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ENERGY PRICES BILL: UNPRECEDENTED INTERVENTION IN UK ENERGY MARKETS

BRIEFING

The UK Government introduced the Energy Prices Bill in Parliament on 12 October 2022, launching a raft of measures that represent a level of intervention in the UK energy market not seen since privatisation more than 30 years ago. In this article, we consider some of the key aspects of the Bill for energy market participants and investors.

Introduction

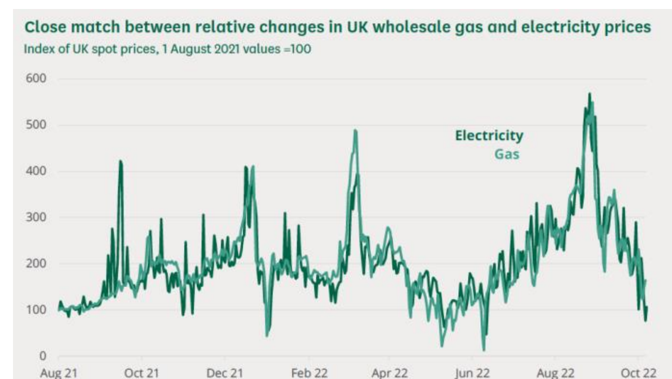
Energy markets globally remain in significant flux. The UK Government—along with many others around the world—has introduced a raft of unprecedented laws and policies to address the effects of three lingering global economic forces: Russia's invasion of Ukraine, inflationary pressures, and an economic downturn in China. The complex interconnectivities of the global economic system make designing domestic policies difficult and governments trying to insulate their populations from these destabilising global conditions encounter difficult trade-offs. On one hand, they must ensure adequate protections from significant real income losses for their populations, while on the other hand ensuring uninterrupted access to energy, maintaining investor and market confidence, and pursuing decarbonisation objectives.

Seeking to balance these concerns, the UK Government introduced the Energy Prices Bill ("the Bill") in Parliament on 12 October 2022. Despite political upheaval in the UK, the legislation has progressed swiftly through Parliament under the process for emergency legislation, although it remains to be seen whether it might be altered under new leadership. The Bill proposes to legislate for several new, and previously announced, short-term measures aimed at reducing UK energy prices and inflationary pressures. In this briefing, we consider some key aspects of the Bill:

- the energy price caps for businesses and households;
- the restrictions on the revenue that may be earned by certain electricity generators, called the "cost-plus revenue limit" ("CPRL") measure;
- the measure to allow generators to voluntarily move to the contracts for difference ("CfD") scheme; and
- the delegated powers sought by the Secretary of State.

Why is intervention necessary?

The global energy crisis, compounded by the Russian invasion of Ukraine and its repercussions for trade relations between Russia and Western Europe, has resulted in significant increases in gas prices. But in the UK and in Europe, despite the significant deployment of renewable and nuclear electricity generation, electricity prices have risen also, closely correlated with gas prices (see graph).



Source: House of Commons Library (2022)

The gas price typically sets wholesale electricity prices in Great Britain. In the day-ahead markets on traded exchanges, the last, most expensive, marginal unit of generation sets the clearing price for the settlement period. Gas-fired electricity generation—with its high fuel cost inputs—is often called upon to generate last in the electricity merit order and so tends to be the marginal cost unit of generation at times of peak demand. As gas prices increase, so do the costs of gas-fired electricity generation and, therefore, wholesale electricity prices.

It should be noted, however, that not all electricity is traded on exchanges. Significant volumes are sold by generators bilaterally under power purchase agreements ("PPAs"), often years in advance of delivery. The pricing under these PPAs may vary - some may provide for a discount to a price quoted on a traded exchange (and so will be tracking the current high wholesale market prices at a discount), whilst others may provide for a fixed price

or use a cap and collar to limit exposure to wholesale price fluctuations.

Despite the UK's energy price cap policy providing some protection for customers on default energy tariffs, predicted average annual household energy bills were expected to increase from £1,971 per year to £3,549 on 1 October 2022. A further increase, to £4,200 per year for an average household, was expected in January 2023. Unaffordable to many consumers, these price rises also add to inflationary pressures. By reducing real incomes and undermining macroeconomic stability, high energy prices remain an immediate threat to the UK's current and future prosperity. In response, the Bill both puts measures already underway to protect consumers on a statutory footing and seeks to "decouple electricity prices from the gas price".

Demand-Side measures

Energy Bill Relief Scheme and Energy Price Guarantee

The Bill formalises arrangements already agreed with energy suppliers. It gives the Secretary of State power to cap energy bills for household and non-household energy consumers. For non-domestic customers, the Energy Bill Relief Scheme provides a cap for six months, from 1 October 2022 to 31 March 2023. This cap will apply to all fixed contracts agreed on or after 1 April 2022, as well as deemed, variable, and flexible tariffs and contracts. The Government will implement the cap through a supported price. This expected price is £211 per MWh (21.1p per kWh) for electricity, and £75 per MWh (7.5p per kWh) for gas. These are less than 50% of this winter's anticipated wholesale prices. Average UK electricity and gas contracts—for delivery between October and March—are currently trading at around £490 per MWh and £170 per MWh, respectively.

Non-household customers on fixed contracts will see their per unit energy costs automatically reduce by the applicable per kWh discount, for the scheme's duration. By contrast, customers on default or variable tariffs will receive a per-unit discount on their energy costs, up to a maximum of the difference between the Supported Wholesale Price and the average expected wholesale price. The Government estimates that the per unit discount will amount to "around £405 per MWh for electricity and £115 per MWh for gas, subject to wholesale market developments". This maximum discount on variable bills effectively limits the Government's risk of taking on completely uncapped liabilities.

Furthermore, for businesses on flexible purchase contracts, energy suppliers will need to calculate the level of reduction according to the individual businesses' contracts, subject to the maximum discount underwritten by the Government. Non-household customers using heating oils or alternative fuels, and not connected to either the electricity or gas grid, will also be eligible for "equivalent support" (the details of which the Government will announce shortly).

The Bill enables similar protection for household consumers via an Energy Price Guarantee ("EPG").[1] The EPG applies to the unit cost of energy so that a typical UK household will pay around £2,500 a year on their energy bill for the next two years, although it was announced on 17 October 2022 that the measures will be reviewed in April 2023 and more targeted support considered. The Bill also includes provisions for Ofgem to monitor and enforce the EPG.

Whilst the need for intervention is widely acknowledged, some commentators have observed that, by suppressing the pass-through of the current high gas prices to retail prices, these measures may lead to misallocation of energy away from socially valuable uses (such as industry and heating inhabited homes) to less valuable uses (such as heating swimming pools and unused property). In addition, because consumers are not exposed to the true cost of energy, they are less incentivised to reduce demand and enhance efficiency.

Supply-side measures

To temporarily decouple high gas prices from electricity generators' revenues, the Bill introduces what it calls a "Cost-Plus Revenue Limit". More specifically, the Bill provides extensive powers for the Government to set a temporary fixed price for low-carbon generators, which are not already parties to fixed revenues through CfDs.[2] The Government's intention is to limit the revenues generators can achieve in the wholesale market, and ameliorate the effects of abnormally high wholesale prices on consumers. In announcing the measure, the Government stated that generators will continue to receive their "existing revenue support or subsidy payments", including Renewable Obligation Certificates ("ROCs").

Cost-Plus Revenue Limit

Under the Bill, the CPRL is effective for a maximum of 5 years from the Act's passing.[3] However, the Government anticipates a potentially shorter duration in its announcement that the measure will "endure until such time as the markets return to normal or generators move onto other market arrangements, such as a Contract for Difference". The Government will prescribe the scope of electricity generators captured by the CPRL, the CPRL's commencement date (likely to be from the beginning of 2023), and the revenue limit in secondary legislation. The Government considers its extensive powers under the Bill justified, on the basis that those are time-limited powers

[1] Clauses 1 to 8, Energy Prices Bill 2022.

[2] Clause 16 (Temporary requirement for electricity generators to make payments), Energy Prices Bill 2022.

[3] Schedule 6, clause 8(1), Energy Prices Bill 2022.

and subject to periodic review.[4] Industry bodies such as RenewableUK have however expressed concern that the measure might deter investment in the UK renewables sector.

The CPRL may allow differentiation for biomass and nuclear generators. The Government has emphasised "the importance of dispatchable and baseload generation for security of supply". It recognises that low-carbon technologies capable of delivering this type of power—including biomass and nuclear—tend to have higher input costs, and notes it is considering these factors "as part of the detailed policy design". Indeed, the Bill enables the Government to determine the technologies and circumstances under which it is most suitable to impose the CPRL.[5] With this, the Government's stated intention is to ensure that the CPRL remains "targeted", "proportionate", and limits any unnecessary deprivation of property in its aims to alleviate the severity of elevated energy prices on the public.[6]

The CPRL proposals differ significantly to the UK's intervention in respect of oil and gas profits. In May 2022, the Government introduced the Energy (Oil and Gas) Profits Levy (the "Levy") of 25% on oil and gas company profits from UK upstream activities.[7] However, affected companies can apply an investment allowance of 80%, as a tax deduction, on capital expenditure, as well as some operating and leasing expenditure. For further information on the Levy, please see our European Tax blog post. While the Government considered extending the Levy to electricity generators,[8] it eventually dismissed such a measure as prohibitively complex. Instead, it considers the CPRL a more effective and efficient measure for the electricity generation sector.

Nevertheless, some stakeholders are framing the CPRL as "a temporary windfall tax on the sector's profits", albeit without any accompanying investment incentives. Other commentators estimate the measure could raise an additional £4 billion to £14 billion in government revenues.

Industry will be considering how the detailed measures compare with those implemented by other countries. For example, on 30 September 2022, the European Union energy ministers agreed a limit on wind, solar, and nuclear power generation company revenues to €180 per MWh. This European revenue limit will apply from December 2022, until the end of June 2023. The European measures will apply to all market segments, but only to realised market revenues (and so are expected to take account of hedging arrangements and different PPA pricing structures). Details of the measures are found here.

UK electricity generators will need to wait for the Government to publish its consultation on the secondary legislation for key details such as the level of the cap, the volumes and the generators affected. In addition, by significantly altering the pre-existing regulatory framework, the CPRL might have repercussions on existing projects and their financing arrangements. For example, the CPRL might trigger "change in law" and "material adverse change" provisions. It is also unclear how the measures will interact with revenue sharing arrangements or a generator's power hedging arrangements. Separately, the CPRL may also enliven potential claims under international investment agreements—such as the Energy Charter Treaty—that the UK Government breached obligations to ensure fair and equitable treatment to investors.

Much will depend on the detailed methodology for calculating the revenue limit, how that revenue limit deviates from similar measures in the EU or other trading partner countries, how it accounts for individual generators' energy trading arrangements, and the extent to which it significantly impedes investment incentives. Nonetheless, a temporary and periodically reviewable CPRL, targeted only at reducing extraordinary profits, and set at a comparable level to trading partners, is likely to weaken potential claims against it.

Upon passing of the Bill, an "affirmative procedure"—requiring active approval by both Houses of Parliament—will apply to the first set of regulations made under the Bill's powers.[9] However, a "negative procedure" will apply to subsequent regulations, which automatically become law, unless rejected by either House within 40 sitting days.[10] This potentially gives the Secretary of State wide powers to designate new categories of generator, limiting the scope for Parliamentary scrutiny.

Voluntary CfDs

One option introduced by the Bill to avoid the CPRL is to take up the offer by government to move to a CfD in 2023. CfDs are already in place as the support scheme for the Hinckley Point C nuclear power plant and for a number of new-build renewable electricity generation projects. CfDs were introduced under the Energy Act 2013 to replace the previous renewable premium support scheme, the Renewables Obligation ("RO"). The Bill

[4] Paragraph 33, Energy Prices Bill 2022: Explanatory Note.

[5] Paragraph 41, Energy Prices Bill – European Convention on Human Rights – Memorandum from the Department for Business, Energy and Industrial Strategy.

[6] Paragraph 41, Energy Prices Bill – European Convention on Human Rights – Memorandum from the Department for Business, Energy and Industrial Strategy.

[7] Energy (Oil and Gas) Profits Levy Act 2022.

[8] Treasury Committee, Oral evidence: The cost of living, HC 343.

[9] Clause 16(7), Energy Prices Bill 2022.

[10] Clause 16(8), Energy Prices Bill 2022.

amends the Energy Act 2013 to provide for powers to enable CfDs to be offered to existing generators as well.

CfDs are designed to reduce a generator's exposure to electricity market price risk by effectively providing a fixed price for the electricity generated. So, although a generator with a CfD must still sell its power in the market, the generator receives a top up when the electricity market reference price is below the contractual strike price under the CfD. However, where the electricity market reference price exceeds the strike price, a generator must pay back the sums received in excess of the strike price. At times of high power prices, projects with a CfD are effectively paying money back under their CfD. In winter 2022, £140.4m was paid by generators to the Low Carbon Contracts Company, the government owned counterparty to the CfD. For historical CFD payment data, see here.

By contrast, under the previous, RO support scheme, RO generators receive a premium payment for 20 years *in addition* to the price they receive for selling the power generated. This premium is recovered by placing an obligation on electricity suppliers requiring them to purchase tradable ROCs awarded to accredited generators according to the MWhs of renewable electricity generated. If a supplier fails to surrender sufficient ROCs at the end of the compliance year, it must pay a penalty established under regulation called the buy-out price (currently set at £52.88 per ROC for the year 2022/23). This penalty effectively underpins the value of ROCs. As a result, at times of high power prices, RO accredited generators receive very significantly more revenue than a CfD generator. The UK Energy Research Centre assessed possible savings under a similar policy in its "Pot Zero" proposal (see here). Under this proposal, it was suggested that moving RO generators to a CfD might result in savings from £4.9bn per year if 50% of eligible wind and solar power plants were to take part, to £12.8bn per year if 100% participated. Higher savings were considered possible if more classes of generator such as existing nuclear and other renewables are included.

However, the mandatory withdrawal of ROCs may be susceptible to challenge on the grounds that it would constitute interference with a vested property right. A mandatory withdrawal of ROCs would also undermine the principle of grandfathering which underpins a number of UK government support regimes, undermining investor confidence and deterring the private investment needed to reach net zero by 2050.

Instead, the proposed transfer scheme is voluntary. But why would an RO accredited generator give up such lucrative power prices? Some RO accredited projects may take up the offer by virtue of the fact that they are approaching the end of their 20-year RO subsidy period and need sufficient revenue certainty to enable them to raise finance to repower or refurbish the project. Others may be incentivised to do so simply in order to secure the long-term revenue certainty of the CfD. The proposals were cautiously welcomed by RenewableUK, a trade association representing certain renewable generators in the UK. The price certainty offered by a CfD may not be attractive for every renewable generator however, particularly those with the expertise and investor appetite to manage electricity market price risk.

For those generators considering the transition to a CfD, the level of the strike price will be a key issue. More detail will be set out in consultation, however the government announcement suggests that generators may also continue to receive their existing revenue support or subsidy payments, for example ROCs, in order to preserve market stability.

Some generators, depending on their power marketing strategy, will also need to consider the implications for their energy marketing strategy such as amending their PPAs to refer to the market reference price under the CfD or the impact on any power hedging arrangements in place (including break costs if these are no longer required).

Generators will also wish to understand the differences between the RO and CfD schemes. For example, unlike the RO where ROCs are awarded even at times of low demand when power prices are negative, no difference payment is payable under the CfD during such times (under the Standard Terms applicable to allocation round 4).

Finally, industry will also be keen to understand whether CfDs for existing projects will be entered into with the Low Carbon Contracts Company or with another entity designated by the Secretary of State and how any payments due from the CfD counterparty will be funded by government. More details are expected to be set out in a consultation regarding the associated secondary legislation.

Forward looking to REMA

The CPRL is intended to be an interim measure prior to the conclusion of the UK Government's Review of Electricity Market Arrangements ("REMA") initiative, which was launched in July 2022 (for full details, please see our previous briefing here).

REMA's aim is to ensure that the electricity market in Great Britain is capable of achieving the Government's goal of full decarbonisation by 2035. Without reform, in the longer term, as the amount of renewable generation increases, renewable plants with low operating costs will increasingly push flexible assets, with higher operating costs, out of the market. These flexible assets will need to recoup their costs within a smaller time period when renewable output is low, making new investment uncertain. At the same time, renewable generators will face lower market prices when renewable output is high. During periods when the wind is blowing and the sun is shining, their similar output patterns and low operating costs will increasingly drive down wholesale market prices, referred to as "price cannibalisation".

Whilst REMA is generally regarded as necessary, the options under consideration will most likely entail

significant changes to the electricity market in Great Britain if implemented, altering the investment landscape for both existing and new generators. A number of options under consideration include proposals which would decouple electricity prices from the gas price. For example, consideration is being given to splitting the electricity market so as to distinguish dispatchable and variable generation.

Other measures

Finally the Bill gives the Secretary of State wide-ranging delegated powers. The Memorandum submitted to the Delegated Powers and Regulatory Reform Committee ("the Memorandum") highlights a number of areas where the government will be taking extraordinary powers.

Section 13(1) provides that the Secretary of State may take such steps "as are considered appropriate to (a) provide support for meeting costs related to the use of energy; (b) enable or encourage the efficient use of energy; (c) provide support for meeting costs related to the supply of energy; (d) enable or encourage the supply of energy". Section 13(2) further provides the Secretary of State with powers to take steps which the Secretary of State considers appropriate in response to the energy crisis. Whilst section 13(3) lists a number of purposes that these powers may be used for, these are widely drafted and non-exhaustive. And although the powers are time-limited for a three and a half years period from entry into force of the legislation, this may be further extended by regulation. Actions in response to the energy crisis are further restricted by section 14, which limits the expenditure incurred in relation to any one project to £100 million without the approval of the House of Commons. However, this requirement for approval may be overridden if the Secretary of State considers the exercise of the power is urgent.

Section 21 goes further and permits the Secretary of State to amend British and Northern Irish energy licences or industry documents maintained under these licences in response to the energy crisis, bypassing Ofgem and established, industry-led governance processes. Section 22 also allows the Secretary of State to give directions to energy licence holders in response to the energy crisis. Whilst the Memorandum anticipates that these powers are to be used to integrate, implement and enforce the consumer support schemes, the powers granted by the Bill are potentially significantly wider. Where measures are brought in without due process and adequate consultation of affected parties, the risk of judicial review is heightened, particularly where any measures impact vested property rights.

Conclusion

If passed in its current form, the Bill would permit an unprecedented level of intervention in energy markets not seen since privatisation. It places the EPG and the Energy Bill Relief Scheme on a statutory footing and so is a vital piece of legislation for UK energy consumers struggling with the rising cost of energy. However, industry will be watching closely to see how the CPRL proposals develop and the extent to which the wide-ranging delegated powers sought are amended as the Bill progresses through Parliament. It is clear, however, that the Government must tread carefully to maintain investor confidence which will deliver much needed investment for the low carbon energy system.

If you wish to discuss any of the issues arising from this briefing, please get in touch with your usual Slaughter and May contact.

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