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By 31st March 2010

Dear Ian,

Project Discovery: Options for delivering secure and sustainable energy supplies

The Renewable Energy Association (REA) is pleased to comment on this consultation. The REA is the largest renewable industry body in the UK, with over 600 corporate members. The association and its members are active across the range of renewable electricity, heat and transport technologies

We welcome project discovery as providing a useful exploration of the issues facing the UK in delivering secure and sustainable energy supplies over the next 10-15 years. We are pleased that this work has stimulated DECC and Treasury to publish its Energy Market Assessment, as clearly it should be Government that sets the structure of the electricity market and determines the extent to which the structure should be market driven or centrally planned.

The consultation is particularly seeking views on the following issues:

- Whether the assessment of the current arrangements are accurate.
- Our view of the proposed policy packages.
- What other policy measures could be considered.
- Extent to which early actions should be considered.

Our response looks at each of these issues focussing on the consequences for the renewables industry, and particularly the impact of meeting the UK target of 15% renewables by 2020.

We strongly feel that consideration of radical changes must take into account the impact on investor certainty and the financial implications for those who are making substantial investment decisions now, based on the current mechanisms and structure. Ultimately government cannot mandate others to build renewables; all it can do is provide the right incentives.

We recognise the importance and issues raised in the report. However we feel, given the short time scale to 2020, that continuation of free market arrangements combined with appropriate policy instruments and incentives are the only sensible way to deliver the UK's energy goals in 2020.

Gaynor Hartnell,
Chief Executive,
REA.

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Responses to main issues

Appraisal of current market arrangements

Renewables

From the perspective of renewables we have concerns regarding the assessment of current arrangements. The whole premise of the report leads from the conclusion that the status quo "may not be sufficient to address the financing challenges and achieve renewables and climate change goals". This is not well justified in the report, and it is not clear what basis and taking into account what factors the statement that the UK may not meet its renewables target was formed on. It seems strange that it refers to this "as one possible outcome" but remains silent on the other possibilities.

It seems to us that the package of measures the Renewables Obligation (RO), the Feed-In Tariff (FIT), the Renewable Heat Incentive (RHI), and other facilitating measures should be enough to achieve our 2020 targets. We consider it very premature to conclude that the current mechanisms will not deliver the deployment needed to meet the UK targets, given the FITs will be launched on 1st April and the RHI is still being consulted on.

The achievement of the 2020 target requires immediate and rapid deployment and the measures have barely had time to kick in. It may be possible to achieve renewables targets through different mechanisms, but there would be a heavy cost to be paid if there is any hiatus, if any radical change were to be made.

In order to deliver the renewable target the industry needs to have confidence in the continuation of mechanisms in a form that is clear and that it understands. It is essential that once an investor has made a decision based on a set of arrangements at the time, this is protected and grandfathered.

The consultation document makes the point that subsidy schemes and separate targets may undermine the carbon price, ideally all external costs would be internalised and reflected in a sufficiently high carbon price. However given the carbon market is still in its infancy, the carbon price is too low to incentivise low carbon investment, technology support schemes are vital for emerging technologies and renewables. There are reasons other than the carbon benefits for providing subsidies and why specific renewable targets are set, these include security of supply and also the long term economic benefits.

Security of supply

It is possible that there is not an adequate incentive to build non renewable low carbon generation, including generation that will have low load factors. It may be that a floor to carbon prices and the introduction of some sort of capacity mechanism in the market would be useful to address these issues. Indeed the political acceptability of prices in an energy only market rising to levels needed

occasionally to support the building of low load factor generation needs to be debated and agreed upon explicitly if a capacity mechanism is not to be introduced. We will not comment on the carbon price further beyond saying that a floor is probably something that would need to be addressed at EU level.

There is a philosophical issue to resolve as to what is meant by security of supply. We do not agree that the definition you propose is adequate. It starts:

"No customer loses supply of gas or electricity if they would have been willing to pay more for a more reliable supply (or is adequately compensated if they do lose supply)"

Whilst this might be acceptable for modest ranges of price variation it is clear that a customer choosing not to take supply when the price is at say £100/KWh is a failure to supply, not an economic decision of the customer not to consume. It may be that the last part of the definition is meant to deal with this.

"All consumers have access to adequate supplies of gas and electricity at prices they can afford and pay no more than they need to in the achievement of these objectives, whilst prices are consistent with the need to finance future investments."

To reconcile this with the first part might involve setting a soft price cap i.e. a price above which any failure to consume is regarded as a loss of supply but with the price being allowed to go higher so as to use efficiently whatever supply is available.

It is ironic that a centrally defined security level in the electricity market was removed when NETA was introduced at a time when the overwhelming majority of customers had no means to respond to price signals. Post smart metering roll out when they may have that ability is combined with discussion on bringing back a centrally determined level.

Consumers

A key question raised in the consultation is which of the policy packages will deliver secure and sustainable energy supplies at the lowest cost to customers. Under Ofgem's own scenario analysis the impact on bills is lower under those involving a high level of renewable deployment. In order to achieve this level of deployment the incentives must be right.

We feel the packages that largely stick to a market approach should deliver benefits of innovation and cost reductions in the longer term. Onsite renewables funded through the FITS and RHI provide a great opportunity for householders to take control of their energy production, rather than being passive recipients of big companies' actions. Feed in tariffs, coupled with the "pay as you save" measures proposed in the Household Energy Management strategy could have particular benefits for those considered to be in fuel poverty. Fitting a fuel poor household with renewable energy equipment and improving its energy efficiency has a long lasting effect.

Possible policy responses

The consultation proposes five policy packages for consideration by government. In this section we highlight the implications for each on renewables.

Package1: Targeted Reforms

This package aims to promote low carbon investment. The proposals include clearer carbon signals, better price signals and improved ability for demand side response. The proposals, such as a minimum carbon price, under this package should incentivise renewable deployment further. Given that current market arrangements remain, and the RO is still the primary mechanism to deliver renewables targets, there should be minimal disturbance on current investment. The REA has no objection to this option.

Package 2: Enhanced Reforms

In addition to changes proposed under the "targeted reforms" package, this second package has additional measures to ensure security of supply. It proposes obligations on suppliers, the system operator, and gas fired generators related to ensuring they can cover demand and have back up supplies. It also includes the facilitation of renewables deployment through a centralised renewables market.

The Renewables Obligation continues to be the main mechanism to deliver renewables, but is supplemented by a centralised renewables market, described in box 2, page 41. This describes a mechanism for which the benefits (at the UK's current level of renewables penetration) seem minimal in comparison with the cost of implementation. At present the bilateral market approach (plus ROCs) operates satisfactorily – and therefore to us does not seem "broke" and in need of fixing.

We think that placing a security of supply obligation on suppliers (other than to buy up to a set price) is fundamentally incompatible with competition between suppliers. There is no way that the volume taken by each supplier to supply their customers can be known in advance.

We would not support enhanced obligations on the system operator to buy reserve or additional generation. Either there is central purchase of all electricity (which for the avoidance of doubt we would oppose) or the market must be allowed to perform. Having some generators make themselves available (ignoring within settlement period and locational issues) on the basis of a contract with NGC would distort the market. There is nothing additional in the Enhanced Reforms that impinges on renewables deployment.

Package 3: Enhanced Obligations with Renewables Tenders

The objective of the third package is to increase the probability of meeting the renewables 2020 target. It proposes a tendering system for renewables, assuming it is better value for customers. The downside is mentioned, which would be the introduction of a new renewables financial support mechanism, and the existing

Renewables Obligation arrangements would need to be grandfathered. However the FITs as proposed could remain in place.

This proposal gives a strong sense of déjà vu, given that the UK had a tendering system, the NFFO, from 1990 to 1998. This was replaced by the RO, which has since moved de facto through fixed headroom and banding to a policy which now delivers something akin to feed in tariffs, but with none of the simplicity.
The NFFO scheme may have had some merits, but to move back to it now, without any substantial justification, is not helpful. It also seems very strange that tenders are introduced for renewables before other types of generation, given there is already a specified amount of renewables driven by the renewables targets in 2020.

Package 4: Capacity Tenders

The fourth package looks at the introduction of tenders for all generation capacity, new gas storage and other gas infrastructure. It would not include a minimum carbon price as specific volumes of low carbon and renewables would be brought forward. This would allow all generators and demand side response to offer a capacity payment at which they would make themselves available and a central body would purchase enough capacity to ensure that whatever standard of security was required could be met. An energy only market would continue to operate.

This would appear to be fundamentally flawed as there would be no means for the central buyer to judge competing offers. Accepting the lowest capacity prices may result in generation winning a tender that will just charge higher prices in the energy market than plant that wanted a higher capacity price but would be content with lower energy prices / predicted lower energy price levels. We would also be concerned with the risks of mis-forecasting,

Package 5: Central Energy Buyer,

Package 5 is the most radical proposal, which aims to achieve large scale investment while significantly reducing risks. This would be achieved through a single entity co-ordinating future investment. This scenario would be a return to the 1980s and a statement that liberalisation was a mistake. We do not believe that this is the case and are confident that free market arrangements combined with appropriate instruments to support low carbon electricity (such as ROCs and the FIT for renewable generation) will provide secure low carbon electricity at a cost that is lower than it would be if a central buyer was in charge of determining what gets built and what does not.

There are risks associated with the central energy buyer not making the right decisions, and government has not historically been that successful with "Picking winners".

Assessment of the five packages

There is recognition that the current arrangements have not brought forward the desired level of investment in low carbon generation to meet government targets. However all the previous targets have not been legally binding and as mentioned previously the introduction of the FITs and RHI, and changes to the RO have been introduced to ensure our renewable targets are met.

The document only briefly touches on network issues and other non-financial barriers. For many projects these are significant barriers, we hope government would take into consideration all the various policy issues to determine what changes are necessary to ensure the UK meets its renewables target. The REA are leading in the UK on the REPAP 2020 project, which is a pan European project looking at how Member States will meet their renewables targets. The REA are drafting a shadow renewables action plan, and in February presented over 100 recommendations to industry to endorse.

Prior to undertaking a total reform of the market, to ensure the UK achieves the necessary level of renewable deployment, other barriers must also be carefully considered.

Timing

We are not supportive of any radical changes to the market, due to the uncertainty this would create for investment. However, a strengthening of the carbon price would likely be beneficial for renewable deployment.