

ClientAlert

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UK electricity market reform: the road ahead

The UK's electricity market is evolving, with far-reaching implications for generators and investors in the renewables sector. As the draft Energy Bill progresses through Parliament this year, further detail is expected in a number of key areas which will prove essential in establishing investor confidence in this market. We set out some key questions and considerations for generators and investors and identify the issues that must be resolved to reduce uncertainty and attract investment.

On 18 June 2013, the Energy Bill received its second reading in the House of Lords, including the measures which the UK Government wish to introduce to encourage the required level of investment in renewable energy generation (Electricity Market Reform or "EMR").¹

EMR is required, according to the Government, to address the significant energy generation investment required as existing generating assets are shut down. The Government estimates that £100 billion of investment in new generating capacity and transmission and distribution assets is required by the year 2020. By any measure, that is a massive challenge and one which generators and investors involved in (or looking to become involved in) renewable energy projects are watching closely to see how the Government will further foster and encourage this level of investment.

Progress of EMR – the energy bill

The Energy Bill (the "Bill"), first introduced to Parliament on 29 November 2012, aims to ensure that the UK has a secure supply of renewable / clean energy in the future, significantly reducing greenhouse gas emissions to meet the requirements of the Climate Change Act 2008 and stimulating investment in new jobs and business. Royal Assent is anticipated by the end of 2013 although the date on which the relevant provisions of the Bill will become effective remains unclear. A raft of secondary legislation providing detail in respect of the measures set out in the Bill will also be required in the coming months.



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¹ The full text of the Lords' debate on the second reading of the Energy Bill can be found online at: <http://www.publications.parliament.uk/pa/ld201314/dhansrd/text/130618-0001.htm#13061896000391> and the latest draft of the Energy Bill at: <http://services.parliament.uk/bills/2013-14/energy.html>
References in this note to sections are generally to the relevant provision in the draft Energy Bill, unless otherwise specified.

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The key elements of the Energy Bill are:

- Feed In Tariff with “Contracts for Difference”;
- Carbon Price Floor;
- Capacity Mechanism; and
- Emissions Performance Standard.

Given the time elapsed since the launch of the EMR concept, in this note (part 1 of a series) we recap on the key principles of Contracts for Difference (“**CfD**”) and outline where the Government’s proposals stand at present. We then identify some of the particular issues which from our discussions with investors and industry need to be addressed in the next big push toward a comprehensive, bankable structure for EMR.

In particular, we draw attention to the significant work which has been undertaken by Government, since the introduction of the Bill in autumn 2012, in the area of potential conflicts of interest for the system operator. This has resulted in a joint DECC/Ofgem report and recommendations which now form a part of the draft Bill. We outline the key aspects of the measures proposed in this area.

Recap: What is a contract for difference and how is it different from the renewables obligation?

CfDs are an incentive mechanism whereby generators in renewable energy, as well as carbon capture and storage (“**CCS**”) and nuclear developers, will be guaranteed a long-term, inflation linked payment in respect of power exported to the grid. This is intended to mitigate price volatility for investors in the renewable energy sector and provide more predictable and long-term revenue streams thereby increasing the attractiveness of such projects to equity and other investors and potentially reducing the cost of financing such projects.

This new mechanism is intended to eventually replace the Renewables Obligation Certificate Regime (“**ROC Regime**”), which requires licensed UK electricity suppliers to source a specified percentage of the electricity they provide to customers from renewable sources. Accredited generators receive certificates for the eligible power they generate from renewable sources. The certificates are then being sold to suppliers who use the certificates to demonstrate compliance with the supplier obligation.

The ROC Regime will close to new accreditations on 21 March 2017, with electricity generation accredited under the ROC Regime continuing to receive full lifetime support (20 years) until the scheme closes in 2037. This gives generators and investors

some confidence that, for projects which are far enough advanced to qualify for Renewable Obligation Certificates, this key component of a project’s economics will remain. Renewable energy generation already accredited under the ROC Regime will not be able to transfer to the new CfD regime.² However, there will be a transitional period during which projects which have not yet been accredited for the purposes of the ROC Regime can make a one-off choice between ROCs or a CfD.

The CfD is a long term contract based on the difference between the determined market price for electricity (the ‘reference price’) and an estimate of the long term price needed to bring forward investment in a given technology (the ‘strike price’). Government has published the CfD “heads of terms” in draft and these are expected to be formally published this summer. A number of key provisions remain the subject of ongoing discussion and/or publication of further government guidance (see our summary of some of the next steps).

Each generator awarded a CfD will enter into the contract with the ‘CfD counterparty’. If the price generators can achieve for their power in the market is below the ‘strike price’, the CfD counterparty will make a top-up payment to generators. This is to be funded through obligations imposed on suppliers through appropriate amendments to their licence terms and conditions (discussed later in this note).

If however the price achieved for electricity is above the CfD strike price, generators must pay the difference to the CfD counterparty, which will then redistribute these funds to suppliers. Commercially, this is one of the most noteworthy differences to the ROC Regime: to benefit from the downside protection on offer, suppliers need to accept that their ability to make additional profit in a boom market could be significantly curtailed if that additional income becomes repayable.

What do we know about the setting of the strike price? Does technology selection play a role?

Initially the Government will set the strike price administratively until such time as the market for generation across the range of technologies is more mature. For generators and investors in the energy market trying to assess potential project returns with CfD contracts, understanding what the strike prices will be and any variations in approach (for example, in the pricing structure for nuclear and CCS) will be crucial in making investment decisions.

The generic strike prices will be set for five year periods, with the first period lasting from 2014 to 2018. Following a process of review and expert assessment (led by the system operator,

² *Electricity Market Reform Policy Overview (November 2012), Annex A: Feed-in Tariff with Contracts for Difference: Operational Framework* (the “Draft Operational Framework”) paragraph 60.

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National Grid Electricity Transmission plc (“**NGET**”) and drawing on data from the Renewables Obligation Banding Review), the House of Lords have reaffirmed the intention to publish strike prices in December 2013 and issue the first CfDs in 2014, subject to Royal Assent being achieved. Draft strike price data is expected to be published alongside the delivery update in mid-2013.

For nuclear projects, however, strike prices are to be negotiated directly with the government on a case by case basis.³ The well-publicised negotiations with EDF are currently throwing up some interesting debates within the industry as to the term of any CfD contract, the applicable strike price and whether government support should be provided in respect of the CfD counterparty’s obligations.

Although the strike prices that will be set out for each technology currently remain uncertain (an update on this is expected in the next month or so and will be reported in the next note in this series), there are hints in the guidance which accompanied the Energy Bill as to the methodology the government will use. For instance, the Government has stated that because the CfD removes long-term electricity price uncertainty from projects, the strike prices will therefore be set to reflect the lower cost of raising finance that is anticipated to follow the reduced risk for investors.⁴

What will be the term of my CfD?

One of the main attractions of the CfD structure for generators will be the long-term duration, which is intended to deliver a stable and bankable, long term revenue stream. Following discussions between DECC and stakeholders, the initial view is that the CfD term for renewables should be 15 years.

Such a term may be suitable for certain parts of the renewables sector, but with regard to nuclear this timeframe is considerably shorter than the industry’s expectations. It does not come close to matching the long-dated asset life and ongoing investment required for nuclear newbuild assets, investors argue. EDF, the generator seeking to agree terms with the UK Government for its investment in Hinkley C, the first nuclear newbuild in the UK for a generation, argues for a 40-year price to be set.

It seems likely that, given the slow pace of new nuclear development in the UK market, the UK Government will finalise its deal with EDF on a non-precedent forming basis. Other deals in the renewables space are holding their breath to see how the announcements on strike price impacts on their deal economics.

³ *Draft Operational Framework*, paragraphs 41-42.

⁴ *Draft Operational Framework*, paragraph 50.

⁵ *Electricity Market Reform: Supporting Investment in Renewable Generation*, DECC presentation, 27 March 2013.

Will the CfD payments to generators be guaranteed?

The key aim of the CfD mechanism is to remove price volatility and provide for a more stable revenue stream over a relatively long period, thereby making renewable energy projects attractive to investors and financiers and reducing the cost of financing such projects. A key bankability issue therefore is having a stable and reliably funded entity with which generators will contract.

The standalone nature of the CfD counterparty is something with which the market is still coming to terms. Government support is not proposed in respect of the CfD counterparty’s obligations. It will only make payments under a CfD as and when it itself is in receipt of funds from suppliers (which is referred to as “pay when paid” mechanism).

The Government’s position is that the revenue flows from suppliers to the CfD counterparty will be sufficient to ensure the liquidity of the CfD counterparty. To support this, supplier payment obligations will be introduced through changes to the suppliers’ licence conditions. For example:

- it will be a term of the license granted to suppliers that they will honour levy-raising requests from the CfD counterparty, which will be set up as an insolvency-remote vehicle whose powers will be set out in primary legislation.⁵
- suppliers may have to give assurance (by way of a letter of credit) with regard to collateral accessible to the CfD counterparty.

Investors should be aware that a CfD is essentially a private law contract, even though the CfD counterparty is a company that has been established by the Government. The implication is that judicial review in respect of any decision of the CfD counterparty is not expected to be available (although in respect of “determinations” made by the Secretary of State under the Chapter 5 and 6 powers of the Bill, public law remedies should be available).

The rather one-sided termination regime is also worth noting. Essentially, the generator has no right to terminate the CfD. Any termination payment to be made in a default scenario will always be from the generator to the CfD counterparty. This may come as a surprise to many people.

Questions remain as to the appetite of the market for counterparty risk in what will at the end of the day simply be a private limited company. Essentially, each licensee will need to assess the ability of the CfD counterparty to pay just like any other commercial arrangement.

Protections from changes

The strike price is to be indexed annually by reference to the Consumer Prices Index (CPI). Changes to the strike price may also arise if there is a Qualifying Change in Law resulting in material Identified Costs being incurred. "Identified Costs" are those costs that a generator reasonably expects it will incur or save arising from the occurrence of the Qualifying Change in Law.

While there has been positive movement in the definition of a Qualifying Change in Law, recognising to some extent the complex regulatory world of renewable energy, nevertheless there are important caveats to the protection given. The Change in Law scenarios in which relief may be granted are limited and the definition is narrow. Of particular note is that Change in Law specifically excludes any modification that arises as a result of any State Aid decision. Foreseeable changes in law and general changes in law (such as would apply to any business) are excluded. There is also to be a materiality test to prevent generators spuriously claiming change in law protection.

The Government's position on gains generated by changes to the financing arrangements of a project also remains to be seen. As we have seen a tightening generally of Government requirements across public-private-partnership contracts in this respect, it may be that similarly stringent tests will be applied in the context of the CfD mechanism.

The system operator: results of conflict of interest analysis

Initially, CfDs will be allocated on a first come, first-served basis, with generators able to submit an application for a CfD at any time of year. In the Government's proposals, allocation of CfDs would be by National Grid as system operator. It was recognised that this presents an inherent potential conflict of interest for the system operator given its multiple roles, given the Company's role in allocating CfDs, its role as the transmission operator, and its commercial operations. Substantive work has been carried out in the past few months to assess the risk of conflicts and a report issued in late April 2013 setting out the risk (considered to be low) and proposed mitigation measures.⁶

Following publication of the DECC/Ofgem Report, the Government still intends for National Grid to carry out the allocation role, but in line with the DECC/Ofgem Report mitigations will be put in place to avoid any risk of conflict and ensure that should a conflict become apparent, steps can be taken. These include (in addition to existing regulatory protections under the Utilities Act 2000 and the conditions of the NGET transmission licence):⁷

- Ofgem carrying out oversight of the system operator and continuing to be responsible for independent regulation of the market. This will be supported by a statutory strategy and policy statement clarifying Ofgem's role and those of Government, the system operator and other bodies.
- Giving the Secretary of State the ability to make modifications under the Electricity Act 1989 including changes to generation, transmission, distribution, supply and interconnector licences; standard conditions attaching to licences; and related documents. This power will enable the Secretary of State to make modifications which he or she determines are required to bring about the appropriate degree of business⁸ separation).
- A power to create an "alternative delivery body" specifically for the purpose of carrying out EMR functions and to transfer the EMR functions to such body.⁹ Conditions attach to the exercise of this power, the satisfaction of any one of which can trigger the power.¹⁰ These conditions are relatively broad, and include a test of the Secretary of State determining it "necessary or desirable" to make the transfer for the purpose of encouraging low carbon electricity generation or providing capacity to meet the demands of consumers for the supply of electricity in Great Britain.
- Enhancement of the duty of energy special administrators under section 154(1) of the Energy Act 2004, to ensure continued delivery of EMR functions.¹¹
- Additional measures are anticipated to be introduced through the design of EMR or through the exercise of the above powers by the Secretary of State, once they become effective.¹² These include transparency, scrutiny and limits on the system operator's discretion; proportionate ring-fencing of some EMR functions within NGET and from other National Grid plc businesses; additional protection for commercially-sensitive information submitted to the system operator; and functional protections with regard to managerial, information, physical, employee and legal separation of certain National Grid plc businesses from NGET.

⁶ "Synergies and Conflicts of Interest Arising from the Great Britain System Operator delivering Electricity Market Reform: Final Report" published by DECC and Ofgem on 23 April 2013 (the "DECC/Ofgem Report")

⁷ See Chapter 5, Part 2 of the Bill.

⁸ Section 39(4) of the Bill provides that "appropriate" means "necessary or desirable as a consequence of conferral of EMR functions".

⁹ Section 40(1).

¹⁰ Section 40(2)(a) through (e).

¹¹ Section 42.

¹² DECC/Ofgem Report, paragraph 80.

Substantive commitment

In order to be allocated a CfD generators will have to demonstrate a 'substantive commitment' to the project. What exactly will constitute 'substantive commitment' remains unclear although it is acknowledged that the test may change depending on the technology under consideration. Wind farm developers are likely to be required to provide proof of planning permission and a signed Grid Connection Offer before being awarded a CfD. For other technologies such as nuclear and CCS, the Government is yet to specify how far the projects will have to have progressed. A "minimum spend amount" was part of the Government's initial proposals in 2011 as a way of indicating commitment to a project, and the detail on this is awaited.

In order to be awarded a CfD, generators will also have to agree a Target Commissioning Window ("TCW") with the System Operator by which they will commence generation. Should generators commission after the end of the TCW they will still benefit from the strike price set out in the CfD, but they will have the term of the CfD reduced to reflect the length of the delay in commissioning beyond the end of the TCW.

When awarded a CfD generators will also be allocated a Long Stop Date. If they fail to commission by such date the CfD will terminate. There is no incentive for a project to be delivered earlier than its TCW; that is the earliest date on which payments would commence. Such an approach may result in financiers being increasingly sensitive to the risk of delays in construction and commissioning.

What about delay to the project? If this is due to force majeure, the protection available is very limited. Grid / distribution system failure does not qualify as force majeure, although failure on the part of the grid or distribution system operator will result in an adjustment to the Target Commissioning Window.

Tackling the final challenges

Impact of "reduced financing costs" on strike price:

On some levels, this new incentive mechanism will clearly benefit generators. For nuclear and wind, for instance, the long-term guaranteed strike price should significantly reduce the risk of financing these projects, which should in turn lower the cost of raising capital from investors. On the other hand, the strike price may be set so as to reflect this lower borrowing rate, arguably neutralising the overall gains for generators. Again, the setting of the strike price and the publication of a workable rationale for it is a key part of the process for finalising EMR.

For some other technologies which are subject to fluctuating fuel costs, the CfD mechanism is not a panacea for inherent commercial risks. For example, rising feedstock prices may lead to a decrease in the net operating cash flow of a biomass project, and this is not mitigated by having a fixed strike price. Whether or not biomass feedstock costs will actually rise significantly is still unclear, but the potential gap between the strike price and a generator's true costs may yet prove a challenge to the market.

Market Liquidity:

While it is hoped that the CfD mechanism will boost liquidity in the market, including by enabling independent power producers to compete, the latest draft of the Energy Bill indicates that if this is not the case then the Secretary of State may intervene further to facilitate participation in the market and/or promote liquidity, for example by amending licence terms. As with other powers reserved to the Secretary of State under the Bill, this is widely drafted, but it does not (as yet) provide much detail about what exactly the Government intends to do if EMR does not have the intended effect.

Allocation, headroom and risk of political change:

There is a real risk for those developing projects with CfDs that the pot of money set aside to support the CfD contracts in a given year may run out, particularly if energy prices drop lower than the Government expects and the CfD counterparty is required to pay out under the CfD. The success of the scheme depends heavily on the ability of the UK Government to accurately determine the reference price and to set an appropriate strike price.

Initially, the allocation is to be undertaken on a first come, first served basis. If early warning signals are triggered that allocation is reaching a specified headroom, then further allocation rounds will be done on a six-monthly basis, presumably through the "competitive process" referenced in the Bill. Eligibility criteria for allocation rounds are to be published in secondary legislation.

Of course, investors also have to be aware of political risk and we have the next general election occurring in the period between the Bill becoming law, and 2017 when transition from the ROC Regime to CfDs begins. In other European jurisdictions (and not only in the Southern European belt), tariff downgrades and withholding of certificates, sometimes even on a retroactive basis, have been seen in recent months with potentially serious implications for the solvency of individual projects. Wherever the strike price is set, the UK Government should take heed of the market's concerns as to the possibility of these sorts of measures and take steps to ensure there is sufficient long-term certainty with respect to the new CfD regime.

Next steps towards implementation

Whilst the draft Energy Bill is a more complete work and enables the market's understanding to move forward in some respects, it is essentially an enabling framework. There will be a host of subordinate legislation, regulations, orders and guidance required to "put flesh on the bones" of the EMR measures identified in the Bill. The next stage of the legislative process, the Lords' line by line review of the Bill in committee, is scheduled to begin on 2 July 2013.

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One of the key challenges on timetable for the first CfDs to come into being in 2014 will therefore be the amount of further documentation requiring review, consultation and final publication. Add to this the fact that the detailed legal provisions will need to work in three different settings (the existing regulatory regime to 2017; transitioning from 2017 onwards; and implementing the new regime) and you have a highly complex legal environment. Those who navigate this complexity best, and plan accordingly, will be positioned to benefit the most.

So what remains to be done, in terms of legislation, consultation and implementation? Some of the key steps and areas are set out below:

- Publication of initial details of the renewable CfD strike price (draft expected July 2013 as part of the Government's draft Delivery Plan).
- Publication of the full CfD contract terms (expected July 2013).
- Further detail on the supplier obligation (expected July 2013).
- Further detail on CfD allocation and price setting processes for CCS and nuclear (expected summer 2013).
- Consultation on NGET's transmission licence modifications (expected autumn 2013 and to be implemented ahead of the issue of the first CfDs in 2014).
- Consultation response on transition from ROC Regime to CfD (expected autumn 2013).
- Consultation on secondary legislation for EMR (expected from October 2013). We hope this process will bring clarity on items such as refinancing approach; qualification criteria and "minimum spend"; reference price setting for baseload projects; availability of CfDs to overseas generators wishing to import to the UK; and as part of the price setting, how EMR will take account of developments in the wider power market (recognising that price setting for renewables cannot operate in a vacuum).
- Royal Assent target date of December 2013.
- Publication of the first delivery plan, including final renewable CfD strike prices (subject to Royal Assent, by end of 2013).
- EMR delivery mechanisms up and running, first CfDs signed: 2014.

We will update on the above activities in future notes in this series, as details become available.

In conclusion, we are entering into a brave new world of administratively-set electricity pricing, which for some time will be based on policy objectives rather than market factors. The prospect of moving back toward a fully market-led approach, when the range of renewable technologies are mature enough to deliver a stable and predictable price, seems at some point in the distant future.

In the meantime, we await the developments that are required to put EMR into clear focus and give generators and their backers the certainty they need to make investment decisions. One should not underestimate the work that remains to be done. But if these next steps can be achieved in fairly rapid succession and with a cohesive approach and message across Government, then we can look forward to a future where EMR has delivered its objectives.