the company to satisfactorily verify whether a single point fair value estimate for the HPC CFD is complete, neutral and free from error. (Verifiability is one of the qualitative characteristics of useful financial information for financial statements as set out in the Conceptual Framework.) The company has therefore concluded that for the time being the HPC CFD fails to meet the recognition criteria (b) as outlined above. Therefore, the HPC CFD has not been recognised as a transaction in these primary statements.

The company has nonetheless set out below its best estimation of the fair value of the contract, and the assumptions which have been considered in its valuation, in the interests of transparency. This follows a ‘Level 3’ methodology under IFRS 13, which allows for use of the company’s own models and assumptions.

### 28.1 Fair value measurement of HPC

The company has set out below its best estimation of the fair value of the contract, and the assumptions which have been considered in its valuation. This follows a Level 3 methodology under IFRS 13 (Fair Value), which allows for use of the entity’s own models and assumptions.

The following table provides an analysis of the fair value of HPC, grouped into Levels 1 to 3 within the fair value hierarchy based on the degree to which the fair value is observable:

| | Level 1 | Level 2 | Level 3 | Total |
|---|---|---|---|---|
| | £’000 | £’000 | £’000 | £’000 |
| As at 31 March 2016 | – | – | – | – |
| **As at 31 March 2017** | **–** | **–** | **28,823,835** | **28,823,835** |

Information on other factors which impact on the fair value of HPC is set out on the next page:

*28.1.1 Start date*
The Target Commissioning Date (TCD: current expected start date) for reactor one and reactor two of the Hinkley Point C project are 1 May 2025 and 1 November 2025 respectively. The TCW for reactor one is 1 May 2025 to 30 April 2029. The TCW for reactor two is 1 November 2025 to 31 October 2029.

Any change to the start date will change the timing of future cash flows and impact on the discounted fair value.

*28.1.2 Equity gain share for Hinkley Point C*
The equity gain share mechanism consists of two separate components: (i) a mechanism to capture gains above specified levels where the Hinkley Point C project outperforms relative to the original base case assumptions; and (ii) a mechanism to capture gains above specified levels arising from the sale of equity and economic interests (direct or indirect) in the Hinkley Point C project.

In each case, as and when the Internal Rate of Return (IRR) thresholds are reached:

- If the relevant IRR is more than 11.4%, the LCCC will receive 30% of any gain above this level.
- If the relevant IRR is more than 13.5%, the LCCC will receive 60% of any gain above this level.

*28.1.3 Installed Capacity*
Hinkley Point C does not have an installed capacity cap and is only entitled to CFD payment support up to a generation gap of 910,000,000 MWh.

*28.1.4 Strike price*
The relevant strike price for Hinkley Point C is specified at £92.50 in real 2012 terms and is not intended to change for the 35 year contract duration, other than through indexation to CPI and certain network charges, the event of certain qualifying changes in law, or the additional factors discussed below.

*28.1.5 Construction gain share for Hinkley Point C*
If the construction costs of Hinkley Point C come in under budget, the strike price will be adjusted downwards so that the gain (or saving) is shared with the company. The gain share is 50/50 for the first billion pounds, with savings in excess of this figure being shared 75% to the company and 25% to the generator, NNB Generation Company (HPC) Limited (NNBG).

If the outturn cost of construction is less than assumed then by reducing the strike price the amounts paid out to NNBG under the CFD will reduce and hence the benefit of the lower construction costs is shared between NNBG and ultimately consumers. There is, however, no similar upward adjustment if the construction cost of Hinkley Point C is over budget.

*28.1.6 OPEX reopener for Hinkley Point C*
The strike price may be adjusted upwards if the operational expenditure costs are more than assumed and downwards if they are less. There are two operational expenditure reopener dates, at 15 years and 25 years after the first reactor start date. The rationale behind the reopener is that the strike price is based on long-term assumptions on operational expenditure costs. The reopener provides a way of mitigating long-term cost risks for both parties.

*28.1.7 Sizewell C strike price adjustment for Hinkley Point C*
If a CFD in relation to Sizewell C is entered into before the reactor one start date then the applicable strike price shall be reduced with effect from the date of satisfaction of the Sizewell C condition by £3/MWh.

**28.2 Sensitivity analysis**
Using a Level 3 technique to assess the value of the Hinkley Point C CFD is permissible when there is no observable input against which to assess the valuation. The company has used BEIS's internally generated models and assumptions consistent with an emissions pathway towards the Government's decarbonisation commitments to generate the wholesale electricity price scenarios used in the valuation of the HPC CFD. There is unavoidable uncertainty inherent in all such modelling and as such the results should be interpreted as a range of plausible scenarios rather than a single point value. However, IFRS13 requires that a single amount be declared for fair value and so to satisfy this condition the company has adopted its central scenario when valuing the HPC CFD.

To provide transparency for the reader it is important to highlight the uncertainty inherent in material values over a long period of time such is the nature of this CFD. The predicted price series from the DDM between 2025 and 2050 (flat-lined from 2050 to 2060) has a higher degree of certainty in the early years (2025-2040) and a lower degree of certainty in later years (2040-2060). This is due to the lack of available market data against which to judge the output.

The company has illustrated some empirical impact of changes in assumptions on the fair value of the HPC CFD. These are shown in the table below:

| | Favourable changes | Unfavourable changes |
|---|---|---|
| | £'000 | £'000 |
| **Change in fair value of HPC if:** | | |
| Electricity prices decrease by 10% | – | 4,477,796 |
| Electricity prices increase by 10% | 4,477,796 | – |
| At generation cap | – | 259,850 |
| 10% less load factor | 2,882,384 | – |
| Estimated Commissioning Date moves backward by one year | 481,230 | – |
| Generation starts at the earliest possible date | 110,636 | – |
| Sizewell C Strike price adjustment for HPC | 2,387,085 | – |
| Low carbon price assumption | – | 6,480,125 |
| High carbon price assumption | 6,340,131 | – |

## 29. Events after the reporting period

There are no post balance sheet events which have a material impact on the company's financial results.

# Glossary

| | |
|---|---|
| **Allocation Round** | The process by which potential generators apply to the National Grid (as "Delivery Body") for a CFD and the successful applicants are selected. Allocation Rounds are announced by BEIS, which sets the available CFD "budget" for the relevant Allocation Round and specifies the generation technologies which are eligible. The first Allocation Round ("Allocation Round 1") took place in 2014/15. Allocation Round 2 was announced in 2016 and will be completed, at the earliest, by summer 2017. |
| **BEIS** | Department for Business, Energy and Industrial Strategy. |
| **capacity provider** | A capacity provider is the holder of a capacity agreement with National Grid (as System Operator). Capacity providers can be new or existing generators, electricity storage providers and significant users of electricity who provide voluntary demand side reductions (Demand Side Response). Capacity providers provide capacity under either a capacity agreement resulting from a Capacity Market auction or from a Transitional Arrangement Auction. |
| **CFD** | A Contract for Difference (CFD) is a long term agreement between a low carbon electricity generator and LCCC. It is designed to provide the generator with a stable pre-agreed price (the "strike price") for the lifetime of the contract. This is done by paying the difference where electricity price (the "market reference price") is less than the strike price and receiving the difference when the market reference price is higher than the strike price. |
| **CFD Counterparty or counterparty** | CFD counterparty is responsible for managing CFDs throughout their contractual life. |
| **CFD standard template** | The relevant standard CFD template contract used in each Allocation Round, referred to as the CFD Standard terms and conditions. |
| **Capacity Market** | The Capacity Market has been designed by BEIS (formerly DECC) to offer capacity providers who have been awarded capacity agreements with a steady, predictable revenue stream upon which they can base their future investments, with the aim of ensuring security of supply in future years at least cost to consumers. Capacity providers can be new or existing generators, electricity storage providers and significant users of electricity who provide voluntary demand reductions. |
| **DDM** | The long term forecast of wholesale electricity prices is derived from the Dynamic Dispatch Model (DDM). The DDM was developed by BEIS to inform policy decisions by modelling investor behaviour in response to fuel and carbon prices and policy environment (the figures for Great Britain are modelled out to 2050). |
| **Demand Side Response** | Demand Side Response helps to manage the demand for electricity. It involves changing the usage patterns of electricity users (the "demand side") in response to incentives. It is used to match supply with demand when unpredictable fluctuations occur and provides a mechanism through which demand can be reduced in peak times when system capacity is tight, thereby minimising the amount of additional generation capacity being brought onto the grid. Demand Side Response is seen as having the potential to help to lower consumer bills, electricity system costs and carbon emissions produced by traditional peaking plant, such as oil, coal and gas-fired generation. |

| | |
|---|---|
| **EMRS** | EMR Settlement Ltd (EMRS) is a wholly owned subsidiary company of ELEXON Ltd.* It is the settlement services provider under a contract with LCCC to manage the operation of the settlement system. (*ELEXON website: www.elexon.co.uk/) |
| **ESC** | Electricity Settlements Company Ltd. |
| **FiDeR** | See Investment Contracts. |
| **Interim Levy Rate** | Under the Supplier Obligation Levy, electricity suppliers make pre-payments consisting of a unit cost fixed Interim Levy Rate, charged at a daily £/MWh rate to fund the cost of CFD generation payments. The Interim Levy Rate is set by LCCC every quarter in advance, based on estimated payments to CFD generators to be made in that quarter. |
| **Investment Contracts** | Investment Contracts are an earlier (April 2014) version of CFDs entered into by the Secretary of State in mid 2014 pending the full establishment of the CFD scheme and of LCCC. The Secretary of State has transferred these contracts to LCCC. The contracts are also known as the Financial Investment Decision enabling Renewables (or FiDeR). |
| **Implementation Coordinator** | In its role as Implementation Coordinator for the CFD scheme, LCCC is responsible for:<br>• overall monitoring of progress and readiness against the CFD Implementation Plan<br>• maintenance of the CFD Implementation Plan<br>• coordinating CFD implementation activities across delivery partners and potential industry participants<br>• passing any policy issues to BEIS if raised as part of implementation discussions<br>• owning and updating the CFD operating model.[24] |
| **Longstop Date** | The relevant Longstop Date is specified in each CFD and is the last date by which the generator's project must achieve its required minimum generation capacity. It is generally 12 months after the end of the Target Commissioning Window for onshore technologies and 24 months for offshore wind. |
| **market reference price** | The market reference price is a proxy for the average market price relating to the electricity sold by the generator. |
| **Milestone Requirement** | The CFD requires generators to demonstrate that, by the "Milestone Delivery Date" set out in their CFD, they have made a significant financial commitment to and are progressing the construction of their project (i.e. new generation plant). This date is 12 months from the date of entry into the CFD agreement. Generators demonstrate this requirement by providing LCCC with evidence that they either have spent 10% of the project cost or have entered into contracts committing to expenditure and development of the project. |
| **Operational Conditions Precedent** | The Operational Conditions Precedent is a milestone. The process requires projects to satisfy (at least 80%) certain commissioning and other tests ahead of qualifying for CFD payments. |
| **Renewables Obligation** | The Renewables Obligation scheme is one of the main support mechanisms for large-scale renewable electricity projects in the UK. The Renewables Obligation scheme closed to all new generating capacity on 31 March 2017.<br>(for further information see: https://www.ofgem.gov.uk/environmental-programmes/ro/about-ro) |

[24] DECC, Electricity Market Reform Contracts for Difference: GB implementation plan, (updated January 2015) page 5, available at: https://lowcarboncontracts.uk/system/files/January%202015%20CFD%20Implementation%20Plan%20V2%20(2).pdf

| | |
|---|---|
| **Secretary of State** | Refers to our shareholder, the Secretary of State for Business, Energy and Industrial Strategy. |
| **SOFM** | The Supplier Obligation Forecast Model (SOFM) is used by LCCC to forecast the Supplier Obligation Levy. LCCC sets the amount of the Supplier Obligation Levy (i.e. the Interim Levy Rate and the Total Reserve Amount) on a quarterly basis ahead of the start of each quarter. |
| **Supplier Obligation Levy** | Electricity suppliers are required under the Contracts for Difference (Electricity Supplier Obligations) Regulations 2014 (as amended) to fund the CFD payments made by LCCC to generators. |
| **Supplier Obligation Regulations** | The Contracts for Difference (Electricity Supplier Obligations) Regulations 2014, the Electricity Supplier Obligations (Amendment & Excluded Electricity) Regulations 2015 and related amending regulations which govern the rules for the management of the Supplier Obligation Levy. |
| **Target Commissioning Window (TCW)** | The TCW is the period during which the generator is obliged to fulfil all its operational conditions precedent, one of which is a requirement to achieve 80% of the project's required generation capacity. The generator must achieve this level before it is entitled to issue a start date notice under the CFD triggering its entitlement to CFD payments. If the generator does not fulfil its Operational Conditions Precedent by the end of the TCW, its entitlement to CFD support payments will reduce day for day for each day of delay in fulfilling this requirement. If the generator does not fulfil this requirement by the Longstop Date, and also achieve its minimum final installed capacity requirement (95% for onshore technologies and 85% for offshore wind) in accordance with the Longstop Date requirements, its CFD may be terminated. |
| **Total Reserve Amount** | The amount the company determines is needed for there to be a 19 in 20 probability of it being able to make all the CFD generation payments required during that quarter, having regard to:<br>(a) the amount of Interim Levy Rate payments which it expects to collect from suppliers during the quarter;<br>(b) the likelihood of any supplier failing to make payments during the quarter; and<br>(c) the estimated income to be received by the company from CFD generators in the quarter, the estimated amount of electricity to be supplied by suppliers in the quarter and the estimated amount the company will need in the quarter to pay CFD generators. |
| **Transitional Arrangements** | Transitional Arrangements were introduced by BEIS to support participation of potential Demand Side Response providers and generating units of less than 50MW in the Capacity Market during the interim period prior to 2018/19, which is the delivery year relating to the first Capacity Auction. In other words, the arrangements are designed to support the development of this sector in the run up to the Capacity Market being in full operation. Transitional Arrangements Auctions are held one year ahead, with capacity agreements being given to successful applicants. |
| **Transitional Arrangements Auctions** | Transitional Arrangement Auctions are one year ahead auctions under the Transitional Arrangements. |

**LCCC is providing:**

- strong independent governance
- commercial skills and industry knowledge
- a close working relationship with government, industry and other key stakeholders
- a focus on delivering better outcomes for the UK.

## Senior Management Team

**Neil McDermott**
Chief Executive

**Catherine Gan**
Chief Finance Officer

**Ruth Herbert**
Head of Strategy & External Affairs

**Claire Williams**
Head of Legal & Company Secretary

**James Rushton**
Head of Commercial

**Cynthia Duodu**
Head of Corporate Services

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