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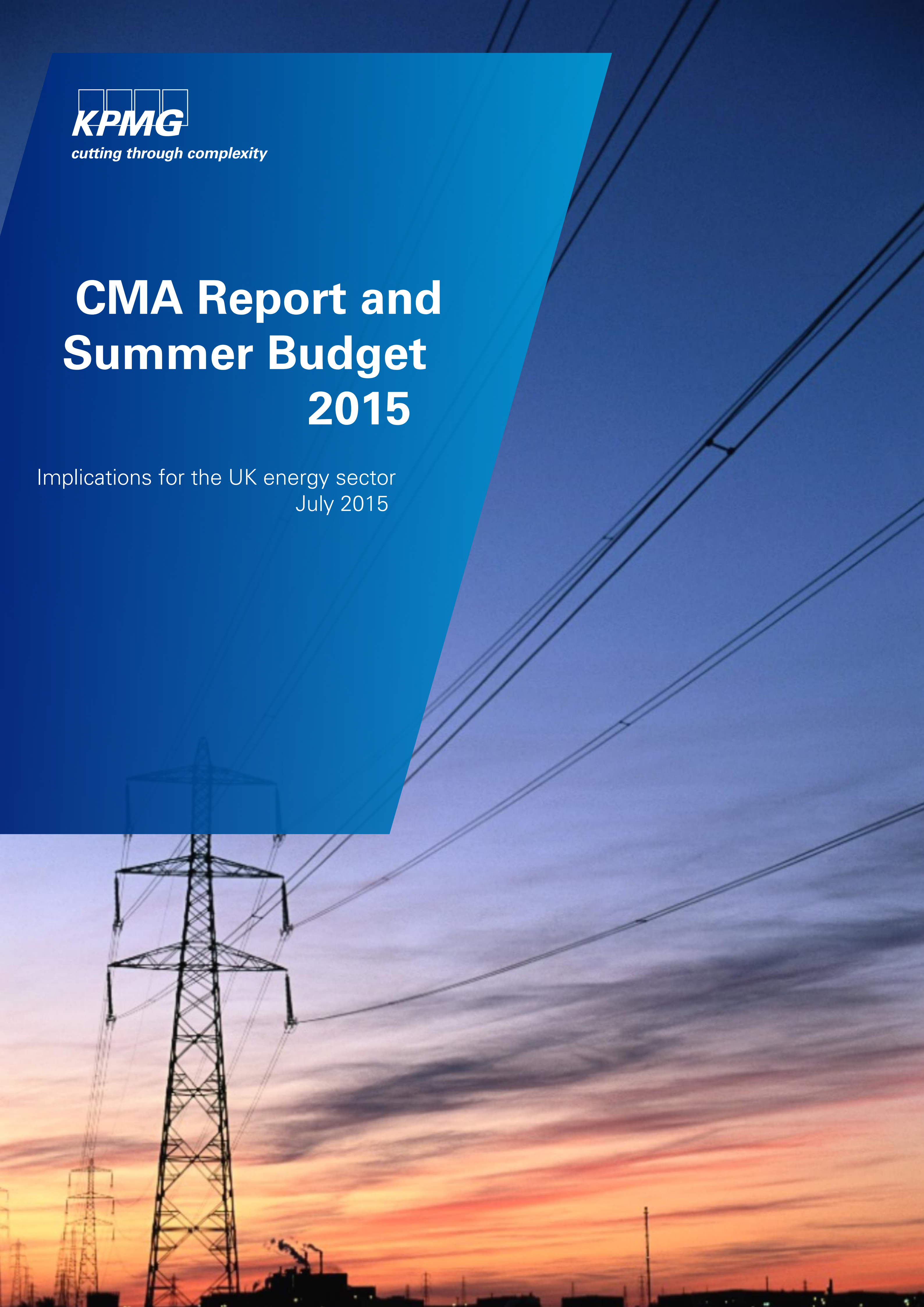
CMA Report and Summer Budget 2015

Implications for the UK energy sector

July 2015



Two announcements this week are likely to have big implications for the way the UK energy market evolves over the next few years. On Tuesday 7 July, the Competition and Markets Authority (CMA) published their provisional findings and proposed remedies to address concerns about a lack of competition in the market. On Wednesday 8 July, the Chancellor signalled significant changes in the Government's approach to environmental taxation and also funding for low carbon technologies under the Levy Control Framework. This note summarises these announcements and some of the implications for the sector.

Budget announcements on energy

On Wednesday 8 July 2015, the Budget signalled changes ahead on both environmental taxation and on the support for low carbon technologies under the Levy Control Framework (LCF).

On environmental taxation, the Budget confirmed that the Government has abandoned the commitment made under the previous Coalition Government to increasing the share of environmental taxes in the total tax take.

Carbon taxes are now very unlikely to rise to the levels previously envisaged by DECC in their projections, implying slower progress towards decarbonisation in the power sector and elsewhere.

The Chancellor announced removal of the exemption for renewable generators from paying the Climate Change Levy (CCL), a measure that will net the Treasury over £900 million per annum in extra tax receipts by 2020-21. There will also be a review of energy efficiency taxes affecting business including the Carbon Reduction Commitment (CRC) and the CCL.

There was no mention of the Government's overall strategy on energy in the Chancellor's speech. However, tucked away in the annex tables from the Office of Budget Responsibility (OBR) are the latest projections for the LCF. They show a **significant overspend** being projected by 2020-21: £11.5 billion per annum in nominal terms by 2020-21, which equates to more than £9 billion

per annum in 2012 prices, against the previously agreed LCF limit (in 2012 prices) of £7.6 billion per annum on a 'business-as-usual' scenario.

There are three main reasons for this:

- Lower wholesale prices (which means higher support levels are needed to reach fixed 'strike prices');
- A surge in solar PV deployment and faster than expected deployment of onshore wind;
- Upward revisions to the load factors used by DECC**.**

The Government will therefore now face some hard choices about which subsidy budgets to cut in order to bring the LCF budget back under control.

The Government has already indicated its commitment to new nuclear and promoting gas-fired generation (which presumably will have to be done through amending the Capacity Market rules.)

They have said they will not support new subsidies for onshore wind, which could mean no new allocations in any future Contract for Difference (CfD) auctions for onshore wind. That leaves question marks over the future for offshore wind, solar, biomass, Carbon Capture and Storage (CSS) and marine technologies (including tidal), which will have to be considered as part of this review. The review of small scale Feed in Tariffs (FITs), which is already underway, will need to be taken into account.

No firm indications have been given yet by the Government about how long this review of the LCF Budget will take. The current Government line is that further announcements will be made 'in due course'. Decisions about the timing of the next CfD auction are also in abeyance pending the outcome of this work, although it seems increasingly likely that we will see some delay from the previously published timetable of a second round starting this autumn. The CMA recommendations also increase the pressure on DECC not to award bilateral CfDs, outside of an auction process, without very strong reasons for doing so.

Given the UK energy market relies on highly mobile international capital, investors will need greater certainty soon about the tax and funding frameworks for UK energy investments, or that capital will increasingly be diverted to opportunities elsewhere. Stalling investment in the low carbon sector would not be a great backdrop as the Paris Climate Change Conference comes into view.

CMA provisional findings and proposed remedies

The backdrop to the CMA Review was major concerns about the effectiveness of competition in the energy market, accusations of profiteering by the 'Big 6' energy firms and a loss of trust and engagement on the part of energy consumers. One manifestation of those concerns was the commitment by the Labour Party to 'break up' the Big 6 and freeze energy prices to protect consumers.

After more than a year of detailed investigation, the CMA has *not* found that the vertical integration (VI) model damages competition, or that the Big 6 having been using excessive market power in the wholesale market to push up prices. The CMA's main concerns have been at the *retail* end where 'sticky customers' (i.e. those that do not switch) appear to be overpaying through remaining on standard variable tariffs.

The CMA's key recommendation is around the introduction of a 'default' regulated tariff for those disengaged consumers who do not switch.

Many details remain to be worked through, including who exactly this would apply to, when would it kick in, and how long would it last? (The CMA argue that this should be a transitional measure only until stronger competition comes through.)

The CMA is also recommending greater use of locational pricing in the allocation of transmission losses, a recommendation which Scottish generators in particular may find challenging. There are recommendations for Ofgem, in terms of unwinding the '4-tariff' limit introduced by the Retail Market Reforms, hosting an independent price comparison site and seeking to simplify the Industry Code process; and also for DECC, in terms of clarifying its relationship with Ofgem, and not allocating further low carbon contracts (CfDs) other than through auction processes.

The CMA has not recommended re-regulating all energy prices, so the emphasis is still on trying to make competition work better in the energy market. The Government and Ofgem have both welcomed the report, indicating that they will implement the recommendations.

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