CLIFFORD
CHANCE

Briefing note — November 2012

Energy Bill – a milestone but still more work to do

After months of speculation, and political wrangling, the UK Government has finally unveiled its new Energy Bill which paves the way for the Government's landmark electricity market reforms. In addition to framework powers on financial support for low carbon generation, carbon price floor and energy performance standards, the Bill also contains new powers to set an electricity decarbonisation target but, disappointingly, leaving the actual target to be decided by the next Parliament. New energy efficiency measures are also set out in a consultation, to the dismay of campaigners who complain that the only measures looking at reducing energy are not to be found in the Bill. This Briefing focuses on the Feed-In Tariff Contract for Difference, the Capacity Mechanism and the new consultation on Electricity Demand Reduction whilst offering some comment on some of the other principal developments on Electricity Market Reform (EMR).

Key issues

- FIT CfDs
  - Detailed Heads of Terms for FIT CfDs published, final form of contract expected in July 2013.
  - FIT CfD heads of terms contain conditions precedent to receipt of FIT payments.
  - Generators will need to satisfy a minimum spend requirement within the first year, similar to "use or lose" provision.
- Electricity Demand Consultation – New financial incentive proposed to encourage energy efficiency; funding likely to reduce low carbon incentives.
- Capacity Market – Existing and new capacity, Demand Side Response and Storage all eligible but not FIT CfD projects. First capacity auction in 2014.

FIT CfDs

The Department of Energy and Climate Change (DECC) has published further details of how the proposed Feed-in-Tariff Contracts for Difference (FIT CfDs) will operate and has also published detailed heads of terms (HOTs) for the FIT CfD for the first time, announcing that final forms of the contract will be published in July 2013.

Key powers within the Energy Bill

The Bill establishes the basic framework for FIT CfDs and the powers of the main parties in respect of FIT CfDs:

- The Secretary of State (SoS) to designate the counterparty to the FIT CfDs (FIT Counterparty);

What Are FIT CfDs?

The proposed new system of FIT CfD payments for generators of low carbon electricity, including nuclear power, is proposed to replace the existing Renewables Obligation.

FIT CfD payments provide a contractual form of guarantee to generators as to their level of revenue – it removes the volatility in power prices. Generators will continue to sell their electricity into the market and then receive variable payments based on estimated market electricity prices (the reference price) to ensure that they obtain the agreed "strike price". As a result, a generator may receive payments to "top-up" its electricity sales to the strike price; on the other hand a generator will be obliged to pay back money where the electricity reference price exceeds the strike price.

Setting the strike price is the critical element for DECC – it needs to be sufficiently high to encourage the development of low carbon energy projects, but not so high that developers are over-incentivised, leading to a 'gold rush'.

- National Grid (the System Operator) and the SoS to require the FIT Counterparty to offer FIT CfDs to eligible generators; and
- the SoS to set maximum costs and target for FIT CfDs – this will enable the SoS to prevent the FIT Counterparty issuing CfDs where such costs would be exceeded.

The SoS will also have powers to introduce secondary legislation to provide for detailed mechanics of FIT CfD and a duty, when making regulations, to require electricity suppliers to make payments to the FIT Counterparty (who would then make payments to the generators).

Form of FIT CfD

Every low carbon electricity generating station will have its own FIT CfD – a private contract signed by the FIT Counterparty, a Government-backed limited company and the generator.

The contracts will be largely standardised and the scope for amending the commercial terms will be slight – although DECC acknowledges that some variations will be necessary – for example to reflect differences between intermittent and baseload generation; and some projects may have particular risk profiles or technologies which necessitate a different approach from the standard contract.

Heads of Terms

DECC has published detailed HoTs which it will use to support a number of stakeholder consultations and presentations to be undertaken in the first half of next year, prior to publishing a final form in July 2013. At over seventy pages, the HoTs are very detailed and it is clear that DECC has already spent significant time and effort in designing the terms of the FIT CfD to ensure that they are investable – meeting the needs of developers and their backers.

DECC characterises the content of the HoTs into four categories, described in further detail below.

Commencement and Term

The FIT CfD will last for ten years for carbon capture and storage projects; 15 years for renewable energy projects and an as yet undetermined period for nuclear projects – to be considered on a case-by-case basis.

The generator will be obliged to provide to the FIT Counterparty evidence of its substantive financial commitment to the project, such as having taken a final investment decision or spent a "minimum spend amount" within a year of entering into the FIT CfD (known as the milestone). The extent of the spend will likely depend on the scale and technology choice of the project.

FIT CfDs will be entered into early in the project's life, probably at or around financial close. This contrasts with the approach of the Renewables Obligation, where projects currently cannot accredit (qualify for support) until commissioning, meaning that until such time, the level of support remains unknown. A series of conditions precedent (CPs) in the FIT CfD will need to be satisfied prior to payments being made (See box inset). Failure to satisfy the CPs could result in the FIT CfD being terminated by the FIT Counterparty. Termination may also arise due to "prolonged" force majeure (although the HoTs do not indicate how long this period would be) and failure to meet the minimum spend milestone.

Payment

Both the generator and the FIT Counterparty will be obliged to make payments to the other, depending on whether the electricity reference price exceeds or is lower than the strike price.

The FIT Counterparty's liability will be on a limited recourse basis – it will only be obliged to make payment to a generator where it has received funds from the electricity suppliers (who will be under an obligation to make such payments) – the "pay when paid" principle. This should provide comfort to generators that the FIT Counterparty will remain solvent and additional measures will be introduced to provide a regulatory backstop to suppliers (for example, mechanisms relating to supplier collateral, loss mutualisation etc which will be included in secondary legislation in due course).

Payment will be made at least monthly and the strike price would be indexed by reference to the Consumer Prices Index (not the Retail Prices Index which applies to the microgeneration FIT scheme).

Generators will need to provide collateral under the FIT CfD in order to manage settlement risks, which may take the form of cash or a letter of credit. The amount of collateral will be determined later.

Conditions Precedent within the HoTs

- Evidence of the generator's and project's compliance with eligibility criteria for the award of a FIT CfD.
- A copy of the detailed planning permission for the "facility"- it is not clear whether development associated with the project will also need to be consented, and it is questionable whether it is feasible for a project to have detailed planning permission when many technical and design details will be unknown in the early stages.
- Copies of all "required authorisations" for the project – although some permits, such as an environmental permit for a biomass plant, may not typically be granted until later in the development phase.
- The Interim Operational Notification in respect of connection to the transmission system has been received, or confirmation must instead be given that the project is connected to the distribution system.
- Confirmation from the Settlement Agent that it has all the data needed to process payments under the FIT CfD
- Evidence that all metering equipment has been installed and meets the relevant criteria.
- Evidence that the installed capacity of the facility is at least a certain percentage (to be determined) of the size which the generator and the FIT counterparty envisaged when signing the CIT CfD.
- Evidence that the required collateral has been provided by the generator.

Change Provisions

The HoTs contain provisions for the variation of the FIT CfDs in certain circumstances to allow a response to unforeseen events – most obviously changes in law and relevant regulations, including industry codes which have a material impact on the project. Critically, low carbon projects will not be insulated from all changes in law – only those which specifically impact the project itself or those in a similar class. The FIT CfD will not be amended to take account of changes which impact the energy industry generally. DECC currently proposes that adverse changes will be compensated by an amendment (upwards) to the strike price. The Government does not appear to propose a reduction in the strike price, although industry may well seek for this to be expressly stated.

Although not currently in the HoTs, DECC has noted that it is considering a refinancing provision, whereby established projects which refinance (and in doing so reduce their costs) may be required to "share a proportion of any refinancing gains received with consumers". This would be a new concept to renewable energy projects – the Renewables Obligation has never proposed a reduction in Renewables Obligation Certificates (ROCs) in circumstances where the generator found cheaper sources of finance; and it is likely to be highly controversial if implemented.

General Obligations

The HoTs propose detailed representations, warranties and undertakings on both the generator and the FIT Counterparty. DECC's rationale is that consumers would expect all projects in receipt of support to provide certain ongoing assurances about its status and compliance with laws. Generators will be used to giving similar covenants to their finance providers. However, in such cases, generators have the comfort that they can negotiate the drafting in the understanding that breaches from time to time will be assessed rationally by a commercial counterparty, i.e. its funder (and that termination is unlikely to be automatic). Few generators will be able to warrant at signing of the FIT CfD that they have every single consent necessary for the project and that all conditions have been complied with; equally warranting that no affiliates of the generator are threatened with litigation could prove problematic. Doubtless the HoTs will be developed by DECC and industry over the coming months and most drafting points should be capable of being ironed out.

Although the HoTs restrict the assignment of the benefit of the FIT CfD without consent of the FIT Counterparty, generators will be pleased to note that the HoTs contain a duty on the FIT Counterparty to enter into a direct agreement with the generator's debt funders upon request.

Electricity Demand Reduction (EDR) consultation

Whilst the Energy Bill concentrates on generation of energy, a consultation paper has also been published on possible measures to stimulate electricity demand reduction. DECC notes that, strikingly, whilst overall energy demand has been steady since 1970, electricity consumption has risen by over 65%. There are already a number of existing or pending policy measures to encourage reductions in demand (e.g. CRC Energy Efficiency Scheme, Energy Company Obligation, CERT) and DECC has carried out gap analysis to identify where additional measures might be helpful in various sectors.

The new measures have been considered in the light of detailed analysis on the low take-up of energy efficiency measures which identified a number of key barriers to implementation. These include: hidden costs or lack of capital; split incentives[1] ; having inadequate information or disregarding energy efficiency in decision-making, risks and uncertainties involved and unacceptable payback periods. Because different sectors suffer these issues in different ways, DECC is considering measures on a sectoral basis: looking at the domestic and non-domestic buildings sectors, domestic and non-domestic products and appliances, industrial processes.

The most significant proposal is for a possible new financial incentive for energy efficiency. Two alternative approaches have been suggested:

Targeted Financial Incentive Scheme

This would provide financial support for replacement of prescribed technologies or a contribution towards the costs of energy efficient systems (e.g. lighting and air conditioning) i.e. similar to the recent boiler scrappage scheme. The scheme would provide a list of qualifying products and payment would arise as a one-off up-front payment and/or a series of payments over time. A list of eligible participants would be drawn up and they would apply to a scheme administrator for payment.

DECC feels this mechanism could benefit the non-domestic building sector although there are concerns as to the extent this might duplicate the CRC Energy Efficiency Scheme, Climate Change Agreements and Green Deal finance. It might also be useful for industrial processes subject to concerns over interaction with Enhanced Capital Allowances scheme and the eco-design regulations and whether replacement of systems is always the best option (as opposed to re-configuration). Domestic / non-domestic products sectors could also receive this support.

General concerns with this sort of measure are that they do not necessarily encourage energy savings, just the replacement of equipment. On the other hand, schemes such as the market-wide financial incentives scheme concentrate on the actual savings made.

---

1. This is where the party responsible for costs of implementation is different from the party that would receive the benefits of the measures implemented (and reduction in costs), e.g. landlords and tenants.

Market-wide Financial Incentives

An alternative incentive approach is offered which could apply to any of the sectors (but possibly implemented in different ways for each sector) and which would rather focus on the energy savings achieved rather than being related to implementation of specified technologies.

Three alternative options are floated:

1. *Premium Payment for Electricity Efficiency*

In this option, energy customers (EDR providers) would be paid a premium payment representing reduced use of electricity – this would be similar to a FiT mechanism. It would either be achieved by:

- a single payment for every kWh saved up to an agreed level; or
- a premium payment with a Contract for Difference. Similarly to how the FiT CfD is intended to work, but in reverse, EDR providers would receive a top-up payment above the electricity price for every kWh saved up to an agreed strike price. If the electricity price exceeds the strike price, a payment back to the scheme would have to be made. This is seen as a more stable option for investment than a single payment mechanism.

In each option, the price to be received by EDR providers would be subject to an auction. A significant amount of further work would need to be put in to scheme design (e.g. in relation to auction design, operation of the scheme and, for a CfD based scheme, determining the electricity reference price).

2. *Inclusion of Electricity Efficiency in the Capacity Market*

This option would involve electricity efficiency measures being included alongside DSR and electricity storage in the Capacity Market. Similar considerations to the premium payment would apply and, similarly, auctioning would probably be used.

3. *Energy Supplier Obligation for Electricity Efficiency*

This option would involve an obligation on energy suppliers to achieve a certain target of electricity demand reduction in the non-domestic sector from their customers[2]. This could be done by working with customers either directly or through third party companies (e.g. ESCOs) or auctions could be run to deliver the required savings.

An independent body would identify allowable measures; suppliers or EDR providers would be issued with certificates representing the savings which could then be traded through open markets or otherwise (similar to the White Certificate scheme operating in Italy).

Each of the above three options will require further work on measurement, verification of energy savings and additionality of those savings (i.e. ensuring that those savings are real and would not have occurred in the "business as usual" scenario). DECC envisages that standards for measurement and verification of savings would be set centrally and would either be based on pre-installation estimations or post-installation measurement (or a mixture of the two). The need to demonstrate additionality has a well-trodden, although not always happy, history in the emissions trading sector, and DECC is looking to routes provided by the UNFCCC Clean Development Mechanism in this regard[3]. DECC considers that the level of financial support provided could be weighted towards the level of additionality achieved.

---

2. This approach would be similar to the Energy Company Obligation being implemented for domestic customers at the end of 2012.

3. This would look at whether projects would be prevented by other non-financial barriers, whether projects are already standard practice and whether significant numbers of "free riders" are anticipated based on experience.

Generators are likely to be concerned that any support given through a market-based incentive will be subject to the Government's Levy Control Framework. As such, the amount of support offered for electricity demand reduction is likely to reduce support provided through other incentives for low carbon generation funded by levy on consumers.

Further potential measures

DECC has not stopped at financial incentives but is looking at a number of other areas to encourage energy efficiency in these sectors including voluntary agreements, labelling requirements, and other possibilities of providing loan finance.

Responses to the EDR consultation must be received by 31 January 2013.

Capacity Market

While work continues on many aspects of the proposed auction-based capacity mechanism, some further detail has been published in an annex to DECC's EMR Policy Overview.

The basic structure for the capacity mechanism would see publication of a forecast of peak demand made 4 years ahead of the relevant delivery year on a rolling basis (the first forecast being expected at the end of 2013). DECC plans to hold the first capacity auction in 2014 to allow for delivery of capacity in winter 2018 / 2019. National Grid (as system operator) will then operate an annual central auction to secure the net amount of required capacity.

DECC has opened up the capacity mechanism widely to operators:

- new and existing capacity will qualify;
- Demand Side Response and storage will all qualify to participate and will benefit from additional transitional provisions;
- Interconnected capacity might qualify subject to further work;
- Capacity covered by the Electricity Demand Reduction consultation might qualify (see Electricity Demand Reduction consultation above);
- The eligibility of Carbon Capture and Storage (CCS) equipment which is turned off at times of stress is also being considered;
- Generation covered by FiT CfD will not qualify since such generation this is considered to be adequately compensated already, but it is undecided as to whether Renewables Obligation capacity could be included.

Other features of the mechanism include:

- National Grid will carry out pre-qualification checks to ensure that individual operators have the relevant capacity;
- DECC currently favours a "pay-as-clear" method of auctioning whereby all successful bidders receive the highest successful bid price;
- Contracts with successful bidders will be based on a single capacity product. Existing plants would have a one year price and obligation but others might be able to choose a length of contract between 1 and 10 years;
- Payments would be made based on a "delivered energy" model whereby providers are obliged to deliver energy or reduce demand in actual situations of stress on the system. If they are not able to fully provide their capacity, a financial penalty will be imposed;

Capacity Market

A Capacity Market is a mechanism to ensure adequacy of electricity supply at all times. It does this by procuring commitments from generators to be ready to provide generation capacity at times of stress during the committed period, and rewarding them by paying generators for making that capacity available.

- Suppliers will make payments to capacity providers on a daily basis through a settlement agency and the system would be governed on a similar basis to the Balancing and Settlement Code;
- Capacity payment costs will be shared between electricity suppliers in the delivery year but how these will be apportioned has yet to be decided.

A number of elements of the scheme remain to be worked up including on eligibility rules, auction design, penalties, payment, and reliability standards. DECC makes a point that final details of the scheme may continue to change as the energy market evolves but would be fixed by May 2013.

Other areas of action

Emissions Performance Standard

As anticipated, the Bill contains provision for Emissions Performance Standard (EPS) which will limit annual carbon dioxide emissions allowed from new fossil fuel power stations, equivalent to 450g/kWh operating at baseload. At this level, the EPS will prevent new coal capacity coming online without CCS but will not have any real impact on gas capacity.

Decarbonisation Target

Many commentators had hoped that the draft Bill would also include powers to set decarbonisation targets for the power sector for 2030. However, the Government announced on 29 November 2012 that the decision on these powers would be taken once the Government has set the 5th Carbon Budget for 2028-2033, following advice from the Committee on Climate Change in 2016.

ROC Purchasing Scheme

The Bill also contains recently announced powers for Government's ROC scheme which will require Ofgem, the SoS or FIT Counterparties to purchase ROCs at a fixed price to ensure that a market still exists for ROCs once the Renewables Obligation is phased out from 2017. This is subject to further consultation.

In addition to the main components of the EMR package, the Government has also published a suite of other documents relating to energy and climate change policy which add colour to the legislative proposals in the Bill, but provide little further guidance about how the key aspects will work in practice.

National Grid Conflicts

In particular, the Government is assessing the extent of conflicts National Grid could be subject to from its varying roles in delivering the EMR, including CfDs, administering the Capacity Market and providing analysis and evidence to the Government. The deadline for responses on this consultation (which also looks at possible synergies) is 29 January 2013.

Energy Security Strategy

The Government is carrying out a wider review on the security of energy supply. It is primarily concerned about ensuring physical security (ensuring consumers have access to gas and electricity and price security) and avoiding excessive volatility in prices.

DECC and Ofgem have published reports directed at ensuring the policy framework is in place to ensure the availability of electricity and gas to meet the demands of Consumers. These reports will be considered by the Government as part of its wider review.

In relation to electricity, the reports highlight (unsurprisingly) that while the transmission network is reliable, new investment is needed in transmission and distribution assets to ensure the future security of supply. In relation to gas, the Government has announced that it will publish its findings on whether there is a case for providing support for gas storage in Spring 2013.

Government Response to Consultation on Consumer Redress

Significant media attention has focused on the Prime Minister's announcement in October that the Government will legislate "so that energy companies have to give the lowest tariff to their customers".

There are no provisions in the Bill to ensure the lowest tariffs are paid. However, the Government has published its response to the consultation on the proposal to provide Ofgem with a new power to make a Consumer Redress Order requiring energy companies in breach of their licence or other obligations to provide redress to customers who suffer financial loss. The Government intends to bring forward the necessary legislation in the Bill.

Final Comments

The publication of the Energy Bill and accompanying documents should give comfort that Government is working hard on developing the proposals. However, it also gives a sense of just how much detail there is still to be worked up, consulted on and finalised. The EMR Roadmap does, however, appear to show that the timescales are achievable and this should give cheer to investors in the power sector, and in particular the renewables and nuclear sectors. Gas-fired power generators will also take heart from the capacity mechanism and will eagerly await the publication of the Government's gas strategy in early December.

The Electricity Demand Reduction consultation is also welcome in its desire to fill the gaps in an area that has much untapped potential. The principal challenge is to ensure that new measures do not confuse or overlap unhelpfully with existing measures, an issue that has already affected schemes such as the CRC Energy Efficiency Scheme and Climate Change Agreements. The potential gains are so great, however, that the additional work should be worth the effort.

We have set out in the Annex to this briefing an implementation timetable for EMR based on the Government's latest announcements.

ANNEX
Proposed Implementation Timetable

Date	Development
January 2013	Close of consultation on ensuring a better deal for energy consumers
January 2013	Close of the call for evidence on the proposed approach for the supplier obligation
January 2013	Close of Government and Ofgem's consultation on potential conflicts of interest associated with the System Operator assuming the EMR delivery role
January 2013	Appointment of Panel of Technical Experts
January 2013	Close of call for evidence on electricity demand reduction
March 2013	Launch of consultation on regulations for the transition period from the RO to the CfD (allowing new generators a choice of scheme)
Spring 2013	Report from Ofgem and HMG on the potential for conflicts of interest associated with the System Operator assuming the EMR delivery role
April 2013	Introduction of carbon floor price
May 2013	Final design proposals published for capacity market
July 2013	Further details on supplier obligation published
	CfD final contract published
	Consultation on published draft delivery plan, including draft renewable CfD strike prices
	Further detail provided on CfD allocation and price setting processes for CCS and nuclear projects after close of CCS completion/Final Investment Decision (FID) enabling process
September 2013	Government response to consultation on the transition period from the RO to the CfD (allowing new generators a choice of scheme)
October 2013	Consultation on the detailed design of the capacity mechanism
October 2013 onwards	Consultations on secondary legislation for EMR
By end 2013	Energy Bill receives Royal Assent (subject to Parliamentary time and will)
By end 2013 (provided Royal Assent has been given)	Publication of first delivery plan, including CfD strike prices
2014	EMR delivery mechanisms in place and in effect
2016 onwards	Advice from Climate Change Committee on 5th Carbon Budget, to be followed in due course by the setting of the Carbon Budget and a decision on powers to set a decarbonisation range for the power sector for 2030.

Notes

Notes

Authors

Nigel Howorth
Partner

Nigel is head of the Firm's Environment & Planning Group and specialises in the planning aspects of infrastructure projects and transactions

T: +44 20 7006 4076
E: nigel.howorth
@cliffordchance.com

Ben Stansfield
Senior Associate

Ben is a lawyer specialising in large power and infrastructure projects with a particular specialism in energy regulatory matters.

T: +44 20 7006 4507
E: ben.stansfield
@cliffordchance.com

Michael Coxall
Senior Professional Support Lawyer

Michael is a lawyer in the Firm's Environment & Planning Group and specialises in legislative and regulatory changes in planning and public law.

T: 44 20 7006 4315
E: michael.coxall
@cliffordchance.com