

Dear Sir / Madam

DECC Consultation on Electricity Market Reform - Response by Highlands & Islands Enterprise

1. Highlands and Islands Enterprise (HIE) is the Scottish Government's agency responsible for economic and community development across the northern half of Scotland and the islands.
2. HIE along with its local partners: the democratically elected local authorities covering the north of Scotland and the islands: Shetland Islands Council, Orkney Islands Council, Comhairle nan Eilean Siar, Highland Council, Argyll & Bute Council and Moray Council have, for a number of years, been making representations to key participants on behalf of industry to influence the way in which renewables are incentivised and grid construction is triggered, underwritten then accessed and charged for in the region. We are working closely with Scottish Government in relation to a wide range of regulatory issues and are supporting its efforts to challenge barriers currently blocking renewables development across Scotland.
3. Renewable energy resources in the Highlands and Islands of Scotland constitute the greatest concentration of potentially exploitable renewable energy resources in the UK. Indeed, the area has a long association with the production of renewable electricity given the existence of much of Scotland's large scale hydro which has contributed to the UK's electricity generation for a number of decades, producing the most cost-efficient power in the country. This would not have happened without political and monetary support and commitment for its (then) ambitious construction programme.
4. The region is also home to some of Europe's strongest sustained wind regimes along with some of the world's best wave and tidal regimes and is well placed to contribute to UK and European carbon reduction and renewable electricity generation targets *if* a favourable policy environment can be developed/maintained and key regulatory barriers can be effectively addressed to facilitate deployment of renewable technologies. The Highlands and Islands are also well placed to contribute to the regulatory objective of security of supply by facilitating the deployment of a geographically dispersed, range of technologies which also makes economic sense in a wider context as demonstrated by the attached Scottish Power report.
5. HIE and its local authority partners welcome the opportunity to respond to DECC's EMR consultation. We are acutely aware of the benefits of renewable energy and following established hydro projects are now experiencing a second wave of renewables which is bringing much needed high value employment and associated economic benefits to some of the UK's most remote and fragile areas. Ongoing political support is critical to maintaining this momentum, and the market support scheme for renewables – the Renewables Obligation (RO) and the Renewables Obligation Scotland (ROS) – is the central building block in this picture. Removing, downgrading and to a large extent; creating uncertainty around this support at this stage

would take with it and is risking all of the activity and trickle-down benefits it stimulates. We cannot stress enough how important this is.

6. First and foremost we feel that the RO works well in its current form. The RO has undergone a number of refinements over the years and it has had a year or so of working well as a banded scheme. The ability to specify more generous support for wave and tidal in Scotland has been a significant driver for inward investment of strategic importance to the UK. This is particularly true of technology developers testing at the European Marine Energy Centre (EMEC) in Orkney and with proposed projects in the Pentland Firth and Orkney waters. However, we recognise that the EMR could ultimately drive more investment in renewables (and much needed support for CCS) but caution that this must be balanced with the cost of uncertainty and risk of investment hiatus in the interim period which could extend out to 2014 according to industry.
7. Our comments are structured by the consultation chapters and we have tried to address the consultation questions in our text. If you would like any further information or advice relating to our responses, please do not hesitate to contact us.

Current market arrangements

8. The consultation frames difficulties with the current market in terms of price uncertainty for many plant reliant on the wholesale electricity market for their returns. We agree that this kind of uncertainty would impact negatively on long-term investments, especially where generators have limited ability in setting the price.
9. We note that there is also uncertainty in network charges which – in feeding through to operational costs – has a comparable impact on investments. Network costs are similarly likely to be more unpredictable and variable as the sector decarbonises – hence there is an important overlap between the EMR and Ofgem's Project TransmiT.
10. HIE has long argued that the current market and regulatory frameworks are a barrier to the development and deployment of renewables in the Highland and Islands of Scotland and impact on the region's ability to contribute to UK and European carbon reduction targets. The combination of EMR, the role of Ofgem and Project TransmiT present an opportunity unlock the generation potential of some of the UK's best resource areas. However, unless all strands of energy market and regulation are developed in harmony, there is significant potential of a hiatus on investment in renewables which could drive the opposite behaviour to that intended by EMR. We appreciate that coordination between these consultations is easy to say but less easy to implement at a practical level and make a special plea to DECC that the EMR takes full cognisance of developments in Project TransmiT and the review of Ofgem's role in order to arrive at a positive outcome that drives investment in renewables in high resource areas.
11. HIE also agrees that new flexible plant, demand side response (DSR) and interconnection are all required to complement variable output generation and inflexible baseload, and will probably not be incentivised under current market

arrangements. We note however that DECC's proposals for market reform do not centre on the balancing market, and specifically do not propose any major reform for long term investment signals for DSR or interconnection. Rather the emphasis for DECC appears to be on providing premium price support for nuclear power and CCS.

12. DECC's analysis, by Redpoint, has target renewable penetration levels of 29% for 2020 and 35% for 2030 – these appear to be model inputs rather than outputs, making it impossible to judge whether policies will impact deployment levels. Redpoint also treats premium FiT payments as exactly the same as a ROC payment, with risks unchanged for renewables between the baseline and the new policy. Risks are notionally reduced for fixed payments and CfDs, but this is with all other things being equal. All this really tells us is that improved certainty on revenues will reduce risks – it doesn't tell us anything however about some of the more disruptive proposals in the consultation, such as removing an obligation on suppliers, auctioning FiT contracts or removing banding.
13. HIE and its local authority partners therefore strongly endorse the view of the Scottish Government that it *"will support new arrangements only when they are demonstrably better than the existing system."*¹

Options for decarbonisation

Feed-in tariffs

14. We broadly agree with the assessment of the relative pros and cons of each of a fixed price FiT, a CfD and a premium. The premium FiT is essentially equivalent to the existing ROC support for renewables. A key attraction of a premium FiT is that it separates the 'green' value of a project from its electricity value in each trading period. This is an important distinction as it retains an electricity price signal whilst giving generators a reliable return for the environmental benefits of their project.
15. HIE agrees with DECC that whilst a CfD might superficially seem attractive, the practicalities of implementing such a model – including actually finding a suitable strike price when nearly all new plant will be receiving premium price support – will make it difficult.
16. However HIE notes that investors require predictability and stability and all three models could provide this. We are not overly exercised about this aspect of the proposals. The key impact of the proposals on investor confidence is how the FiTs are implemented, and specifically, how FiT contracts are allocated amongst market players. Unfortunately different allocative models are not assessed by Redpoint and we feel that this is a serious shortfall which does not allow us to judge the most important impacts of the proposals. There are also risks attached to basing important decisions on assessment from only one source.

Risk transfer

¹ Scottish Government, interim position on the EMR

17. We do not agree with some of the analysis on risk transfer from generators. Specifically DECC's view on offtake risk seems to be limited to the risk of being out of merit in an economic despatch system each half hour. It ignores the impact of transmission access rights on despatch which in the current market framework is a very important factor.
18. DECC's analysis also ignores the risk that generators will invest in plant, only to have no offtaker at all if they fail to secure a FiT contract. This is a risk that falls out of the FiT allocation mechanism, and one which will impact severely on the cost of developing projects. If Government expects generators to invest in renewables, they will need some security on the likelihood of a market for the power. If they need to compete for offtake contracts at the end of a development process, investment appetites will inevitably be negatively impacted. This will feed through into a less well resourced development phase and probably poorer quality projects. We have particular concerns about the impact of this uncertainty on small and community projects which are of vital importance in building confidence, resilience and wealth at community level. We have not explored the potential implications for access to finance that these proposals and the extra layer of complexity and uncertainty they introduce but have concerns about the impacts- particularly for small and community projects.

Price signals

19. With low operational costs and environmental benefits that are only realised through generating, renewables are naturally high merit order plant. Nuances in the nature of market support are unlikely to alter this fundamental position, relative to thermal plant. HIE accepts that high renewables penetration might lower the wholesale energy price.
20. There is a key interaction here between the transmission charging regime and market design, especially for transmission charging proposals that seek to price congestion in wholesale energy costs.

Capacity mechanism

21. HIE agrees that there is a need to improve incentives for flexible response, complementing variable output renewables. The need for this flexibility is emphasised throughout the consultation. It is therefore disappointing that the proposals to address this – the capacity mechanism – do not seem to bring substantive reform. In particular the proposal seems aimed at flexible generating plant and assumes that other measures outside of the EMR consultation will address interconnection and DSR. HIE feels that this is hopeful, and would prefer to see comparable market-based measures that reward the long-term security of supply value of interconnection, DSR and storage as well as flexible generating plant.
22. Furthermore, the consultation notes National Grid already contracts for response and reserve (which contributes to the provision of capacity margin) as well as a variety of other ancillary services which help to balance the system. Should there be a centrally set level of capacity margin on top of this? HIE perceives that the main requirement for change lies in the need for

longer-term investment signals for new flexible plant, storage, interconnection and DSR providing ancillary services.

23. National Grid will not contract for long periods at present, in part because of its own investment signals through annual System Operator (SO) price controls. Redpoint's analysis assumes that a central body – presumably National Grid – will be able to strike long-term contracts for up to 20 years for flexible plant (again, disappointingly Redpoint do not model DSR, interconnection or storage). Therefore this work would seem to be overlapping with National Grid's SO incentives, and whether Ofgem will support National Grid in striking long-term contracts with sometimes novel service providers.
24. The latter point is we feel important for incentivising new technologies, and therefore HIE favours a targeted capacity mechanism that can bring on innovative balancing services that might not be a competitive, volume-based auction. The longer-term sustainability benefits of storage and interconnection should balance out the shorter-term higher costs.
25. We do not fully understand why DECC sees a centrally procured capacity margin as further away from today's market arrangements, given that National Grid regularly strikes ancillary service contracts with generators which are advertised to the market.

Implementation issues

26. HIE supports industry views in the rejection of the use of auctions for allocating FiT support.
27. We fear that auctions would impact negatively on competition, favouring large, well resourced players.
28. We do not support any degradation of banding currently provided through the RO, nor of any degradation of Scotland's devolved ROS powers. At the recent Renewables UK Wave & Tidal Conference, Greg Barker, Minister for Climate Change spoke about the gathering support for 5 ROCs for marine projects across the UK. Higher support levels for marine have been available in Scotland for a number years, firstly through the Marine Supply Obligation and latterly through enhanced ROCs. This has driven activity in marine renewables in Scotland which has been of strategic importance to the UK. The fact that UK Government is now considering parity in revenue support for marine renewables across the UK supports the conclusion that the decision to provide higher support in Scotland was driven by industry needs rather than geographic ambitions. It is therefore extremely important that the ability to modify any future support mechanism is retained by the devolved administrations if they do not agree with UK Government's assessment of industry requirements.
29. In proposing the kind of changes to how renewables support is allocated, DECC is seriously undermining confidence in the renewables market. The current obligation-based, banded RO sits in the specific GB market, planning and grid context. It is the culmination of experience, trial and error. GB has tried and largely failed with auctioning contracts through the old NFFO and

SRO contracts. The RO was a uniform obligation but this was deliberately designed out of the RO because, in DECC's own words it want to make the RO *"more effective"* to *"bring on additional deployable technologies by providing appropriate levels of support and certainty for future investments through the RO"*.

Reversing these decisions would inevitably impact severely on investor confidence. By way of example, banding and enhanced marine ROCs in Scotland has been the main driver in attracting world-class marine developers to the UK and supporting the development of a number of indigenous technology developers. Government has also invested in the European Marine Energy Centre (EMEC) on Orkney to facilitate investment. Altering the ROC support regime for these projects – some of whom may well not be on-line by 2017 – would alter the basis on which these investments were made. Any hiatus or uncertainty during the transition would also very likely deter supply chain investors whom we and others have worked very hard to attract to the area.

30. The UK has carbon reduction targets and renewable energy generation targets which, from an economic development perspective, become hollow unless the supply chain required to deliver these targets is supported and developed in the UK. Project developers are warning of delay's in investment decisions of up to three years while this review is undertaken at a time when efforts are being made to ramp up capability and capacity in local supply chains and key industry players are making decisions about where to base their future operations to respond to global opportunities in renewables. HIE and its sister agencies, Scottish Enterprise and Scottish Development International have developed the National Renewables Infrastructure Plan which identifies eleven strategic deepwater port facilities suitable for delivering large scale offshore renewables projects. We are actively seeking and supporting inward investment into these sites to help deliver an estimated 28,000 jobs and £7.1 billion in value to Scotland's economy over the next ten years. In addition, proposed developments in the Pentland Firth and Orkney waters could generate up to 5,000 jobs and £2.4bn to the UK economy *if* current investment and support for marine renewables is maintained. DECC must balance the future potential benefits of ERM with the immediate and medium term risk of uncertainty and its impacts on investment and development of a UK supply chain for delivering against UK targets at this crucial stage in the development of the renewables sector.
31. The consultation does not draw on previous NFFO/SRO experiences, rather it refers to experiences in other markets with completely different circumstances. For instance, the auction for Horns Rev II, cited by DECC, took place in the context of a pre-selected site and a grid connection provided and paid for by the local network company. A FiT auction would be an entirely different prospect for an offshore wind developer in GB which has already bid to secure a site, faces major cost uncertainty on the grid connection, and which has already invested substantial sums on the basis of an offtake contract being available after having overcome all of these hurdles!
32. Crucially, the RO is undersubscribed, and as long as this remains the case, there is limited justification for introducing any form of additional competition for renewables generation. Generators already compete keenly for, amongst other things development sites, transmission access and finance. Communities benefit from the economic activity around development and

from the community funds and environmental enhancement that flow from good quality projects. This is an important feature of the current RO and it is very noticeable in the Highlands and Islands of Scotland. Losing this momentum and investment would be a major blow to the region.

I hope you find our comments useful and that they will be taken into consideration as part of the consultation process. Please don't hesitate to contact me should you require any further information on the points raised.

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Highlands and Islands Enterprise

In partnership with:
Shetland Islands Council
Orkney Islands Council
Comhairle nan Eilean Siar
Highland Council
Argyll & Bute Council
Moray Council

