# Electricity Market Reform Update

December 2012

The UK government introduced a bill in parliament last week, which includes range of measures to promote low carbon power generation between now and 2020, as part of its Electricity Market Reform (EMR) package. The bill is slated to have two parliamentary debates before the end of 2012, with the aim of passing early in 2013 and achieving Royal Assent late 2013, thereby becoming legislated.

The EMR will bring about the largest transformation in the UK's electricity market since its privatisation. The reforms introduce two key mechanisms: Contracts for Difference and the powers to implement a Capacity Market. These aim to attract the estimated £110bn of private sector investment needed by 2020 to provide a more diverse and low-carbon energy mix. It is expected that the EMR will be closely observed by other European member states facing similar issues.

The current bill addresses a number of key issues such as Contract-for-Difference (CfD) strike prices and the establishment of a government-owned limited liability company to act as the CfD counterparty. However, there remain some unresolved items that are expected to be determined through further consultations and secondary legislation. These include: strike price levels for each renewable technology; the allocation process of the subsidy pot, route to market and market liquidity.

***What the bill proposes***

The reforms introduce two key mechanisms: CfD and the powers to implement a Capacity Market that will help to attract the £110 billion of private sector investment needed to replace ageing energy infrastructure with a more diverse and low-carbon energy mix. The CfD's are a form of low carbon generation subsidy with two revenue streams. The first is the variable revenues from the electricity sales in the wholesale market, with the second being a top-up or top-down payment calculated as the difference between the market wholesale price (the reference price) and an agreed strike price. The Capacity Market will provide out of market payments to peaking and flexible plants to ensure the security of supply in a system with significant renewable energy sources. Already through the EMR, an Emissions Performance Standard (EPS) has been introduced ensuring that any new coal fired power stations will have to have CCS fitted to be able to operate within limit. Furthermore the UK government has already legislated to establish a Carbon Price Floor from April 2013.

***Solidifies the commitment of the UK government to renewable energy investment***

The current government target for low-carbon energy generation by 2020 is expected to be followed by an additional target for 2030. The government is looking assume powers to set a carbon intensity reduction range for the electricity sector to 2030. However, a decision to exercise this power will not be taken until after the next general election in 2015.
The Levy Control Framework (LCF), which is a cap on how much money is allowed to be channelled to low carbon sources from consumer electricity bills, is expected to increase significantly from the current level of £2.35bn in 2012/13 to £7.6bn in real terms in 2020/21.

***Expected implementation timeframe***

Subject to parliamentary debate, the energy bill is expected to achieve Royal Assent by the end of 2013. During this time, additional clauses may be added as a result of a number of government consultations including proposals to promote energy efficiency through Electricity Demand Reduction. There is expected to be a secondary legislation (on issues still undetermined) starting on October 2013.

CfDs are available for investors in renewable energy, new nuclear or CCS. The government will consult on the first range of CfD strike prices, which largely determine the overall level of support, for renewables in mid-2013 and expects to be able to announce the 2013-2018 prices by the end of 2013.

The UK government is inclined to run the first Capacity Market auction in 2014. Capacity providers who are successful in this auction may be required to provide capacity from the winter of 2018/19. For renewables, generators will have to decide whether to apply under the CfD or the capacity market but they will not have access to both.

***Why the UK government is undertaking this objective***

EMR is designed to deliver £110 billion of investments in the low carbon electricity sector to 2020. This amount represents almost half of the infrastructure investment needed in the UK and is expected to kick-start a renaissance in construction of low-carbon energy infrastructure and manufacturing supply-chains. As a result, we feel that this will also provide significant investment opportunities for institutional investors, with a significant expected pipeline of projects becoming available for investment during the construction and operational phases.

***When this investment is needed (timeframe)***

The amount of market support to be available for low carbon electricity investment (under the Levy Control Framework) up to 2020 has also been agreed. This will be set at £7.6 billion (real 2012 prices) in 2020.

***Risks that have been addressed and those still outstanding***

A number of issues have been decided, such as the establishment of a government-owned limited liability company as the CfD Counterparty (CP) and granting the government powers to establish a capacity mechanism.

However, a large number of issues remain unresolved and these will be determined through consultations and secondary legislation, with the most important being:

- The strike price level for each technology, duration of the CfDs (expected to be 15 years), definition of the reference price and level/type of indexation (most likely to be CPI)
- Principles for the allocation process of the subsidy scheme (first come first served vs allocation rounds)
- Provisions for route to market access and market liquidity for merchant generators (If PPA availability is not addressed there is potential for significant basis risk between PPA price and reference price)

***PCCP commentary***

While several significant details have yet to be determined this parliamentary submission of the EMR bill provides some clarity and more importantly commitment by the UK government to low carbon generation build-out and investors.

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