Department of Energy & Climate Change

The Rt Hon Edward Davey MP
Secretary of State

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Roger Witcomb
Investigation Panel Chair
Competition and Markets Authority

By email

23 March 2015

Dear Roger,

Re: DECC's Response to the Competition and Markets Authority's Updated Issues Statement

Your Updated Issues Statement is an important milestone in the market investigation. It sets out some important initial conclusions on the wholesale market and also the further work that you think is necessary to reach a firm conclusion on competition in the retail market. The increased competitive pressure that we have seen over the last few years is concentrated largely in the fixed-term tariff segment of the market and I have long been concerned that the majority of customers remain on more costly standard variable tariffs with the largest suppliers. As such I particularly welcome your focus on this area of the market in the next stage of your work.

I also welcome your proposals to examine the micro-businesses market, which as you point out, is an area on which little information is currently available. I look forward to the development of a more robust evidence base for this sector of the market.

As you know I think it is important that your investigation takes into consideration security of supply, the need to ensure that all consumers, including the vulnerable, benefit from competition, and the need for the market to support alternative and innovative business models. I am pleased to see that you have given serious consideration to these matters and that significant progress is being made.

Theories of Harm

I have noted the useful adjustments and clarifications to your theories of harm, particularly the addition of a new theory covering industry code governance. I welcome the extension of your investigation into this area and look forward to your conclusions on whether or not industry governance is having an adverse effect on competition.

Government policy

The Updated Issues Statement contains some analysis of the pro-competitive reforms we have implemented for delivery of the Contracts for Difference (CFDs) and the Capacity

Market and the effects of our other reforms, such as the Transmission Constraint Licence Condition and Ofgem's Secure and Promote liquidity reforms. I am setting out some initial points of clarification in response to some of the issues you raise on areas of government policy.

In addition to this response my officials will provide you with further information and clarifications in response to your Working Papers and in the hearing scheduled for 31st March.

Contracts for Difference

We consider that there are strong efficiency arguments for replacing the RO with the CFD and that competitive allocation enables us to capture reductions in project costs and ensure that consumers benefit from them. I have set out in the attached annex a more detailed consideration of the points you raised on CFDs including the benefits of competition, our intention to move to technology neutral auctioning and the limited circumstances in which bi-lateral contracts may be appropriate in the future.

The Capacity Market

You set out your initial views on the relationship between the Capacity Market and reserve scarcity pricing (one of the elements of Ofgem's cash-out reform programme). If it would be helpful my officials would be happy to meet you together with Ofgem, to talk through the connections in more detail. For the moment it is worth noting that this mechanism and the capacity market are intended to be complementary, but not to achieve precisely the same goals: along with improving interconnection, effective scarcity pricing has the potential to lessen and even eliminate the need for the capacity market in the longer term. We are committed to continuing to work with Ofgem to ensure that the measures work effectively together.

You also state that you will look more closely at issues in relation to demand-side response participation in the capacity market. While a number of parties have made representations on this point I hope that we will be able to explore the full range of evidence. Given the relatively short lead-times for DSR capacity, and the likely commercial attractiveness for providers of attracting customers with a more immediate offer, there is good reason to focus on the T-1 rather than T-4 auction for participation for this sector. And in relation to agreement length, we are clearly seeking only to use longer agreements where absolutely necessary – to avoid unnecessary inflexibility and distortion.

I think it is fair to say that DECC has received relatively little robust evidence on the DSR sector in past consultations, for example on any need for longer-term agreements, and we have now commissioned research to better understand the cost structure of different DSR technologies across various sectors. Again my officials would be very happy to brief you on this work and share any evidence as it emerges.

Smart metering benefits

As noted in the Updated Issues Statement, smart meters which can record energy consumption in each half-hour period could obviate the need for deemed profiling, and you consider that moving to half-hourly settlement in the domestic market as soon as practicable based on actual consumption should deliver benefits to consumers and the broader energy system.

Energy suppliers can already offer tariffs that encourage consumers to shift load away from times of peak demand and can elect to settle their customers on a half-hourly basis. However, reforming settlement processes would create greater commercial incentives on suppliers for innovative tariffs, as cost savings from shifted load would feed through directly to them. We think that there is a strong case for half-hourly settlement and that work to develop it should be prioritised.

These benefits are of course just one element of the total benefits expected from the roll-out of smart meters which largely accrue from supplier cost savings and energy savings to consumers[1].

More broadly we note that you ask for further views and evidence on the likely size of consumer benefits related to smart metering. We would wish to alert the CMA to a recent DECC publication - the Early Learning Project (ELP). The ELP[2] presents the findings of an extensive programme of research from the early stages of smart meter deployments into how best to deliver smart metering consumer benefits through effective engagement.

The next stages of the investigation

Delivering your provisional findings in early summer and your final report by the end of 2015 will be critical if the market is to move forward in a way that delivers better outcomes for consumers.

As I have said publically, I expect that one of the great strengths of this report will be that any conclusions it reaches will be backed by in-depth research and a robust evidence base, regardless of the findings. I believe that this is critical to ensuring widespread buy-in to your conclusions.

As always DECC officials are ready to provide any support you may need including briefing on key policies.

EDWARD DAVEY

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1 https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/276656/smart_meter_roll_out_for_the_domestic_and_small_and_medium_and_non_domestic_sectors.pdf

2 https://www.gov.uk/government/publications/smart-metering-early-learning-project-and-small-scale-behaviour-trials.

Annex 1 – points relating to CfDs raised in the Updated Issues Statement

FID Enabling for Renewables

Early CFDs, in the form of Investment Contracts, were awarded through the FID Enabling for Renewables process. This process was introduced to avoid an investment hiatus ahead of the enduring CFD regime.

The awarding of early contracts through the FID Enabling for Renewables process played a crucial role in enabling the transition to competition into the full CFD regime on a much faster timescale that originally envisaged.

The first CFD auction allocation round

The first allocation round demonstrated the value of competition in driving down costs to consumers. The projects awarded CFDs in the first round cleared the auction significantly below the maximum administered strike price for each technology.[3]

Whilst it is our intention to move to technology neutral auctioning there are some circumstances in the transition where this may not be possible or practical e.g. projects that are large, unique etc. Current regulations do, however, allow the Secretary of State the power to issue CFDs without competition to technologies that are ineligible for the generic allocation process. Where possible, the Secretary of State will seek to create competitive tension in non-auction processes that ensure that projects are not over-compensated and drive value for money for the taxpayer.

The Secretary of State has committed to engage with the sector to explain the rationale for using these issuance powers, the rationale for engaging with a particular technology or group of technologies, and explain how value for money will be ensured.

The use of allocation pots

The Government considers that the use of allocation pots currently supports the achievement of both short-term and medium-term value for money objectives. These objectives require investment both in important low carbon technologies that are currently less expensive but not yet cost-competitive with non- low carbon technologies and those which are currently more expensive but where significant progress is being made in cost reduction (and such cost reductions are contingent on UK deployment). This combination of short and medium-term objectives is particularly important where there may be limits on the ability to deploy the cheaper low carbon technologies. It is our intention to move to technology neutral auctioning in the long term.

Overlap with the Renewables Obligation

You suggested that the ROC value may create a floor for the CfD auction. We agree that there may be a potential issue in relation to some Pot 1 technologies, given that solar and onshore wind projects are generally quick to build/deploy and so will be applying for early delivery years (for which the RO is still a viable alternative form of support).

However, there will also be projects in that pot that are either aiming for later delivery years (when the RO is no longer a viable alternative) or who are only able to secure

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[3] Reference to where results were published

financing on the basis of the CfD. Those projects will need to bid competitively and will shape the wider competitive dynamics of the auction. Finally, the risk also reduces over time - as we get closer to the RO closure date in March 2017, the ability for projects to pursue the RO as a viable alternative is reduced.