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Briefing note

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The Draft Energy Bill

The UK Government has published an early draft of its Energy Bill and in doing so has sent a message to industry that it intends to introduce its energy market reforms, first announced nearly eighteen months ago, on time. However, whilst the Government is working hard to stick to its timetable to implement the reforms, considerable hurdles remain and key aspects of the most critical measures remain unknown.

Introduction

The Department of Energy and Climate Change (DECC) has published a draft Energy Bill for pre-legislative scrutiny. When presented to Parliament this Autumn, the Energy Bill will have a high profile and the Government will be eager to drive it through the legislative process in order that it can receive Royal Assent during 2013.

The Government's aspirations for an extensive national portfolio of low carbon electricity generation projects have taken a hit recently and there are growing concerns amongst some opposing certain aspects of the energy market reforms that the cost burden for consumers will be too great.

As a result, the Government is rolling political dice with the draft Energy Bill – if the reforms are successful and low carbon electricity generation capacity is developed, industry will breathe a sigh of relief, but there may be a consumer backlash if they feel that they are bearing the brunt of excessive and unnecessary subsidies. However, if the reforms do not succeed, the political fall-out could be huge – in announcing the draft Bill, Ed Davey, the Secretary of State for Energy and Climate Change claimed that:

"leaving the energy market as it is would not be in the national interest. If we don't secure investment in our energy infrastructure, we could see the lights going out, consumers hit by spiralling energy prices and dangerous climate change".

In this briefing, we set out an overview of the key elements of the draft Energy Bill and describe the next steps for the implementation of the energy market reforms.

Key issues

- The UK Government has published a draft of the Energy Bill, which it intends to formally introduce to Parliament in the Autumn
- It is hoped that the Energy Bill will receive Royal Assent during 2013 so that a pilot phase of the Feed-in Tariff with Contracts for Difference can start in 2014
- The main purpose of the Energy Bill will be to provide the framework for the introduction of the energy market reforms previously announced by Government
- Key to those market reforms is the introduction of a FIT CfD, which will apply to all low carbon energy projects
- The Energy Bill will also establish the Office for Nuclear Regulation; introduce provisions to allow the sale of the Government Pipeline and Storage System; and make a technical amendment to the offshore transmission regime

The Scope of the Draft Energy Bill

The draft Bill's primary purpose is to introduce a legislative basis for the Government's energy market reforms described in its White Paper published in July 2011. In addition, the draft Energy Bill provides for:

- the introduction of an Energy Strategy and Policy Statement;
- the formal creation of the Office for Nuclear Regulation;
- measures to enable the sale of the Government Pipeline and Storage System; and
- technical amendments to the UK's offshore transmission regime.

Energy Market Reforms

The Government will consider its energy market reforms to have been a success if they bring about significant investment in a diverse portfolio of low carbon technologies. The Government has stated that its long-term vision, which is likely to be at least ten to fifteen years away, is a market whereby all low carbon technologies can compete without subsidy or support (see box below setting out DECC's outline of the four stages of energy market reforms). As described in our previous client briefings[1], the UK's energy market reforms comprise a series of new measures, including a capacity mechanism; an emissions performance standard; a carbon floor price; and the Government's flagship energy policy: a feed-in tariff based on contracts for difference (CfD), which is the focus of our analysis.

Stage 1 2014 - 2017	Current arrangements (Renewables Obligation) alongside Contracts for Difference with prices set administratively. Capacity auctions could be initiated depending on the security of supply outlook.
Stage 2 2017 – 2020s	Technologies mature (but at different rates) and some are able to enter competitive technology-specific auctions. The capacity market could be fully operational if initiated.
Stage 3 2020s	All technologies have matured and move to technology-neutral auctions. Demand-side response and additional storage and interconnection will play an increasingly large role in managing supply and demand.
Stage 4 Late 2020s onwards	Technologies are mature enough and the carbon price is high and sustainable enough to all generators to compete without intervention.

Feed-in Tariffs based on Contracts for Difference

The draft Energy Bill itself does little to advance the general understanding of how the CfD will operate, which was well-described in its White Paper and subsequent technical update papers. Much of the detail of the CfD will be contained within

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[1] "**Energy Market Reforms - A major new consultation package**" (December 2010); "**Further Changes to UK Renewables Incentives**" (April 2011);" **Electricity Reform White Paper - Increasing Investor Confidence**" (July 2011); and "**UK Electricity Market Reform: Some more technical detail announced**" (December 2011).

secondary legislation and changes to codes and licences. Alongside the draft Energy Bill, DECC has published a draft operational framework which sets out its current proposals for the operation of the CfD (the draft Operational Framework).

Key messages from the draft Operational Framework include:

Setting the Strike Price

It is expected that in mid-2013 the Government will announce the strike prices for the transitional/pilot phase during 2014 to 2018. For the period beyond 2018, the strike price will likely be set in 2015 after the system operator, National Grid, has gathered evidence on pricing, which it will start in mid-2014.

Much like the Renewables Obligation "banding" process, DECC proposes to set different strike prices for different low carbon technologies. For nuclear generators, the strike price will be set on a project-by-project basis, although this may change in future, not least as such an approach may be considered to lack transparency.

The strike price is expected to be indexed annually by reference to the Consumer Price Index, although it will not be affected by changes in fuel costs incurred by biomass generators, due to the lack of an established biomass price index and the diversity of feedstocks.

Allocation

DECC proposes that CfD allocation rounds will run every six months for renewable energy projects. For nuclear and carbon capture and storage (CCS) projects, allocation will be via the final investment decision enabling process.

Unlike the existing Renewables Obligation, where projects cannot be accredited until the relevant plant is very close to commissioning, under the CfD, DECC "*is minded to allow*" projects to apply for a CfD immediately before financial close, which will increase investor confidence enormously. The Government considers financial close to be when banks or equivalent organisations commit to financing the project; although it recognises that on-balance sheet financing will need further consideration.

Additionally, it is likely that projects will need to meet various milestones post-financial close to avoid financial penalties (or reductions in their strike price), such as:

- Receipt of all consents and permissions to enable construction to commence;
- EPC contract (or equivalent) signed;
- Commencement of ground works at the site;
- Grid or distribution connection agreement signed;
- Turbine or generation engine installed;
- National Grid commissioning acceptance test date scheduled; and
- The date of commissioning the project (likely to be a target window).

Transitional Arrangements

As previously advised by DECC:

- projects commissioning on or prior to 31 March 2017 can be accredited under the existing Renewables Obligation and receive ROCs for the life of the project;
- projects reaching financial close from mid-2014 can apply for a CfD; and
- projects needing to make a final investment decision prior to all details of the CfD being known, but which may not be able to accredit prior to April 2017, can apply to DECC to take part in early discussions which may give them the necessary comfort to make a final investment decision.

Reference Pricing

The market price for electricity to be referenced in the CfD will be based on the hourly day ahead auction price for the GB zone for intermittent power; and on the year ahead price for baseload power.

Auctioning

The Government hopes that, for some renewable technologies, a competitive process could be adopted to set the strike price as soon as 2017.

CfD Length

DECC's current view is that for renewable technologies, the CfD should last for 15 years; and 10 years for early-stage CCS projects. Nuclear and long-term CCS project CfDs are still to be determined, although in principle, the Government would not expect nuclear to receive a CfD of less than 15 years.

Financial Management

Having been at risk of soaring liabilities under the microgeneration feed-in tariff regime, in particular in relation to solar schemes, the Government has stressed that the CfDs need to be affordable.

Certain projects, such as nuclear powered generation plants, will be subject to a bespoke, case-by-case negotiation, but DECC recognises that there will be many more renewable projects which cannot be subject to individual negotiations. To avoid rapid reductions in tariffs, even the threat of which would shake investor-confidence, the Government proposes to instruct the System Operator (National Grid) who will have administrative responsibility for the CfD regime, only to issue CfDs for low-carbon generation "*up to the value of the amount set out in the Levy Control Framework*". The Government is currently considering three options as to how this may be achieved, and will decide upon the most appropriate mechanism when it issues its final CfD Operational Framework in autumn 2012:

- **Option 1: price setting with specific controls over particular renewable technologies** - this would involve setting an overall cost envelope for each of nuclear, CCS and renewables to avoid over-deployment. This may be achieved by giving one or two years' advance notice of strike prices for technologies which have the possibility of rapid deployment (e.g. solar PV and biomass conversions). Alternatively, or additionally, such projects may be required to pre-accredit so that once a certain threshold or capacity trigger is passed/met, DECC could change the strike price for unaccredited projects adopting the same technology.
- **Option 2: setting specific volume targets for technologies** - initially, CCS and nuclear targets would be managed through negotiation; but renewables could be subject to targets set by reference to the UK's Renewables Roadmap. Unused capacity in any given year could be rolled-over to future years. Whilst such an option would give detailed control, the Government has recognised that accurate target-setting would be difficult and could affect supply chain establishment and growth.
- **Option 3: control by price setting alone** - reviewing and amending strike prices if technology costs and/or the deployment of the number of projects seeking CfDs, are significantly greater or less than expected. Under this mechanism, the total amount of money for a 5-year period would be set and could be distributed by the System Operator via CfDs until it had been spent.

Strategy and Policy Statement

Chapter 8 of the draft Bill introduces a Strategy and Policy Statement – a new statutory document, which will set out:

- the Government's strategic priorities in formulating its energy policy;
- the particular outcomes to be achieved as a result of the implementation of its energy policy; and
- the roles and responsibilities (in particular of DECC and Ofgem) of those involved in implementing the policy.

The Strategy and Policy Statement must be followed by DECC and Ofgem in the fulfilment of their duties and it is proposed to be reviewed every five years, but that review can be brought forward if there is a general election or a substantial change in energy policy.

In its accompanying explanation to the draft Energy Bill, the Government has explained that the Strategy and Policy Statement will only reflect existing policy and will not be "*the main vehicle for publishing any new policy*" but it is acknowledged that policy gaps may be identified in producing the statement.

The Office for Nuclear Regulation

In February 2011, the Government announced the creation of the Office for Nuclear Regulation (ONR) and the draft Energy Bill proposes to formalise that body, giving it a statutory basis and thereby consolidating all existing functions which are divided between the Secretary of State and the Health and Safety Executive.

The draft Bill will give the ONR responsibility for:

- Nuclear safety;
- Nuclear security;
- Nuclear safeguards;
- The transport of radioactive material by road, rail and inland waterway; and
- Health and safety on nuclear sites.

Government Pipeline and Storage System

The draft Energy Bill introduces the possibility that the Ministry of Defence (MoD) may sell the Government's Pipeline and Storage System (GPSS), which was established in 1939. The GPSS is a network of approximately 2,500km of pipeline and includes storage depots, pumping stations and other sites; it is responsible for distributing 40% of all aviation fuel within the UK, supplying Heathrow and Gatwick airports, as well as Royal Air Force and US Air Force airfields.

The draft Energy Bill seeks to create transferable rights to maintain, use, remove, replace, renew and access the GPSS; and to restore and inspect affected land as such rights are currently personal to the MoD. The draft Bill also provides for a compensation scheme for affected landowners.

Offshore Transmission

The draft Energy Bill provides for the correction of a gap in legislation relating to the testing and commissioning of offshore windfarms. It is not possible to hold both generation and transmission licences, which poses a problem for generators who wish to test the transmission lines, which they have constructed themselves under the OFTO "generator build option".

To avoid generators committing an offence in commissioning their wind farms, the draft Energy Bill proposes an exemption from the requirement to hold a licence, subject to certain specific matters.

Implementation Timetable

The draft Energy Bill will be closely scrutinised by the Energy and Climate Change Select Committee which has announced an inquiry to examine the draft Energy Bill and which will doubtless hear evidence from a number of leading industry figures. The Select Committee hopes to produce its report soon after the House of Commons rises for the summer recess (on 17 July) in order that its recommendations can be incorporated into the final Energy Bill before it is presented to Parliament in the Autumn.

DECC hopes that the Energy Bill will receive Royal Assent towards the end of 2013. Secondary legislation will be developed during 2013 and DECC is likely to launch a consultation towards the end of that year, in order that the regulations can come into force in mid-2014.

For the rest of 2012, DECC and the System Operator will continue to progress the detailed design of the CfD, including commencing the "price discovery process" which will inform the first strike prices for 2014. The final version of the Operational Framework for the CfD will be published in Autumn 2012 and will include draft CfD terms.

Final Comments

With over £110 billion investment, much of which will come from overseas, needed to decarbonise electrical power generation and upgrade the grid in the UK, the stakes for the proposed energy market reforms could barely be higher. Since first launching a consultation in respect its proposals in December 2010, the Government has worked hard to develop and refine a series of policy measures which it believes will create the right market environment necessary to secure investment on such a tremendous scale.

In general terms, the draft Energy Bill and DECC's accompanying publications, particularly the draft Operational Framework, have been reasonably well-received by industry, although politicians and large developers alike are all alive to the consumer lobby who are understandably focused on the impact of the FIT CfDs on energy bills, rather than the environmental benefits of low carbon generation.

Although some additional details were published regarding the approach to the design of the FIT CfDs, as outlined in this briefing, many developers and investors were hoping for a flood rather than a trickle of information – developers of low carbon projects still do not know where the strike price is likely to be set, unless DECC accepts them into its early stage discussion programme to enable final investment decisions to be taken and the form of the CfD is still a mystery.

There is clearly a balance for the Government to strike between publishing the details of its reforms quickly and making sure that those policies are sufficient to secure the necessary investment. It seems that the Government is taking the medium-long term approach by taking all steps possible to get its policy right and acknowledging that some parts of industry may be disappointed at the lack of pace (and detail) in the short-term.

Implementing the FIT CfDs cheaply, quickly, properly and transparently will go a long way to keeping both investors and consumers satisfied and it is certain that the next 12-18 months will see further policy refinement and debate – so far the renewables, nuclear and CCS industries have been fairly closely allied with their public comments on energy market reforms, but once the strike prices are published it could be every technology for itself.

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