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Lord Oxburgh of Liverpool
The House of Lords
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28th November 2012

Dear Lord Oxburgh

ENERGY BILL 2012-13

I would like to thank you for establishing and chairing the informal Peers scrutiny group that conducted Pre-Legislative Scrutiny on the Electricity Market Reform (EMR) provisions in the draft Energy Bill, which was published on 22 May 2012. You formed and conducted this group, taking evidence from witnesses and providing a report, in a matter of weeks, and I, and my predecessor, are extremely grateful. I am writing to respond to your report and the specific points that it raised.

In your report, you queried the level of detail being provided in the primary legislation. Documents published alongside the Introduction of the Bill, in particular the Operational Framework, provide additional detail. The Government's view is that the level of detail on EMR in the primary legislation is appropriate. Further detail will be included in secondary legislation, which is being developed and will be published for consultation in 2013. There will be opportunity for Parliamentary scrutiny when secondary legislation is laid in Parliament which, it is hoped, will be in early 2014.

Your report highlighted the fundamental importance of increasing investor certainty. I would like to assure you that we hold regular discussions with the investor community to ensure that the EMR policies are designed in such a way as to provide maximum investor certainty. Alongside the Bill we are publishing significant amounts of further detail on how EMR will work (including the CfD operational framework and Heads of Terms), which will provide investors with additional certainty on the way forward.

Contracts for Difference

The Government attaches great importance to being accountable for the policy outcomes of the decisions it will make during the initial administrative phase of EMR but equally recognises that decisions must be robust and independent expertise is important in ensuring that. This is why we have proposed a clear process for the EMR delivery plan.

Decisions made by Ministers (CfD strike prices for renewable, volumes when we move to auctions or when the first capacity auction will be held) will impact on the three key objectives for EMR¹ in different ways. Ministers will need to balance these objectives based on the detailed analysis which has been commissioned and on which the Government will consult in mid 2013. It is important that Government has the ability to make these trade-offs. Additionally, Government must be accountable for, and able to manage, wider impacts for which it is responsible.

In May, the Government published an outline of how the process for developing the EMR delivery plan will work. The process is designed to ensure that Government receives the appropriate independent expertise to inform its decisions. This will involve analysis by the System Operator, which is being formally commissioned alongside publication of the Energy Bill, as part of its EMR delivery role. The analysis the System Operator will conduct will be based on existing evidence (e.g. the RO data) and that gathered from industry, and the analysis will focus on the impacts of strike prices on Government's objectives. The analysis will be scrutinised by a Panel of Technical Experts. The Panel will be established by Government but members will be independent of particular view points, including not being active market participants.

This evidence-based approach is familiar to industry, and replicates elements of the process used to set the Renewables Obligation bands since 2009, so ensures coherence with the ongoing Renewables Obligation process.

To further ensure that both the final decisions and the analysis on which they will be based are transparent, the Government will hold a public consultation on the evidence and analysis informing the delivery plan in mid 2013 before final decisions are taken, and publish the delivery plan at the end of 2013.

Over time the content of delivery plans and its annual updates will evolve through the phases of EMR², though the principles and rationale for this process will endure so that Government decisions are made through a robust process and based on independent expertise. Further information on the process is set out in the publications alongside the Bill.

The report also made a number of comments regarding the design of the CfD. Whilst the Government believes the initial payment model and legal framework published in the draft Energy Bill would have functioned effectively, the Government has listened to the concerns of the Committee, industry and investors and considered whether this is the right model to attract investment. We are proposing in the Energy Bill a revised framework which will include a single counterparty to the CfDs, which will hold private law contracts with generators, act as a specific institutions for generators to interact with over the lifetime of the contracts, and which will have levy-raising powers to enable it to meet payments to generators. We believe this will alleviate industry concerns.

Under the CfD, there will continue to be an incentive to offer PPAs. This arises due to the fact that independent generators are less able to manage imbalance risks than larger electricity utilities or specialist independent aggregators. The offtaker will be able

¹ To ensure continuing security of supply; decarbonisation of electricity generation; and to maintain affordability for consumers

² See page 25 of the EMR Policy Overview, published 29 November 2012

to charge for managing this risk, most likely by purchasing the power at a discount to the market price, providing the incentive to offer contracts. In addition, the CfD effectively removes price risk meaning there will no longer be a requirement for floor prices in a PPA. Removing this significant risk from a PPA is likely to reduce the discounts applied, resulting in greater pass through of the wholesale price to generators. It is also likely to change the way that PPAs are accounted for, potentially enabling large energy suppliers to offer more PPAs, increasing competition and further reducing discounts. However, we are aware that stakeholders have reported a decline in the market and are concerned that there could be a difficult period of transition which Government may need to manage. We have held a call for evidence to help identify issues affecting the current PPA market. This will help identify if Government intervention is appropriate and, if so, will inform development of possible solutions.

Your report also raised questions around the setting of prices and allocation of Contracts for Difference (CfDs).

The Operational Framework, published alongside this document, sets out the Government's preferred approach and further detail on how we would determine reference prices for intermittent and baseload generation. It also sets out detail of how strike prices may be amended either mechanistically or by reference to an independent expert under change in law or force majeure provisions.

We strongly welcome the input into the development of the allocation process we have received. As set out in our response to the Energy and Climate Change Committee, in particular recommendations 23 and 27, our proposed approach to allocating CfDs has changed since the approach set out in the draft Operational framework in May. We now propose a two stage allocation approach in which projects are able to apply for a CfD once they have cleared lower but still meaningful hurdles such as planning permission and a grid connection agreement, and then have to complete a small number of further hurdles post CfD-award in order to retain the contract. This will give industry greater confidence to incur project develop costs whilst protecting Government from allocating support to projects that fail to complete.

Government has made clear that we wish to move to a competitive price discovery process in the longer term - as we believe that a competitive price setting process can reveal better price data and therefore lower the cost of decarbonisation. However, we do not believe that the conditions have yet been met and therefore have set out our intention to set the strike prices using an administrative process in the meantime.

Electricity Demand Reduction and Demand Side Response

Your report highlighted the importance of demand-side measures and noted the potential of efficiency measures, and recommended that the Bill include provisions to encourage flexible, responsive demand.

In the EMR White Paper, we recognised that reducing demand for electricity is likely to offer a cost-effective alternative to building additional generation capacity.

The assessment we published in July concluded that there is significant potential to use electricity more efficiently in the UK, and that current trends and policies will capture

only part of this potential. We have therefore today published a consultation on options to encourage permanent reductions in electricity use.

We are considering a wide range of policies, including policies which could be implemented within the Electricity Market Reform programme, and approaches outside of EMR. A Feed in Tariff for Electricity Efficiency is among the options under consideration.

We believe this timeframe to be consistent with introducing clauses in the Energy Bill by amendment in the spring, should the final preferred option(s) require this. However, we have made no commitment to taking action in the Bill as this may not be the most appropriate way to take forward all the options under consideration.

Independent generators

I am pleased that your report noted the importance of ensuring that independent generators can benefit from the proposed reforms, potential through Power Purchase Agreements (PPAs). The Government's view is that CfDs will improve competition in the PPA market by making them simpler and more transparent (because there is no longer a need to market the Renewables Obligation Certificate and price risk is removed), potentially improving the terms available to independent generators. However, there may be a period of transition as market participants respond to the new support mechanism and consider the appropriate response to pricing and risk transfer.

Taken with the lower risk profile of the CfD and the removal of a number of temporary factors (including the Renewables Obligation and regulatory uncertainty), a competitive PPA market is likely to develop. We will focus on the efficient delivery of the EMR programme and we will ask market participants to initiate a process from December 2012 to prepare for the CfD and identify changes to the PPA market that may be required to ensure a speedy transition.

If it becomes clear that the implementation of EMR and associated market-led approaches have not led to the development of an efficient market for PPAs then we will consider the need for intervention. The Government is seeking backstop powers in the Energy Bill that would enable Government to make modifications to electricity supply licences for the purpose of reducing barriers to entry associated with the PPA market. These powers, if needed, may be used to impose obligations on suppliers to participate in the market in certain ways if the PPA market does not develop as anticipated.

Ofgem is currently taking forward reforms to address poor liquidity in the wholesale electricity market and expects to see further progress in winter 2012. However the Government is also ensuring that it is able to act, if it proves necessary, to address poor liquidity in the wholesale electricity market. The Government will therefore be seeking backstop powers in the Energy Bill to address liquidity if Ofgem and industry actions do not deliver sufficient improvements.

Emissions Performance Standard

Your report made the recommendation that the Emissions Performance Standard should be extended to cover existing power stations. The Government is proposing not to apply an EPS retrospectively to existing plant. Making retrospective changes to

existing power stations can have significant economic impacts on the operator. For example, if an obligation to fit CCS to existing coal-fired power stations were imposed, it is likely that developers would choose to close their power stations because the alternative – to fit a costly and untested technology - is unattractive.

There would be direct security of supply risks associated with a retrospective EPS. Around 5 Giga Watts (GW) of existing coal plant has notified its intention to close by end March 2013 and a further 3 GW will close by no later than end 2015 as a result of EU environmental legislation (the Large Combustion Plant Directive – LCPD) .

The Industrial Emissions Directive (IED) replaces the LCPD and sets more stringent limits from 2016. It is uncertain what proportion of the remaining coal capacity will make the investment needed to meet the IED limits, or otherwise be required to close by 2023 at the latest. In any event the remaining coal plant are anticipated to increasingly provide capacity helping to ensure security of supply but over time with increasingly lower load factors as they are displaced from the system by lower-carbon plant.

Applying the EPS, to existing coal plant could increase regulatory risk, creating an incentive for such plant to opt-out rather than make the investments needed to meet IED emission standards, and close by the early 2020s or earlier. Closing more existing coal plant than will already occur under the IED and LCPD would increase the security of supply risks. It is also questionable as to whether it would be lawful as it may interfere with existing rights of operators.

Such a policy could also have a significant negative impact on the attractiveness of the UK as a place for investment in the electricity sector. One of the unavoidable risks in the energy sector is regulatory: at any point during the operating life of a power station, Government may change the regulatory environment and undermine the economics of a power station, forcing early closure with implications for the investor's finances. However investors will gauge the overall regulatory risk in the UK, based on Government behaviour and a series of discrete, individual decisions.

Where investors perceive actions are taken against one set of generators, they will become increasingly nervous and might choose not to make new investments in the UK because of their perceptions of the regulatory risk.

However, the Government is also aiming to avoid creating incentives to extend the lifetime of existing plant significantly, at the expense of building new, modern power stations, which are likely to be more efficient, including those fitted with CCS technologies.

Therefore it is proposed that the EPS be applied to existing plant where they undergo a significant life extension or upgrade (excluding plant which install Selective Catalytic Reduction, the equipment needed to meet the IED emission standards, or plant that reduce their carbon emissions by retrofitting CCS to a proportion of their capacity), requiring them to meet the same emissions standards applicable to new plant at the time of the upgrade.


Immature Technologies

Innovation will be extremely important in the wider field of energy and could significantly reduce costs (e.g. the development of cost-effective electricity storage). We feel that it is not realistic to expect to support certain technologies – such as wave or tidal power, geothermal, and Carbon Capture & Storage that have not yet been demonstrated at scale – by the same mechanism as technologies that are more mature. A strike (or auction) price that was high enough to cover the investment uncertainties associated with a long term contract for the implementation of a technology that had not been through the later stages of development would have a very strong probability of ending up being unfair to the consumer. It does not make any sense to try to do this before the final stages of development have been de-risked by the operation of several full scale plants.

In addition to early stage support for emerging technologies, promising but immature technologies should be promoted by a different and probably discretionary means and incorporated into the more general process when they have matured.

I hope you find this helpful, I am copying this letter to the members of the Lords informal scrutiny group, and I am placing copies of this letter in the House library for the interest of fellow members. Again, I would like to thank you for the time you and your fellow Peers have taken in scrutinising the draft Bill, and I look forward to engaging with you during the Bill's passage in the Lords.

Kindest regards

A handwritten signature in black ink, appearing to read 'Sandy Verma', with a horizontal line extending to the right.

BARONESS VERMA