

Planning our Electric Future DECC White Paper on Electricity Market Reform Part 1 - Feed-in Tariffs with Contracts for Difference

Introduction

In July of this year the Department of Energy and Climate Change (DECC) published its much anticipated white paper on the reform of the UK electricity market. The Electricity Market Reform package aims to help the UK achieve the mammoth task of improving the diversity of electricity supply whilst meeting increasing demand and keeping consumer costs as low as possible. This briefing note is the first in a series of four which will focus on the key measures included in the white paper:

1. a new system of Feed-in Tariffs with Contracts for Difference (FiT CfD);
2. the introduction of a Carbon Price Floor;
3. an Emissions Performance Standard (EPS) set at an annual limit of 450g CO₂/kWh at baseload;
4. the introduction of a Capacity Mechanism.

What is a Feed-in Tariff with Contract for Difference?

The primary aim of FiT CfD is to stabilise revenues whilst promoting investment in low-carbon energy generation. A FiT CfD is therefore a long-term contract between a contract counterparty and an electricity generator in terms of which an agreed tariff for electricity is set (the strike price) and then variable payments are made to top-up the level of payment to the generator to the agreed tariff when the market price for electricity (the reference price) is lower than the strike price.

Payments under the contract can flow both ways between the generator and the contract counterparty. If the reference price is higher than the strike price, the generator will have to return the difference to consumers.

The leading alternative in consultations was the Premium Feed-in Tariff (PFIT), in terms of which generators would receive a fixed payment on top of the revenue generated from the sale of electricity. This was therefore more similar to the existing Renewables Obligation (RO) regime and was favoured by renewables generators.

Advantages of FiT CfD

The most significant benefits of FiT CfD, as anticipated by DECC, are that:

- it reduces capital costs by de-risking long-term electricity price exposure. The White Paper states that switching to long-term FiT CfD would reduce the cost of capital by around £2.5 billion over the period up to 2030;
- it reduces support costs, by replacing a fixed subsidy with a variable top-up depending on the level of market prices;
- it therefore leads to lower consumer bills. On average, it is estimated that the FiT CfD model could mitigate the impact of rising bills for domestic consumers by around 6% by 2030 when compared to the situation if the status quo was maintained;
- it is able to operate effectively in the electricity market and should facilitate market entry by addressing price risk;
- it is likely to lead to a more rapid decarbonisation trajectory than PFIT;
- it compliments other aspects of the reform proposals well, especially Carbon Price Floor (CPF);
- it is a flexible and resilient option which functions in a large amount of different situations and can cope with unpredicted outcomes on carbon prices, fossil fuels or technology costs;
- it is the option which provides the greatest amount of certainty in terms of meeting carbon targets
- it can be delivered by several types of organisation including private sector bodies

Introduction of FiT CfD and Institutional Arrangements

The Government intends that the introduction of FiT CfD will begin with an administrative price discovery process which will move to more competitive forms of price discovery, for example, tenders and auctions when the market gets to a position where it can support these mechanisms. However, the Government concedes that the current market is some years away from being able to support such technology-specific tenders and auctions and it estimates that such ideas cannot become a reality until the early 2020s.

In order for FiT CfDs to be successful, there must be an institutional framework which is clear and inspires confidence in investors. The move to FiT CfD will involve existing organisations acquiring new roles and responsibilities or the creation of new organisations to administer the contracts. The delivery organisation will be responsible for: transforming the Government’s policy goals into technical requirements; contract delivery; managing payments under the contracts; and monitoring compliance and enforcement. The white paper states that the delivery organisation must be accountable, independent, credit worthy and possess technical, commercial and financial expertise whilst also providing value for money to consumers.

There will be close interaction between FiT CfD and the Capacity Mechanism and therefore the announcement on which organisation will be responsible for FiT CfD will not be made until the Capacity Mechanism design has been agreed upon, which is likely to happen early next year.

The Government expressed a preference for a UK-wide FiT CfD. However, devolution in the energy sector is complex and there are differences in devolved powers across the regions. Therefore, a UK-wide FiT CfD will only be achieved by working with the devolved administrations and the Government have pledged to work positively with the devolved administrations as well as liaising with the European Commission and other EU stakeholders to ensure that a cohesive energy policy can be developed.

The Design of FiT CfD Contracts

If the FiT CfD model is to be implemented successfully, it is essential that the contracts are designed in a way which will work for all forms of low-carbon generation. The various types of generation have very different commercial and operational characteristics and therefore some of the key features of the FiT CfD will vary depending on the type of generation involved. The White Paper identifies three classes of plant:

- intermittent – plant which has minimal or no control over how much power it generates and when, e.g wind, wave and solar;
- baseload – level of power generation is constant e.g nuclear, some biomass and Carbon Capture and Storage Plant (CSS); and
- flexible – plant which is responsive to changes in demand and can vary output accordingly e.g biomass and CSS.

The table below outlines the proposed design of FiT CfD for intermittent and baseload generation:

	Intermittent	Baseload
Contract Form	Two-way FiT CfD	Two-way FiT CfD
Strike price	Annual inflation indexation	Annual inflation indexation Minded not to include fuel indexation for biomass. To be confirmed for CSS.
Market Reference Price	Day-ahead price Choice of baseload or hourly prices Not averaged over a longer period	Year-ahead baseload price Choice of price sources
Contract Volume	Metered output	To be confirmed, metered output or firm volume

Forthcoming Government Action and Timetable for Implementation

As FiT CfD replaces the RO regime, suppliers will no longer have an obligation to buy from renewable sources, prices offered under bilateral PPAs may become less attractive and smaller, independent generators will be forced to trade in the market. The White Paper recognised that the success of FiT CfD will therefore depend on improving liquidity in the market to give confidence to generators and entice new entrants into the market. The Government has pledged to continue to work in partnership with Ofgem to tackle market liquidity. It also promises to ensure that there is scope within the implementation timetable for proper assessment of the efficacy of the FiT CfD model and conduct further research into the contract-letting process with the aim of ensuring fairness across processes used by all developers.

DECC is expecting to publish a Technical Update on EMR around the turn of the year, which will include a high level proposal for the institutional framework for FiT CfD.

If the Government meets the projected timescales, it is expected that the first FiT CfD contracts will be signed in the Spring of 2014. However, the Government has stated that there will be, until 31 March 2017, a transitional period during which generators can choose between the existing Renewables Obligation (RO) and the new FiT CfD. It is expected that more extensive transitional measures will also be announced in an attempt to facilitate early investment decisions.

Comment

There has been a mixed response to the White Paper from industry stakeholders and politicians. The biggest concern is that the new reforms are more beneficial to some forms of generation than to others. In particular, the Scottish Government has expressed reservations about the switch from RO to FiT CfD and is concerned that the FiT CfD will be more favourable to nuclear energy generators than to renewable generators, a key strategic concern given the overwhelming commitment in Scotland to renewable generation.

The White Paper is a step towards the substantial reform which is required if the UK is to have any chance of meeting its energy targets. It provides the skeleton of the reforms and removes some of the uncertainty surrounding future energy policy. However, it is clear that much more detail is required, particularly in relation to FiT CfD, if the desired increase in investor confidence is to be achieved. The enhanced level of detail which is expected in the Technical Update ought to permit a better analysis of whether or not the concerns which have been raised in relation to FiT CfD are well founded, and we shall issue a further briefing note once the Technical Update is published.

The White Paper is available at: <http://www.decc.gov.uk/assets/decc/11/policy-legislation/EMR/2210-emr-white-paper-full-version.pdf>

MacRoberts Energy Group

Our expertise in market regulation has been drawn from our experience in the sector since privatisation in the 1990s and covers all areas of the electricity and renewables market, where we advise clients on:

- Licensing and consents, including:
 - o Consents under the Electricity Act 1989 and other relevant consents and licences
 - o Planning legislation, including applications, appeals and public inquiries
 - o Marine consents
- Obligations under the Balancing and Settlements Code, and connection and use of system arrangements
- Regulation of the market in ROCs, Feed-in-tariffs, LECs, REGOs etc
- Health and safety compliance and enforcement
- Environmental permits and environmental enforcement actions

Key Contacts



Nick Jones
Partner
Real Estate
nick.jones@macroberts.com



Michael Murphy
Partner
Corporate, M&A, Regulatory
michael.murphy@macroberts.com



Jamie Grant
Partner
Real Estate, Environment
jamie.grant@macroberts.com



Lillian Mackenzie
Partner
Project Finance
lillian.mackenzie@macroberts.com



Christine Worthington
Senior Associate
Construction and Engineering
christine.worthington@macroberts.com



Moray Thomson
Senior Associate
Planning and Environment
moray.thomson@macroberts.com