

Will Fletcher
Project Manager
Competition and Markets Authority
Victoria House
Southampton Row
London
WC1B 4AD

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Dear Mr. Fletcher,

Please find below a response to the CMA's consultation on proposed remedies put forward under its energy market enquiry. RenewableUK is the trade association for the wind, wave and tidal stream industries in the UK, with over 500 members across the value chains of those sectors. Our members are on the supply side of the energy industry, and so we do not address remedies focused on the demand side. This response therefore concerns Remedy 1 and Remedy 2. If you have any queries about this response, please don't hesitate to contact me at gordon.edge@renewableuk.com or 020 7901 3027.

Yours sincerely,

Dr Gordon Edge
Director of Policy
RenewableUK

Remedy 1

The CMA considers the current methodology for transmission loss charging to have an adverse effect on competition (AEC). RenewableUK agrees that there is an in-principle technical case for locational loss charging, though we believe that such a regime, as it would apply to onshore and offshore wind, would fail to address the CMA's stated issues and would therefore have a disproportionate impact relative to the benefits. RenewableUK is also concerned with the CMA's proposed remedy of requiring the introduction of licence conditions to implement a scheme which the CMA deems more appropriate.

The issue

For context, the CMA reports that current the charging regime for losses ("CRL") means that generators are incentivised to produce 1% more power than contracted and that the value of energy lost (through T-losses) was £220m in 2014. This is likely to add £3 onto the average domestic bill¹. Whilst consumer protection is not an explicit remit of the CMA's, these figures suggest that CRL is not a major issue in the wider context of competition in the energy market. RenewableUK would therefore question whether:

- Locational charging for losses would address the issues the CMA reports;
- If not, whether the modelled benefits outweigh the impacts.

Proposed remedy

The CMA proposes modifying licence conditions of BSC parties to reflect a reformed CRL. Given the lack of quantitative assessment, we strongly recommend that any changes to CRL be referred to a BSC modification panel to ensure that all relevant assessments can be undertaken. RenewableUK also notes that the issue of locational charging has been raised and rejected several times in the past. UK generators are entitled to consider the matter closed (and plan investments accordingly), subject to new evidence coming to light. RenewableUK does not consider that the CMA has raised any new matters, relying exclusively on either (a) old analysis that did not make a compelling case for reform when previously attempted or (b) new analysis that has not been published for scrutiny. As with any area of the BSC, parties are able to raise proposed modifications which will be assessed in accordance with the relevant procedures and rules. RenewableUK therefore considers this route to be the appropriate one for examining such issues and providing evidence in a transparent manner and with greater visibility for affected parties.

Impact and RenewableUK's views

Whilst the reform of the CRL to reflect the locational nature of losses could lead to some benefit with regards to thermal plant competing at the margin, it is doubtful that such a reform would address the CMA's stated issues with regards to renewable generation, particularly wind farms in Scotland and the north. We discuss the relevant issues from the perspective of these generators.

¹ We assume that the final bill for losses is ultimately paid for in customer's bills, either explicitly as a supplier charge or through the wholesale price. The actual charge will depend on suppliers' charging structures. However, assuming that the average cost reflects the pro-rata split of domestic, industrial and commercial electricity demand, domestic users would pick up 36% of the bill, covered by 26.4m households.

We further note the absence of quantitative assessment of the main issues identified (and discussed below) makes a full response difficult. RenewableUK's response is therefore a qualitative one pending further detail from the CMA or, in due course, Ofgem/BSC panel.

The CMA identifies two main issues with CRL:

- (1) Long-run/siting impacts: "The lack of locational pricing may lead to inefficient investment in generation".

It is very doubtful that a system of location charging for losses would have any meaningful impact on siting decisions for renewable generation, particularly anything over and above existing signals in transmission charging methodology². Geography – in terms of resource quality and access/environmental receptors – is the single most important factor in siting wind farms. It so happens in the UK that higher resource and less constrained sites tend to be found further north, away from demand centres. Locational loss charging would not therefore constitute a material investment signal that renewable generation would be sufficiently incentivised to respond to at present³

- (2) Short-run/dispatch impacts: "(without locational charging, short-run) costs will be higher than would otherwise be the case".

It is similarly doubtful that locational charging for losses could, unless the charges become very large, have any meaningful impact on dispatch and trading behaviour. Given current market conditions, gas fired generation tends to be at the margin in day times (coal generally overnight). Wind generators will, subject to network constraints, always displace the marginal plant when the wind blows. The incentives to trade/purchase renewable generation and thereby displace marginal thermal plant are strong:

- firstly the cost of dispatching wind is close to zero (indeed, there will be operational costs associated with not generating when the resource is available), unlike fuelled plant;
- secondly, much renewable generation receives financial support over and above the traded market price. Support is generally linked to output, creating an incentive to generate and a competitive advantage;
- thirdly, many suppliers own and/or directly contract with renewable assets to manage their exposure to cash-out under the renewables obligation;
- finally, renewables (wind farms in particular) are increasingly being asked to provide balancing services like frequency response, which require them to stay on the system⁴.

Given these features, to have any material impact on dispatch behaviour (at least as it affects renewable generation), locational losses would need to be valued at more than the difference between the short-run marginal cost of dispatching fuelled and non-fuelled generators *and*

² TNUoS already contains a substantial locational element.

³ Against a backdrop of radically reduced revenues for onshore wind (for instance if no CfD was made available in the future) a revised CRL could perhaps become a material factor for projects at the margin. A working group process, as suggested above, would allow for the examination of sensitivities such as this.

⁴ We note that thermal plant also have agreements with the System Operator that would similarly limit their ability to flex their output. RenewableUK encourages the CMA to consider whether this affects the general case for reform of CRL.

sufficiently high to undermine any competitive advantage introduced through financial support for subsidies. As an indicative figure, this could need to be as high as £80/MWh⁵.

Finally, RenewableUK also wishes to note that the impact of any CRL reform would fall disproportionately on Scottish generators because of the different definitions of 'transmission' in Scotland and England/Wales. This should be taken account of in any distributional impact assessment alongside other relevant policy changes, for example removal of the small generator discount⁶.

⁵ If 0.9 ROC/MWh is valued at £40/MWh and the variable cost of wind is £5/MWh, then the value of foregone financial support/competitive advantage is -£35/MWh. The marginal cost of CCGT of a 50% efficient CCGT is assumed to be c.£45/MWh, comprising a fuel and carbon price of £40/MWh and variable OPEX of £5/MWh. The total cost is the difference between the two.

⁶ Generators connected at 132kV in Scotland currently receive a discount of 25% on their transmission charges, to account for the different definitions of transmission in Scotland and everywhere else in GB. This is due to lapse in April 2016.

Remedy 2

RenewableUK and its members, having engaged extensively in the development of the Contract for Difference (CfD), welcome this new support instrument. Through its combination of revenue certainty and private contract form, the CfD should over time lead to a lower cost of capital and thus minimise the cost of supporting low-carbon electricity generation. The renewables industry also recognises the benefits of competitive award of the CfD, which further ensures that decarbonisation is carried out in the most cost-effective manner, and, importantly, is seen to do so.

This support for the CfD also arises because, for the foreseeable future, it provides the only credible route to investment, alongside the Capacity Market. Wholesale power prices are very unlikely on their own to provide sufficient income to justify significant capital investment in new capacity – there are a number of factors in play that will all depress energy prices:

- Falling demand – as efficient technology spreads and product efficiency policy continues to have effect, demand for electricity is reducing. New demand for heating and transport may reverse this trend, but not for a decade at least.
- The Capacity Market – generators supported under this policy, which is the majority of the overall power market, will be able to charge less for the energy they produce for the same return. This is not a criticism of the CM, merely an observation of its impact.
- Climate change policy – if there is a successful global deal on climate change in Paris this year, then demand for fossil fuel generally will fall, and hence prices will likely remain low.
- The merit order effect/‘cannibalisation’ – the presence of a large amount of high capital/low running cost generation, like wind and solar but also nuclear, will result in depressed power prices. When these generators run, they push out the most expensive marginal generator and clearing prices fall. The more of our fleet is made up of these technologies, the lower the wholesale price will go. This is an effect observed across many European power markets with significant renewable penetrations, for instance in Germany.

Consequently, it appears unlikely that a rational investor would sink their money into capital-intensive generation capacity unless there was a mechanism like the CfD to support it. For related reasons, higher-carbon generation is likely to need the CM. It is thus essential that the system to allocate the CfD and define the prices awarded is fit for purpose. As a result we strongly support the CMA’s focus on making this system work effectively, otherwise we risk locking in costs for 15 years or longer that could be avoided.

However, CfD allocation risk threatens to negate the benefits of the CfD and competitive allocation. This risk concerns the likelihood and impact of failing to secure a CfD. Since the eligibility criteria for the CfD are planning consent and a signed grid connection offer, the cost of entry can be very considerable, in the order of £50-100m for an offshore wind farm, so the consequences of not securing a contract are high. Due to a combination of circumstances, the supply of projects seeking CfDs is high and the available budget is low; the likelihood of signing a CfD is low. This combination could result in a significant hiatus in development of new projects, with the consequence of lowered competitive tension in future allocation rounds, once the current surplus of projects is cleared, and the possibility that the projects brought forward are not the most cost effective.

The remedies proposed by the CMA in this area would go some way to making the CfD budgeting process more transparent and are therefore helpful. One area of uncertainty over the use of the limited budget under the Levy Control Framework (LCF) is how much will be devoted to the contracts

negotiated directly by the Secretary of State. Having a clearer process to justify such negotiations should help developers of other technologies understand and predict the impact on the budget available to them. Similarly, having better justification for the division of technologies among the competitive pots and the budget available to them will improve the predictability of the auctions.

However, reform should go much wider than this. A more holistic and coherent policy is required on how technologies are introduced to the CfD system (and thus might need negotiated contracts or minimum allocations) and move through it to ultimately compete in technology-neutral auctions. DECC's stated ambition is to have all technologies compete against each other, but has not articulated how this is meant to happen in an environment where technologies have different characteristics (e.g. scale, construction time) and different levels of technological maturity. Even more important is the need to have a well-defined system for overall LCF management so that clear investment signals are given to developers.

There will be significant benefits from defining the LCF budget well in advance and signalling to the market what will be available through each channel (Pot 1, Pot 2, negotiation etc.). Developers will be able to judge the 'demand' for new capacity and, with knowledge of the relative position of their projects on the supply curve, make rational decisions on whether to bring those projects forward; wasted investment in development will thus be reduced, and the return required on successful projects thus also reduced, resulting in lower strike prices. Budget visibility will also lead to more rational bidding in auctions, as the 'apply or die' dynamic will not exist – it will be clear what future opportunities to secure CfDs will exist. There should be fewer project failures as a result.

In order to secure these benefits, there needs to be transparency on how budget usage is calculated, and we believe the CMA should mandate DECC to publish its view of remaining budget regularly, with as much detail as possible on the assumptions used. There also needs to be reform of how the CfD is accounted for under the LCF in the face of variable power prices. While the overall cost of CfDs to the consumer does not change with movements in the power price (and this is indeed an intentional part of the mechanism's design), falls in the power price make CfDs look more 'expensive' when seen through the lens of the LCF. However, these falls in power prices result in the consumer paying less for all other forms of power. Given that the presence of low-marginal cost power like wind exerts downward pressure on power prices, it would be perverse for renewables development to be curtailed or sanctioned on the basis of it having contributed to overall reductions of energy costs to the consumer.

Having a failure of accounting lead to a failure in meeting our objectives on decarbonisation is surely not right. This needs to be addressed if the LCF is to become successful in giving confidence to the market and bringing forward cost-effective low-carbon power. While it is right to consider the money flowing directly through the Renewables Obligation and Feed-In Tariff when budgeting for them, given that they take the form of fixed or quasi-fixed premiums to the power price, this is not the case for the CfD. The relevant measure when considering the budget for the CfD is not the money flowing through that system directly, i.e. the reference price to strike price cost, but either the overall cost of the power procured to the consumer, i.e. the zero to strike price cost, or the premium that the strike price represents to the investment counterfactual, e.g. new entrant unabated gas. The LCF should be recast to reflect this difference.

With Government intending to extend the LCF beyond 2020, it is vital to re-establish this budgetary system as a signal to developers that early-stage investment in projects is rational. This will only be possible if the uncertainty caused by the 'buying power' of the LCF being dependent on variable

wholesale prices is removed. We would strongly advocate that the LCF should be de-risked in this way, lowering the cost of capital for development and minimising the wasted costs in developing projects that cannot be afforded.

As a final general point, we would point out that if the benefits of competition are to be fully realised, then no technology should be arbitrarily excluded from CfD allocation. Since, as noted above, the CfD represents probably the only route to market for low-carbon projects for the foreseeable future, then to exclude any technology is effectively to prevent it from participating in the market. If the technology excluded is the lowest cost new power available, as onshore wind is set to be in the next few years, then consumers will pay more than is necessary for their power as they will be denied access to the cheapest resource. The CfD auctions will consequently clear at higher prices, locking in this economic inefficiency for 15 years. We believe the CMA should require all low-carbon technologies be allowed full access to at least the technology-neutral auction, in order to ensure that competition is maximised.

Response to specific questions regarding proposed remedies

Remedy 2a

(a) Would the remedy ensure that CfDs that are allocated outside the auction mechanism are awarded only when the benefits of doing so outweigh the costs?

The proposed remedy could potentially ensure this outcome, but clearly the process used would have to be open and transparent, and evidence-based so that bias, conscious or unconscious, is minimised. Through the use of open consultation around any proposal to enter negotiations, the justification can be tested and, if the decision to negotiate is made, it should then be done on the basis that a reasonable observer would agree that the published analysis supports the proposition that the benefits outweigh the costs.

(b) How much discretion should DECC retain in terms of the weight it places on each factor that it takes into account in coming to a decision on which projects to award CfDs outside the CfD auction mechanism? Should DECC be required to consult on and determine these factors and their relative importance in advance to enhance transparency? Should the weighting of each factor be constant across projects?

DECC should use a consistent set of weightings for all the decisions it makes around awarding contracts outside of competition. To treat different projects differently would appear to be unfair. DECC should consult on what those weightings should be ahead of their first application, and if it wishes to change those weightings at any time, there should be further consultation.

(c) In which, exceptional circumstances should DECC be able to allocate CfDs outside the auction process? For example, for reasons of industrial policy, where there are wider market failures, or where there may be insufficient competitors to hold an auction?

The general justification for awarding contracts non-competitively is that the interests of consumers or society at large are better served by such award than the alternatives. Clearly potential economic benefits arising from the development of new industries, such as lower costs in the future or prospective export earnings for the UK economy, should be appropriate factors to take into account. Other factors could include the need to develop technology options for the future or over-riding energy security concerns. However, the place of non-competitively awarded contracts in the complete CfD allocation system needs to be decided in the round, and we would urge DECC to bring

forward a coherent policy in this regard so that the appropriate justifications for such awards can be determined in the right context.

Remedy 2b

(a) Would the remedy ensure that future decisions by DECC on the allocation of technologies and the CfD budget to the different pots are taken in a robust and transparent manner?

The remedy could be part of an overall process that guides how technologies move through the various CfD award channels to ultimately reside in the technology-neutral auction pot, but Government needs to define clearly the policy within which the remedy could sit. Without a clear statement of principles applying to support of technologies and explaining any choices made around groupings and budgets, it will be difficult to determine if Government's proposals around these are justified by evidence.

(b) Is the remedy likely to result in a positive change in how DECC makes decisions regarding the allocation of the CfD budget to the different pots?

The remedy should be positive in this regard, but needs to be expanded so that there is visibility on groupings and budgets for two or more allocation rounds ahead. Developers need foresight in order to make rational decisions on investment in bringing projects forward, and the conditions that apply to their technologies in the auctions are a vital part of that.

(c) How regularly should DECC review the allocation of technologies between pots? What information should DECC publish when deciding to amend the allocation of technologies between pots? Should it also on a regular basis consult and/or publish reasons for not amending the allocation of technologies between pots?

DECC should review the technology groupings on a periodic basis, though the exact frequency would need further consideration. Again, however, this decision needs to be in the light of an overarching policy on technology progression.

(d) Should DECC be limited in the maximum proportion of the CfD budget that it can allocate to each of the different pots?

RenewableUK does not believe that mechanistic caps of this kind would be helpful, but this is in the context of having an agreed and clear policy on the treatment of technologies through the CfD allocation system.