The Energy Bill and Electricity Market Reform

LEAD OFFICER: John Groves
REPORT AUTHOR: Denice Gallen

Summary and Recommendation:

This report is an update on the Electricity Market Reform paper presented to the Board on the 17th July 2012. It provides a summary of the Electricity Market Reform (EMR) and the Contracts for Difference (CFD) as outlined in the Energy Bill 2012 which was introduced to the House of Commons on November 29th 2012.

Recommendation:

That the contents of the report are noted.

1. Introduction

1.1 Up to £110 billion investment in electricity generation and transmission is likely to be required by 2020 to keep the 'lights on' in Britain, more than double the current rate of investment. The Energy Bill puts in place measures to attract that investment and to reform the electricity market with the purpose of encouraging low carbon electricity generation and ensuring security of supply.

1.2 There is a recognition that there needs to be sufficient incentive for developers to invest in new nuclear power stations. The Chief Executive of EDF, Vincent de Rivaz, told MPs at the House of Commons Energy and Climate Change Select Committee on Tuesday 23rd October, that the company needed safeguards from the Government that the financing of future nuclear deals would be fair.

1.3 Much of the support will be delivered through long-term contracts for difference (CFD), designed to guarantee stable revenues for investors in low-carbon energy. They will provide cash for generators of nuclear power and renewables if the market price of electricity drops below a specified strike price. A new company will act as a single counterparty to the CFDs.

The Energy Bill includes provisions for:

- Contracts for Difference – long-term instruments to provide stable and predictable incentives for companies to invest in low-carbon generation;
- Investment Instruments – long-term instruments to enable early investment in advance of the CFD regime coming into force;
- Capacity Market – to ensure the security of electricity supply;
- Conflicts of Interest and Contingency Arrangements – to ensure the institution which will deliver these schemes is fit for purpose;
- Renewables Transitional – transition arrangements for investments under the renewables obligation scheme, and
- Emissions Performance Standard – to limit carbon dioxide emissions from new fossil fuel power stations.

2. Contract for Difference (CFD) Counterparty

The Secretary of State (SoS) will designate a company or a public authority as a CFD Counterparty. This will be regulated by the Secretary of State. This is designed to ensure the protection of suppliers and ultimately consumers.

The cost of the contracts to the CFD counterparty and the costs of the CFD counterparty itself will be met by licensed electricity suppliers. Suppliers in turn are likely to pass such costs onto consumers. Where the CFD counterparty receives payments back from the electricity generator under the contracts these will be passed on to suppliers, it is assumed that these savings will then be passed onto customers although this is not stated and will need to be detailed in further legislation.

The CFD Counterparty is a company or a public authority. The Counterparty will enter into and manage CFDs with eligible generators, and will act as the interface between generators and suppliers.

The National Grid will determine the eligibility and issue a direction in line with the regulations to the CFD counterparty to offer a contract to the eligible generator in line with agreed objectives set by Government and with the terms upon which the contracts must be offered (including price) set out in regulations. (The price and regulations are not contained within the Energy Bill).

In the longer term allocation and price will be determined by a competitive process.
The SoS will then instruct the CFD counterparty to offer such contracts. Thereafter the CFD counterparty will be in a commercial relationship with the generators, governed by the terms of a generator's contract. The designation of a company as the CFD counterparty can

be revoked by the Secretary of State. (Duties of CFDs are set out in Clause 4 of the Energy Bill)

3. Contracts for Difference (CFDs)

The CFD provides developers with a long term contract that provides for a stable revenue stream enabling investment in low carbon electricity generation such as nuclear power stations. CFDs are set out in Clause 3 of the Bill[1].

- Most contracts will be allocated to generators by the National Grid Electricity Transmission PLC (National Grid).
- The National Grid will determine eligibility and issue a direction in line with the regulations to the CFD Counterparty.
- The CFD will work by setting a "Strike Price" which will be a price per unit of electricity generated which will be at the level determined to be necessary to support the particular technologies supported by the scheme.
- National Grid has recently conducted a 'call for evidence' and the strike price has not yet been indicated.
- Contracts will also refer to a —'reference price' which is a price which attempts to reflect the wholesale electricity price at a particular time.
- When the strike price is higher than the reference price, the counterparty will pay the generators the difference between the strike price and the reference price.
- When the reference price is above an agreed strike price, payments will be made by the generator to the CFD counterparty.
- The cost of the contracts to the CFD counterparty and the costs of the CFD counterparty itself will be met by licensed electricity suppliers (Suppliers in turn are likely to pass such costs onto consumers).
- Where the CFD counterparty receives payments back under the contracts these will be passed on to suppliers. (Clause 7)
- The CFD counterparty will be regulated by the Secretary of State

4. Responses to the proposed reforms to date

4.1 The Energy and Climate Change Committee conducted an inquiry to scrutinise the draft Bill a report of which was published on 23 July 2012. Refer to: http://www.parliament.uk/business/committees/committees-a-z/commons-select/energy-and-climate-change-committee/news/energy-bill-report-published/

[1] http://services.parliament.uk/bills/2012-13/energy.html

4.2 Some MPs expressed concern that the proposals in the Government's draft Energy Bill could impose unnecessary costs on consumers, lead to less competition and deter badly needed investment.

4.3 The proposed new model has raised concerns that the plans are now too complex and possibly not legally enforceable. MPs called on the Government to use its AAA-credit rating to underwrite the new contracts in order to keep the costs of energy investment down for consumers.

4.4 There was also concern that the new contract system will reinforce the dominance of the "Big Six" energy companies and prevent new entrants into the electricity market.

4.5 An informal Lords Committee also met to consider the bills draft provisions. They expressed concern at how the government could feasibly set a 'strike price' for the electricity for the duration of the nuclear energy generator project which could be over 15 to 25 year periods.

4.6 They also identified the lack of detail of how the CFDs would work as a major concern, stating:

"Even without the missing detail the proposed scheme is already seen as extraordinarily complex and for that reason unattractive to investors who would also be suspicious of the use of ministerial discretion and possible interference[2]"

5. Implications for Copeland

5.1 Developers are seeking a form of revenue certainty prior to them committing to invest billions of pounds in what is a long term return in investment in projects such as nuclear power stations.

5.2 Copeland's future economic prosperity is intrinsically linked to the potential nuclear new build project at Moorside. The Energy Market Reform and CFDs in particular are vital to instil faith and viability in the nuclear sector.

5.3 Nuclear new build developers have indicated that the proposed reforms have come at the right time and could be highly influential in ensuring the success of future new builds.

5.4 EDF are awaiting the results of the strike price before making a final investment decision, they were due to make a final investment decision to build a new nuclear power plant at Hinkley Point before the end of 2012 but this has been deferred until the new year. All potential nuclear new build developers will be awaiting the

[2] http://www.decc.gov.uk/assets/decc/11/policy-legislation/Energy%20Bill%202012/6149-lords-working-group-paper-on-the-draft-energy-bill.pdf

outcome of the Energy Bill and importantly the strike price before making a significant commitment to build new power stations.

6. Way Forward

6.1 The introduction of the Energy Bill marks the first stage of the reform process. The Government intends to legislate for the key elements of this package in the second session of this Parliament and for legislation to reach the statute book by the end of the next session (by spring 2013) so the first low-carbon projects can be supported under its provisions around 2014.

6.2 The Government needs to make solid progress with the Energy Bill and the EMR to provide assurance to enable large scale investment in projects such as nuclear new build. Developer's final investment decisions will hinge on what the Energy Bill says, how it will be implemented and administered. Therefore the EMR and the Energy Bill are significantly linked to the economic regeneration of Copeland.

6.3 Work is ongoing on the implementation of the CFD system and the development of the CFD contract with a view to issuing the first CFDs in 2014. They aim to publish the full contract terms in [July 2013] in advance of consulting on secondary legislation in late 2013. Indicative strike prices will appear in the Draft Delivery Plan of the bill in mid-2013, with final strike prices being published in the Final Delivery plan in late 2013 subject to Royal Assent.

6.4 The Bill was debated at second reading on 19 December 2012. The House of Commons voted for the Bill to be sent to a Public Bill Committee that will scrutinise the Bill line by line. The Committee is expected to report by 12 February 2013.