

THE UK'S CROSS CUTTING NET ZERO STRATEGY – POWER

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In the first sector article of our Net Zero series, our team looks at what the UK's Net Zero Strategy ("the Strategy") means for industry stakeholders in the power sector. To read our introductory article on the Net Zero Strategy and an overview of the implications of the Strategy on the sectors outlined in the report, please [click here](#).

WHAT DOES THE STRATEGY MEAN FOR YOUR SECTOR?

In the power sector, several of the key commitments should drive change, though it is likely that further policy development will be needed to give market participants certainty.

Key commitment: *Take action so that by 2035, all our electricity will come from low carbon sources, subject to security of supply, bringing forward the government's commitment to a fully decarbonised power system by 15 years.*

This ambitious target must be considered against an anticipated 40-60% increase in electricity demand across industry, homes and businesses (paragraph 10). While this is a welcome goal, the detailed path to achieving it is unclear at present. The usual suspects are included within this element of the Strategy – nuclear, CCUS and flexible technologies such as interconnectors, electricity storage and demand-side response. The Strategy does stress the importance of reliability and the need to balance intermittent renewables, making investment in those flexible technologies a crucial element of any development path.

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Key commitment: *Adopt a new approach to onshore and offshore electricity networks to incorporate new low carbon generation and demand in the most efficient manner, taking account of the environment and local communities.*

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Building on the Offshore Transmission Network Review (“OTNR”), the Strategy states that this approach will be used to review transmission network arrangements. To move this forward, BEIS will “*publish, jointly with Ofgem, an Electricity Network Strategy, which will set out how we will facilitate an agile, flexible onshore network that allows the rapid, transformational change required while responding to consumer and energy system needs*” and which will include “*plans to introduce competition in the onshore building, ownership, and operation of onshore network assets*” (paragraph 23).

Arguably this is not a new approach, built as it is on the recent OTNR (which is still ongoing) and the perhaps more distant memory of the CATO regime, which was never fully implemented given lack of parliamentary time after the Brexit referendum in June 2016. However, the recognition that the regulatory platform, which facilitates the management of our energy system, is the first building block in a fully low carbon network is helpful.

Key commitment: *Provide £380m for our world-leading offshore wind sector, investing in supply chains, infrastructure and early coordination of offshore transmission networks, securing jobs and benefitting communities across the UK.*

With £160m already promised in the Ten Point Plan, the Strategy promises to “*build on this with £380m for our world-leading offshore wind sector, investing in supply chains, infrastructure and early-coordination of offshore transmission networks, securing jobs and benefitting communities across the UK*” (paragraph 33). With slightly ambiguous wording, it is unclear at the moment if this is an increase of the £160m to £380m, or an additional sum, making £540m in total available. In any event, additional funding demonstrates a commitment to a technology and however it is deployed (whether through grants, competitions, or other means) it may offer valuable assistance to smaller businesses and developers in the offshore wind supply and infrastructure chain. Such grants are unlikely to sway any return on investment analysis for the major players but a buoyant local supply chain, for example, has the potential to make UK wind investment an even more attractive prospect.

Key commitment: *Reform system governance so that the whole system can achieve our net zero ambitions and meet consumers’ needs.*

Key commitment: *Ensure that consumers pay a fair, affordable price for their energy and can engage with a retail energy market that offers the products and services required to make choices that support net zero.*

It is certainly vital that system governance is flexible enough to move with rapidly changing technology, while remaining resilient enough to maintain safety standards and security of supply. It is also very clear that affordability and a resilient retail energy market are issues that need to be urgently addressed, as has been thrown into sharp relief by a slew of supplier insolvencies over the last few years and even more poignantly in recent months.

These measures will clearly affect technology innovators and power project developers, but they will also impact lenders and investors who are considering their offtake strategy with any major utility or residential energy supplier. The (politically popular) focus on keeping energy prices manageable for domestic consumers means the burden of cost increases is increasingly likely to be borne by the suppliers. The knock-on effect for generators is a reduced pool of offtakers with tighter controls on their fixed price offerings.

WHAT ARE THE RISKS AND OPPORTUNITIES?

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The opportunities in relation to power system decarbonisation are huge. The Strategy confirms the government intends to continue to rely on a market-led approach:

We are not targeting a particular solution but will rely on competition to spur investment in technologies which are cheaper and more efficient and on innovation to reduce the cost of existing options. The government's role is to ensure a market framework which encourages effective competition and delivers an affordable secure and reliable system that is, consistent with net zero emissions. (paragraph 15)

First movers will therefore have an advantage as UK power regulation tends to follow the market, rather than the other way around. Early adopters of flexibility technologies who have the resources to scale up quickly will be clear winners. Investment in systems to optimise batteries and other storage infrastructure will set people in good stead to offer any newly reformed grid the crucial services it needs to

balance the intermittent renewable energy supply.

In terms of the offshore wind announcements, further clarity is required about specifically where the funds will be applied. Investment in the UK supply chain is needed, particularly to mitigate impacts of Brexit, both in terms of extra levies and/or duties and of potential customs delays.

In terms of system governance, and the way industry codes are reviewed and modified, it is hard to say without more detail what the risks and opportunities will be here. While self-governance of the codes allows industry participants to raise modifications as required, the process can be clunky and time consuming. Ways of more easily implementing required changes would no doubt be welcomed by stakeholders.

Finally, we turn to the changes to energy retail markets and consumer protection. Given supplier insolvencies, there is a risk of a distinct narrowing of the pool of potential power offtakers available for developers. For new entrants to the supplier market this also looks challenging. With over 20 Supplier of Last Resort processes having taken place and the first energy special administration process under way, new entrants will need to have robust business models and, even so, will likely struggle to obtain investment and financing.

WHAT DOES THIS MEAN FOR:

- **Lenders to projects?**

The Strategy provides significant political comfort to lenders that the UK Government is committed to a multi-faceted decarbonisation strategy for the future. Whilst regulatory reform and consumer-based restrictions can be unattractive, they are a necessary element of sophisticated and adaptable markets.

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The market-led approach to decarbonisation means lenders can apply their usual risk-assessments to low carbon projects and related infrastructure – if the returns are attractive and the documentation package is credit worthy and bankable there should be minimal or no regulatory or change of law concerns around investments. Credit committees may need time to get up to speed with new changes as the practical implementation details are developed to implement some of the lofty key commitments set out above.

The scale of the offshore wind market in particular offers attractive secondary market opportunities and an assured pipeline of core and ancillary assets in development over the next decade.

- **Investors/ shareholders in projects (including borrowers)?**

As has always been the case with renewable and other innovative technologies, projects with investors and shareholders who have larger risk appetites are likely to push forward, taking advantage of innovation opportunities and banking on a common-sense approach from BEIS and Ofgem. Many R&D programmes and competitions run by BEIS do allow some leeway for successful applicants in terms of derogations from current or future network and governance standards.

As with lenders and their credit teams discussed above, risk committees may need to adjust to any new requirements and regulations. However, this market is demonstrably nimble and both investors (and equally their lenders) are well-versed in fast paced change.

- **Project developers?**

The focus for project developers will not change – they will continue to strive to develop projects on time, to budget and at the required quality, to ensure that equity returns are met and loans can be repaid.

The impact of the Strategy will not affect these core objectives. Although developers will be buoyed by the level of investment required to meet the Strategy goals, as well as the assurance of a supportive regulatory landscape, they will be keeping a very close eye on how the supply chain, the contracting market and the logistics providers will respond to the opportunities (and challenges) being presented and how that response will, or may, impact on the developers' core objectives, particularly around pricing, in what is already, and will almost certainly continue to be, a highly competitive market.

WHAT DOES THIS MEAN IF YOU'RE NOT IN THE UK?

Many international investors look to invest in power infrastructure in the UK. As one of the first liberalised electricity markets, there is a long track record to review and to provide inward investors with confidence. It is hoped that the current promise of change and consistent support of the Strategy should outweigh the element of regulatory uncertainty for most international investors.

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There is therefore reason for optimism. For example, the most prolific investors in UK offshore wind are multinational power houses (Orsted, Vattenfall, Equinor, etc.) and their existing presence and contribution toward a net zero future will certainly give them a seat at the table in discussions with BEIS and Ofgem. New investors such as green investment funds may look to partner up with existing investors, which would allow them to become more familiar with the UK regulatory landscape and to get involved in stakeholder workshops and consultations as BEIS continues to consider and consult on potential actions and reforms.

HOW WILL PROGRESS BE MEASURED OR DEMONSTRATED?

In the case of the key commitments relating to power, there is an obvious measure of success in the proportion of energy supply coming from renewable power sources on a periodic basis. Further, the number and quality of new projects coming online is a tangible measure of success. Grid reform is necessarily a more complex and time-consuming process. Public consultations are required, giving stakeholders enough time to understand issues and proposals and to formulate their own responses.

Once the way forward is confirmed, the government will go through implementation stages, which may involve changes to primary and secondary legislation, and to industry codes. While this phase is also likely to be time consuming, we will see concrete progress more easily and businesses can then adapt their structures and investment decisions with tangible reform in sight.

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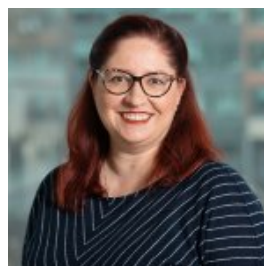
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