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OFGEM PUTS FORWARD NEW APPROACH TO FUNDING GREEN GENERATION

> - **Renewable generation is important in tackling climate change and the existing support scheme has brought more renewables to market**
> - **Current scheme is a very costly way of achieving this – domestic and business customers pay even if renewable generation doesn't get built**
> - **Ofgem therefore proposes a system that will cut the cost of reducing carbon emissions through renewable electricity generation.**
> - **Government's proposed review of the RO has yet to address problems**

Ofgem has suggested an alternative approach to the way the UK provides financial support to renewable electricity generation. The regulator has confirmed that the current mechanism is a very expensive way of reducing carbon emissions compared to other alternatives. It has urged the government to consider a plan that promises to deliver more carbon reductions through renewable generation at a lower cost to domestic and business users.

Ofgem recognises that climate change is one of the greatest challenges facing the world and it believes that renewable generation has an important role to play in helping to cut carbon emissions. And the regulator acknowledges that the existing support mechanism – the Renewables Obligation (RO) - is providing strong financial incentives to build renewable generation.

But the way the RO operates means that customers end up paying even if renewable generation doesn't get built, for example, if projects are delayed by planning problems – which is frequently the case. It also fails to link the level of support to the price of electricity or the price of carbon emission allowances under the European Union Emissions Trading Scheme. So existing and future renewable generators will benefit, at customers' expense, from much higher electricity prices.

This is leading to much higher returns for current renewable generators than investors expected or required. In its contribution to a government consultation on reform of the RO, Ofgem has called into question the RO's cost-effectiveness. It has asked the government to consider an arrangement based on auctions of long-term contracts that offer renewable generators a fixed return and link the level of support to the wholesale electricity price. This could meet the government's renewables targets at a lower cost to customers.

"We support emphatically the Government's aim of cutting carbon emissions and recognise that renewable generation has a part to play in achieving that aim. But we think that a review of the scheme could provide more carbon reductions and promote renewable generation at a lower cost to customers - who are already facing higher energy bills," said Ofgem Chief Executive Alistair Buchanan.

"We urge the government to consider our alternative to the RO and we would be willing to take part in the development of any proposals for options," he added.

Ofgem has pressed the government to extend its consideration of possible reforms for the RO beyond its current proposal that the support for green generation should be banded to give better returns to

specified technologies. "We do not think banding fundamentally addresses many of the issues that have been raised," said Buchanan.
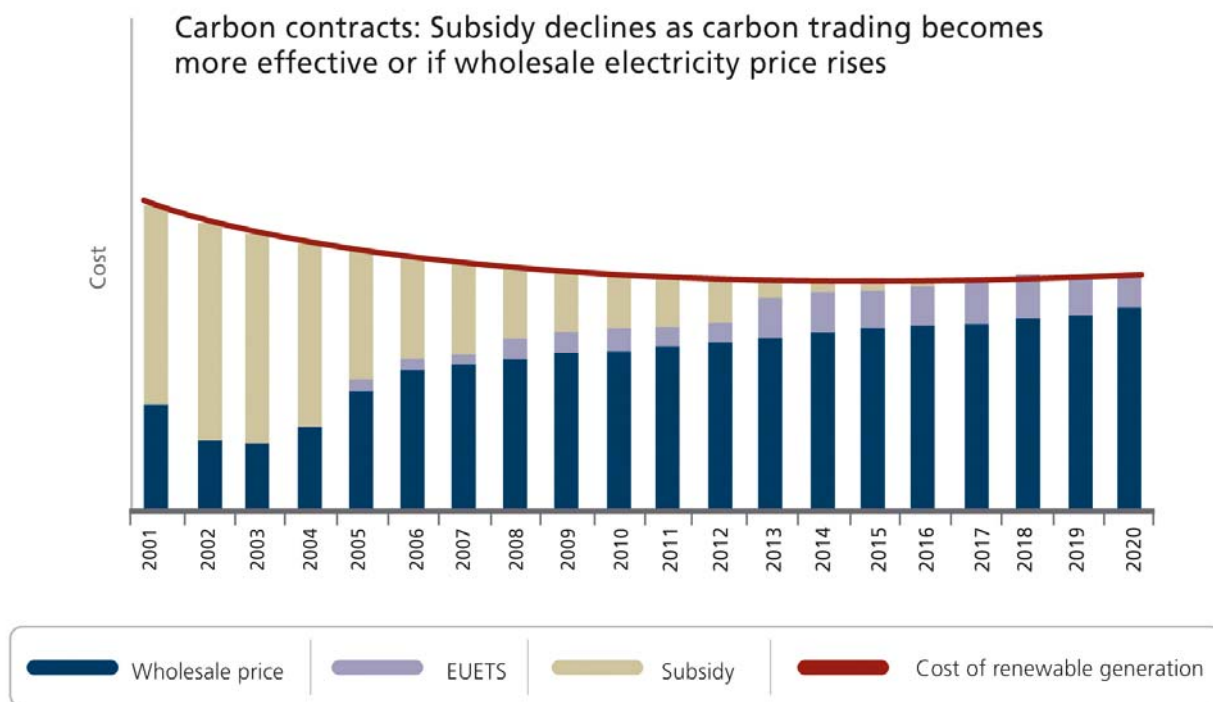
"More rigorous exploration of the costs and benefits of the government's proposals and other options will ensure that business and domestic customers can be much more confident that what is finally chosen is the best option available for meeting environmental targets," he added.
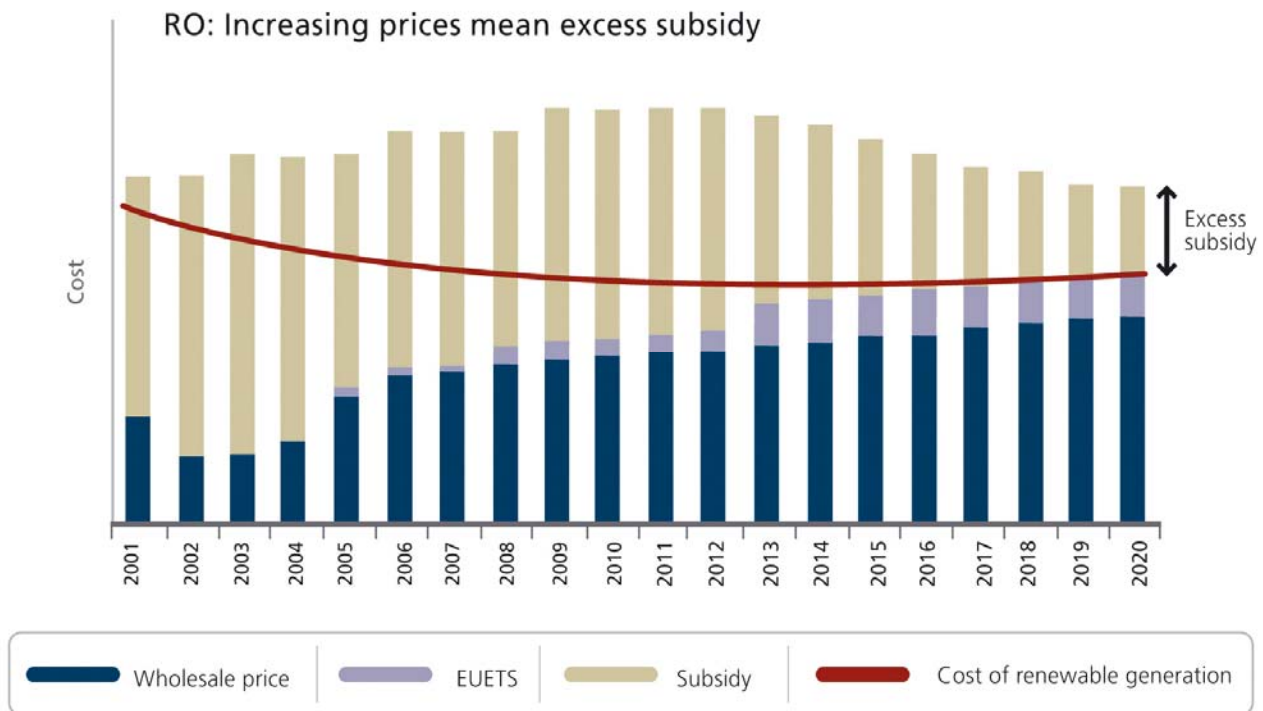
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Notes to editors

1. The cost per tonne of carbon saved under the RO is, at £184-481, higher than the costs of other policy measures such as the EU Emissions Trading Scheme at £12-70 a tonne, the Climate Change Levy at £18-40 a tonne and the Energy Efficiency Commitment which ranges from bringing a benefit to a cost of £60 a tonne.

2. Under long-term contracts the customer pays only for electricity generated by renewable plant so they get more real carbon savings for their money compared to the RO. The contracts would link the level of support to the wholesale price of electricity. So if the price of electricity rises – for example because of rising fossil fuel prices or carbon prices under future phases of the European Union Emissions Trading Scheme, the level of support would fall. This sort of contracts scheme would provide greater certainty on returns for investors and can include penalties for failure to deliver contracted green output (see graphs below).

Carbon contracts: Subsidy declines as carbon trading becomes more effective or if wholesale electricity price rises

RO: Increasing prices mean excess subsidy

Legend: Wholesale price | EUETS | Subsidy | Cost of renewable generation

3. Ofgem gives its full support to the government policy of building on the European Union trading regime for carbon dioxide emissions. The scheme puts a price on carbon emissions and provides financial incentives for sustainable generation– such as renewable generation. But Ofgem questions the need for extra burden placed on customers by the RO.

4. Planning is a major constraint on the development of renewable generation and the planning bottleneck increases the price per tonne of carbon saved under the RO. This is because the RO is set as a percentage of total supply and suppliers who do not meet their RO with electricity from renewable generators pay a buyout price for the shortfall. So where planning delays block renewable plant development the shortfall increases and so does the price for each tonne of carbon saved.

5. Ofgem is the Office of the Gas and Electricity Markets, which supports the Gas and Electricity Markets Authority, the regulator of the gas and electricity industries in Great Britain. The Authority's functions are set out mainly in the Gas Act 1986, the Electricity Act 1989, the Competition Act 1998 and the Utilities Act 2000. In this note, the functions of the Authority under all the relevant Acts are, for simplicity, described as the functions of Ofgem.

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