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Dear Sir

Consultation on Electricity Market Reform

- Comments from the Confederation of Paper Industries

The Confederation of Paper Industries (CPI) is the trade association for the paper industry in the UK and has within its membership paper manufacturers, corrugated packaging manufacturers and mill-owned and independent recovered paper merchants and exporters.

Paper is a sustainable material and while substantial improvements have been made in energy efficiency (in part driven by Climate Change Agreements); by its nature, production is still energy intensive. The Pulp & Paper sector has already responded positively to the green agenda, with paper mills and associated converting companies providing the key market for recycled paper collected in the UK; making major investments in general energy efficiency; and widely deploying CHP including an increasing the use of biomass. A commitment to a low carbon resource efficient economy is clear.

Our sector continues to be a major manufacturer, producing just under than 5,000,000 tonnes of paper each year in the UK, with over 50 paper mills still in production. Around 20,000 people are employed directly by the sector. With over 10,000,000 tonnes of paper consumed annually in the UK, manufacture of pulp & paper should be well placed to play an important role in the growth envisaged for the manufacturing sector.

We are pleased to see a restatement by Government that the economy needs to be rebalanced with more UK manufacturing and additional recent comments by the Prime Minister promising a supportive legislative framework. **We are concerned that these proposals will not deliver these aspirations and indeed will cause serious damage to the competitiveness of UK industry.**

We recognise the need for investment in the UK electricity generation industry to ensure security of supply and a continued move away from an over-reliance on high carbon fossil fuels such as oil and coal. However proposals must be both affordable and realistic if they are to command the support of the market and secure the requisite investment.

Paper – the sustainable choice

We highlight a number of key concerns.

- Cumulative impact of policies on cost. While the Government may be persuaded that the costs of each policy are bearable in isolation, the cumulative impact of policies on energy costs is not. Alongside assessments of the feasibility of individual energy related policies, more attention must be paid to the cumulative impact of the imposed costs. CPI is a member of the Energy Intensive Industries Group and the EIUG submission contains an updated report highlighting the cumulative impact of all electricity related policies. We urge this report is given serious consideration.
- Competitive energy prices in the UK – affordability of proposals. It is critical to the long term future of paper manufacturing in the UK that energy costs are in line with costs in other manufacturing nations both elsewhere in Europe and other regions. Policies specific to the UK that lock industry into high costs make the UK less likely to win investment for new facilities as well as the reinvestment required to secure the long term future of existing installations.
- Decarbonising the electricity supply should be considered across the EU. We have already highlighted concerns that the UK specific CPS proposals guarantee high carbon costs in the UK, without the same impact on overseas competitors.
In our submission to the CPS consultation we have already identified additional costs to UK paper mills of £210m pa in 2030, against an average annual sector profit for 2008 and 2009 of well under £100m. In this context the cost of the proposals are clearly unaffordable and unsustainable.
- Carbon leakage. With a captive market for electricity supply, there is no problem for generators in passing through additional costs caused by these proposals to customers; indeed this ability to pass through costs is a critical justification for the proposals. There should be no assumption that manufacturers have the same opportunity, nor that the sector is in a position to absorb these additional costs. Indeed this issue has already been recognised by the European Commission where energy intensive sectors subject to international competition are partially protected from increased costs in the EU ETS by the continued free allocation of allowances for heat use. The loss of allowances for electricity production and use will already cost the sector in the region of £44m each year from 2013 in EUA costs for fuel used in electricity generation and passed through costs in purchased electricity (assuming an EUA cost of £15 and the ESI only passes through the direct cost of the EUA). UK specific policies add another layer of additional costs and there should be no doubt these will impact on UK manufacturing with a consequent loss of employment and wealth creation. It is disappointing to note a continued lack of attention paid to this issue.
- Divergence between European and UK energy policies. A divide is evolving between energy policy at a European level and that in the UK. On the one

hand policies continue to be developed by the Commission to provide an interconnected liberalised energy market across Europe, while on the other, the UK is developing policies to increase costs in the UK compared to elsewhere in the EU. The CPS proposals are one obvious example.

- Scale of available investment. The UK energy market is dominated by companies operating across a number of different countries. With massive energy related investments required in many Member States (and indeed globally) and with a limited pool of capital, there is a danger that individual nations will begin a bidding process to attract investment and draw in new capital with unsustainable costs being passed through to consumers. The guaranteed rates of returns proposed in the CPS proposals indicate this is a real possibility and the Government should be aware of this issue. Assuming the pool of capital is limited, the only winners will be the energy developers guaranteed high rates of return at the expense of energy consumers.

Windfalls to existing generators. Some of these proposals are likely to lead to windfall profits for installations already operating or those not requiring additional support. Changes to support mechanisms should be designed to ensure these windfalls are not generated, or if they are they are put to productive use. A fully funded programme for the development of energy efficiency in the industrial sector would be one obvious possibility.

- A global context. Increasingly key competitors are located outside Europe in un-carbon constrained economies. Putting such a high price on carbon inside the UK will simply continue the trend towards de-industrialisation. Simply moving the release of emissions outside the UK and then importing manufactured product with embedded emissions makes no sense and has no impact on global emissions.
- Providing confidence to the investment market. Policies to meet unrealistic targets at any cost will not be affordable and will inevitably be subject to review as this becomes clear. As the rationale behind these reforms is to provide long term confidence to potential investors in UK based electricity generation this is a key factor. If proposals are uneconomic or unaffordable, early reviews become inevitable meaning investment trust will not be built. While EMR policies seek to offer long term solutions, no Government can bind its successors and policy changes on (for example) CHP, CRC, RO, FIT and EU ETS targets all undermine confidence for investors. Long term stability in regulatory policies is critical.
- The speed of change in energy markets. Recent changes in the structure of the gas market have not been fully considered in Government policies. Natural gas offers a proven relatively low cost and lower carbon (compared to coal) methodology to generate electricity and heat. As a minimum and on affordability grounds, the role of gas should be re-examined – indeed para 23 page 27 of the consultation acknowledges the advantages of gas generation, but then largely discounts them due to the 2020, 2030 and 2050 targets that

look increasingly unrealistic. It follows that many of the options put forward in the consultation are constrained by these unrealistic targets.

- Simplicity in regulation. The Government has already acknowledged the overlapping and confused nature of climate change policies and is in danger of adding to this complexity. In principle regulation should be simplified and there seems overlap between some proposals. When developing low carbon generation plant, support is essentially required during the capital intensive construction phase and support is not required during the low cost operational phase. These policy proposals have exactly the reverse effect; offering no support when actually required. It is time for the possibility of grant aid to build new plants to be fully considered as an alternative and simpler approach.
- Impact of the viability of Combined Heat & Power operation. In our response to the CPS and separate letters to key Ministries, we highlighted the potential impact of these proposals on the continued viability of the operation of existing CHP plant. This makes no sense given their proven cost effective reduction to national GHG emissions as well as contributing clearly to security of supply. These aspects are generally accepted and that CHP is worthy of support to encourage the delivery of environmental benefits arising from its deployment and we urge this issue is properly addressed. Indeed we urge that both renewable and gas fired CHP is made eligible for support under the reforms based upon the carbon savings delivered by the CHP.
- Over-reliance on subsidy. The dependence of wind and solar electricity generation on high levels of subsidy should highlight the fundamental problems that will be caused if they are encouraged by grant regimes to become a major part of the UK electricity generation mix. In the same way that the solar FIT has very quickly become unaffordable, this is likely to happen with wind power. We note such reviews are already under way in other Member States including Germany, Denmark, Holland and Spain.
- Negawatts. We accept that demand side management is an important part of the solution and some industrial activities may be able to play a part both in demand switching and overall improvements in energy efficiency. Short notice power interruptions for process operations are very difficult to manage and expensive in disruption to production. However given the right incentives payments and early notice of the need to curtail demand this could be beneficial to both the ESI and industry. We would be pleased to facilitate further discussions.

Comments of the main policy proposals.

Feed in Tariffs.

For the sake of regulatory simplicity, we cannot see a role for both a Carbon Price Support mechanism and Feed in Tariffs.

However if a FIT regime is imposed, then the analysis presented in the consultation does a good job in presenting the relative merits of different methodologies and it is reassuring to see international experience being quoted.

Again we highlight the long-term un-affordability of the proposals as a key issue and note the reservations about premium/fixed FITs not necessarily achieving the desired economic impact; leading to either excessive cost or an insufficient level of support. We also note that contracts for difference run a risk of insulating supported generators from the role of the competitive market in ensuring efficiency. Additionally the role of industrial demand in establishing long term demand for new generation is worthy of more analysis. We note long-term supply contracts offered by nuclear plant operators in France to industrial users and would urge similar levels of support should be available in the UK.

We would welcome clarity on the use of any windfall income the government or generators receive if wholesale electricity prices are higher than envisaged and contract for difference are utilised. Indeed we see a key opportunity for Government in being the contracting party, thus increasing confidence in market investors and ensuring the costs of FIT payments are spread as widely as possible and not imposed on the industrial sector.

FIT support should be available equally to all types of proven low carbon generation – differentiating between technologies is not appropriate.

Capacity payments.

It is not clear that such widespread changes to the market are required and the possibility of incremental changes to the existing mechanisms should also be examined.

Any suggestion that new gas fired plant should be built as back up for intermittent wind generation is likely to be unaffordable and in any event should be considered within the economic and environmental case for wind per se. Back up capacity should be provided by old and otherwise uncompetitive generation equipment held in reserve. The increased fluctuations in generation capacity (and additional costs in back up capacity) are directly caused by the development of heavily subsidised wind generation and this should be further considered.

Emissions Performance Standards.

This is a matter that should be left to EU regulation and the operation of the EU ETS scheme. Any higher emissions would be within the overall European cap and so offset by reductions elsewhere.

Comments on specific questions.

As many of the questions refer to the operation of the wholesale electricity market, we have restricted our comments to questions that cover the general impact of proposals and those that directly affect industrial electricity use.

Current Market Arrangements

1. Do you agree with the Government's assessment of the ability of the current market to support the investment in low-carbon generation needed to meet environmental targets?

Generally 'no' for the following reasons;

- The increasing amount of intermittent generation is caused by the increased amount of wind generation in turn driven by expensive and unsustainable subsidy. This reliance on wind directly leads to the requirement for additional interventions to address this self-imposed problem.
- Interconnections highlight the potential to address issues across wider geographic areas. If this is the case, then costs to consumers should be broadly in line across linked countries and we note this is certainly not the case at present. Additionally if electricity generation costs are lower outside the UK then there will be an incentive to build new generation at the far side of the connectors and import the electricity. Again this highlights problems with the way carbon emissions are reported at Member State level, with emissions embedded in imports being discounted from national accounting. If this situation does develop, the UK misses out on the benefits of building and operating plants as well as making it even more unlikely that UK manufacturing will gain from new orders flowing from the investments.
- The benefits of gas fired generation are acknowledged on page 27 and the table on page 29, but discounted as a key part of the answer due to the unrealistic nature of the 2050 targets. This stance should be re-examined particularly in the light of increased LNG supply and trading as well as the growth in the exploitation of shale gas that is changing the supply demand balance and costs on a world-wide basis. Wider deployment of gas fired CHP would maximize the environmental benefits.
- CHP is identified as a potential technology to develop lower carbon generation. In our response to the CPS proposals we have highlighted the potential adverse impact on CHP operations of some of these proposals.
- While diversity of electricity supply is sensible, it makes no sense to offer unsustainable levels of support to high cost, intermittent or unproven technologies to the neglect of proven technology and supplies that are recognisable safe and secure.
- The role of energy efficiency is neglected in this section and generally by the Government. We note with regret the closure of the DECC sponsored IEEA programme through which it was intended to develop a programme to support improved energy efficiency in UK paper mills.

2. Do you agree with the Government's assessment of the future risks to the UK's security of electricity supplies?

We accept there is a forthcoming problem with the existing UK electricity generation fleet, but note the proposals to increase the scale on intermittent renewables will make network management more difficult and expensive. Additionally the acceptance that Member States will be required to effectively bid against each other to secure new

investment is very worrying (para 43 page 34). This issue can only be addressed at a European level.

Missing from the analysis (para 45 page 35) is the likely requirement to revise the targets as the unaffordability of proposals becomes clearer.

Options for Decarbonisation

Carbon Price Support

Alongside this document we have provided an additional copy of our detailed concerns over the impact of the CPS proposals.

In summary;

- We are not convinced the new taxation is required. EU ETS is the European Union wide scheme designed to price carbon used by Energy Intensive Industries and it is this scheme that should be used on a pan European and better global scale to price carbon.
- We are not convinced the policy will achieve the desired objective of stimulating investment in low carbon generation as it offer price support at the revenue stage when support is required at the construction stage. The “contracts for difference” initiative may be a more appropriate methodology.
- We are concerned that windfall profits will go to incumbent generators with no guarantee of re-investment. There is also likelihood that generators will take the opportunity to increase profit margins as there is no clarity on the cost pass through mechanisms.
- If the CPS is implemented, it should be at the lower trajectories. We note that the additional cost to the sector in 2030 is £240 million (at 2009 prices) against an estimated 2009 sector profit of £125 million.
- If the CPS is implemented, then the taxation should be included in the provisions of a renewed CCA scheme as is the existing CCL. CCA participants could simply reclaim a portion of the CPS element of purchased electricity via a rebate set at the effective grid average CPS rate.
- We have particular concerns about the impact of the proposals on the viability of industrial CHP and urge that the Government simply exempt CHP from the new CCL CPS as it is already exempted from the existing CCL via the current ‘good quality’ CHP scheme.
- If the Government is concerned about the loss of revenue, then we note that the auctioning of EU ETS permits will already form a significant stream of revenue.

Feed-in Tariffs

3. Do you agree with the Government’s assessment of the pros and cons of each of the models of feed-in tariff (FIT)?

The proposals for both CPS and FIT increase the complexity of the regulatory framework and both are not required. If CPS is not sufficient to achieve the objectives

than it should not be imposed – if the primary purpose is to raise taxation this should be stated and acknowledged, thus moving the basis of the debate firmly into the area of simple unaffordability on competition grounds.

4. Do you agree with the Government's preferred policy of introducing a contract for difference based feed-in tariff (FIT with CfD)?

Yes, this would seem to offer the lowest cost option, but please see our comments on FIT noted above.

5. What do you see as the advantages and disadvantages of transferring different risks from the generator or the supplier to the Government? In particular, what are the implications of removing the (long-term) electricity price risk from generators under the CfD model?

In principle Government can borrow capital at a lower rate than the private sector so this should reduce the overall cost. What cannot be afforded is loading costs onto the industrial sector.

6. What are the efficient operational decisions that the price signal incentivises? How important are these for the market to function properly? How would they be affected by the proposed policy?

Guaranteed rates of return mean the pressure for efficiency improvements are diluted and there is no mechanism to share the saving from any improvements in operational efficiency.

11. Should the FIT be paid on availability or output?

Output to reward actual performance.

Emissions Performance Standards

12. Do you agree with the Government's assessment of the impact of an emission performance standard on the decarbonisation of the electricity sector and on security of supply risk?

Generally no – any new plant would be required to participate in the EU ETS scheme that would price the carbon at the appropriate level to ensure the overall EU emissions cap is met.

13. Which option do you consider most appropriate for the level of the EPS? What considerations should the Government take into account in designing derogations for projects forming part of the UK or EU demonstration programme?

CCS, either pre or post combustion remains unproven on a commercial scale and due to technical difficulties and the inherent requirement for additional fuel use may never

become economic without excessive subsidy. Again the issue of affordability should be considered.

14. Do you agree that the EPS should be aimed at new plant, and 'grandfathered' at the point of consent? How should the Government determine the economic life of a power station for the purposes of grandfathering?

Investment certainty is critical when decisions are made.

15. Do you agree that the EPS should be extended to cover existing plant in the event they undergo significant life extensions or upgrades? How could the Government implement such an approach in practice?

No, this could restrict or prevent investment in modernising plant that would otherwise happen. Any new investment would be included in the EU ETS scheme so the overall emissions cap would not be breached.

18. Do you agree the principle of exceptions to the EPS in the event of long-term or short-term energy shortfalls?

Even with a reduction in the amount of coal powered electricity generation there is still a role for the generation plant in providing back up capacity. The requirement for such back up capacity is likely to be even more important if the amount of intermittent renewables increases on the network.

34. Do you agree with the Government's assessment of the risks of delays to planned investments while the preferred package is implemented?

We agree that attention should be paid to this issue to ensure investments are not delayed by regulatory uncertainty.

35. Do you agree with the principles underpinning the transition of the Renewables Obligation into the new arrangements? Are there other strategies which you think could be used to avoid delays to planned investments?

We welcome the acceptance that continued support for existing operational plant built under the existing regulatory regime is important and that grandfathering is an appropriate methodology.

36. We propose that accreditation under the RO would remain open until 31 March 2017. The Government's ambition to introduce the new feed-in tariff for low carbon in 2013/14 (subject to Parliamentary time). Which of these options do you favour:

•All new renewable electricity capacity accrediting before 1 April 2017 accredits under the RO;

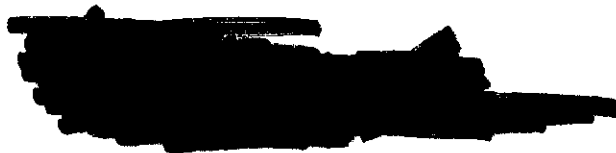
•All new renewable electricity capacity accrediting after the introduction of the low-carbon support mechanism but before 1 April 2017 should have a choice

between accrediting under the RO or the new mechanism.

A realistic option would be to allow new investment to choose between the different support regimes as commissioning dates would be altered to suite anyway. Most important is investment certainty over the type and level of support required when investments are confirmed. Pre-approval of support regimes may be appropriate for large new investments that could be delayed by investment uncertainty caused by an ongoing or planned review of support levels.

We would be pleased to provide additional information on any of the issues discussed above.

Yours sincerely

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