Energy Intensive Users Group

British Ceramic Confederation
Chemical Industries Association
Mineral Products Association
Major Energy Users Council
UK Steel
British Glass Manufacturers Confederation
EnergyQuote JHA
Confederation of Paper Industries
Rio Tinto Alcan
BOC; Air Products

elec.marketreforms@decc.gsi.gov.uk

14 March 2011

DECC Electricity Market Reform Consultation:
Response from the Energy Intensive Users Group

1. General Comments

Energy Intensive Users

The Energy Intensive Users Group (EIUG) is an umbrella organisation that campaigns for secure, internationally competitive industrial energy supplies. EIUG recognises the potential threat posed by climate change and supports global diplomatic, scientific and regulatory efforts to address the issue, including the cost effective abatement of carbon emissions.

Energy intensive manufacturing sectors include steel, chemicals, paper, cement and mineral products, glass ceramics, industrial gases and aluminium smelting. These industries have a critical role to play in a rebalanced UK economy, directly employing 225,000 workers and contributing over £15 billion to UK GDP. They are at the head of many supply chains covering such important manufacturing sectors as automotive, aerospace, and low carbon generation technologies, not least in the nuclear sector. Energy intensive sectors are highly exposed to international competition and consequently at risk of 'carbon leakage' if UK industrial energy prices are driven to internationally uncompetitive levels as a result of carbon taxation and other unilaterally imposed decarbonisation costs.

Market based Energy Policy

We recognise the urgent need to attract investment to ensure security of future energy supplies and to decarbonise electricity production, provided this is done cost effectively. In our view, a competitive model is best placed to deliver least cost provision of energy supplies and least cost carbon reduction within the power sector.

It is regrettable that many of the Electricity Market Reform (EMR) proposals appear to represent a move away from market based policy towards a planned energy economy. We do not share DECC's faith that government is better placed than private investors to optimise the fuel mix in power generation or to select the most practical and cost effective technologies to ensure its decarbonisation. We are therefore concerned that many of the EMR proposals will prove unnecessarily expensive and hence detrimental to the welfare of consumers.

We appreciate that policy is constrained, formally at least, by the supposedly 'legally binding' EU target for 15% of UK energy consumption to be met from renewable sources by 2020, which in practical terms requires more than 30% of electricity to be generated from renewables. In common with the relevant government department and the chief scientific adviser at the time,

EIUG disagreed with the UK's unexpected decision to sign up to the target, criticising its negative implications for security and cost of future electricity supplies.

These criticisms have proven well founded and it is now openly acknowledged within the energy industry (and tacitly by others in private) that there is not the remotest chance of the target being achieved. It is also clear that the cost of attempting to meet it – over £100bn, according to DECC's own analysis – significantly exceeds the potential environmental and economic benefit, including the avoidance of any plausible cost to the UK of non-compliance. Whilst sympathising with the position in which DECC currently finds itself, the non-credibility of the renewable target is hardly a secret to energy investors who are well aware that policy measures built around it are neither politically nor economically sustainable, and hence are un-bankable in the longer term. It would be preferable therefore for energy investors and consumers alike if DECC was able, sooner rather than later, to acknowledge this fact in public.

Security of Supply

Our members fully understand the need for diversity in the provision of new baseload generation capacity in order to maintain security of supply, and appreciate that assurance of an acceptable return is required for investment to take place relevant forms of secure, low carbon generation with very high initial investment costs which must be recouped over a lengthy future period. Indeed, our members are faced with similar long-term investment decisions themselves. It does not follow from this, however, that 'de-risking' such investment (in fact, transferring the risk to consumers and/or taxpayers) should be done to such an extent that incentives for economically efficient investment are diluted, or that in doing so windfall profits arise to incumbent generators from the operation of existing assets.

Regulatory Impact Assessments

Our response to the EMR consultation takes place in the context of escalating energy costs arising from existing UK and EU climate policies that are already eroding the international competitiveness of intensive manufacturing and deterring the investment in these sectors that is necessary to assure their future. EIUG drew attention to the unacceptable cumulative burden of these policies in a report jointly commissioned with the TUC from independent consultants Water Wye Associates, which was shared with government departments and published in June 2010. One of the conclusions of this report, which appeared to have been accepted by government, was that future climate policy consultations should include impact assessments for intensive industrial energy users specifically, both with regard to the marginal impact of individual proposals *and* the cumulative burden in the context of existing policies.

As with HMT's recent consultation on Carbon Price Support (CPS), our members were disappointed that DECC failed to publish an impact assessment for the EMR proposals on intensive energy users, let alone one quantifying the cumulative competitive burden in conjunction with existing climate policies. In the absence of clear evidence to the contrary, suspicion naturally turns to the possibility that a decision has been made not to publish such an assessment for fear of publicly acknowledging the detrimental impact of the proposals on industrial competitiveness, which is essential for the survival of energy intensive industries in the UK.

In the absence of an adequate impact assessment, EIUG has commissioned an update report from WWA on the impact of climate policies (including the CPS and Energy Market Reform proposals) on energy intensive businesses, a copy of which is appended to this response.

International Competitiveness

As DECC is well aware, progress towards an international agreement on carbon emissions has stalled, no developed economy outside Europe is prepared to subject its industry to a fixed cap and trade scheme, and no developing economy of any global significance has signalled a willingness to be bound by an absolute national emissions target.

In this context, encouraging carbon leakage by imposing costs on energy supplies that will not be faced by our EU competitors, let alone those outside the EU, would simply damage our economy, resulting in the redistribution of industrial emissions globally but not in their reduction. For the UK to show that a low carbon economy is both achievable and economically sustainable, it is vital that intensive industries can remain located here.

Regulatory Complexity

It is regrettable that the CPS and EMR proposals overlap with one another. For example, if the proposals for Feed in Tariffs for low carbon generation go ahead, it is not clear why a CPS mechanism would also be needed.

EIUG has always accepted the intellectual case for internalising the cost of carbon emissions from power generation, subject to the caveat of maintaining the competitiveness of trade exposed energy intensive industries. However, instead of this being done via a single price signal for carbon, energy users face a multiplicity of climate policy costs arising from the EU Emissions Trading Scheme, the Climate Change Levy and (for non-intensive business use) the Carbon Reduction Commitment – a list to which the proposed Carbon Price Support mechanism must now presumably be added. How many times does the cost of carbon need to be internalised? Such complexity is neither in the interests of energy investors nor consumers.

To these costs must also be added the direct and indirect costs of renewable subsidies – the former mainly arising from the Renewables Obligation (or its Feed in Tariff replacement), the latter including inflated transmission and distribution charges to cross subsidise economically inefficient location of onshore and offshore wind turbines and the proposed capacity mechanism to help ensure sufficient part-loaded conventional plant is available to provide back up for their unreliable output.

An opportunity has therefore been missed for the simplification and improvement in economic efficiency of climate policies. Instead, the energy industry and its consumers are facing even greater complexity and policy overlap. DECC should also bear in mind that a simpler, less complex regulatory environment is needed to encourage investment in energy efficient manufacturing as well as in low carbon power supplies.

Liquidity

We support action to increase liquidity in the spot and forward electricity markets. It is important that Ofgem and DECC work together closely on this – currently, there is no proper UK reference price, although plenty of examples exist in liberalised markets elsewhere in Europe (e.g. Nordpool).

DECC should be aware of the danger that a combination of large power volumes being supported by Feed in Tariffs, coupled with the move to capital intensive low carbon power generation, could be counterproductive as far as liquidity is concerned, benefitting larger, vertically integrated incumbent energy companies to the detriment of independent players.

Conclusions

Despite the reservations noted above, there are some positive aspects to the EMR proposals – particularly the fact that the low carbon status of nuclear as well as renewables will be more equally recognised in future – that we are pleased to acknowledge and support.

Comments on the specific EMR proposals follow.

1. Feed in Tariffs

EIUG believes the needs of consumers are best met by allowing the investors to have maximum flexibility in terms of the fuel mix for low carbon power generation. We have never supported the notion that government should pick arbitrary technology-specific targets for power generation, whether from renewables or any other source, regardless of the mechanism by which such targets are supported. Nevertheless, we recognise that the Renewables Obligation is a particularly poor mechanism for subsidising the production of renewable electricity which delivers carbon abatement at unnecessary cost, in many instances well in excess of the government's own estimate of the social cost of carbon, and would therefore welcome its eventual abolition.

We have reservations about the potential cost implications of DECC's favoured option of Feed in Tariff (FIT) based on Contract for Difference (CFD) but recognise that it is the least unattractive of the FIT options that has been considered. In their favour, CFD FITs have potentially positive implications for availability of long-term industrial supply contracts, especially related to nuclear new build, which could be of benefit to energy intensive users.

We note that the government appears to be offering a generous deal to nuclear investors, both through the proposed CPS and FITs, and consequently believe it is fair to ask what that industry should offer to consumers in return. One obvious possibility would be to require FIT backed investors to offer cost-reflective, long term, fixed price supply contracts to industrial energy users. There could be parallels here to the French Exceltium deal, which gives industrial users access to power supplies at a stable long term price of around €40/MWh.

It is not clear who the contracting party for FITs would be although the consultation document implies this might be government, in the first instance at least. EIUG believes that it is right that some of the risk associated with FITs should be borne by future taxpayers to avoid a disproportionate burden being placed on current energy consumers, as has already been done with the Renewable Heat Incentive. It is also unclear what would happen to recycled (windfall) benefits. Who would receive this benefit, should it arise – HMRC or consumers? EIUG believes that much work is needed to develop the CFD FIT proposal further and that industrial energy users should be involved in this process.

EIUG believes that FITs should not favour particular technologies and that all mature, low carbon technologies should be treated on an equal basis. We therefore welcome the fact that CFD FITs, if they go ahead as proposed, could be available to nuclear as well as renewable power generators.

EIUG believes that the alternative option of a premium FIT would be problematic and should be rejected. Evidence from other EU markets where similar measures have been imposed shows the difficulties that arise when governments attempt to pick the 'right' premium. Too low and the desired renewable investment is not delivered – too high and the result is windfall profits, especially during periods when fossil fuel-driven wholesale prices are high and there is least need for additional subsidy.

As noted previously, there is a need for regulatory simplicity. Assuming FITs work as intended, it is not clear why a carbon floor price is required as well.

2. Capacity Payments

EIUG is not convinced of the need for a targeted capacity payment mechanism. We share the view of National Grid and many power generators that existing mechanisms (STOR, demand response, etc.) could be developed further without major intervention and that capacity payments are not therefore required, although there may be a case for considering them should the UK eventually become very highly dependent on unreliable wind power.

As with other measures proposed in the EMR it is difficult to know the likely impact of capacity payments on industrial power bills, but as discussed in the report from WWA attached to this response, they could prove a very expensive option.

We believe that the possibility of introducing targeted capacity payments at some stage in the future requires much further thought, but note that there is more than adequate time to consider the advantages and disadvantages in greater depth well before there is any question of the UK having to deal with some 25GW or more of intermittent wind generation.

Should DECC wish to press ahead with capacity payments it will be important to consider how they could affect and support voluntary, commercially driven demand side response, though DECC should be aware that this is different technically to generation, not core business for industrial energy users, and cannot therefore be relied on too regularly.

3. Emissions Performance Standard

EIUG believes that an Emissions Performance Standard (EPS) is neither necessary nor desirable. Power sector carbon emissions are already capped under the EU ETS so there would be no environmental benefit from their imposition. The ETS was promoted as an alternative to this sort of regulation, which simply reduces flexibility in power generation and compromises the ability of the market to ensure security of supply at least cost.

One possible consequence of an EPS could be to encourage the more frequent use of numerous diesel backup generators in place of the limited use of centralised oil and coal generation. The latter may in fact be preferable (or at least no worse) that the former in terms of overall emissions.

DECC should also be mindful that an unduly restrictive EPS could encourage higher carbon electricity generation to be sited elsewhere in Europe to supply the UK via interconnectors, exporting jobs, growth and investment quite apart from the increased risk to security of supply.

Should DECC be determined to impose an EPS, despite all these disadvantages, it is essential that the emissions level is neither too low nor too inflexible hat it impacts negatively on security of supply. An EPS set on an annual basis (similar to the regime for plant opted out of the LCPD) would help minimise security of supply risk. The aim should be to minimise the time high carbon generation is run, not to remove it from the system.

With regard to the level at which such an EPS might be set, we are pleased to note that DECC has implicitly rejected the Committee on Climate Change's unrealistic advice that 'investment in conventional gas after 2020 should be ruled out'.