

By email to: Department of Energy and Climate Change
emr-condoc@decc.gsi.gov.uk

Cc: Energy and Climate Change Committee
ecc@parliament.uk
and individual members

10th March 2011

Dear Sirs

Re: Electricity Market Reform Consultation

SmartestEnergy welcomes the opportunity to respond to DECC's consultation on Electricity Market Reform.

Introduction

SmartestEnergy is a licensed electricity supplier operating primarily in the half hourly electricity market. We consolidate small generation and supply electricity to corporate and group customers.

We consider ourselves to be a champion of renewable generation and believe that any reforms to the market should be consistent with generally accepted free market principles; the market should operate as a level playing field for all players and where necessary incentives should be built around those arrangements, not as part of them.

Summary

We broadly support the government's proposed package of market reforms as they are both consistent with government policy of promoting renewables whilst ensuring security of supply, and are "market-friendly."

We have some concerns on the detail and implementation. For example, we prefer Premium FITs to a CfD/auction mechanism (because we prefer not to see price and volume-fixing solutions) and we would strongly urge CHP exemption from the carbon support levy proposed.

We are completely opposed to other measures hinted at as future possibilities (such as a Central Renewables Agency or a centralised demand-side) as these are not market

solutions. Should the current package of proposals fail to deliver the investment required, then further incentivisation would be the best course of action.

We do, however, have a major concern over continued and unscheduled government intervention in that it becomes a self-fulfilling prophecy; the fear of intervention limits investment in generation and demand-side/load-managing initiatives which may in turn mean that inefficient centralised solutions are inevitable.

Any demand side solutions should be market based and preferably co-ordinated by suppliers who have incentives to balance. There is, however, scope for distributors to contract with local storage in the longer term (which would help them manage local constraints) and their remits should be extended in this regard.

Reform Proposals

Capacity Payments

As a general rule we are not in favour of capacity mechanisms. Capacity mechanisms, no matter how well intentioned and designed, are always going to be open to gaming and/or overcompensation. There are also serious issues surrounding the confusion between what is being delivered (energy, reserve or capacity) and arbitrage between these markets, unfairness on those not included and the arbitrariness of any targets set by the central body.

We would ordinarily be against targeted mechanisms because the generation types which are targeted are determined centrally which leads inevitably to arbitrary winners and losers. It is not desirable that the inefficiency associated with inaccurate decisions by administrators/system planners should translate into additional costs across consumers.

However, as part of a package of proposals to achieve the government's policy objectives we can see that a targeted capacity mechanism mitigates the security of supply risk which is introduced when pursuing a greater proportion of renewable energy in the fuel mix.

We would suggest two highly important features which must form part of any capacity mechanism:

- 1) That it is market based either open to all or extremely targeted. Anything else would create distortions to the market.
- 2) That it is open to all sizes of generation and that there are no advantages to large-scale players. This will be consistent with the government's aim to encourage local generation.

We agree with the suggestion that storage should be an important element of any capacity mechanism. We would be keen to see arrangements which explicitly encourage emerging flexible technologies such as batteries and compressed air.

Carbon Price Support

As a general rule we prefer to see the use of incentives rather than taxes as a means of encouraging markets and modifying behaviour. The government needs to be mindful of the effect of higher prices on customers, particularly businesses competing in global markets (although we appreciate that the increased costs which result from taxing fossil fuels will encourage more efficiency, especially in the domestic market.)

We can see that such a tax is consistent with government policy and as part of a package of reforms which includes other incentives we can support it.

We would, however, suggest that it is not appropriate to apply CCL to CHP. This may simplify arrangements but it is not in keeping with the desire to encourage distributed generation. CHP, by its nature, tends to be locally situated and is significantly more efficient than CCGTs. CHP should not be treated differently from any other low carbon technology.

Taxes, by their nature, do not tend to include any "grandfathering arrangements" and therefore such an arrangement runs the risk of giving great cause for concern to investors. The government not only needs to give serious thought as to how it can send clear signals well into the future but also to giving as much notice as possible for definitive changes to the tax system. We would suggest that three years is required for the latter if the wholesale market is to continue functioning, otherwise liquidity will get worse, not better, in the wholesale market.

Feed in Tariffs

Extending FiTs to larger scale projects will help encourage investment in renewable. Consideration should be given to a MW limit if the allowable range of technologies is particularly wide. It would not be satisfactory if the arrangements encouraged energy giants to build large projects and squeeze out independent investment.

As with capacity payments it is important that smaller players are not disadvantaged in comparison with large-scale players. Indeed, in keeping with government policy it should positively encourage distributed generation.

Of the FiT options outlined we prefer the Premium FiT on the basis that it is more transparent, simple and clear for investors. It is more incentive based and does not suffer from inefficiency if the wholesale market is not particularly liquid; the costs and consequences of an inefficient CfD mechanism would fall on suppliers/customers. A CfD

with auction mechanism would introduce significant central and industry change in terms of administration and operations.

In our view the "winner's curse" presents a major obstacle; many successful bidders will find their projects are ultimately unrealisable at the price struck (especially if the mechanism is "pay as bid" rather than marginal) and the prospect of non-delivery penalties is hardly going to reverse the problem.

The Fixed FiT option is, however, by far the least appropriate solution; it is furthest removed from a market solution. If the price is set by government it will either be too low (leading to a lack of investment) or too high (increasing costs for consumers unnecessarily). Further intervention would be inevitable.

We do not believe it is a good idea for the RO and FiT arrangements to exist side by side between 2013 and 2017. This would lead to great deal of uncertainty in the ROC market.

Emissions Performance Standard

To meet government objectives the Emissions Performance standard should be as tight as possible and based on the most efficient technology available

The current plan is to apply these to coal plant only. We would suggest that standards should also be applied to CCGTs and OCGTs.

Other potential changes

Central Renewable Agency

SmartestEnergy and other suppliers already act as consolidators for intermittent wind, in other words wind developers are free to contract with a range of suppliers and gain the benefits a larger portfolio brings to the issue of balancing. Any form of centralisation would be "anti-market" and introduce distortions into the market i.e. give an unfair advantage to wind generation over other forms of generation. The incentives to balance on all suppliers create a level playing field which should not be "tilted."

Large Scale Generation Reserve Funding Mechanism

We note that connecting larger nuclear units to the system means the system operator must incur greater cost as additional response will need to be held (ie generation which can be held in readiness) to ensure frequency remains within the acceptable range. Greater reserve is also required. NGET have estimated that the associated additional cost would be around £160m per annum.

We are of the view that there has not been sufficient consideration of whether the costs should be passed on to customers through smearing or whether there is merit in passing the costs back to the plant types which cause the need for additional response. Consideration should be given to the possibility of a mechanism which ensures that each MW of nuclear generated electricity makes a contribution to the additional capacity, in other words a Large Scale Generation Reserve Funding Mechanism.

Remainder of this document

Our answers to the specific questions contained within the consultation document can be found in the Appendix to this letter.

Should you wish to discuss this further please do not hesitate to contact me.

Yours faithfully,

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APPENDIX: Answers to specific questions in the Consultation Document

Current Market Arrangements

1. Do you agree with the Government's assessment of the ability of the current market to support the investment in low-carbon generation needed to meet environmental targets?

By and large we agree that further incentivisation and clear signals are required to encourage the level of investment in the preferred fuel types of generation.

2. Do you agree with the Government's assessment of the future risks to the UK's security of electricity supplies?

We agree that security of supply becomes a more significant issue when attempting to pursue a more renewable-based fuel mix.

Feed-in Tariffs

3. Do you agree with the Government's assessment of the pros and cons of each of the models of feed-in tariff (FiT)?

No. We believe there is a significant difference between creating incentives through a FiT/ROC scheme (as per a Premium FiT arrangement) and price/volume setting (which is effectively achieved through Fixed FiT or, to a lesser extent the FiT with CfD option).

We are also concerned that the FiT with CfD arrangement introduces an additional market mechanism which will cause additional operational costs to industry and is much more intensive in terms of central co-ordination.

There is also the issue that large parties who operate in both the wholesale market and who are bidding into a CfD auction will have greater awareness of price. We do not believe that the CfD auction and the wholesale markets will be as independent as seems to be anticipated in the consultation document.

Both the Premium FiT and FiT with CfD options encourage power to be traded through the market and hence help liquidity. The fixed FiT arrangement is not so helpful with liquidity and is also much less market based.

We would caution against any mix and match approach to FiTs. It is not appropriate to offer a different type of FiT depending on size (along the lines of

fixed for small, premium for medium sized and CfDs for larger sites) as this would reduce the competition levels in any auctions and increase the administrative burden.

4. Do you agree with the Government's preferred policy of introducing a contract for difference based feed-in tariff (FiT with CfD)?

For the reasons given under q3 we prefer the FiT Premium over the FiT with CfD option but both are significantly preferable to the fixed FiT arrangement.

5. What do you see as the advantages and disadvantages of transferring different risks from the generator or the supplier to the Government? In particular, what are the implications of removing the (long-term) electricity price risk from generators under the CfD model?

There is a possibility that the strike prices are not optimal and the costs of such sub-optimality will be passed to consumers.

6. What are the efficient operational decisions that the price signal incentivises? How important are these for the market to function properly? How would they be affected by the proposed policy?

The price signal incentivises investment. The Premium FiT gives a guaranteed market price and a premium. The incentive is not as great under the CfD option as the upside is capped. This will lead to less investment.

7. Do you agree with the Government's assessment of the impact of the different models of FiTs on the cost of capital for low-carbon generators?

No. See answer to q6 and q8.

8. What impact do you think the different models of FiTs will have on the availability of finance for low-carbon electricity generation investments from both new investors and existing the investor base?

Both the Fixed FiT and FiT with CfD will provide certainty, but we believe that the market modelling conducted by investors will value the upside associated with the FiT Premium on top of their base case.

9. What impact do you think the different models of FiTs will have on different types of generators (e.g. vertically integrated utilities, existing independent

gas, wind or biomass generators and new entrant generators)? How would the different models impact on contract negotiations/relationships with electricity suppliers?

The Premium FIT option allows the market greater flexibility to determine the ultimate fuel mix. An auction based on volume targets is more centralised in its concept and therefore less market-based.

We assume that all generation will ultimately be sold through suppliers.

10. How important do you think greater liquidity in the wholesale market is to the effective operation of the FIT with CfD model? What reference price or index should be used?

The relative lack of liquidity in the UK market is a function of the bi-lateral nature of the market and is the unfortunate downside of complete freedom to trade. However, any lack of liquidity should not be used as an excuse to reform the market away from free-market principles. This is one of the reasons that we prefer the Premium FIT option.

In terms of which index is preferable the first question to ask is whether the price needs to be determined ex-ante or ex-post. In the former case we would suggest LEBA in the latter UKPX or Elexon's MIDP.

11. Should the FIT be paid on availability or output?

We believe FiTs should be paid on output. This is because it is a) easier to administer and b) it is output that counts.

Emissions Performance Standards

12. Do you agree with the Government's assessment of the impact of an emission performance standard on the decarbonisation of the electricity sector and on security of supply risk?

Yes

13. Which option do you consider most appropriate for the level of the EPS? What considerations should the Government take into account in designing derogations for projects forming part of the UK or EU demonstration programme?

The level should be as stringent as possible or set at the very highest standards that are currently available. We are, however, unable to say whether we prefer 450g/kWh with exemptions or 600g/kWh.

14. Do you agree that the EPS should be aimed at new plant, and 'grandfathered' at the point of consent? How should the Government determine the economic life of a power station for the purposes of grandfathering?

This seems reasonable. We have no view on how the Government should determine the economic life of a power station for the purposes of grandfathering.

15. Do you agree that the EPS should be extended to cover existing plant in the event they undergo significant life extensions or upgrades? How could the Government implement such an approach in practice?

This seems reasonable but we have no view on how this could be implemented in practice.

16. Do you agree with the proposed review of the EPS, incorporated into the progress reports required under the Energy Act 2010?

Yes

17. How should biomass be treated for the purposes of meeting the EPS? What additional considerations should the Government take into account?

Biomass should be exempt on the basis that it is never going to be developed to such a large scale. North Sea Gas-fired generation is a much stronger candidate for incorporating into EPS.

18. Do you agree the principle of exceptions to the EPS in the event of long-term or short-term energy shortfalls?

No. The principle should be that emissions are based on a per kWh basis.

Options for Market Efficiency and Security of Supply

19. Do you agree with our assessment of the pros and cons of introducing a capacity mechanism?

Capacity mechanisms, no matter how well designed, are always going to be open to gaming and/or overcompensation. There are also serious issues surrounding "hiatus" of investment, the "slippery slope effect" of under investment for energy purposes, confusion between what is being delivered (energy, reserve, capacity) and arbitrage between these markets, unfairness on those not included, arbitrariness of the level set by the central body.

20. Do you agree with the Government's preferred policy of introducing a capacity mechanism in addition to the improvements to the current market?

As part of a package of proposals to achieve the government's policy objectives we can see that a capacity mechanism mitigates the risk that pursuing more of a renewable fuel mix increases the dangers of security of supply.

21. What do you think the impacts of introducing a targeted capacity mechanism will be on prices in the wholesale electricity market?

It is hard to see that wholesale process would reduce by an amount corresponding to a capacity purchase obligation. However, if extremely targeted the cost should not be too great.

22. Do you agree with Government's preference for the design of a capacity mechanism:

If the government is to go ahead with this we agree with the broad design of a central body holding the responsibility and making it volume based, not price based. We are, however, concerned at the notion of it being targeted as this strikes us as being too centrally planned.

It seems sensible that it should apply to new capacity only but this also seems unfair on existing plant. It therefore needs to be extremely targeted.

23. What do you think the impact of introducing a capacity mechanism would be on incentives to invest in demand-side response, storage, interconnection and energy efficiency? Will the preferred package of options allow these technologies to play more of a role?

We agree that storage has more of a role in a capacity/reserve mechanism than an energy market. Despite several efforts by industry over the years demand-side response has not been a great success; it is difficult to know whether demand reductions would have taken place anyway. Capacity/reserve should be arranged as an ancillary service to NGT/grid operators.

24. Which of the two models of targeted capacity mechanism would you prefer to see implemented:

- Last-resort dispatch; or
- Economic dispatch.

The very existence of this question shows that capacity does not sit well in a privatised, bi-lateral market because the purpose is for last-resort but given the option it would be irrational not to go for economic despatch.

25. Do you think there should be a locational element to capacity pricing?

Is the purpose of capacity to aid the System Operator operationally or is it to create capacity generally? We are led to believe that it is the latter. In terms of the generating system we can see that there are advantages to locational pricing. However, on the demand side it would be difficult to match and it would be too much to expect suppliers to bid for capacity on a locational basis. Either way we would prefer the costs to be recouped through a charge from the system operator.

We are in favour of locational pricing for energy because it is the actual flow that counts. We are not in favour of locational pricing for capacity. It is no proxy for locational energy pricing.

Analysis of Packages

26. Do you agree with the Government's preferred package of options (carbon price support, feed-in tariff (CfD or premium), emission performance standard, peak capacity tender)? Why?

Yes, but we have concerns about whether the capacity mechanism will achieve its objectives.

27. What are your views on the alternative package that Government has described?

We prefer this as we believe that the Premium FiT option is better than the FiT with CfD.

28. Will the proposed package of options have wider impacts on the electricity system that have not been identified in this document, for example on electricity networks?

Distributors should be encouraged to contract for storage as this will alleviate constraints and obviate the need for some system reinforcement.

29. How do you see the different elements of the preferred package interacting? Are these interactions different for other packages?

We have no strong views on this.

Implementation Issues

30. What do you think are the main implementation risks for the Government's preferred package?

There is a great deal of complexity to be ironed out for both the capacity mechanism and any auction associated with FiTs. If the government were to stick with a package of Premium FiTs, Carbon Support and Emissions Performance Standards we can see these being achieved satisfactorily within the timescales.

Are these risks different for the other packages being considered?

Yes, as stated, the FiT with CfD and auction will be much slower and more complex to introduce than Premium FiT.

31. Do you have views on the role that auctions or tenders can play in setting the price for a feed-in tariff, compared to administratively determined support levels?

An auction can be successful if all generation within a technology band receives the same marginal strike price i.e. it is important to avoid the "winner's curse". However, this makes the arrangement little different from an incentive based arrangement (like the current RO arrangement) and therefore it is better to avoid the administrative costs of an auction in the first place.

- Can auctions or tenders deliver competitive market prices that appropriately reflect the risks and uncertainties of new or emerging technologies?

There would be a requirement to set targets for different technologies. The associated central planning is bound to be inefficient and it is not necessary as the exact fuel mix can set itself if the incentives are appropriate.

- Should auctions, tenders or the administrative approach to setting levels be technology neutral or technology specific?

We feel it should be technology specific so that it is possible to increase and reduce the incentives as technologies become more established. Reviews should

be scheduled and there should be no deviation or market/investor uncertainty would increase.

- How should the different costs of each technology be reflected? Should there be a single contract for difference on the electricity price for all low-carbon and a series of technology different premiums on top?

If an auction is chosen the result should be a strike price for each technology.

- Are there other models government should consider?

We have no specific suggestions but for us the focus should be on greater analysis and modelling by the government to create the most appropriate levels for Premium FiTs.

- Should prices be set for individual projects or for technologies.

We think it should be technology specific. Consideration could be given to whether particularly large projects need FiTs. They are less likely to meet the government's environmental aims and would also discourage smaller "local" projects. A cap of 50MW would seem appropriate as this is consistent with the automatic licence exemption.

- Do you think there is sufficient competition amongst potential developers / sites to run effective auctions?

Insufficient competition is a definite possibility and bids would consequently be unnecessarily high. It is also possible that the whole process is administratively burdensome for developers who would find it much easier to make assessments on published Premium FiT.

- Could an auction contribute to preventing the feed-in tariff policy from incentivising an unsustainable level of deployment of any one particular technology? Are there other ways to mitigate against this risk?

As already stated, setting technology targets is one way around this problem but it introduces the likelihood of "picking the wrong winners".

32. What changes do you think would be necessary to the institutional arrangements in the electricity sector to support these market reforms?

We would anticipate any auction being run by e-serve. Premium FiTs could be implemented using the same resource and processes as the RO.

33. Do you have view on how market distortion and any other unintended consequences of a FIT or a targeted capacity mechanism can be minimised?

We believe that a targeted capacity mechanism would introduce distortions. However, the more targeted it is the less that distortion would be.

34. Do you agree with the Government's assessment of the risks of delays to planned investments while the preferred package is implemented?

It is imperative that the government decides what to do and implements it as soon as possible. We are particularly concerned about uncertainty in the ROC market (as a result of the FiT proposal) and the wholesale market (as a result of the Carbon Price Support proposals). Also, investors and developers will certainly be holding back to see which technologies will be most favourable.

35. Do you agree with the principles underpinning the transition of the Renewables Obligation into the new arrangements? Are there other strategies which you think could be used to avoid delays to planned investments?

We believe that a period of choice between 2013 and 2017 will create uncertainty in the ROC market. Our preference would be to defer the new FiT arrangements until 2017.

36. We propose that accreditation under the RO would remain open until 31 March 2017. The Government's ambition to introduce the new feed-in tariff for lowcarbon in 2013/14 (subject to Parliamentary time). Which of these options do you favour:

- All new renewable electricity capacity accrediting before 1 April 2017 accredits under the RO;
- All new renewable electricity capacity accrediting after the introduction of the low-carbon support mechanism but before 1 April 2017 should have a choice between accrediting under the RO or the new mechanism.

We prefer the first option.

37. Some technologies are not currently grandfathered under the RO. If the Government chooses not to grandfather some or all of these technologies, should we:

- Carry out scheduled banding reviews (either separately or as part of the tariff setting for the new scheme)? How frequently should these be carried out?
- Carry out an "early review" if evidence is provided of significant change in costs or other criteria as in legislation?

We believe that as of 2017 all technologies should be grandfathered. Banding reviews should be unnecessary after that.

- Should we move them out of the "vintaged" RO and into the new scheme, removing the potential need for scheduled banding reviews under the RO?

We are not in favour of transferring "vintaged" RO to the new scheme.

38. Which option for calculating the Obligation post 2017 do you favour?

- Continue using both target and headroom
- Use Calculation B (Headroom) only from 2017
- Fix the price of a ROC for existing and new generation

Fixing the price of a ROC would remove the uncertainty.

