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*Promoting choice and value for all
customers*

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Dear Megan

2005-6 Review of the Renewables Obligation Preliminary Consultation Document – Ofgem’s response

Context for Ofgem’s response

Ofgem’s principal objective is to protect the interests of present and future consumers, wherever appropriate by promoting effective competition. We have a number of secondary duties, several of which relate to the environment. These include the duty to:

- ◆ have regard to the effect on the environment of the activities connected with the generation, transmission, distribution or supply of electricity, and with the transportation and supply of gas;
- ◆ carry out our functions in a manner best calculated to secure a diverse and viable long-term energy supply;
- ◆ carry out our functions in a manner best calculated to contribute to the achievement of sustainable development;
- ◆ have regard to the social and environmental guidance about Ofgem’s contribution to the attainment of wider social and environmental policies, issued to us from time to time by the Secretary of State;
- ◆ carry out and publish an assessment of the likely impact of implementing a given proposal, including an assessment of the likely effects on the environment of implementing the proposal;
- ◆ *inter alia*, promote energy efficiency and enhance amenity; and

- ◆ administer the “executive functions”, ie administering Government programmes such as the Renewables Obligation (“RO”), the Climate Change Levy exemptions and the Energy Efficiency Commitment.

This range emphasises the need to identify policy options that satisfy our economic, social and environmental duties simultaneously wherever possible and wherever this is not possible, to prioritise according to our principal objective. As a result of these duties, Ofgem considers that the facilitation and development of actions which form part of the Government’s Climate Change Programme which affect the gas and electricity industries is an important part of its work. The RO forms part of that programme which is a series of measures designed to deliver demanding reductions in greenhouse gases, and particularly CO₂ emissions.

Ofgem is also committed to the principles of better regulation and has a duty relating to best regulatory practice. In the light of this and following the principles of the Hampton report, Ofgem is keen to ensure that the administration burden on all participants is no more than it needs to be.

It also considers that in order to further the principal objective, it should support and encourage the Government to pursue policies and programmes which move the UK towards its environmental objectives at the least cost to present and future consumers, and in a way that supports and is compatible with competitive energy markets. This point is consistent with the 2003 Energy White Paper goals and with the Government being aware that the combined effects of measures like the RO, the Energy Efficiency Commitment and the EU Emissions Trading Scheme (“EU-ETS”) could have significant implications for fuel poverty.

Issues to be addressed

In Ofgem’s response to the Government’s consultation on the Terms of Reference for this Review, Ofgem raised the following issues and encouraged the Government to consider these in the Review. Ofgem remains of the view that these issues are important to the effectiveness of the scheme and so should be addressed as part of the statutory consultation. Ofgem notes that some of these issues are contained within the Terms of Reference:

- a. the cost per tonne of carbon saved by the RO compared to other measures such as the EU-ETS, energy efficiency measures or alternative methods of carbon abatement;
- b. the level of support required by different renewable generation technologies in order for them to be profitable, and the ability of the RO to foster newer technologies;
- c. the costs and benefits of other consequences of the RO (eg job creation, export earnings, diversity of supply, rural development);
- d. the extent to which the RO has created and/or is likely to create in the future economies of scale in renewable generation technologies;
- e. the realistic prospects for large-scale deployment of renewable technologies in the next decade; and
- f. a benchmark comparison of the costs and benefits of the RO with support mechanisms in other EU Member States in fulfilment of the Renewables Directive.

Ofgem's detailed response seeks to address these points where Ofgem considers it appropriate for it to do so.

Broad market-based measures

Ofgem considers that broad market-based measures such as taxes and emissions-trading are likely to be the best way for the UK to achieve its climate change goals at least cost. The design of such measures will be crucial to their success in achieving carbon reductions in the most cost effective way. Flexible market-based instruments that are well-designed, eg that are seen to be sufficiently long-term to assure investor confidence, are the best means of meeting the Government's long-term environmental objectives whilst protecting customers' short-term interests. They promote innovation and efficiency in meeting environmental constraints and should, therefore, ensure that emission reductions are met at minimum cost to customers with any price rises minimised. The EU-ETS could be a significant step in this direction and future expansion in scope, both in terms of gases and industry sectors, and tighter caps would allow greater savings to be made more efficiently. More certainty about Phase II and subsequent Phases would be welcomed as this would lead to greater efficiency of investment.

Nevertheless, Ofgem agrees that investments made under the current renewables support mechanism should continue to receive appropriate support but the scheme should be reviewed from time to time to ensure that it is well targeted, particularly in the light of the emerging effects of the EU-ETS, the potential for more large-scale deployment of renewables and the overall balance of benefits and costs to consumers.

Policy Aims of the Obligation

Ofgem notes the criteria set out in the Regulatory Impact Assessment ("RIA") for deciding on any proposal and will continue to work with the DTI and the Scottish Executive on the development of the Obligation in the light of those criteria. However, Ofgem notes that the five policy aims set out for the Obligation are not evaluated.¹

To take one example, Ofgem notes that one of the stated objectives of the Obligation is "to assist the UK to meet national and international targets for the reduction of emissions including greenhouse gases". Ofgem has estimated that the implied cost of carbon to consumers for the Obligation is £198-515/tC, much greater than the £40-50/tC estimated for the allowance price under the EU-ETS based on recent higher prices. While this is not a like-for-like comparison and both schemes are relatively new, it does indicate that the RO costs are likely to be higher than might be needed to achieve similar carbon reductions. This would suggest that the Obligation is not as efficient a mechanism for achieving carbon reductions.

However, the Obligation also has a number of other stated objectives referred to above, including to:

- ◆ help provide secure, diverse, sustainable and competitive energy supplies;
- ◆ stimulate the development of new technologies necessary to provide the basis for continuing growth of the contribution from renewables into the longer term;

¹ These were set out in the Renewables Obligation Statutory Consultation, DTI, August 2001

- ◆ assist the UK renewables industry to become competitive in home and export markets and, in doing so, provide employment; and
- ◆ make a contribution to rural development.

If the RO is in fact a long-term instrument aimed at fostering innovation and supporting development of new generation technologies that will be necessary to meet future, tougher emission reduction targets, the scheme could, then, be considered to have objectives beyond those covered by the EU-ETS. Being long-term, it may present a more immediately viable alternative for investment in renewables development.

In this context, Ofgem recognises that there may be some benefit to retaining a specific renewable generation support mechanism, aimed at the wider objectives linked with renewable generation and any binding EU targets which may emerge. However, this will require careful co-ordination with policies aimed at reducing carbon emissions so that inefficient outcomes are avoided. In other words, Ofgem recognises that there are costs associated with combating climate change but considers that the Government should be looking to minimise the costs where possible and to ensure that the money that is spent is appropriately targeted all of which will help ensure better value for money for consumers on whom costs will fall. For example, with the RO functioning alongside a broad-based emissions trading scheme, account should be taken of any benefit that renewable generators receive as a result of the introduction of the EU-ETS. Ofgem notes the contents of the report that DTI has commissioned from Oxera as a part of this consultation and our comments on this report are detailed in Appendix 2 of our response.

Renewables target

Ofgem understands that the Obligation target of 10.4% of supply to customers being from renewable generation by 2010 equates to the Government's 10% renewables target which was given as a manifesto commitment. Ofgem further understands that the national indicative target as set out in the Renewables Directive (2001/77/EC) is 10% of all renewables by 2010 – this includes generation from large hydro and the biodegradable fraction of energy generated from waste. Ofgem would welcome a statement from the Government that the significant target that the Government is hoping to achieve is the Directive target. Such a statement would allow the Government to continue to work towards its aims of reducing the excess subsidy in the scheme and makes it clear that all renewable technologies do not automatically require subsidy.

European comparison

The Renewables Directive requires Member States to encourage renewable electricity and to report on measures to achieve the national indicative targets. The Council for European Energy Regulators has set up an Environment Task Force to undertake work looking at the effectiveness of Member States' different support schemes for renewables and identifying aspects of these that lead to market distortions. It is also identifying recommendations for harmonising aspects of each Member State's support mechanism to reduce, prevent or remove these market distortions. It is expected that this work will feed into the Commission's report required by the Renewables Directive and expected in October 2005 about the likelihood and feasibility of harmonisation. Early indications are that harmonisation will not be supported by the Commission at this stage and Ofgem agrees with this position. Nevertheless, Ofgem considers that the Government should carry out a benchmark comparison of the costs and benefits of other support schemes and

their effectiveness in meeting the Directive indicative targets in comparison to that of the Obligation.

Evidence-based analysis

Ofgem considers that the Government must properly assess through rigorous, evidence-based analysis the effectiveness of the Obligation as a means of achieving the UK's long-term goals for carbon reduction and security of supply as well as meeting its renewables target. Such analysis would clearly be consistent with the intentions for the Review as set out in the Energy White Paper. It would also enable the Government to have a firm basis on which to form a view on how the Obligation might develop towards 2020 and beyond for any later Reviews.

Ofgem supports the Government's goal of achieving very major long-term reductions in greenhouse gas emissions to help combat climate change by ensuring that decisions that need to be taken in its pursuit are as a result of evaluation of the most efficient and cost-effective measures. We recognise that there is a legitimate argument for policies to promote technological innovation, including in the development of renewable technologies, to meet that goal. As emissions reduction targets become increasingly challenging, they will require increasingly costly measures, and the deployment of renewable technologies is likely to become at some point a cost-effective tool for carbon abatement.

However, policy toward renewables must be developed in the context of their overall position in the portfolio of available measures. At present there are other measures available, eg through EU-ETS that could reduce carbon emissions at much lower cost than renewables. The case for supporting large-scale deployment of renewables now rather than in 10 or 20 years' time rests crucially on the potential for that deployment to reduce future costs by fostering innovation and "learning by doing". That potential should be the subject of careful analysis, in particular before considering any further extension of the Obligation. As one contribution, we have commissioned independent analysis from Cambridge Economic Policy Associates ("CEPA") and Climate Change Capital ("CCC"), which is attached with our response and will be published on our website. We would interpret CEPA/CCC's analysis as arguing for a degree of caution in assessing the potential for cost reductions in renewable technologies. While their analysis is by no means definitive, it should be taken into account.

Conversely, it is hard to see any strong argument for including within the RO any additional technologies where those technologies are already mature and unlikely to see sufficient innovations. This would apply to both CHP and energy from waste.

Climate Change Programme Review

Ofgem notes that the Climate Change Programme is currently in the process of being reviewed and Ofgem has responded to the consultation on this. In terms of achieving more cost effective carbon reduction, there would seem to be cheaper measures than the RO available in the short-term. Ofgem looks forward to the revised Climate Change Programme having urged the Government to confirm the position of the EU-ETS in its central role in combating climate change which should help bring about those cheaper measures.

Yours sincerely



Steve Smith
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