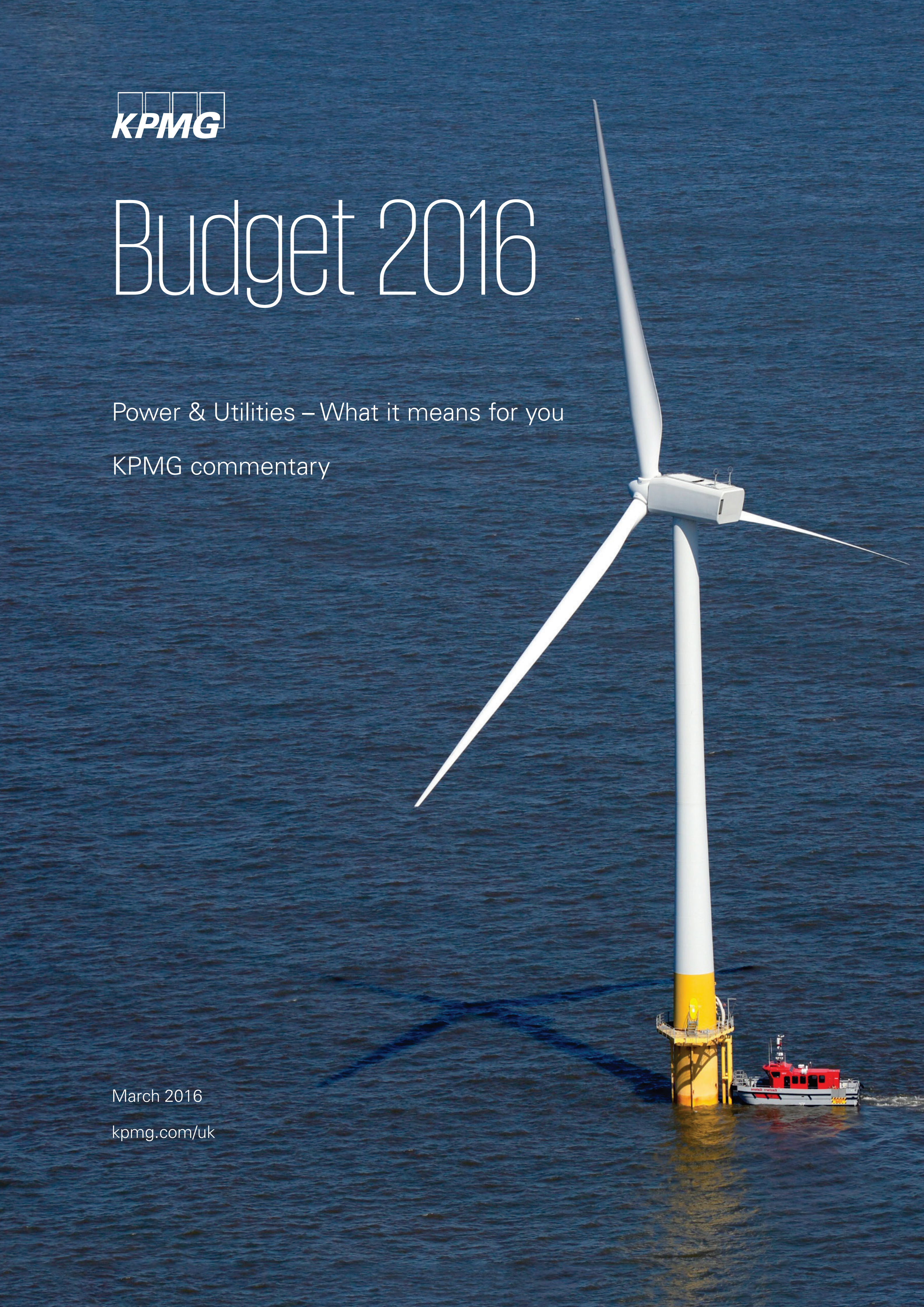

KPMG

Budget 2016

Power & Utilities – What it means for you

KPMG commentary

March 2016

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Budget 2016

Key points

- The Carbon Price Floor (CPF) remains in place. CPS rates are increased in line with inflation for 2020-21 from £18 t/CO2. Review announced of future trajectory for the CPS.
- Renewables: £290m for second CfD auction later this year – enough for up to two large offshore wind projects to secure contracts, with a total budget for new renewables deployment in this Parliament of £730m.
- OBR revises down forecast for spend on low carbon generation under Levy Control Framework (LCF) to £8.7bn in 2020/21 (2011-12 prices), down from previous forecast of £9.1bn, following cuts to subsidies last year.
- Simplification of business energy efficiency tax landscape with abolition of Carbon Reduction Commitment. Offsetting increases in Climate Change Levy to recoup lost revenue.
- Small Modular Nuclear Reactors (SMRs): £30m for UK nuclear capability and Road Map later in the year.
- Energy Delivery Landscape – DECC commits to simplifying energy delivery landscape. Confirmation that E-Serve will move out of Ofgem, alongside a commitment to 'greater independence' for System Operator.
- Government accepts National Infrastructure Commission recommendations on energy.
- Commitment of at least £50m over the next five year for innovation in energy storage, demand-side response and other smart technologies.
- Corporation tax rates reduced to 17% from 2020 but restriction in utilisation of tax losses may adversely impact project economics.
- Tax relief for interest to be restricted to 30% of EBITDA with detailed rules yet to be fully defined.

Carbon Price Floor

The Government has decided to retain the Carbon Price Floor (CPF) policy. The rate of Carbon Price Support (CPS) in 2020-21 will be the £18 t/CO2 rate set for 2019-20, uprated for inflation. The Chancellor has agreed to set out the long term direction of the CPS rates and Carbon Price Floor policy at the next Autumn Statement.

There were calls for the CPF to be scrapped altogether, given it pushes up energy prices in the UK relative to other countries. Had it been scrapped, there would have been impacts on Renewables Obligation (RO) projects and the outlook for CCGTs. So its continuation (at least for now) will be something of a relief for those investors.

For onshore wind developers, there were also important developments in Parliament this week, with the Energy Bill passing its Third Reading in the Commons. This increases the chances of the Bill reaching Royal Assent by 31 March, and the grace period arrangements for the RO set out by the Government becoming law.

Renewables – CfD auctions

There was also some good news for offshore wind developers. The Government has announced a budget of £290m for the Contract for Difference (CfD) auction due to take place later this year. This could enable up to two large offshore wind farms to secure contracts. Further, the Government set out that, in total, £730m of new subsidy, enabling up to 4GW of offshore wind to be deployed, would be made available during this Parliament.

The Government also announced the trajectory for the 'strike price' caps, which set the cost reduction profile expected for offshore wind. The cap will be £105/MWh (in 2011-12 prices) for delivery in 2021/22 to £85/MWh for delivery in 2025/26. At £85/MWh, the Government is expecting offshore wind to be below the strike price agreed for Hinkley Point C.

Despite this steep price reduction trajectory, we expect a highly competitive second auction with a number of projects bidding for the budget available.

Levy Control Framework

The latest OBR forecasts show spending on low carbon generation under the Levy Control Framework at around £8.7bn (2011-12 prices) in 2020/21.

This represents a reduction from £9.1bn forecast by the OBR last July. This reflects the cuts in subsidies announced since the July Budget, including for onshore wind, solar, and biomass, to bring spending back towards the LCF limit. The Government also cancelled the CCS competition, which had spending allocated to it under the LCF.

However, despite these cuts, this new forecast is still higher than the LCF limit for 20/21 set under the Coalition Government of £7.6bn.

Business Energy Efficiency

The Government has completed its review of business energy efficiency tax simplification. It has decided to abolish the Carbon Reduction Commitment (CRC) post 2018-19. The Chancellor also announced an increase in the main rates of Climate Change Levy (CCL) from 1 April 2019.

The Government is proposing to explore integration of the existing compliance and reporting requirements of CCAs, EU Emissions Trading System, and the Energy Saving Opportunity Scheme (ESOS) with any new reporting framework, to further minimise administrative burdens with consultation to be published later in 2016.

Nuclear

The Government reconfirmed its support for the Hinkley Point C project last week, with DECC publishing a list of five reasons why it needs to go ahead.

The Chancellor has also announced further allocation of at least £30m for an SMR-enabling advanced manufacturing R&D programme to develop nuclear skills capacity in the UK.

The Government will be setting out next steps on the competition for Small Modular Nuclear Reactors (SMRs), with a roadmap to be published later in the year.

Smart Power

The Chancellor has agreed to implement the National Infrastructure Commission's (NIC) recommendations on energy. The NIC has argued that by developing a 'smarter' power system, costs could be reduced by £8bn a year.

To support this vision, the Chancellor announced a commitment of at least £50 million for innovation in energy storage, demand-side response and other smart technologies over the next five years to help new technologies and business models access to the market. The Chancellor also announced that Ofgem will consult later this year on the future of the £100 million Network Innovation Competition to maximise the delivery of genuinely innovative projects and technologies.

The Government has announced they support the "market delivery" of *at least* 9GW of *additional* interconnector capacity. Whilst it is unclear what is meant by "market delivery", according to Ofgem, 6.3GW of interconnectors are seeking to deploy under the Cap and Floor regime. In addition to the 4GW already installed, this would see 10.3GW of interconnector capacity, leaving room for at least another 2.7GW to deploy.

Energy Delivery Landscape

This Budget starts the process of some significant changes in the roles and organisation of the bodies involved in the delivery of energy policy objectives.

The Government has confirmed that E-Serve will be taken out of Ofgem to allow Ofgem to focus on its core activity of promoting competition and protecting consumers. This follows a review of the roles of all economic regulators by a 'Star Chamber', chaired by Oliver Letwin. This reform will take some time to enact as it will require primary legislation.

DECC has confirmed that it is committed to streamlining the bodies involved in delivering energy policy objectives, and that plans will be set out for this at the Autumn Statement later this year. This will need to confirm which body (or bodies) take on the functions currently delivered by E-Serve.

The Budget also confirms that Ofgem will be given new powers to ensure industry codes are supporting competition in the sector. This follows the CMA report which noted that the current industry code process is likely to frustrate competition and innovation.

The Government has also confirmed that it sees a 'strong case' for greater independence of the System Operator. Further details on what exactly this means are expected from DECC soon.

Corporation tax rate reduction and change in loss utilisation rules

The headline rate of corporation tax will be reduced to 17 per cent by 2020. Although welcome for some in the industry, this news may be overshadowed for others by the restriction on the ability to use brought forward tax losses. With losses brought forward only able to shelter half the profits in a period, tax may be paid earlier in the project life cycle thereby impacting project economics.

Tax relief for interest

The Chancellor confirmed the introduction of a restriction to interest deductibility to the expected 30 per cent of earnings. A group ratio exemption will be introduced that will assist many in the sector, as it will allow a higher deduction where the group as a whole has a high level of debt finance.

Rules are to be introduced to ensure that the restriction does not impede the provision of private finance for certain public infrastructure in the UK. The extent of that exemption remains unclear and further consultation will be conducted on the detailed design of all aspects of the rules later this year. The new rules will apply from 1 April 2017.

Aggregates Levy

HMRC are to consult on the introduction of an exemption from aggregates levy on aggregate arising from utility projects involving pipe-laying. Historically, HMRC have demanded levy on many such projects although it is not certain that Parliament intended them to be affected by aggregates levy which is a tax on quarrying.

Contact us

Simon Virley, CB

Partner and UK Chair of Energy and Natural Resources

T: +44 (0)20 7311 5037

E: simon.virley@kpmg.co.uk

Simon re-joined KPMG in February 2015, having been Director General for Energy Markets and Infrastructure at DECC, 2009-15. In this role, he advised Government on oil and gas, renewables, nuclear, CCS, retail markets and energy security. He now advises clients on strategy and deals in the UK market and abroad.

Andrew Lister

Partner and Head of Energy and Natural Resources Tax

T: +44 (0)20 7694 3751

E: andrew.lister@kpmg.co.uk

Andrew Lister has worked in corporate tax with KPMG for over 20 years. Andrew leads KPMG's Energy and Natural Resources tax practice in the UK. He works with power and utility companies in the UK and across the World.

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