



The 'Reset' Speech

RIP King Coal, 1882 - 2025



“Let me be clear, this [coal] is not the future”

Having led the Industrial Revolution with coal as a key energy source, the UK is now aiming to be the first major European country to exit unabated coal fired generation. In spring 2016, DECC will consult on ending the use of unabated coal plant by 2025, with restrictions on use in place from 2023.

In 2014 coal accounted for 23% of total installed capacity in the UK (circa 19.9 GW). Approximately 7.7GW of coal closures are already expected by March 2016 due to economic (low dark spreads) and regulatory (Industrial Emissions Directive- IED) changes.

Currently, circa 9.3GW of coal plants have Capacity Agreements for delivery in 2018-19, of which 5.6GW has 3-year agreements for delivery through until 2020-21. Given that the penalty for closures before the delivery year are set at £25/kWh and the impact on security of supply, we don't expect coal plants with capacity agreements to close before 2018. However, this announcement could significantly impact the bidding behaviour of coal plants over the next few auctions as the timing of closures will be driven by major maintenance and outage cycles. There will also be a hit on the value of coal stations that have invested in new technology in order to be IED-compliant.

This announcement confirms the direction of travel of policy and confirms an end date for coal's use in electricity generation. Further, the commitment to end unabated coal is an important signal with the Paris Climate Change negotiations only a few weeks away.

“In the next 10 years, it's imperative that we get new gas-fired power stations built”

The closure of coal plants can be seen as clearing the pathway for investment in new gas-fired generation. There were no details on exactly how this would be done, although the speech also highlighted a potential review of the Capacity Market post the 2nd auction to ensure sufficient incentives to unlock further investment in CCGTs.

We expect that, given flat or declining peak demand and increased competition from Interconnectors, small scale generators and DSR, further coal closures alone may not be enough to unlock the investment in gas generation. Further incentives through the Capacity Market, or other changes to electricity market arrangements, will therefore be needed to get new CCGTs built.

“Opponents of nuclear misread the science”

The speech reaffirmed the Government's commitment to the new nuclear programme highlighting the role of the projects at Wylfa and Moorside to follow on from Hinkley Point C (HPC). Given that Government expects HPC to commission by 2025, there maybe a need to refresh the Nuclear National Policy Statement to allow for any post-2025 commissioning dates.

“Support for offshore wind... if, and only if, the Government's conditions on cost reduction are met ...”

Secretary of State announced that Government would make funding available for three Contract for Difference (CfD) auctions in this Parliament (the first of these before the end of 2016) with a view to supporting up to 10GW of new offshore wind by 2030. However, the statement comes with a big BUT. The Secretary of State has clearly set out that offshore wind, even at the 2015 CfD auction clearing prices of £119.89/MWh and £114.39/MWh (2012 prices), is still too expensive and industry must move quickly to reduce costs. The commitment to three auctions is not set in stone and the number will be wholly contingent on industry meeting the cost reduction conditions which are yet to be set out by Government.

However, looking to its market comparators from the speech, the offshore wind industry can expect to be required to be cost competitive with nuclear and gas (well below £100/MWh), on a system impact adjusted basis, within 5 years. Enforcement of such a trajectory can be easily achieved by Government with the use of the Administrative Strike Price (ASP) mechanism built into the CfD Allocation Framework. Government could simply set the ASP at their desired level forcing eligible generators to compete below this threshold.

Government will need to follow up the speech quickly with the detail of the price reduction expectations to ensure that the circa 5GW of projects in the immediate pipeline know the rules of the new game ahead of the CfD auction next year.

“When costs come down... so should support...”

The Conservative Government’s manifesto made a clear commitment to end any new public subsidy for onshore wind farms – a commitment which was upheld by the Energy Bill 2015. In July 2015, DECC also launched the “Consultation on changes to financial support for solar PV” (early Renewables Obligation (RO) closure for solar) and in August 2015, the “Consultation on a review of the Feed-in Tariff scheme” (substantially reduced tariffs, inbuilt degeneration and deployment caps for solar and onshore wind), ostensibly signalling the end of support to these technologies.

The announcement confirmed that Government believes its 2020 onshore wind deployment ambitions have been met and that, Government expects to see 12GW of solar deployed by 2020 – even with the currently proposed cost controls in place. As such, despite that Government has spent several months collecting information with regards a “zero-subsidy CfD”, it now seems likely that any pot 1 CfD would be for post 2020 commissioning only.

“The EU Emissions Trading Scheme is exactly the kind of intervention that should be made...”

The Government believes that the market should determine pricing wherever possible. The European Union Emissions Trading Scheme (EU-ETS) has long been Government’s favoured approach to pricing carbon. However, due to the system flaws witnessed through phases I, II & III, the EU-ETS has not driven a robust price on carbon and, as such, the Carbon Price Support (CPS) was implemented

to supplement the EU-ETS and encourage switching to lower carbon technologies.

However, with the adoption of the Market Stability Reserve (MSR) measures, there is now at least some prospect of firmer carbon prices from the EU ETS before 2020.

This may lead the Government to conclude that the market no longer needs the CPS post 2020/21. Should this be the case, the biggest impact (assuming coal is phased off the system) of such a move would be seen in the interconnector market where current uptake assumes substantive portions of flows are directed inwards to the UK. Removal of the CPS would remove the carbon price arbitrage currently at play between the UK and its interconnector hosts, reducing the attractiveness of exporting power to the UK (and in some instances, of the commercial investment case, altogether).

Depending on what happens to the European Union Allowance (EUA) price, this could have significant implications for the wholesale price from 2021 onwards, with Renewables Obligation (RO) facilities bearing the biggest burden of such a change.

“...we also want intermittent generators to be responsible for the pressures they add to the system when the wind does not blow or the sun does not shine”

The position is clear on taking a “whole system” approach to the cost of renewables where intermittent renewables could be penalised for increased cost in the balancing market and grid re-enforcements. DECC is currently undertaking a study to understand the implications of integrating intermittent renewables on to the electricity system, which is due to be published in Q1 2016.

Key points

The long awaited ‘reset’ speech by Amber Rudd signals the end for coal-fired generation by 2025. Further, the speech outlined the following:

- Focus on getting new CCGTs built, but unclear what policy changes will be needed to make this happen
- Commitment to new nuclear reaffirmed
- More funding for offshore wind but only if costs continue to fall
- Renewed effort to reform the EU ETS to provide an effective carbon price
- Removal of (non-financial) barriers for decentralised energy
- New strategies promised on heat and energy efficiency

This note analyses the speech in order to understand implications for industry players in the near future.

“There is a strong case for greater independence for the system operator to allow it to make the necessary changes”

Given the growth of interconnection and decentralised energy, the governance and independence of the system operator is under question. Recently, the newly formed National Infrastructure Commission published a Call for Evidence from the industry to provide views on the role of the System Operator to consider how to reform the current system operator model to make it more flexible and independent.

The Secretary of State confirmed that this is also a key issue for the Government, given the prospective changes in the way the electricity market will work over the next 10-15 years. We can expect a

review of the options ranging from further separation requirements on National Grid; to the role of System Operator being taken out of National Grid's hands.

“Locally-generated energy supported by storage, interconnection and demand response, offers the possibility of a radically different model. It is not necessarily the job of Government to choose one of these models.”

The Secretary of State has confirmed the commitment to the Smart Meters Programme. On decentralised energy, the Government is supporting removal of non-financial and regulatory barriers to unlock Demand Side Response (DSR) and storage technologies through measures such as the introduction of Time-

of-Use Tariffs from 2017 onwards. The emphasis is on the market developing these solutions, without long-term funding support from Government.

“We need a long-term plan for heat and energy efficiency”

The speech confirms that the energy efficiency and heat policy will be redesigned to “improve transparency and deliver a long term plan that will work and keep costs down”. There is also a commitment to streamline the tax and regulatory framework for energy efficiency. We can expect that the ECO and RHI schemes could be overhauled with new, more targeted policies replacing them. The speech includes a clear signal that ECO funding will be more targeted on the fuel poor in the future.

What comes next:

1. We expect the next period to be very busy for the industry with various Consultation Documents as well as Response to Consultations emerging from the Department of Energy and Climate Change. Potential new consultations include the launch of the:

- a) Review of the Capacity Market 2016
 - b) Consultation on the closure of unabated coal by 2025
 - c) Consultation on the barriers to development of a ‘smarter’ energy system.
2. Further clarity from Government will be needed around the necessary cost reduction profile it expects the offshore wind industry to meet going forward.

3. Before then, the Paris Climate Change negotiations will take centre stage. The Government will be hoping that the commitment to end the use of coal will provide some extra credibility as they seek a strong global deal to reduce greenhouse gas emissions.

Contact us

Simon Virley CB
Partner and UK Chair,
Energy and Natural Resources
T: +44 (0) 20 7311 5037
E: simon.virley@kpmg.co.uk

Wafa Jafri
Associate Director
T: +44 (0) 207 311 8891
E: wafa.jafri@kpmg.co.uk

Bridget Beals
Associate Director
T: +44 (0) 2073114684
E: bridget.beals@KPMG.co.uk

kpmg.com/uk



The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavour to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.

© 2016 KPMG LLP, a UK limited liability partnership and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative (“KPMG International”), a Swiss entity. All rights reserved.

The KPMG name and logo are registered trademarks or trademarks of KPMG International.

CREATE | CRT055608 | JANUARY 2016