Government announces consultation on "fundamental" reform of the low-carbon energy market

Introduction

Chris Huhne, the Energy and Climate Change Secretary, today announced a Government consultation on low-carbon energy reform that will "reshape this market more fundamentally than at any time since the 1980s".

The reform seeks to construct comprehensive legislation to replace the present overlay of instruments, which Huhne has described as a "piecemeal response" to the need for low-carbon energy. The Government believes that the proposed reforms can provide greater certainty to the market and greater assurance of decarbonisation as well as lower energy bills.

The proposed reforms

The reforms are framed around four "inter-locking" policies, each of which are summarised below.

1. NEW FEED-IN TARIFF WITH CONTRACT FOR DIFFERENCES

The Government is proposing to introduce a new Feed-in Tariff scheme as a further incentive to clean energy investment. Low-carbon electricity generators would be guaranteed prices under clear long-term contracts.

The existing system consists of a limited FiTs scheme recently introduced by the Government for small-scale renewables energy generation, together with the Renewables Obligation (RO) which currently incentivises large-scale renewable generation. Under the RO, electricity suppliers are required to supply an increasing percentage of their electricity from renewable sources.

The Government is now proposing (over time) to replace this system with a more comprehensive Feed-in Tariff scheme. Its preferred option is a FiT with a Contract for Difference (CFD). Under this scheme, a long-term contract is signed between the Government and the low-carbon generator under which variable payments are made to the generator to ensure the generator receives the agreed tariff. The FiT payment is made in addition to the generator's revenues from selling electricity into the market when the wholesale price of electricity is low. The Government can claw back funds where the wholesale price of electricity exceeds the tariff level.

One advantage of this scheme over the RO is that the level of support guaranteed by the RO is determined only at the date the new generating capacity is built and connected to the grid. The proposed scheme envisages the signing of contracts much earlier in the process, providing greater certainty for investors.

The Government has confirmed that support given to existing renewable facilities under the RO will continue to be available. It will be interesting to see whether the Government will permit switching from the RO to FiTs, for example, for consented facilities which have not yet been built.

2. CAPACITY PAYMENTS

A further proposal is that capacity payments will be made to non-renewable energy sources to secure the provision of back-up power to cater for surges in demand and intermittent supply. The payments would also be used to import electricity from other European countries where peaks in demand are different. Companies could also receive capacity payments in return for entering into contracts to reduce their energy demands at peak times, for example, by suspending industrial processes (so-called "negawatts").

3. CARBON PRICE SUPPORT

From April 2013, the Government proposes to introduce a "carbon price support mechanism" (or carbon tax) on the carbon content of fossil fuels used in electricity generation. It has long been argued that the price of carbon is too low to encourage investment in low-carbon energy on the scale the UK needs if it is to meet its targets under EU and UK law. The price of carbon is set by the market under the EU ETS. The Government wants to see a floor to the carbon price and the way it wants to achieve this is to introduce a tax on electricity generators based on the carbon content of their fuels. It hopes to introduce this measure at the next Budget in 2011, effective in 2013.

4. EMISSIONS PERFORMANCE STANDARD

The emissions performance standard (EPS) will introduce limits on the level of carbon emissions per kilowatt hour of electricity generated by new coal-fired power plants. The aim is to reinforce the existing requirement that no new coal-fired capacity should be built without carbon capture and storage. The Government is consulting on the precise level of the standard but it has confirmed that it will adopt a principle of "grandfathering" so that the level of the EPS on the date of consent for a new power station will apply for the economic life of the installation. Opinions are mixed as to the appropriateness of introducing an EPS on coal. At a time when the Government is trying to encourage investment in clean coal technology, an unsuitably constructed EPS which applies to coal-fired generation could discourage new clean-coal investment in favour of unabated gas generation infrastructure.

Responses to the consultation on the carbon price floor need to be submitted to the Treasury by 11 February 2011 and in respect of the other proposals to DECC by 10 March 2011.

If you have any questions or would like further information on these proposals, please contact:

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0112env
December 2010