

Utilities

UK Energy Policy - Investors Had Been Warned

Key Takeaway

The past few weeks have seen some seminal developments in UK energy policy, all of which have caused or might cause losses for investors in the sector. These announcements may seem unrelated, but in fact they are closely linked.

The Budget: Last week's budget announcement contained a nasty surprise, when the government announced that from 1 August renewable power generators would no longer benefit from the climate change levy (CCL) exemption. The CCL is worth c.£5 per MWh for renewable generators and therefore for an on-shore wind farm, for example, would represent around 6% of current revenues. The loss of the CCL payment will feed directly through to profits as there is (obviously) no off-setting cost reduction. This announcement stunned corporates and investors in renewable projects. Of the listed companies Drax has fallen 30% and Infinis by 19% (adjusted for dividend payments) since the budget. However the real financial damage is likely to be found in the non listed sector, where many developers have created leveraged structures under-pinned by the "stable" subsidy stream including the CCL. Coupled with the low wholesale power prices (based-load is currently £44 per MWh) many renewable power projects will now struggle to cover their cost of capital and some will undoubtedly face financial stress.

The change to the CCL payments is particularly damaging to investor confidence because it came as a surprise, and it comes perilously close to breaking the 'grandfathering' rule that is central to the trust between government and the capital markets.

On-shore Wind: Last week the government introduced a new Energy bill to parliament, the centre-piece of which is to end subsidies via the Renewable Obligation certificate scheme a year early i.e. April 2016. Planning law will also be reformed to ensure that local authorities will have the final say as to whether or not projects go ahead. Whilst projects which already have signed contracts to connect to the national grid together with planning permission will be given a grace period to complete, it is expected that several GW's of projects currently under development will be scrapped. Looking forward, on-shore wind projects will not be financially viable without subsidy unless there is a doubling of the wholesale power price.

Competition & Markets Authority Proposals: Last week the CMA released its interim findings into its investigation into the energy sector. The CMA set forth a series of proposed reforms to the energy market which are now out for comment. Perhaps the most significant of these proposals was that those retail customers currently on standard variable tariffs (c.70% of retail consumers) would be moved onto a new "safe-guard tariff". There would be a single safe-guard tariff across all suppliers based upon the cost base of an 'efficient supplier'. Either the CMA or Ofgem would set the new tariff and would in effect determine what was a reasonable cost to serve and also set the gross profit margin. The merits of this proposal will be the subject of intense debate in the coming months, but if implemented it will undoubtedly mark the most significant intervention in the competitive supply market since liberalisation in 1997.

What Connects These Three Events? Whilst these events may seem separate they are in fact closely related and follow a well established pattern. The first two events listed above are just the latest manifestation of the on-going affordability crises in European energy policy. EU countries have embarked on one of the most extensive and expensive industrial transformation programs in history. The aim is to transform the electricity generating sector from one largely based on fossil fuels to one overwhelmingly based on renewables and nuclear and to achieve this by 2030.

Please find the rest of the discussion in the following pages.

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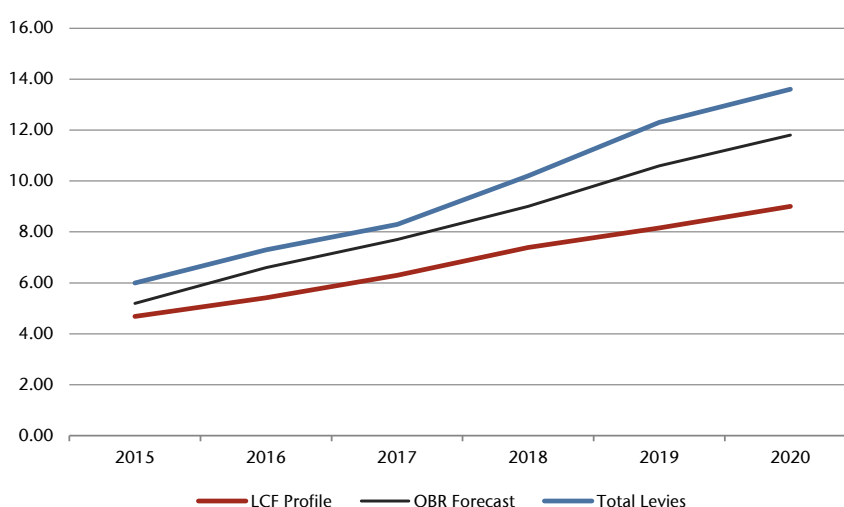
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This program is however proving to be much more expensive than originally envisaged and is being implemented in a profoundly more challenging economic environment. When European governments have been faced with the affordability crises they have, without fail, chosen to ease the pain on consumers by inflicting pain on investors.

For a while investors thought the UK was different, but this was just a matter of timing. The UK's transformation program has been running several years behind most other EU countries and therefore the point at which the inevitable affordability crises hit was also delayed. Last week the Office of Budget Responsibility (OBR) laid bare the UK's problem – see chart below. The OBR now forecast that total environmental levies on consumers to fund the transformation of the power sector will now cost £13.6bn in 2020/21. That is a £10bn increase from the £3.6bn these levies actually cost in 2014/15. By way of context, the total amount spent by all UK consumers (domestic and industrial) on electricity in 2013/14 was £34.1bn. The OBR forecasts show that the government is likely to bust its own cap on costs (the Levy Control Framework) by some 31% by the end of the decade.

Chart 1: Current estimates of the cost of environmental levies (£ bn)



Source: Office of Budget Responsibility and Jefferies estimates

The third event, the CMA proposal for the introduction of a regulated tariff that would initially cover 70% of the retail market, also fits into a pattern. Policy makers appear to have lost confidence in the ability of markets to deliver energy efficiently. On the generation side the UK is now in a position whereby not a single MW of capacity can be built without the government under-pinning the economics through one of the myriad of subsidy / support mechanisms that now totally dominate investment decision process. A small group of civil servants now decide what power stations get built, using which technology, where they are built, and when they will commission. The UK now has a level of central planning in power generation that arguably exceeds that seen when the industry was actually nationalised.

And now the CMA are suggesting that ALL customers using standard variable tariffs are “dis-engaged” from the market and therefore in need of state intervention in order to protect them. The CMA proposal may have some merits (although we struggle to understand what they are) but it would undoubtedly represent yet another gigantic intervention in the energy market, putting the state in the role as arbiter of what is a “fair price” for energy and what is “a fair profit” for suppliers. One thing that can be guaranteed should the CMA proposal be implemented is that a long list of unintended consequences will flow from this intervention that will in turn trigger further and even more intrusive interventions.

Lessons for Investors: many investors have been shocked by recent events, although they can't really complain that there were no warning signs. Investing in a company or an

asset whose economics depends upon government support / subsidy automatically carries policy risk. The level of risk varies and can be mitigated to some degree. But if the underlying public policy is fundamentally unstable – which is the case for UK / EU energy policy – then the risk faced by investors is automatically high. It is extremely hard to mitigate against the policy risk in UK energy because the policy has a huge unaddressed contradiction at its heart – cost versus affordability.

Investors often take a silo approach, looking at the potential returns on a particular project and comforting themselves that the legal framework around their particular investment will provide sufficient protection against policy risk. Unfortunately, experience from across Europe over the past five years shows that this approach often leads to very nasty shocks and the destruction of capital. In our view investors need to do their own assessment of UK / EU energy policy and decide for themselves whether or not policy is likely to be sustainable for the full payback period of their investment. Unless investors are certain that current and future energy consumers in the UK are both able AND willing to pay the cost of the policy, then there is clearly a material risk of investment becoming stranded. If your answer to the question “will consumers pay” is a No or a Maybe, then investing in assets that require a subsidy should be avoided, in our view.

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