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UK Electricity Market Reform: 2014 – a year in review

2014 was a year of considerable progress in terms of UK Electricity Market Reform (EMR), the cornerstone of the Government's plans to reform the electricity sector. In this note (part 2 of a series) we outline key EMR developments of 2014 and highlight further steps we anticipate will be taken in 2015 as the implementation of EMR continues.

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CfD Strike Prices: What more do we know? What strike price applies to me?

This time last year, strike prices were set for both 'established'[1] and 'less established'[2] technologies for projects commissioning for each year in the five year period 2014/2015 – 2018/2019[3]. As expected, prices applicable to 'established' technologies are generally lower than those for 'less established' technologies. Collectively, the Government deems the strike prices sufficient to enable the UK to generate at least 30% of electricity from renewable sources by 2020.

Generators and investors in the energy market benefitting from a CfD and wanting to calculate potential project returns will no doubt welcome the publication of finalised figures, but should bear in mind that the strike prices are indexed annually by reference to the Consumer Price Index (CPI). In addition, a change to the strike price may occur if there is a Qualifying Change in Law resulting in material Identified Costs being incurred.

Generators should be mindful that a pre-determined strike price does not equate to the revenue it will receive for each megawatt of generation. The relevant strike price will be compared against a reference market price. If the reference market price is lower than the strike price, the generator will receive a top-up payment of the difference from the CfD counterparty. If the reference market price is higher than the strike price, the generator must pay the difference to the CfD counterparty. Accordingly, so long as a generator is under its own power sales arrangements paid close to the reference market price, a reliable and stable revenue stream should be forthcoming. However, the generator takes the risk of establishing a route to market for its power reflective

1 Onshore wind (>5 MW), solar photovoltaic (>5 MW), energy from waste with CHP, hydro (>5 MW and <50MW), landfill gas and sewage gas.

2 Offshore wind, wave, tidal stream, advanced conversion technologies, anaerobic digestion (>5 MW), dedicated biomass with CHP and geothermal.

3 Details of the strike prices can be found in *Investing in Renewable Technologies – CfD contract terms and strike prices, page 7* https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/263937/Final_Document_-_Investing_in_renewable_technologies_-_CfD_contract_terms_and_strike_prices_UPDATED_6_DEC.pdf

of the reference price. The characteristically intermittent nature of renewable power means that entering into an offtake arrangement at a wholesale market price equal, or similar to, the reference market price may prove challenging. Generators may find themselves paid less than the reference market price to account for the 'intermittent generation' risk.

Strike prices for carbon capture and storage (CCS) and nuclear projects are to be negotiated on a case by case basis. After nearly 12 months of investigation concerning the compatibility of CfD support with EU state aid rules, the European Commission approved a 35 year-term CfD and guarantee arrangement between for Hinkley Point C in October 2014. The European Commission's decision does not substantively change the agreement of October 2013, but has reinforced the "gainshare" mechanisms designed to share potential future benefits with customers should the construction costs or equity returns be more favourable than forecast.

With respect to CCS projects, the CfD is the primary tool to drive the commercial deployment of CCS in the UK. The government signed Front End Engineering Design (FEED) contracts with White Rose and Peterhead in December 2013 and February 2014 respectively, and is currently negotiating the terms of support through CfDs. Plans are also afloat to engage with developers outside the CCS Competition in 2015 to design a generic CCS CfD and determine how CCS CfD's might be allocated in the future.[4]

The Offtaker of Last Resort: Added Comfort for Investors

The Government created the Offtaker of Last Resort (OLR) last summer in an aim to ensure that generators with CfDs secure access to the market. The OLR seeks to encourage competition in the PPA market by providing eligible generators with a 'backstop' PPA (BPPA)[5] on specified terms with a certified offtaker, and therefore a guaranteed route to market. Under the BPPA, Offtakers will pay generators at a significant discount to the market reference price ensuring such arrangements really are a 'last resort'. Implementation of the OLR will be through an obligation placed on certain suppliers to bid to enter into a one-year BPPA with an eligible generator when requested.

By guaranteeing access to the market at a specified price, the OLR should provide comfort to investors and lenders in terms of the worst-case scenario price a generator will receive for its power, and should make investors and lenders more comfortable with accepting alternative routes to market for independent generators, including shorter term PPAs and PPAs with new entrant counterparties. The government is continuing to work with Ofgem to promote and implement the OLR. It is envisaged that further guidance will be published in advance of the application for BPPAs opening in October 2015.

CFD Counterparty Payment Undertakings: Added Comfort for Generators

In part 1 of this series we remarked that having a stable and reliable CfD counterparty for generators to contract with that will meet its payment obligations under a CfD contract is fundamental to securing a bankable project. The CfD Standard Terms and Conditions[6] issued by the Secretary of State on 29 August 2014, and standardised across all technologies now include a number of undertakings to support the relevant CfD counterparty's payment obligations that should provide a degree of comfort to generators that they will receive payment from the CfD counterparty when due.

To what extent can I modify the CfD Standard Terms and Conditions?

Generators should note that the *Contracts for Difference (Standard Terms) Regulations 2014* issued on 29 August 2014 set limits as to the modifications generators may request to the CfD Standard Terms to ensure no generator gains a commercial advantage over another. A generator can only apply to the Low Carbon Contracts Company (LCCC) for a modification once an allocation round notice has been issued by the Secretary of State, and such application must be submitted promptly no later than 20 working days before the closing date of the relevant application round. It should be noted however that the LCCC is only mandated to agree 'minor'[7] and 'necessary'[8] modifications. As the test is inherently subjective and the scope for modification limited, generators would be wise to analyse the CfD Standard Terms prior to submitting an application to ensure they are well-placed to enter into the CfD Contract if and when offered by the LCCC.

4 *Next Steps in CCS: Policy Scoping Document*, 7 August 2014.
https://www.gov.uk/government/publications/ccs-policy-scoping-document

5 *Backstop Power Purchase Agreement.*
https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/356059/2014-09-16_BPPA_Final.pdf

6 *CfD Standard Terms and Conditions*, 29 August 2014.
https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/348142/Generic_CfD_TCs__29_August_2014_.pdf

7 *The Contracts for Difference (Standard Terms) Regulations 2014*, Regulation 7.

8 *The Contracts for Difference (Standard Terms) Regulations 2014*, Regulation 8.

The First CfD Allocation Round – October 2014

The final CfD Allocation Framework for the first allocation round was published on 2 October 2014 and set out the terms on which the first allocation round would operate, the rules for competitive allocation procedures and the valuation formula that will be applied to applications in respect of the 2015/16 budget year amongst other things. On 16 October 2014, the two-week application window for the first CfD applicants opened, for which the Government budgeted £300 million. In response to recently published European Commission *'Guidelines on State aid for environmental protection and energy 2014 – 2020'*[9] calling for a shift towards openly competitive processes for some technologies, competitive allocation rounds were held rather than allocation being undertaken on a first come, first served basis, as initially envisioned. Projects will be assessed against those of similar technology types grouped within the same budgetary 'pot': 'established' technologies, 'less established' technologies, and 'biomass conversions'. No budget was made available for biomass conversions in the first allocation round.

Only an 'eligible generator'[10] can be awarded a CfD. The definition is intentionally broad to allow a CfD to be offered to any project using relevant low-carbon generation technologies across an array of suitable project structures. A generator must demonstrate that it meets the 'eligibility criteria'.[11] If the £300 million budget for the first round is exceeded, an auction will be held to ration the available budget between qualifying applicants.

The generic CfD allocation process described here may not be appropriate in every instance. In line with the government's policy objectives regarding the deployment of nuclear, CCS, tidal and large hydro technologies, the Secretary of State may direct the LCCC to enter into a CfD with eligible generators of such generation technologies outside the generic allocation process.

The first CfDs are expected to be signed in February 2015, and the second allocation round is scheduled to open in October 2015.

Decision to modify the NGET Electricity Transmission Licence

Following consultation in July 2014, the Gas and Electricity Markets Authority took the decision to modify NGET's transmission licence in October 2014. The previous obligations on NGET as licensee to produce a Seven Year Statement and an offshore development information statement, have been replaced (effective from 16 December 2014) with the requirement to produce a new, combined statement of network development information – the Electricity Ten Year Statement (ETYS).

The Capacity Market: Update

First Capacity Market Auction

The Electricity Capacity Regulations 2014 and the *Capacity Market Rules 2014* brought the UK's capacity market into force on 1 August 2014. Through a competitive auction process, the Capacity Market is designed to ensure sufficient reliable capacity during periods of system stress. Investors obtain certainty as to part of their future revenues as Capacity Agreements are offered to new and existing capacity providers four years ahead of the year in which capacity must be delivered. Prior to the first Capacity Market auction, a pre-qualification stage was held to confirm the eligibility and bidding status of all potential capacity. The Government received 513 separate applications from small and large, established and emerging players in the market; testament to the revenue certainty that comes with a long forward plan. 62 Gigawatts (GW)[12] of derated electricity generation capacity pre-qualified to bid in the auction, exceeding the targeted 50.8GW the Government has sought to procure.

On 16 October 2014, the first Capacity Market auction opened. Pre-qualification results had signalled it would be oversubscribed and competitive[13]. The auction closed on 18 December 2014 following the Government's procurement of 49.26GW of capacity at a clearing price of £19.40kW to be paid to flexible power stations to guarantee their availability on top of any power they produce. Final results were published on 2 January 2015 showing that fierce competition drove down prices to levels lower than many generators and market commentators had anticipated[14]. The majority of Capacity Agreements were awarded to Combined Cycle Gas Turbine (CCGT) plants (45% of capacity), coal (19% of capacity), and nuclear power (16% of capacity), and for a one-year term[15].

9 http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52014XC0628(01)&from=EN

10 *The Contracts for Difference (Definition of Eligible Generator) Regulations 2014, Regulation 3.*

11 *The Contracts for Difference (Allocation) Regulations 2014, Regulation 7(3)(a).*

12 https://www.emrdeliverybody.com/Shared%20Documents/Prequalification%20Results%20Summary.pdf

13 https://www.gov.uk/government/news/huge-interest-in-first-ever-energy-capacity-market-auction

14 https://www.emrdeliverybody.com/Shared%20Documents/Final%20Auction%20Results%20Report.pdf

15 https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/389832/Provisional_Results_Report-Ammendment.pdf

The Capacity Market: A level playing field?

However, the capacity market mechanism is not without its critics. In November, a challenge was filed with the European General Court in which allegations were made that the UK Capacity Market is discriminatory, favouring new-build gas plants that can secure 15 year Capacity Agreements over existing gas plants that are restricted to a one year term (or three years if they undertake a plant upgrade), risking the premature shut-down of existing gas-fired power plants.

A further challenge has been filed with the European General Court in December 2014 claiming the UK capacity market is an unlawful subsidy, prioritising fossil fuel electricity generation over more reliable and cheaper demand-side options.[16] If either of the challenges are successful, capacity contracts could be considered unlawful and, ultimately, capacity payments repaid. However, it should be noted that the European Commission heard and rejected similar appeals from the sector during its approval of the Capacity Market Rules earlier in 2014 and is expected to defend its decision in court, arguing that the capacity market is within European state aid rules and does not discriminate against the demand-side-response sector.

Demand Side Response

The Government has expressed its commitment to supporting the growth of the demand-side-response sector, and plans to hold two further capacity auctions for that sector in 2015 and 2016, for delivery in 2016-17 and 2017-18 respectively.[17] This tailored support is predicted to help expand demand-side industries, and create effective competition between traditional fossil fuel power plants and new forms of capacity, driving down future consumer costs.

The Supplier Obligation

The Contracts for Difference (Electricity Supplier Obligations) Regulations 2014 came into force on 1 August 2014 pursuant to which all licenced electricity suppliers in Great Britain must make payments under two levies. The CFD supplier obligation levy is a compulsory levy that will enable the LCCC to meet the costs of CfDs. Separate from this levy is the operational costs levy to enable the LCCC to meet its operational costs. Electricity suppliers should note they will be liable to make payments under both levies from 1 April 2015. In September 2014, the Government consulted on the implementation of exemptions from CfD costs for electricity intensive industries and imported renewable electricity. We understand the changes will be introduced via new regulations that will amend the current regulations and, subject to parliamentary consent, will come into force before the first supplier obligation payments become due in April.

Emissions Performance Standard: Update

On 25 September 2014, the Government launched a consultation on its proposed approach to the regulations that will fully implement the Emissions Performance Standard (EPS).[18] The consultation closed on 6 November 2014 and investors can expect to receive more clarity on the detail of the EPS regime when the implementing regulations come into force later this year, on or around 1 April 2015.[19]

Putting Flesh on the Bones

Extensive legislation, regulations, orders and guidance emerged in 2014 to put flesh on the bones of the EMR measures identified in the Energy Act 2013. The key legislation and regulations are listed below:

- *The Electricity Market Reform (General) Regulations 2014* – made on 31 July 2014 and came into force on 1 August 2014;
- *The Contracts for Difference (Allocation) Regulations 2014* – came into force on 1 August 2014;
- *The Contracts for Difference (Definition of Eligible Generator) Regulations 2014* came into force on 1 August 2014;
- *The Contracts for Difference (Standard Terms) Regulations 2014* came into force on 1 August 2014;
- *The Contracts for Difference (Electricity Supplier Obligations) Regulations 2014* came into force on 1 August 2014;
- *The Electricity Capacity Regulations 2014* – came into force on 1 August 2014;
- *The Capacity Market Rules 2014* – entered into force on 1 August 2014 and updated on 15 October 2014;

16 See Press release http://www.tempusenergy.com/press-release-04122014.pdf

17 http://www.publications.parliament.uk/pa/cm201415/cmgeneral/deleg4/141204/141204s01.htm

18 https://www.gov.uk/government/consultations/implementing-the-emissions-performance-standard

19 *Changes to the CFD supplier obligation*, DECC, September 2014. https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/370825/Supplier_Obligation_Consultation_September_FINAL.pdf

- *The Electricity Market Reform Dispute Resolution Guidance*[20] – published by Ofgem on 28 August 2014 regarding disputes between the National Grid Electricity Transmission plc (NGET) and the Capacity Market;
- *The Contracts for Difference Standard Terms and Conditions 2014* – issued by the Secretary of State on 29 August 2014;
- *The Contracts for Difference Final Allocation Framework for the 2014 Allocation Round*[21] published on 1 September 2014;
- *The Contracts for Difference Allocation Round Guidance* – published on 3 October 2014[22];
- *The Power Purchase Agreement Scheme Regulations 2014* – certain regulations came into force on 14 October 2014, with the remaining regulations due to come into force on 1 October 2015;
- *The Electricity Market Reform Annual Update 2014*[23] – published 6 November 2014, and presented to Parliament pursuant to s1(4) of the Energy Act 2013; and
- *Electricity Capacity (Supplier Payment) Regulations 2014* – laid before Parliament on 10 November 2014 and entered into force on 18 December 2014.

There has been some questioning as to the usefulness of such a complex legislative and regulatory matrix. When the Secondary Legislation Scrutiny Committee questioned Michael Fallon MP (Minister of State for Energy) on 8 July 2014, he reasoned that this first major reform of the electricity market for over 25 years is inherently complex and necessarily required a certain amount of legalese. However, he emphasised that efforts have been made to divide *"what has to be in the regulations, the rules, so that the market understands them, and what can be given as friendly guidance"*[24]. Only time will tell whether he is right.

Looking ahead: EMR in 2015 and beyond

Going forward, the following key EMR milestones anticipated for 2015 and beyond are:

Date	Milestone
By 30 January 2015	Capacity Agreements issued to successful applicants.
January 2015	Emission Performance Standard implementation.
3 February 2015	Deadline for successful applicants to sign CfD contracts.
Early 2015	Secondary legislation amendments.
From April 2015	EMR running costs and CfD charges begin.
October 2015	Second CfD allocation round commences.
December 2015	Second Capacity Market auction commences.
October 2016	Demand-side Capacity Market begins.
2017	Renewables Obligation (RO) closes to new projects.
2018	Extension of the CfD regime to renewable energy projects outside the UK and connected to the electricity systems of Great Britain or Northern Ireland,[25] once the CfD regime is fully implemented across the UK.
Winter 2018/2019	Full Capacity Market begins.

20 https://www.ofgem.gov.uk/ofgem-publications/89569/emrdrguidance.pdf

21 https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/349370/Final_Allocation_ Framework.pdf

22 https://www.emrdeliverybody.com/Shared%20Documents/CFD%20Round%20Guidance%20ISSUE%202%20Final.pdf

23 https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/371384/Annual_Update_Print.pdf

24 *See revised transcript of evidence taken before The Secondary Legislation Scrutiny Committee on the Electricity Market Reform Regulations 2014.* http://www.parliament.uk/documents/lords-committees/Secondary-Legislation-Scrutiny-Committee/SLSC-14-07-08-Ev1-TRANSCRIPT-Fallon-(revised).pdf

25 *See CFD for non-UK Renewable Electricity Projects*, August 2014. https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/340932/DECC_Non-UK_CfD_August_2014.pdf

Conclusion

The roll out of the EMR continued apace in 2014. Secondary legislation now provides much needed detail with respect to the operation and practical implications of various aspects of EMR however much work remains to be done. Serious questions remain as to whether the capacity market as structured will prevent the premature closure of existing plant and will support the growth of the demand side sector. It also remains to be seen whether the CfD arrangements are sufficient to encourage the required investment in renewable generation together with development of the CCS market.