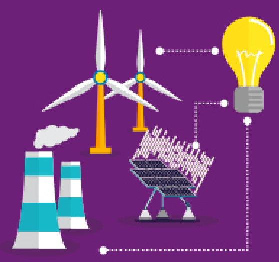
What does the Boris Johnson Government mean for energy?



Key points

- The big question in UK energy policy remains how to get to a Net Zero carbon economy by 2050;
- Government has issued a series of consultations on specific energy policy issues, including new funding models for nuclear and Carbon Capture Utilisation and Storage (CCUS), which they see as essential for meeting the Net Zero target;
- Brexit will dominate the work of the new Government, with little progress likely in the near term on any of the big outstanding energy policy issues;
- The new Secretary of State, the Rt Hon Andrea Leadsom MP, was previously Secretary of State for the Environment and a junior energy Minister, so knows energy brief and has publically committed to meeting Net Zero, suggesting broad continuity in the direction of energy policy;
- Planned Energy White Paper now likely to be delayed until later in the Autumn at the earliest.

Detail

New Prime Minister Boris Johnson has appointed Andrea Leadsom as Secretary of State for Business Energy and Industrial Strategy (BEIS). Boris Johnson's brother, Jo, has been appointed Minister of State at BEIS and will attend in Cabinet, as will Kwasi Kwarteng (also Minister of State at BEIS). Claire Perry has taken on the role of COP26 President and has relinquished her Ministerial role. The Ministerial portfolios for all BEIS Ministers will be published over the next few days.

Brexit will dominate the work of the Government and that of BEIS. On energy policy, we can expect broad continuity in the direction of travel towards a decarbonised energy system. Andrea Leadsom has previously been both Secretary of State for the Environment and a junior energy Minister at the Department of Energy and Climate Change (DECC). So she knows the energy brief well. In her campaign to be Prime Minister, she welcomed the move to Net Zero and said she would declare a 'climate emergency' if elected PM. She has become a supporter of more renewable energy, but also supports gas and fracking. Given the breadth of her brief at BEIS and her role as a leading Brexiteer, her focus will be on leaving the EU on 31 October, with or without a deal, and helping business through that transition. There will be very limited bandwidth for her to deal with energy policy issues in the near term.

That said, the Government now has a legally-binding target to achieve a Net Zero carbon economy by 2050. In his last act as Secretary of State, Greg Clark issued a series of consultation documents on specific energy policy issues aimed at helping achieve this. He had wanted to get a White Paper out setting out future direction for UK energy policy but failed to get agreement to do this. As a result, instead of any overarching vision or framework on how to meet the legally-binding Net Zero target, we have a series of consultations on specific issues. The key points from these consultations are highlighted below.

01 Regulatory Asset Base (RAB) funding model for new nuclear

The Government has restated its belief that new nuclear is still needed to provide baseload low carbon electricity given the prospect of significant electrification of heat and transport (see chart below). Following the cancellation of the Hitachi and Toshiba-lead projects at Wylva and Moorside respectively, the Government has been considering how to get new nuclear built at lowest cost and in a way that does not sit on the Government balance sheet. The consultation proposes the Regulated Asset Base (RAB) model, which is used for transmission lines and other infrastructure assets, like the Thames Tideway Tunnel.

The proposed RAB model is based around four key elements:

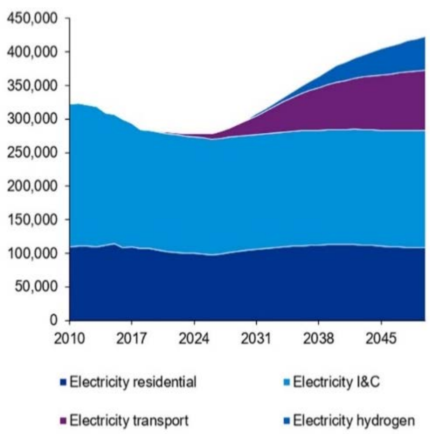
- Government protection for investors and consumers against specific remote, low probability but high impact risk events, through a set of contractual arrangements (the 'Government Support Package' or 'GSP');
- A fair sharing of costs and risks between consumers and investors, established through an 'Economic Regulatory Regime' (ERR);
- An economic regulator (the 'Regulator') to operate the ERR; and
- A route for funds to be raised from energy suppliers to support new nuclear projects, with the amount set through the ERR, during both the construction and operational phases (the 'Revenue Stream').

The RAB model represents a major departure from the previous Contract for Difference (CfD) model. The aim is to get the cost of capital down and therefore reduce the costs for consumers of new nuclear.

EDF say they can build Sizewell C under RAB model for the low £60s/Mwh. But nuclear power is more complex than building a sewerage tunnel, or a transmission line, and the Government will want to retain control over key aspects, like safety and security. If significant risks remain with Government, then the costs of the projects could stay on balance sheet. If so, HMT's interest in the RAB model is likely to dissipate quickly as they will want to avoid a significant increase in borrowing. The model is already facing objections from consumer groups, as the RAB model transfers more risks to consumers, for example if there are cost overruns. Moreover, consumers start paying for the new plants during construction, which is many years before a nuclear plant is operational. EDF have said they want to take a final investment decision on Sizewell by 2021. However, it could take significantly longer than this to get the new system established, given it will need primary legislation and the establishment of a new regulatory team (probably at Ofgem) to implement it.

BEIS are consulting on the basis that the RAB model would be introduced alongside the existing CfD model for delivering new nuclear projects, rather than as a complete replacement. A decision on which model was most appropriate for a particular project would be made on a case-by-case basis, leaving the door open for EdF to consider both CfD and RAB models.

Electricity demand projections (GWh)



Source: National grid 2019 future energy scenarios

02 New funding model for Carbon Capture and Storage (CCUS)

The Government has also signaled that it agrees with the CCC's recommendation that Carbon Capture, Usage and Storage (CCUS) is essential for hitting Net Zero and unlocking the potential of low carbon hydrogen pathways, which the Government views as essential for meeting the target.

Historically, when Government has considered CCUS projects, they have done so on a 'full chain' basis i.e. a single consortium takes on risk across the value chain and all associated interdependencies. Following consultation with industry on least cost pathways, the Government now sees benefit in isolating the component business models of the CCUS value chain, and providing individual funding models for each part. The consultation looks at a variety of funding models, including RAB for transport and storage (T&S), and a Contract for Different (CfD) for power generation CCUS:

— **RAB model for Transport & Storage of CO2:** To establish non-project specific T&S infrastructure will require significant capital investments upfront, which may only receive a market driven return over the medium to long term as more CCUS projects connect into the available network. Like use of the national electricity or gas grid system, Government proposes users of the T&S system would pay a fixed access fee for utilisation of T&S infrastructure, but is considering how owners of the T&S system would be compensated prior to critical mass being achieved and what the appropriate formula for compensation would look like.

— **CfD for power generation CCUS:** Government considers that CCUS for power generation should operate 'mid-merit' or mid-way in the merit order for electricity generation i.e. not displacing renewable generation in order of dispatch. This would, by implication, define CCUS as a dispatchable generation source, responding to the supply and demand needs of the electricity system. The impact is that revenues would be inherently more uncertain and Government has been considering a range of funding models for deployment. The leading options appear to be CfDs with adaptations, including ensuring that Gas CCUS projects are able to operate ahead of unabated gas projects in the merit order and fuel price adjustments.

Assuming a partial chain approach is taken, there are a number of interface risks that would need to be addressed, which the Government is seeking views on, including:

— cross-chain risks – the risk of underperformance in one part of the chain impacting performance of another part;

— stranded asset risk – where one part of the value chain becomes permanently unavailable; and

— leakage risk – the risk of captured carbon leaking from the store over time.

03 Flexible and responsive energy retail market

The Government has launched a consultation into 'Flexible and Responsive Energy Retail Markets' which builds on the joint review launched by BEIS and Ofgem in November 2018 to investigate what policy, legal and regulatory changes might be needed to ensure that the energy retail markets is fit for the future. It outlines a number of existing schemes and policies that support the roadmap to the future and seeks views on a number of specific further changes.

The consultation recognises the need for change in energy retail to realise the vision of a market which embraces innovation to deliver consumers increased flexibility, and lower costs based on a smart and low carbon system. It also sets out the market features which support that vision and some of the challenges to be overcome in delivering it, that is: a wide choice of energy services; consistent consumer protection; minimal market distortions; competitive prices for all; ensuring consumers in vulnerable situations receive the services they need.

While the need for change is recognised and views are sought on a number of options for amending the licencing regime, there is, though, a tone of caution. Many of the options set out are viewed as medium term possibilities, while more radical changes to the licencing and regulatory approach are described as a longer term option.

The consultation goes on to consider some features of the current landscape outlining for example that the conditions for lifting of the temporary price cap will remain under review; and schemes such as ECO and the Warm Homes Discount which some argue skew the cost base of larger suppliers in comparison with smaller suppliers will be reconsidered; and that consideration will be given to regulation of third party intermediaries, including those who serve the energy retail market.

It is hard to argue with the general direction of travel here. However, the consultation is very open ended and lacks any clear statement on what it would take for the Government to lift the price cap.

04 Energy efficiency and fuel poverty

Spending on energy efficiency has been cut significantly in recent years (see chart below). A significant step up in energy efficiency will be required if Net Zero is to be achieved.

The call for evidence primarily seeks views on whether existing policies such as the Capacity Market and Energy Company Obligation (ECO) are sufficient to incentivise uptake of energy efficiency, or whether there is a need for the design of new markets and mechanisms to support energy efficiency.

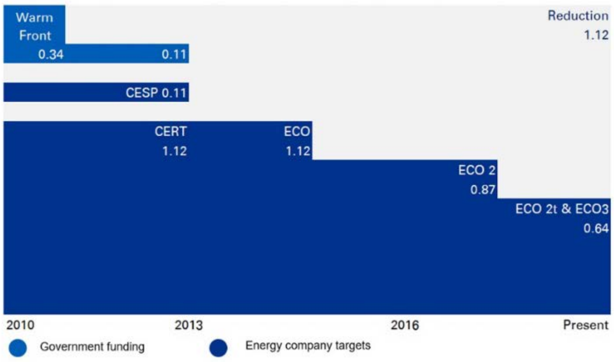
On 25 July, BEIS also launched an ECO3 technical consultation to take account of the TrustMark Government Endorsed Quality scheme into ECO3 as a way of demonstrating compliance with the most up to date, relevant standards and ensuring sufficient consumer protection processes and guarantees are in place.

The consultation on the Fuel Poverty Strategy for England is limited to a providing an update on progress made since the Government's 2015 fuel poverty strategy and to seeking views on proposals to maintain some elements of the existing strategy, such as the statutory fuel poverty target, and to update others.

The proposed updates include implementing new metrics for the measurement of fuel poverty; to refine the principle of vulnerability as it relates to fuel poverty; and to implement a new principle to ensure that policies contributing to the fuel poverty target are complementary to other government priorities.

An outcome of the consultation will be a streamlined and consolidated policy plan describing the actions needed to overcome the challenges identified in the 2015 Fuel Poverty Strategy.

Annual spending on national energy efficiency scheme (£bn)



Source: Citizens advice UK ERC unlocking Britain's first fuel: The potential for energy savings in UK housing

05 Capacity Market 5 year review

The 5 year review of the Capacity Market (CM) concluded that there is a continued need for the CM to maintain security of supply and that it has been operating well in meeting its original objective of ensuring adequate capacity margins at least cost to consumers.

The five year review highlights the expected future changes, based on planned Call for Evidence, that are likely to occur over the coming years:

— **Implementation of the EU Clean Energy Package:** By 1 July 2025 any site built before 4 July 2019 shall not receive capacity payments if they emit more than 550gCO2/kWh and no more than 350kg CO2 per installed kW in a year. This will limit the participation of existing coal, diesel (including behind-the-meter DSR) and some older less efficient gas fired generation in future CM auctions.

— **Future proofing and technology neutrality:** There is a package of reform expected for ensuring the CM is fit for purpose for the future, including the treatment of Demand Side Response (DSR), agreement length, renewable participation, penalties and timing of the auctions.

— **Simplification:** As noted in previous consultations, there is a drive to simplify the CM in order to reduce the barriers to entry in the CM auctions and the Government expects Ofgem to introduce a few procedural measures in order to meet this objective.

— **Procuring the right amount of capacity:** To ensure cost effectiveness of the CM auction, there is an intention to review the reliability standard and other demand parameters such as NET-Cone. The Government will also be analysing the impact of 'Split Auction' design, where new-build and existing capacity is procured separately, in 2019 and consulted on in 2020.

BEIS also published its final evaluation report for the Electricity Demand Reduction (EDR) pilot. The pilot was deemed a successful way for reducing peak demand (another way of offering security of supply) and considered a cost effective solution for the consumers and participants. However, the pilot concluded that the participation of EDR in the CM would require changes to the CM rules and regulations in order to increase uptake of energy efficiency on the system. The immediate issue remains getting the CM restated, following the Tempus ruling. BEIS aim to do that with a T-3 auction later this year.

06 Code governance

Government has reiterated that it sees reform of the energy industry code landscape as necessary for meeting the UK's ambitions to move to a smarter, cleaner energy system capable of delivering the Net Zero target.

This week two models have been put forward for significant institutional reform. One potential model would see the establishment of a code manager function responsible for day-to-day code change processes (including related systems) alongside a separate strategic body responsible for translating Government's vision for the energy system into a strategic direction for the codes. An alternative model would see these two functions combined within a single integrated rule making body.

The aims of the consultation align closely with the CMA's 2016 market investigation remedies. However, Government's proposals go somewhat further posing more fundamental questions about which parties should be involved in the institutional framework and what their roles and responsibilities should be.

Government is committing to improving strategic direction of the codes by introducing a strategic body function – but is still considering whether this should be carried out by Ofgem, the Electricity System Operator, or a new independent body.

Government also plans to replace the existing code administrators with a smaller number of more empowered and accountable code managers with responsibility for identifying, proposing and developing and prioritising changes to the codes. Government aims for this to make development of the codes more independent, but is still considering the arrangements to ensure that industry expertise can continue to be captured.

Finally, Government is proposing to reduce the number of industry codes and simplify their content. The consultation is seeking views on how many codes there should be (including the option for a single unified code for the industry) and how a partial consolidation would be achieved – whether by activity or by fuel, or a combination of these.

The consultation on these proposal closes on 16 September and Government has set out that it expects implementation to take a number of years as these reforms with need to take into account wider reforms of the industry structures.

Conclusion

The Johnson Government will be dominated by Brexit and seeking to leave the EU by 31 October with, or without, a deal. This will squeeze the time and attention given to domestic policy issues, including energy and further delay establishing a clear policy framework on how the UK plans to hit its Net Zero target by 2050. For businesses looking to make major long-term investment decisions, many of which involve assets that will still be operational in 2050, this represents a serious problem. Without a clear and stable policy and regulatory framework, highly mobile international capital is likely to find more attractive investment opportunities abroad.

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