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RES response to: The CMA's provisional findings on a case for Electricity Market Reform

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Introduction

The RES Group is pursuing a 'subsidy' free vision in order to deliver the best value energy to consumers. We believe that, as one of UK's biggest independent developers of both wind and solar PV generations, we are leaders in these efforts. As such, we have become strong proponents of Contract for Differences (CfD) and Competitive Allocation of these contracts across all low-carbon technologies¹. We believe that these mechanisms will drive all investment in low-carbon generation for the foreseeable future.

We are, however, very concerned by the lack of transparency, visibility and accountability that surround these mechanisms, as well as by distortions created by some of the design features. Because of the adverse effects that we believe these concerns have on the market, competition and therefore consumer bills, we have decided to submit this response to your call for views.

The LCF, CfD and CfD allocation processes are a new market and will drive all investment in low-carbon generation in the foreseeable future. As such we believe that it is important that the CMA goes beyond the current scope of the investigation which has focused on the CfD allocation processes. This market has three distinct components the LCF, the CfD and the CfD allocation process and these all require the CMA's scrutiny when considering potential adverse impacts on competition.

Our response therefore goes beyond your questions and seeks to shed light on the complex new dynamics of the electricity market and investment in new generation which is no longer driven by the electricity wholesale market.

The importance of a CfD

The CfD is a common law contract that will protect a generator from political risk and reduce revenue risk once secured. We therefore agree with the CMA that this will reduce the cost of capital that low-carbon CfD generators face. We do, however, believe the full reduction potential is not expected to manifest itself immediately in the market, and will be affected by a recent increase in political uncertainty.

The finance community is cautious and it will take time for them to get comfortable with this new mechanism and its robustness² to heightened levels of political risk. Reduction to the cost of capital is, however, essential if we want to deliver low-cost low-carbon generation because it is so capital intensive. From our onshore wind portfolio we believe that a 1% change in the cost of finance roughly equates to between a £4/MWh to £5/MWh change in the required strike price. We have as of yet not entered into detail commercial negotiations for our CfD project so it is difficult to value this benefit of the CfD but we do expect CfD finance to evolve over time.

¹ Low-carbon technologies as defined by the CfD process: Renewables, Nuclear and CCS.

² Important: The robustness of the CfD, i.e. the contract, is not the same as CfD allocation process or LCF which are entirely subject to political risk.

As highlighted by the report Report from the Panel of Technical experts³, we are in a period of unprecedented low interest rates. Gas prices are also at low levels. Over the lifetime of investments in the energy infrastructure both are likely to rise. By encouraging investment, setting the CfD and securing finance today, the consumer will be protected from both eventualities.

Critically, for a number of reasons⁴, the electricity wholesale price does not provide a reliable investment signal for new-build generation, including high-carbon generation technologies and is unlikely to do so in the foreseeable future. This was the primary driver for the EMR and a problem that has justified the development of the Capacity Market.

The wholesale price is an effective dispatch signal but not an effective investment signal making the CfD is an essential component of a viable a route-to-market for all low-carbon generators.

The importance of a competitive process in awarding CfDs

We are also strong proponents of allocating CfDs in an equitable manner across low-carbon technologies in a non-discriminatory technology-neutral competition. The current design of the allocation process is a competitive market mechanism that and we believe the transition of low-carbon technologies towards the established pot needs to be as rapid as possible if we are going to deliver lowest cost decarbonisation to consumers.

It is important to note that the CfD allocation process is essential to passing on the cost-reduction benefits of the Contract to consumers. Without competition, and in light of the asymmetry of information that exists within the value chain and between the industry and Government, we cannot see how else this can be achieved. This information asymmetry is particularly extreme in the more complex and less commoditised projects, where there are few points of effective reference.

We therefore agree with the CMA findings that it is reasonable to assume that CfD allocation outside the competitive process will most likely result in higher costs to consumers.

The importance of a correct counter-factual for the subsidy calculation

Without a correct point of comparison between the technologies, any evaluation of effective competition and the extent to which a 'subsidy' is granted is distorted.

The current perceived subsidy level of the CfD is the amount of top-up paid to a CfD generator above wholesale electricity price. However, the true counterfactual is the cost of the lowest alternative new-build generation technology, currently believed to be new-build CCGT.

³ Annex E: Report from the Panel of Technical experts - <https://www.gov.uk/government/publications/electricity-market-reform-delivery-plan>

⁴ The current wholesale market has only really stimulated new-build gas generation in times of clear system inadequacies. In other words the wholesale market has stimulated investment in the system's marginal technology, i.e. the price maker hedging against changes in operational costs, in the context of strong demand. With the move to low carbon generation that is characterised by a low or zero marginal cost generation and the continual political intervention in the market, the wholesale price is no longer an investable signal.

This has been identified by The Committee on Climate Change, in Annex 1 of their most recent progress report⁵. An appropriate analogy is the procurement for the construction of a new government office building; using the electricity wholesale price as the counter-factual in the subsidy calculation is equivalent to using the operation and maintenance costs of an equivalent existing office building as a counter-factual for assessing the bids put forward through the procurement process.

A more precise benchmark for the subsidy calculation is therefore the lowest-cost new build generation technology, including any carbon price. In their example, the CCC uses new-build CCGT as the cheapest alternative to low-carbon generation. Using this metric the CCC demonstrates that this accounting error results in a perceived higher cost to consumers through the need for more LCF budget for the same volume of CfD generation of ~+8% 2020 and ~+25.5% by 2025.⁶

We believe the CMA should recommend a review of the calculation methodology for determining how technologies should be compared to create the framework for effective competition.

Adverse effects on competition: Unquantifiable allocation risk of budgets

To maintain an efficient competitive market and avoid adverse effects on competition, it is essential that a clear investment signal is provided to incentivise development and maintain competitive tensions during the allocation process.

Mixed political and regulatory signals create significant uncertainty regarding allocation risk; the likelihood of a developer not securing a CfD at the end of the development process and associated spending. The implication is that this will lead to very low levels of development, and the only development that will take place will be large corporations pursuing projects which have gone through a negotiated process.

In the competitive process the allocation risk is defined by:

- Budget Transparency for the LCF
- Transparency for CfD budget allocation

We believe that the lack of transparency, visibility and accountability that surround LCF and CfD allocation budget decisions create an adverse effect on competition by undermining the investment signal, and increases the barriers to generators entering the market. This is particularly damaging for independent generators that may not have the capital reserves to ride through policy changes.

In this section we highlight a primary concern, the absence of an investable investment signal which we believe will result in adverse effects on competition by lowering competitive tensions in future auctions.

In response to your question 29 (a), (b) & (c) we believe that although the remedies proposed by the CMA are significant improvement on the current framework but remain insufficient.

⁵ <https://www.theccc.org.uk/publication/reducing-emissions-and-preparing-for-climate-change-2015-progress-report-to-parliament/>

⁶ This underlying information used in the calculation, i.e. the 2014 LCF budget information DECC is known to be wrong. It overestimates the wholesale price whilst we are confident that competition will continue to push clearing prices down. Both are dynamics that increase the resulting error in the calculation of the subsidy received.

Budget Transparency: LCF Budget

In this new market, the amount of affordable capacity is defined by the amount of budget the government makes available, first through the LCF.

The government has as of yet not provided any visibility on how the LCF budget was set, will be set, when it will be updated and how, when and if this will be allocated. The entire LCF budget design and definition process has received no public scrutiny and in this section we highlight some of the direct impacts on the investors.

The lack of transparency around the LCF budgeting process is compounded by concern over the ability of forecasting expenditure reliably. The recent forecast published by the Office of Budget Responsibility has created significant uncertainty in the market by pointing towards a significant overspend, a ~2.5bn, or 33%, increase in forecasted expenditure in less than a year from DECC's November 2014 Annual Energy Statement figures.

It is critical that the underlying figures and assumptions of the most recent LCF budget projections are publicly disclosed as soon as possible and with any future publications. This will provide a higher level of scrutiny resulting in a clearer understanding and greater reliability in this critical investment signal. It will also allow stakeholder to develop their own views on the associated risks of Government intervention to control overspend:

These retrospective changes have rattled investor confidence to an unprecedented level and is likely to result in an increase in the cost of capital as well as a significant amount of stranded investments.

We urge the CMA to investigate the LCF budgeting process and make the necessary recommendations to make sure that developers have clear and reliable investment signal.

Budget Transparency: CFD Budget

In this new market, the amount of affordable capacity is defined by the amount of budget the government makes available. Whilst the total amount of budget is defined by the LCF, the budget individual projects will get access to is defined by how the LCF budget is distributed to the various CfD allocation mechanisms. Today this consists of:

- Pot 1: Established technologies
- Pot 2: Less-established technologies
- Pot 3: Biomass conversion only
- Negotiated contracts

The CMA has concerns over complete lack of transparency behind the reasons for allocating LCF budget to these mechanisms. We agree that this results in an adverse effect to competition.

However we feel that in itself the transparency around the reasons for allocating the LCF is insufficient. There is also a much greater need for transparency on how and when the budget will be allocated. Even more damaging is the level of transparency surrounding when any decisions will be made if at all. This limits accountability and limits an effective investment signal that the LCF should provide the market with, further undermining the incentive to develop projects and effective competition.

We urge the CMA to review the overarching rules for the CfD budget allocation and make recommendations make sure that developers have clear and reliable investment signal.

Adverse effects on competition: Picking Technology ‘Winners’

As highlighted by the CMA, we believe that in some exceptional circumstances that there is a justification for differential treatment under the CfD regime, primarily in acknowledgement of a need to stimulate innovation and in light of barriers to new entrant technologies. We therefore support the need for an allocation outside of an auction process (pot 1 and pot 2 only) for select cases and first of a kind technologies.

In response to your questions 26 (c) we therefore agree that in exceptional circumstances DECC should be able to allocate CfDs outside the auction process.

The current framework allows for arbitrary decisions to be made on how technologies are treated within the CfD and how that treatment may change in time. This results in an unquantifiable allocation risk. So although we welcome the remedies proposed by the CMA we feel that these do not go far enough. They do not provide the necessary framework or certainty to simulate investment in the pipeline of ‘desirable’ technologies where there is not clear definition of ‘desirable’.

In response to question 29 (c) we believe that the CMA remedy does not capture the overarching issue with arbitrary decisions on technology/project treatment in the CfD, this will reduce investment in developing assets and lower competitive tension in future auction rounds.

Adverse effects on competition: Technology management framework

We support the objective laid down by the Planning our electric future: a white paper for secure, affordable and low-carbon energy⁷ as early as 2011 of a transition to technology neutral auctions however, despite a number of assertions by DECC that this ambition is central to the CfD framework, how this will be achieved remains unknown.

Furthermore, RES supports a rapid transition of all low-carbon generation technologies to technology-neutral non-discriminatory auctions to maintain competitive pressures and pressures on cost reduction to deliver best value for consumers.

Investment in innovative and first-of-a-kind projects can only be stimulated if there is an understanding that there is a clear route-to-market into the CfD and how they will be expected to transition towards pot 1. Additionally, the transition of a technology to a more competitive level in the CfD allocation mechanism will result in a change in the dynamics of the recipient pot. It is therefore essential that technologies and investors understand how this transition will take place.

This is why we have supported RenewableUK’s requests for DECC to develop a clear framework on how various technologies will be treated under the CfD regime and how this treatment might evolve over time, including the criteria which would inform these decisions.

We believe such a framework is a precondition to the remedies that you are proposing and central to informing investment decisions.

⁷ <https://www.gov.uk/government/publications/planning-our-electric-future-a-white-paper-for-secure-affordable-and-low-carbon-energy>

In response to question 26 (b), we believe that it is important that DECC should engage in a consultative process on the design of any framework being put forward.

Adverse effects on competition: Irregular pot 1 auctions

The results of the first Pot 1 allocation round demonstrate that it delivers the cheapest low-carbon generation in the UK. Additionally the successful bidders are a diverse group of companies and investors. This pot therefore sets a clear benchmark against which ALL new-build technologies can be measured for cost effectiveness as well as the benchmark that will stimulate cost reduction in innovative and less-established technologies.

We expect that increasing competitive tensions in the next round will serve to further drive down costs and that the result of a 2nd round could very well result in a clearing price that is below the cost of new-build gas generation⁸. This would establish the benchmark against which ALL investment in electricity generation should be measured and the additional cost to consumer from Government investment decisions.

We also believe that continued investment in established technologies will further reduce costs. Regular Pot 1 auctions are therefore essential to maintain a transparent benchmark.

Unfortunately there no information on any follow-up Pot 1 auction or even a requirement for there to be one which severely undermines confidence in the regime and investment decisions.

We believe that the only functional remedy is an amendment CfD regulation to ensure regular Pot 1 auctions take place on an annual basis with a minimum budget allocation (~£50m) and that this should be accessible to all low-carbon generation technologies.

In response to your questions 29 (c) and (d) we believe that your proposed remedy needs to be amended so that regular pot 1 auctions are guaranteed to avoid adverse effects on completion.

Adverse effects on competition: Artificially constraining technologies in Pot 1

To maintain the integrity of the pot 1 price signal/benchmark, it is equally important that competitive tensions within Pot 1 are not undermined by arbitrary decisions to exclude a specific or multiple technologies. Such a principal is consistent with the inclusion of landfill gas generators in Pot 1⁹ as well as integral to the long term vision of technology-neutral auctions.

Although no policy decision has been made regards to the exclusion of any technology from the established pot we feel that the ability to do so results in an adverse effect on competition.

We therefore believe the CMA should recommend a change to regulation that prevents the exclusion of all low-carbon technologies from the competitive established pot.

Existing Market Distortions: FIDER

We agree with the CMA's findings that there is a lack of transparency around the FIDER process which has and will continue to result in higher costs to consumers. As a common law contract it

⁸ The CCC use the unabated cost of gas generation with a carbon price in line with the projected carbon floor price. Additionally, the availability and range of possible prices for new build gas that we have access to, i.e. publically available, might be outdated.

⁹ It is correct that landfill gas remains eligible for the CfD even though it has an administered strike price (£55/MWh) well below the current pot clearing prices and did not participate in the 1st Auction.

would not be acceptable and costly for the Government to terminate signed Investment Contracts and we would not support this.

We do however believe that in the instance of the biomass conversion investment contracts, the CMA might be able to prevent the adverse costs to consumers without terminating any contracts. This is because these projects have not received state aid clearance, a condition to their validity, due to concerns by the DG competition on the possible distortion the scale of these projects could have on the biomass fuel market.

The CMA should propose that in the event that the Biomass Conversion investment contracts do not receive a clear state aid approval that the respective budget should be allocated competitively.

Existing Market Distortions: Pot 3- Biomass conversion

We do not agree with the creation of a 3rd pot for biomass conversion or any other technology specific pot. In this specific instance, we believe that biomass conversion technology and industry are sufficiently mature to participate in the pot 1 auction process and that there limiting their exposure to competition with mature technologies will result in a higher cost to consumers.

The existence and possibility of creating pots arbitrarily represents an allocation risk for all technologies. To date DECC has chosen not to use the pot 3 and has also excluded biomass conversion from the pot 1 auctions providing no route-to-market in the CfD mechanism.

On the other hand, the possibility that DECC allocates budget to a 3rd or new Pot going forward, without foresight or explanation, represents an unquantifiable risk for generators looking to Pots 1 and 2 for a route-to-market.

In the current environment of severely constrained budget this further compounds the allocation risk and therefore has an adverse impact on competition.

We believe the CMA should recommend the disbanding of Pot 3 and changes to ensure that biomass conversion or any other low-carbon technology, is allowed access to Pot 1 auctions.

Conclusion

For a number of reasons the electricity wholesale market does not provide the necessary investment signal to stimulate new-build generation and will continue to do so in the foreseeable future. This led to government intervention in the form of the EMR however the implications of this paradigm shift have not yet fully permeated through Government, Government's institutions and industry.

The CfD and the CfD allocation processes are now the only reliable route-to-market for low-carbon generators and with the LCF budget the CfD framework is the only investment signal for developers. Every single one of these mechanisms are fully controlled by the Government, through DECC and Treasury, and as such the government is in complete control of the investment signal for all new-build generation in the UK.

Today the result is that low-carbon generation industry is faced with an unquantifiable allocation risk the focus of our response. This is primarily a result of the lack of transparency, visibility and accountability that surround the decision making process. Today there is concerning evidence that

this is undermining the development pipeline with an 80% drop in the number of planning submissions for renewable projects record last month on the previous year¹⁰.

We feel this drop in planning permission is not necessarily a result of the significant increase in political uncertainty linked to the new government, industry has momentum resulting in a level of delay. We therefore feel that this is more likely to be linked to the uncertainty created by the unquantifiable allocation risks mentioned in our response. Today we are acutely aware that these cumulative uncertainties are leading to redundancies throughout the industry. Our own business went through a restructuring process last year and will struggle not to follow this more recent trend if serious corrective measures are not taken soon and another established pot auction, that does not discriminate against any mature low-carbon technology, does not proceed soon. A hiatus in 'desirable' project development seriously threatens the UK's ability to maintain competitive tensions in future CfD auctions with only one certain outcome: an increase cost of decarbonisation.

Although the CMA's proposed remedies are helpful these fall-short of what is necessary. In this response we cover the questions put forth in your preliminary findings but our primary aim has been to highlight, as far as possible, serious adverse risks to competition from the unquantifiable allocation risks that have not been captured by the scope of the CMA's work to date. We urge further investigation as soon as possible. We have also put forward a number of recommendations for remedies that we feel are particularly urgent but accept that the CMA must be its own judge on the merit of these.

We are not seeking to 'undo' any of the award CfDs and more importantly we urge that any recommendations avoid undoing any of the CfD framework but focus on the improvement of what has the potential to be an excellent market mechanism.

In light of the importance and urgency of the concerns that we have raised, RES would be happy to assist any further investigation in any means possible so please do not hesitate to be in contact.

¹⁰ <http://www.clickgreen.org.uk/news/national-news/126291-exclusive-planning-bids-for-renewable-energy-projects-drop-by-80.html>