

EEF/UK Steel Response to DECC Electricity Market Reform Consultation

Need for reform

- Electricity market arrangements need reform. They need to provide better incentives for investment in low-carbon energy and better value-for-money for the consumers who subsidise it.
- But reforms should not be rushed and would benefit from a more strategic approach that re-examines the case for the 2020 renewables target and links work on carbon pricing, electricity markets and the green investment bank.

View on overall package

- The proposals will benefit investors by providing certainty over returns and transferring risk to consumers. But they risk damaging the competitiveness of UK manufacturing by unilaterally increasing the already considerable impact of climate policy on industrial electricity prices.
- Rather than simplifying the policy landscape, the proposals will add further cost and complexity. Electricity in the UK will be subject to up to four different carbon prices – a tax on generation, two separate taxes on consumption and the EU Emissions Trading Scheme (EU ETS) price.
- Manufacturers feel in the dark about the impact of the proposals on their businesses. There is no information on how they will affect industrial electricity prices. This must be rectified to enable an informed debate about the proposals and reach an informed decision on market reform.

View on individual measures

- Replacing the Renewables Obligation with feed-in tariffs (FITs) based on contracts for difference should benefit consumers by lowering the cost of supporting renewable energy. But the case for introducing a carbon price floor as well as FITs has not been made - each policy on its own would deliver the core objective of greater certainty over returns for investors in low-carbon electricity.
- The case for introducing a capacity mechanism now is moot. Current arrangements have delivered electricity security for a decade and National Grid already has a range of tools to ensure the system continues to have adequate back-up in the future. The need for a capacity mechanism, which will cost consumers, should be kept under close review and alternative solutions, such as strengthening National Grid's existing ability to procure reserve capacity, should be fully explored.
- An Emissions Performance Standard is likely to deliver little or no environmental benefit. Power sector emissions are already capped under EU ETS and UK regulations already effectively preclude the building of unabated coal-fired power stations.

Improving the package for consumers

- Government should explore the possibility of sharing the risk and burden of funding the proposals with consumers. Taxpayer funding of the Renewable Heat Incentive offers a precedent.
- A review of the cost-effectiveness and feasibility of the 2020 renewables target should be carried out alongside the market reform programme. A number of the proposed reforms are designed around meeting the target. Whilst renewables will play an important part in reducing emissions, there are many pathways to decarbonising our economy, some more cost-effective than others. Pursuing the target without subjecting it to rigorous cost-benefit analysis first risks burdening consumers with unnecessary costs.
- If FITs are introduced, the government should ensure that the benefits of revenue certainty are shared with consumers who are likely to fund them. For example, suppliers could be required to offer consumers long-term fixed-price contracts linked to the FITs.

- If the carbon price floor is introduced, it should be as part of a package with simplifies and reduces the burden of carbon pricing such as reducing the Climate Change Levy rate for electricity to the EU minimum and/or abolishing the CRC Energy Efficiency Scheme.

1. EEF AND ITS MEMBERSHIP

EEF is an employers' organisation and the representative voice of manufacturing businesses with a growing membership of over 6,000 companies employing some 900,000 people. All our members are energy consumers. For some, like those in energy-intensive industries such as steel, a secure and affordable supply of electricity is crucial to the competitiveness of their business.

So we welcome the opportunity to provide a manufacturing perspective on the government's proposals for electricity market reform. To inform our response to this consultation, we engaged extensively with our membership, which included running a dedicated focus group on the proposals.

This response also represents the views of EEF's UK Steel division, the trade association for the UK steel industry.

2. SCOPE OF OUR RESPONSE

EEF views HM Treasury's carbon price floor proposals and DECC's electricity market reform proposals as a single package of measures. They interact with each other and will both have a significant impact on electricity producers and consumers.

3. THE ELECTRICITY MARKET NEEDS REFORM

EEF supports the objectives of the reforms – creating a market framework that will deliver secure and low-carbon electricity more cost-effectively.

The UK needs substantial investment in low-carbon generation over the next few decades in order to cut carbon dioxide emissions and replace the significant number of power stations scheduled for retirement in the near future.

However, the current electricity market arrangements fail both investors and consumers. Investors lack sufficient certainty over returns to make long-term investments in high capital cost technologies like nuclear and offshore wind, whilst consumers are paying over the odds to fund renewable energy.

4. BUT A MORE STRATEGIC APPROACH IS NEEDED

To attract investors and meet the needs of consumers, the UK needs an electricity market which is efficient, internally consistent and stable. So EEF is concerned that the current rush of major changes to climate and energy policy seems to be being carried out in piecemeal fashion.

Three major and overlapping policy initiatives are being undertaken by different government Departments and according to different timescales – i.e. the carbon price floor, electricity market reform and the Green Investment Bank. Each will have a major impact on investment in power generation, but each seems to be being developed in isolation – e.g. nobody appears to be looking at the cumulative impact on industry or how the proposals will interact. The government should take a more strategic and coordinated approach. All these changes should be developed, consulted and finalised as a single package.

In addition, the case for the 2020 renewable energy target should be re-examined. It is driving two of the main proposals in the electricity market reform package – a technology-specific support mechanism and a capacity mechanism to compensate for the intermittency of wind power.

EEF is highly sceptical that the current renewables target is the right approach to decarbonising the UK economy and range of alternatives exist. For example, giving the market greater freedom to decide appropriate mix of low-carbon technologies to meet emissions targets could be a more cost-effective approach.

Blind commitment to the renewables target runs the risk of damaging manufacturing and imposing unnecessary costs on our economy. This would damage our growth prospects by locking in uncompetitive energy prices for no environmental benefit.

The previous administration signed up to the target without assessing its impact or exploring the alternatives. The coalition government should carry out a thorough and transparent cost-benefit analysis of pursuing the target before consumers begin to incur significant and potentially avoidable costs.

5. VIEW ON THE OVERALL PACKAGE

Proposals could damage manufacturing

Despite some good individual measures, we are concerned that the overall package will damage manufacturing. The proposals will deliver a better investment environment for low-carbon, but this could come at a high price. The combined effect of DECC's electricity market reforms and HM Treasury's carbon price floor proposal could significantly undermine the international competitiveness of UK manufacturing which the government is looking to drive economic growth.

The government estimates that the net effect of the proposals on 'non-domestic' consumers, compared to continuing with the current arrangements, will be higher electricity bills until 2025 and lower bills thereafter.

Current climate policies account for approximately 20% of electricity bills and are already adversely affecting investment in manufacturing. Increasing the cost of electricity still further for the next fifteen years could have serious consequences for the competitiveness and attractiveness of manufacturing in the UK. Indeed, the unilateral nature of the measures will put UK manufacturers at a significant cost disadvantage to European competitors.

To better understand the impact of the proposals on manufacturing, the government needs to identify how its plans will be funded and by whom. Specifically, will the burden fall entirely on consumers or will the government share the cost?

Proposals will create unnecessary cost and complexity

The coalition government is committed to simplifying the tax system and reducing the regulatory burden on business. But instead of rationalising the policy landscape, the proposals will add further cost and complexity.

Under the proposals, electricity in the UK will be subject to up to four different carbon prices – a tax on generation (the carbon price floor), two separate taxes on consumption (the Climate Change Levy and the CRC Energy Efficiency Scheme) and the EU Emissions Trading Scheme (EU ETS) price. The government should be looking to consolidate rather than further fragment carbon pricing.

Most importantly, the consultation fails to make a convincing case for the need to introduce both a carbon price floor and FITs for low-carbon technologies. Either policy on its own will be sufficient to stimulate investment in low-carbon energy by providing certainty over returns. Government should reconsider the need for a carbon price floor. The case for introducing FITs is stronger – they would be more effective at reducing investor risk and would do so at a lower cost to consumers.

FITs based on contracts for difference would provide absolute certainty for investors over returns rather than merely guaranteeing a minimum return like the carbon price floor. In addition, legal contracts are enforceable in court and would not be subject to the same political risk as the carbon price floor – which could be changed at any moment.

FITs would replace a costly support mechanism with a more cost-effective one rather than merely introducing an additional subsidy. Furthermore, FITs would mean that consumers only pay for low-carbon electricity when it is generated. Whereas the 'carbon price floor' would represent an immediate cost to electricity consumers as soon as it is introduced, irrespective of the level of low-carbon electricity actually being generated.

Manufacturing in the dark over price impact

Manufacturers feel in the dark about the impact of the proposals on their businesses. There is no information on how they will affect industrial electricity prices. Failure to provide this information before policy is decided would represent a major failure in stakeholder engagement.

The impact assessment estimates the effect of the proposals on 'non-domestic' electricity bills. Inferring the impact on industrial electricity prices from this information is extremely difficult. The government should publish this information and the assumptions lying behind it on future consumption and energy efficiency. This is critical to a proper understanding of the implications of its proposals for the competitiveness of UK manufacturing, particularly energy-intensive industries.

For manufacturing, in which the potential for greater energy efficiency varies considerably by industry and process, prices are a much more meaningful guide to the impact of a policy proposal than bills. Lumping all 'non-domestic' consumers together - i.e. the corner shop and the electric arc furnace - further obscures the impact of the proposals on manufacturing.

In our opinion, without a better understanding of the impacts an informed debate and decision on market reform is not possible. A more detailed impact assessment has been promised as part of a White Paper, but we fear the decisions on future market arrangements will already have been made by the time it is published.

6. EEF VIEW ON INDIVIDUAL PROPOSALS

Replacement of Renewables Obligation with Feed-in Tariffs

EEF strongly supports replacing the Renewables Obligation (RO) with feed-in tariffs based on contracts for difference. It should be a major benefit to consumers by lowering the cost of supporting renewable energy. There is a large body of empirical evidence demonstrating that the RO has cost significantly more per unit of renewable energy capacity delivered than the feed-in tariffs used in a number of continental European countries.

We also support the government's preferred option of basing the feed-in tariffs on a two-way 'contract for difference' model under which generators are entitled to a top-up payment if wholesale electricity prices fall below a specified level, but must pay money back if prices rise above that level.

A contract for difference model will provide the best protection for consumers against the risk of low-carbon generators being over-subsidised. Under the government's fall-back option of 'premium' FITs, low-carbon generators would receive a fixed subsidy irrespective of how high the wholesale electricity price and carbon price go.

However, further information needs to be provided on how the FITs will be funded when wholesale prices are low and what will be done with windfall profits when wholesale prices are high. In addition, cost-effectiveness must be factored into the design of the FITs and the tariff levels should not be unduly tilted in favour of relatively expensive low-carbon technologies like offshore wind. EEF would welcome the opportunity to be involved in the detailed design of the FITs.

Capacity Mechanism

The rationale for introducing a capacity mechanism appears to be a concern that current market arrangements will not adequately remunerate the additional back-up plant that large volumes of intermittent wind power will require.

Yet the case for a capacity mechanism now is not proven. Current arrangements have delivered electricity security for a decade, the capacity margin is forecast to remain healthy for the next ten years and National Grid already has a range of tools to ensure the system continues to have adequate back-up in the future.

Instead of implementing a policy which could start costing consumers before the need is proven, EEF believes that the need for a capacity mechanism should be kept under close review and the full range of alternative options

explored (e.g. strengthening the existing Short-term Operating Reserve market or introducing an obligation on suppliers to have access to sufficient back-up capacity).

Emissions Performance Standard

EEF believes that an Emissions Performance Standard (EPS) is at best redundant and at worst could undermine security of supply.

Power sector emissions are already capped under EU ETS and UK regulations already require new coal-fired power stations to fit carbon capture technology to a third of their capacity. Building a coal plant, fitting an expensive and unproven technology to part of its capacity and then operating the remainder unabated makes no commercial sense whatsoever. So introducing an EPS set to a level designed to preclude building unabated coal plant would deliver little or no environmental benefit but could have significant negative consequences.

A poorly implemented EPS, for example one set low enough to affect gas plant, could undermine UK energy security. For example it could encourage higher carbon electricity generation to be sited elsewhere in Europe to supply the UK via interconnectors. As well as creating risk to security of supply, this would export jobs and investment overseas without reducing overall emissions.

On a steel-specific point, if an EPS were to be introduced, it would be essential to design it in such a way that it did not undermine the use of process gases arising within integrated steelworks to generate electricity. These gases are an unavoidable by-product of iron and steel making, and are put to a variety of uses including electricity generation. If an EPS made the latter unviable, then the only alternative would be to flare the gases (for safety reasons), which would be wasteful of energy and increase the UK's carbon emissions.

7. IMPROVING THE PACKAGE FOR CONSUMERS

The reforms need to strike a better balance between the interests of investors and consumers or risk damaging manufacturing and by extension the growth prospects of the UK economy. EEF recommends the following changes:

- Drop plans for introducing a carbon price floor, which feed-in tariffs for low-carbon generation will make redundant.
- Government should explore the possibility of sharing the risk and burden of funding the proposals with consumers. For example, it could underwrite or fund a part of the cost of introducing feed-in tariffs. Taxpayer funding of the Renewable Heat Incentive offers a precedent.
- If FITs are introduced, the government should ensure that the benefits of revenue certainty that they bring to investors are shared with consumers who are likely to fund them. For example, suppliers could be required to offer consumers long-term fixed-price contracts linked to the FITs.
- If the carbon price floor is introduced, it should be as part of a package with simplifies and reduces the burden of carbon pricing. Potential offsetting measures include reducing the CCL rate from £4.85 per MWh to EU mandated minimum of £0.42 per MWh and abolishing the CRC which was recently transformed from a sophisticated policy that rewarded companies which successfully cut their emissions to a crude tax on energy consumption.

[REDACTED]

[REDACTED]

