Response to:

Consultation on Electricity Market Reform

Introduction

Covanta Energy is the world's leading developer and operator of Energy from Waste (EfW) power facilities. The company operates 44 facilities globally, transforming some 18 million tonnes of residual waste into over 9 million MW hours of renewable and low-carbon electricity.

Covanta is active in the UK market with six strategic projects in development, all of which will be designed to operate as combined heat and power (CHP) facilities. These facilities are conceived to serve joint municipal and merchant residual waste markets and between them will have the capacity to process some 3 million tonnes of such materials each year. They will represent inward investment to the UK's waste and energy infrastructure of some £2.5 billion.

The government's Electricity Market Reform (EMR) proposals are designed to provide a basis for long-term investor confidence to deliver some £200 billion of infrastructure investment in the sector to 2020. Covanta Energy welcomes this opportunity to comment briefly upon the government's EMR proposals as they affect investment in EfW.

Role of EfW

There has long been recognition that that EfW has an important part to play not only in meeting sustainable waste objectives of moving waste up the hierarchy away from landfill and ensuring that beneficial use is made of residual wastes. More recently, there has been growing awareness of the important part that EfW can play in making the transition to a low-carbon economy as a proven, affordable source of base-load renewable and low-carbon energy.

The terms of reference of the review of English waste policy launched by DEFRA in June 2010 included seeking ways to ensure that cost effective recovery of the energy value of residual wastes is maximised.

The draft UK "Carbon Plan" published by DECC on 8 March notes that "generation of energy form waste is likely to become an increasingly important source of low-carbon energy." The strategy notes that EfW can be an important source of sustainable electricity and heat. It endorses the use of established technologies, such as combustion, and the development where appropriate of emerging technologies.

This is an important point. Established thermal treatment technologies have the greatest potential to deliver substantial new capacity in the short- to medium term and to provide cost-effective solutions. There has been a tendency in UK waste and energy policy in the past to tilt the balance of support more favourably towards emerging technologies. Arguably, this has been a significant factor in inhibiting investment in the sector. The result is that while landfill diversion has increased very substantially, the UK's level of energy recovery has not increased significantly (and continues to stand well below levels seen in leading EU countries).

It is important that the EMR package addresses this issue and encourages rapid deployment of this technology to contribute to meeting looming 2020 targets.

Current Market Arrangements

We agree with the government's assessments of the ability of current market arrangements to attract investment into the sector on the scale required and of the future risk to security of energy supply.

As far as EfW is concerned, specific failures within the current arrangements that government should seek to address through the EMR package are:

- The low cost of carbon and the need to provide a well-signalled direction of travel for future increases in the carbon price to stimulate early investment. The proposed carbon price support mechanism has the potential to fulfil this role.
- Failure of the current support mechanisms for renewable energy generation to encourage mass deployment of market-ready technologies. The Renewables Obligation (RO), in effect, is a market development instrument for emerging technologies, not the facilitator of mass deployment that is needed if renewable energy targets are to be met. This has the perverse effect of incentivising investment in projects that deliver least in terms of beneficial carbon outcomes. Future arrangements should be technology neutral, focussing instead of aligning support with delivery of carbon outcomes.
- Excessive complexity. The sector suffers from the lack of a single, cohesive driver for behavioural change. Instead, there is an inter-locking set of measures that are both complex and uncertain. The RO, for example, has been subject to review several times since its introduction (for example with the introduction of banding etc). Each time the regime has become more

complex, less flexible and less focussed. It is important that the future arrangements are settled and consistent as well as simple.

Carbon Price Support

Covanta Energy responded in detail to the HM Treasury consultation on the proposal for a carbon price support mechanism. We support this approach very strongly and believe that it should be the central plank of the government's approach to encouraging investment in renewable and low-carbon generating capacity. We favour early introduction and an aggressive approach to early increases in the price of carbon.

This is especially important for EfW where the carbon price support mechanism can work with the analagous landfill tax to drive early development of residual waste treatment capacity to meet 2020 targets. We are aware that there is some sectoral concern that the design of the support mechanism may have perverse market impacts, for example in disincentivising CHP. We expect that government will consult further with industry and other stakeholders over the detailed design of the mechanism and that such matters can be resolved satisfactorily in that process. The important thing, given the long planning and construction lead times of EfW projects, is that an early 'in principle' announcement is made about the introduction and level of the carbon price support mechanism.

Feed-in Tariffs/Contract for Difference

The broad principles underlying the existing RO regime are sound. However, the architecture of the Obligation has become complex and unwieldy over time and increasingly divorced from its true objective of providing a clear fiscal incentive for the deployment of new capacity. It has evolved into a mechanism that discriminates between technologies, not on the basis of the carbon outcomes that they deliver but on their market-readiness. Perversely, the less market-ready the technology is, the greater the level of support it receives.

A replacement mechanism must avoid the pitfalls of complexity and technology discrimination.

The Feed-in Tariff (FIT) with Contract for Difference (CfD) has the potential to achieve this. As ever, the devil will be in the detail. From the perspective of an EfW developer, it is important that the new regime:

- Includes all forms of EfW and both electricity only and CHP operation;
- Does not seek to differentiate between the different EfW technologies in terms of the level of support offered
- Rewards all technologies equally relative to their carbon performance
- Does not seek to serve as a proxy to underwrite the development costs of emerging technologies.

An important consideration in the financing of EfW projects is that (increasingly risk-averse) lenders tend to discount to a very large extent third-party income, including electricity sales income, largely because they cannot e supported by long-term contracts. The FIT/CfD mechanism could help to address this by removing long-term electricity price risk from operators. This would both encourage customers to enter into longer-term power off-take arrangements and ease funder concerns. Such a mechanism would be likely to lead to renewed investment appetite among the tradition lenders and potentially bring new players into the market, helping to reduce the cost of finance.

In line with our comment above that payment should be based on carbon outcomes, we consider that FIT should be paid on the basis of output not on availability. This will encourage investment in technologies able to contribute base-load capacity.

Implementation issues

In our view, the key objective of using support mechanisms to encourage development of new capacity should be to meet adopted targets for renewable and low-carbon generation in the most cost-effective manner possible. In effect generators should be rewarded for the amount of carbon they take out of the system.

Therefore, all technologies should be eligible for a minimum level of support (this might be set at a very low level in recognition of the fact that some technologies are at or near market-readiness). This could be achieved either trough setting a fixed basic level of tariff or though an auction process. Transitional arrangements will be important. The government hopes that legislation to underpin its new approach will be in place by 2013/14. Provided that the approach adopted is genuinely technology neutral and genuinely embraces all available technologies, we believe that the FIT/CfD regime is likely to be more beneficial for EfW than the current RO regime. Therefore, we would wish for the transitional arrangements to allow capacity accrediting after enactment of the new regime, but before the 2017 ‘closure’ of the RO to be able to benefit from it. Such capacity should be eligible to opt in to the FIT/CfD regime.