

# **Lords Informal Working Group**

## **Report on the Draft Energy Bill**

**July 2012**

### **INTRODUCTION**

1. We acknowledge that the Government is undertaking an essential and Herculean task in reforming the energy market. Significant new investment in this area is unlikely until the future shape of the market is clear. The long term aim of the reform is to achieve an electricity market in which there is competition on a level playing field between different means of generation to meet the policy objectives at minimum cost to the consumer. For the low-carbon investor it is urgent that rapid progress be made on the Bill. Twelve months after the White Paper there are still key elements that are out for public consultation and uncertainties remain over key elements of the Bill and indeed over the Government's long term policy. We also have concern about the long lead times needed for construction and in some cases grid connection even after finance and consents have been obtained.

### **CONCERNS ABOUT A FiT/CfD MARKET**

2. We understand that the Government's long term aim is that of a competitive market for electricity but we have serious doubts that it can be reached by the mechanisms proposed in the Draft Bill. We recognise that any new and unfamiliar means of structuring energy markets will raise concerns simply because unfamiliarity appears as complexity. However, we believe that some of the concerns raised in evidence have merit.
3. We have two main concerns. The first relates to the lack of information on how the proposed arrangements, namely the Feed in Tariff (FiT) by use of Contract for Difference (CfD), would work in detail (see submission of Lord Browne). Much appears to be being left to secondary legislation not all aspects of which will be subject to parliamentary scrutiny.

4. No doubt the absence of some of this information from the draft bill is a reflection of the difficulty of producing the details of a workable scheme. This lack of clarity makes parts of the proposal difficult both for us and for potential investors to evaluate.
5. The second concern is that, if these proposals are implemented, the process for awarding contracts to supply electricity will, for much of the time between now and the end of the decade, be largely at ministerial discretion. The Government would have to estimate reasonable prices (“Strike Prices”) for electricity generated by each particular means (e.g. gas with or without CCS, off-shore wind, nuclear etc.) for the duration the contract – presumably between fifteen and twenty five years. We do not see how the Government can do this in any credible way, even with the assistance of the System Operator. Ministers would have few market benchmarks by which to set prices. Furthermore they would need to judge the balance between different generation methods and this depends, among other things, on estimating the long term future price of fossil fuel and what new technologies might become available. In any case with the end of the Renewables Obligation on suppliers, what is the future for renewable generation? We see the following additional difficulties:
  - In the transition period to the full operation of this new system of CfD FiTs even more ministerial discretions are proposed with minimal transparency.
  - Ministers would be exposed to intense lobbying by private interests
  - The exercise of ministerial discretion makes the deals vulnerable to judicial review and may expose them to challenges from Brussels on the matter of state aid.
  - Much of the risk arising from forward pricing of electricity generation by ministerial judgement could fall on the consumer and little or none on the generators or the supply companies. In the absence of competitive pricing the consumer is unlikely to see good value.
  - There is no guaranteed demand for renewable electricity and independent generators are unlikely to be able to conclude Power Purchase Agreements for their electricity at satisfactory rates. This

means that for independent renewable generators off-take risk could actually increase under the proposed arrangements.

6. We also note from evidence given either to us or to the Commons Committee:
  - Concerns about determination of the reference price in the wholesale market
  - Even without the missing detail the proposed scheme is already seen as extraordinarily complex and for that reason unattractive to investors who would also be suspicious of the use of ministerial discretion and possible interference.
  - There is significant external concern about the robustness of the arrangements for counterparty payments under the CfD scheme – if this were the only difficulty it could probably be managed.
7. We are also concerned that, given the very long lead times and the need to bring in significant amounts of new low carbon generating capacity before 2020, the shape of the generating system in the UK could well be set for several decades under a system that was both opaque and devoid of any serious external scrutiny.
8. This uncertainty about future gas prices (and indeed of other fuels and of the traded Carbon Price) , combined with uncertainty about the speed and cost of development of new technologies makes it likely that Contracts for Difference - lasting 15 to 25 years – could turn out to be set at entirely inappropriate prices - to the severe detriment of either the government (or rather business and domestic consumers) or to the supplier. This led some of the Group to advocate break clauses in some of the contracts – or at least Review Points – either at intervals in the long term contract or if prices deviated beyond a certain threshold. We comment below on possible indexation. Whilst explicit break points might make the contracts less attractive to potential suppliers, owing to the need to amortise capital costs over a shorter period, Review Points could actually give all parties more protection from these uncertainties. We would hope the Government could at least consider this point and indicate their intentions before they introduce the Bill.

9. Even after the closure of 10GW of coal fired generation in 2015/16 there will likely remain around 20GW until 2023. Given the low price of coal and the low, and politically uncertain, carbon floor price to be introduced next year, there will be every incentive for the C-intensive generation to continue as long as possible. It would be a welcome signal to low-C investors if the Emissions Performance Standard were extended to all plant.

## **AN ALTERNATIVE APPROACH**

10. For these reasons we believe that a suggestion put to us by two of our witnesses deserves serious attention, namely that many of these difficulties are avoided if an auctioning process for long term contracts is used from the outset. Auctions of many kinds are possible. One of our most compelling witnesses Professor Dieter Helm advocated the two-stage auction process that is not uncommonly used to market complex and valuable assets of other kinds and has been used successfully in the power sector in the US. In the first stage the auctioneer invites non-binding indicative bids and on the basis to these invites a limited subset of bidders to submit final bids. The other witness advocating an auction approach, Dr Anthony White, suggested that the auctions would most appropriately be run by an arms-length electricity procurement body working under a Government remit.
11. By using auctions the Government would be free, if it chose, to specify whatever carbon intensity, availability, or other considerations of national importance was required to meet its targets. Auctions could also be used to ensure the same availability of capacity that would have been achieved through the capacity mechanisms proposed in the Bill. There could be multiple auctions with different requirements. The difference would be that contracts would have been secured in an open manner that would be hard to challenge. In a few cases (e.g. nuclear) difficulty might arise because initially there might be only one bidder but this would be true of any scheme. The interesting possibility arises that wind farms might team up in a mutual hedging arrangement with gas-fired power stations to offer a supply of low-carbon electricity on demand. Once a contract had been won at a particular price and for a particular term it should be investible.

12. Insofar as gas is likely to play an important role in UK energy generation for at least a number of decades it is worth observing that world gas markets are changing rapidly at present. The advent of cheap shale gas in the United States has reduced its demand for liquefied natural gas (LNG) more of which is now available for other markets. This may be expected to somewhat ease imported gas prices in Europe. However, if indigenous gas resources were developed that could feed directly into the gas grid in the UK there would be a major effect on domestic energy prices because the relatively high costs of LNG compression, decompression and transport would be avoided. For this reason the Government may wish to build indexation clauses into some long term contracts.
13. We have not had the time to explore the auction approach in any great detail but we believe that it has the potential to free the Government from the responsibility of speculative price-fixing and to test the market directly so that consumer costs are as low as possible. Government could retain the responsibility for determining the overall shape and characteristics of a power sector that would be implemented through market mechanisms. Provided the auctions were run fairly the outcomes should be less exposed to the risk of judicial review and state-aid challenges from Brussels. Auctions would also demonstrate the costs of the different generation modes. We believe that the Government might wish to move ahead without delay to set up an auction for some gas-fired generation.

## **IMMATURE TECHNOLOGIES**

14. Innovation will be extremely important in the wider field of energy and could significantly reduce costs (e.g. the development of cost-effective electricity storage). We feel that it is not realistic to expect to support technologies such as wave- or tidal current-power, geothermal, and Carbon Capture & Storage that have not yet been demonstrated at scale, to be supported by the same mechanism as technologies that are more mature. A strike (or auction) price that was high enough to cover the investment uncertainties associated with a long term contract for the implementation of a technology that had not been through the later stages of development would have a very strong probability of ending up being unfair to the consumer. It does not make any sense to try to do this before the final

stages of development have been de-risked by the operation of several full scale plants.

15. In addition to early stage support for emerging technologies, promising but immature technologies should be promoted by a different and probably discretionary means and incorporated into the more general process when they have matured.

## **DEMAND SIDE MANAGEMENT**

16. The bill focuses largely, but not exclusively, on the supply side of the energy challenge. We were somewhat puzzled by the DECC projections of future demand and were concerned that the most recent expectations of population growth were not incorporated in their forecasts.
17. We and others feel that the demand side should have been given more emphasis in the Bill. One of the key objectives of EMR is to deliver the very considerable investment needs of the power supply industry over the next decade and beyond. By greater attention to demand side management and demand side response we feel that the total level of investment could be appreciably reduced. We recognise that the Government already has a number of initiatives in this direction e.g. the Green Deal and smart meters. There is however much more to be done. The bill could, for example, more clearly support the aggregation of consumer demand management that would offer cost savings for all consumers by helping to reduce the need for back up capacity. The development of such a market could incentivise the commercialisation of technologies such as frequency controls on refrigeration equipment. We note that some activity of this kind is underway already in the commercial and industrial sectors.

## **CONCLUSION**

18. Restricting our comments to that part of the EMR process that has sufficient detail to be judged, our concern is that the proposed arrangements for dealing with the construction of new generation capacity between today and the 2020s would be largely discretionary within a scheme that is still not fully developed. While accepting the Government's long term objective, we were unanimous that private arrangements made

by ministers with individual companies on individual terms and on the advice of a private company would be unlikely to be a satisfactory means of attaining it. We were told that other countries are watching the UK's proposed new system with great interest. It is hugely important that we get it right.

19. In conclusion we should emphasise that replacing the obsolescent generating capacity in the UK over the next decade is inevitably going to be very expensive and very large amounts of capital will be required. Market confidence is what will reduce the cost of that capital. Capital markets are international and whatever form of market is adopted in the UK will be of little consequence unless it is sufficiently attractive to stand comparison with other investment opportunities in this country or elsewhere.

Appendices (papers provided to the group):

1. Dieter Helm's Paper <i>EMR and the Energy Bill</i>
2. Anthony White's submission to the Group
3. Simon Skillings' E3G paper
4. Lord Browne of Madingley submission to the Group