fieldfisher

Managing the business impact of the reduction in Government energy subsidies

February 2023

Paul Graham and Nikhil Shah

Managing the business impact of the reduction in Government energy subsidies

Introduction

There is a well-documented perfect storm contributing to the current volatility in energy costs - given the potential consequences of sustained price volatility, there is unsurprisingly a strong commercial desire within the business community to limit their exposure to these price increases. Fortunately, late last year the UK Government stepped in to mitigate the impacts of these historic price rises via the Government's Energy Bill Relief Scheme (Relief Scheme) which provided energy bill relief for non-domestic customers in Great Britain and Northern Ireland.

The Relief Scheme is wide-ranging, and covers a broad swathe of industry. However, given the costs involved, on 9 January 2023 the Government announced that from 31 March 2023 the Relief Scheme will be replaced with a new Energy Bills Discount Scheme (**Discount Scheme**), to apply from 1 April 2023 to 31 March 2024 for eligible non-domestic consumers in Great Britain and Northern Ireland.

Energy Bills Discount Scheme

Whilst the new Discount Scheme will provide welcome continued support for some businesses, its scope and reach is expected to be far more limited than that under the Relief Scheme and so some businesses will remain exposed to volatile energy costs. This exposure may manifest itself in various ways: by energy suppliers no longer deducting significant discounts automatically from bills, but also potentially by suppliers looking to pass on their own increased costs to organisations by means of price increases under their supply contracts.

The effect on businesses is predicted to be substantial. But of course, the impact may differ depending on whether an organisation is principally a supplier or purchaser of goods/services. Regardless, given the short time left until the changes come into effect, it is clear that businesses will, in readiness for the new scheme, need to be fully appraised of the contractual and operational levers available to them to mitigate the impact.

In this article, we look at:

- the (reduced) scope of the Discount Scheme; and
- some of the operational and contractual mechanisms your organisation may be able to utilise to mitigate the impacts of the reduced coverage under the Discount Scheme.

Reduced scope of Discount Scheme

Up to date information on the Discount Scheme can be found on the Government's website. Official rules and comprehensive guidance have yet to be published for the Discount Scheme, although as with the Relief Scheme, the Energy Prices Act 2022 gives the Government its powers to establish the Discount Scheme. The following is a summary of the key provision of the Discount Scheme as known at the date of writing.

The Discount Scheme will provide energy bill relief for non-domestic customers in Great Britain and Northern Ireland between 1 April 2023 and 31 March 2024.

There is no change to the eligibility criteria for the Discount Scheme from the initial criteria applicable to the Relief Scheme – i.e. in theory, the same organisations will be able to benefit.

The Relief Scheme is available to all customers on a "non-domestic contract", including:

- businesses;
- charities and other not-for-profit organisations; and
- public sector organisations (including e.g. schools, hospitals and care homes),

who are:

- on existing fixed price contracts agreed on or after

1 December 2021;

- signing new fixed price contracts after 1 December 2021;
- on deemed / out of contract or standard variable tariffs; or
- on flexible purchase or similar contracts.

While both the Discount Scheme and the Relief Scheme are both intended to cover the field broadly, there are limited exclusions – e.g.:

- where gas and/or electricity is not supplied via a licenced supplier (although on 29 December 2022, the Government announced that support comparable to the Relief Scheme would be extended to those who receive gas or electricity via public networks from non -licensed providers); and
- gas / electricity used to generate electricity to be sold back to the grid, including where this has been stored first.

Reductions to Bills

As per the Relief Scheme, the Government will subsidise a per-unit discount on customers' gas and electricity rates, triggered if wholesale prices go above a certain price threshold. The subsidy will be subject to a maximum discount, which for the majority of eligible organisations has been set at:

- electricity - £19.61 per megawatt hour (MWh), with a price threshold of £302 per MWh
- gas - £6.97 per MWh, with a price threshold of £107 per MWh

For most businesses, these discounts are considerably lower than those available under the Relief Scheme. The discount is calculated as the difference between the wholesale price payable under the relevant energy contract and the price threshold, and becomes applicable when the contract's wholesale price exceeds the floor price, until the total discount per MWh reaches the maximum discount for that fuel.

By way of comparison, prior to the Relief Scheme coming into effect, wholesale costs in England, Scotland and Wales for the period covered by the Relief Scheme were expected to be:

- electricity - £600 per MWh / 60p per KWh
- gas - £180 per MWh / 18p per KWh

The Government essentially covers the difference between the two rates (which it goes without saying, is a very considerable amount). Note that while the p/kWh Government support for comparable contracts will be the same across suppliers, the absolute level of individual bills will continue to vary subject to different contracts and tariffs.

However, with energy prices anticipated to fall going into the summer and beyond, it is looking increasingly possible that estimated wholesale rates will not go above the applicable thresholds. For example, electricity rates are currently at roughly £140 (see live data here). This in turn means that the discounts may not apply to a number of organisations.

Having said that, certain sectors of the economy are particularly vulnerable to high energy prices due to their energy intensive and trade exposure (referred to as Energy and Trade Intensive Industries or ETIIs). In recognition of that, those sectors will receive a higher level of support under the Discount Scheme – although this will still be subject to a maximum discount (which will only apply to 70% of energy volumes). The maximum discounts and price threshold for those sectors are:

- electricity - £89 per MWh with a price threshold of £185 per MWh
- gas - £40 per MWh with a price threshold of £99 per MWh

For a full list of businesses in scope, see the List of sectors eligible for the Energy and Trade Intensive Industries ("ETII") scheme.

Managing the business impact of the reduction in Government energy subsidies

Applying the reductions

As with the Relief Scheme, suppliers will automatically apply reductions to the bills of all eligible customers, and the Government will make those suppliers whole. However, eligible ETII customers will have to apply for the higher level of support. Further details on how this will work will be published in due course. As before, while the p/kWh Government support for comparable contracts will be the same across suppliers, the absolute level of individual bills will continue to vary subject to different contracts and tariffs.

Note that, unlike the Relief Scheme, the Government has now set a total cap on spend at £5.5 billion, based on current estimated volumes. One might expect this pool to be drained fairly quickly as we approach autumn and winter this year.

Mechanisms that can be used to mitigate the impacts of rising bills

Given that changes to the Government subsidy regime are imminent, and that for most businesses the effect of those will be an increase in costs, now is the time to start thinking about the options available to your business to help mitigate the impacts of price rises.

How, and how much, the changes will impact your organisation will depend on a number of factors – including, importantly, whether your organisation is principally a supplier or purchaser of goods / services. Organisations that are principally suppliers of goods / services will likely feel the impacts of price rises through:

- an increased cost base – for both the raw materials / unprocessed goods (where their own suppliers are looking to pass through their increased costs) and resources (i.e. fuel costs, workforce costs, infrastructure costs etc.) required to produce and provide their goods and services; and
- an inability to pass those increased costs through to their own customers - whether for commercial or contractual reasons.

On the other hand, organisations that are principally purchasers of goods/services will likely feel the impacts of price rises through:

- their suppliers increasing their prices, in an attempt to pass through their own increased costs to their customers;
- an increase in their own costs of doing business (e.g. increased fuel costs, workforce costs, infrastructure costs etc.); and
- an inability to pass either of those categories of increased costs through to their end users / their own customers.

For both suppliers and customers, there are a number of contractual and operational tools available to help mitigate the impacts.

Contractual tools for suppliers

To mitigate these risks, when entering into new contracts or re-negotiating existing contracts, suppliers might consider seeking to:

- include clauses allowing them to pass through increased supply costs (generally) or increased power costs (specifically) to their customers during the term. In practice, we would expect most sophisticated customers to push back on the former right, given the significant pricing uncertainty that would create for them. However, in certain energy intensive sectors it is not unusual for suppliers to reserve specific rights to increase prices where their own fuel costs have increased;
- reduce the payment window available to customers, for cash flow reasons and to mitigate the risk of customer financial distress (as customers will be facing their own financial pressures);
- build spikes in energy costs into the definition of force majeure events (for example, as a subset of government action or regulatory change), allowing the supplier to claim relief from their usual service level obligations in circumstances where prices exceed an agreed threshold; and/or

Managing the business impact of the reduction in Government energy subsidies

- build in rights to terminate the arrangement in circumstances where the supplier's costs exceed a certain threshold and the supplier is otherwise unable to pass through those costs (acknowledging that this is unlikely to be a palatable solution to the problem in all but the most extreme circumstances).

Existing Contracts

With respect to their existing supply arrangements, it may prove difficult in practice for suppliers to introduce provisions that would afford them the ability to mitigate the impacts of increased costs (not least since customers will be alive to the issue and subject to their own pressures). However, suppliers' existing contracts may already furnish them with some of the tools they need. Suppliers should consider as a priority whether to conduct an audit of their existing contracts to better understand the rights available to them under those – including (in addition to the rights listed above):

- rights to vary the contract during the term (ideally unilaterally) – whilst a blunt tool, a contract change may be a useful means of introducing some of the levers noted above without needing to engage in a full re-negotiation of the contract;
- the remaining duration of the contract term – if there is very little time left in the initial term, the supplier may be better served by waiting for a natural expiry of the contract (followed by a re-negotiation of terms) rather than seeking to force through changes;
- periodic price adjustment rights, giving the supplier the ability to increase prices through the term in line with certain published indices (some of which factor in energy costs into a broader basket of goods) or inflation; and
- rights to pass through environmental costs, which in certain circumstances may pick up costs of energy.

It is important to note, however, that conducting such an audit is typically a time consuming task, often requiring business and other stakeholder input both to locate and identify the relevant agreements and also to advise on the commercial desirability of exercising any contractual rights that may exist. The time and cost impacts of any audit should be factored in, and the need for external support should be considered, at an early stage.

When considering rights to increase prices during the term, suppliers should also be mindful that customers will typically push for such rights to operate both ways – i.e. a price reduction where energy costs decrease. Given the current price volatility, this could present an administrative nightmare if the rights are able to be exercised too frequently. In addition, suppliers should consider whether any price increases can be effected retrospectively, and whether there is any ability to include administrative overheads in the increase (given the amount of time and effort it may require to process any such rights).

Contractual tools for customers

For organisations that are principally purchasers of goods and services, many of the same considerations as apply to suppliers are also relevant, but in reverse – for example:

- seeking to increase the payment window available to them under their supply arrangements, to enable them to effectively manage their spend under those contracts and their expenditure on increased business costs;
- including clauses in their own contracts with end users, allowing them to pass through increased costs to those customers (whilst remaining sensitive to the commercial imperative to remain competitive) or to ratchet up prices in line with inflation or other indices;
- seeking higher standards of service from their suppliers to compensate for increased spend – which may in turn enable them to scale down provision from other suppliers;
- building in rights to terminate the arrangement in circumstances where prices under the contract exceed a certain threshold (again, acknowledging that this is unlikely to be a palatable solution to the problem in all but the most extreme circumstances), or to suspend certain services to preserve budget; and
- looking to their rights to vary the contract during the term (ideally unilaterally), to e.g. scale services and volumes up and down as required (to offset a per service unit price rise).

Managing the business impact of the reduction in Government energy subsidies

In addition, customers specifically might consider:

- whether a fixed price procurement model is an appropriate means to mitigate price volatility generally (although suppliers will typically seek to bake a level of contingency into their fixed prices to reflect uncertainty in their own cost base – and with energy prices slated to drop over summer, this may not reflect the best commercial outcome); and
- whether they have any rights to benchmark service provision against the market generally (which may afford scope to keep rates low where the suppliers' competitors have not themselves been able to increase rates) or to conduct price audits (which may act as a disincentive to suppliers to increase their prices).

As with suppliers, customers' existing contracts may already furnish them with some of the tools they need. As such, customers should also consider as a priority whether to conduct an audit of their existing contracts to better understand the rights available to them under those.

Operational tools for suppliers and customers

Of course, for both suppliers and customers there may be good commercial and operational reasons why it is not desirable to exercise available contractual rights. For example, as a supplier a straight cost pass through may increase your prices to a level that makes your organisation uncompetitive in the market, straining your relationship with customers and potentially resulting in a loss of business in the long term.

As such, organisations may also wish to consider some of the operational mechanisms available to them to help reduce their costs - including:

- considering alternative approaches to energy procurement – for example, through corporate power purchase agreements (CCPAs). Unlike traditional supply arrangements where energy is procured from licensed energy suppliers who source power in wholesale markets and deliver it to customers via a fixed grid network, CPPAs establish a direct contractual relationship between the generator and the end user. Both physical and financial CPPAs have gained popularity because they allow organisations to lock in energy prices for long periods of time (10-15 year contracts are common), rather than going through regular energy tenders; and
- in some sectors (including the telecoms space), we have seen both an increase in the use of alternative energy sources to reduce dependence on the main power grid; and network load optimisation to reduce energy consumption. For more information, please refer to our video on this topic - Reducing energy costs in telco networks and ICT infrastructure - YouTube.

For tailored advice on the measures your organisation could take to help mitigate the impact of price increases, please contact your regular Fieldfisher contact or one of the authors of this article.

Other support available to businesses

There are a range of schemes in place to support businesses with their energy costs, including:

- the Industrial Energy Transformation Fund (IETF), which supports manufacturers in England, Wales and Northern Ireland with high energy use to cut their energy bills and emissions by investing in energy efficiency and low-carbon technologies. Sites in Scotland can apply for grant support through the Scottish IETF;
- a number of advice and support schemes that businesses may be eligible for, to help to improve the energy performance of buildings and processes and lower their energy bills. Search for local schemes that provide advice and grants; and
- the UK Business Climate Hub which provides advice on cutting emissions and saving money. If businesses are based in England, they may also be able to access support via local Growth Hubs.

Contacts

fieldfisher

Paul Graham
Partner, Technology
+44 330 460 7094
paul.graham@fieldfisher.com

Nikhil Shah
Director, Technology
+44 330 460 6346
nikhil.shah@fieldfisher.com