Energy UK

The voice of the energy industry

Energy UK response to the Call for Evidence on introducing Fixed Price Certificates into the UK-wide Renewables Obligation schemes

20 October 2023

About Energy UK

Energy UK is the trade association for the energy industry with over 100 members - from established FTSE 100 companies right through to new, growing suppliers, generators and service providers across energy, transport, heat, and technology.

Our members deliver nearly 80% of the UK's power generation and over 95% of the energy supply for 28 million UK homes as well as businesses.

The sector invests £13bn annually and delivers nearly £30bn in gross value - on top of the nearly £100bn in economic activity through its supply chain and interaction with other sectors. The energy industry is key to delivering growth and plans to invest £100bn over the course of this decade in new energy sources.

The energy sector supports 700,000 jobs in every corner of the country. Energy UK plays a key role in ensuring we attract and retain a diverse workforce. In addition to our Young Energy Professionals Forum, which has over 2,000 members representing over 350 organisations, we are a founding member of TIDE, an industry-wide taskforce to tackle Inclusion and Diversity across energy.

Executive Summary

Energy UK welcomes the opportunity to respond with this letter, to the recent Call for Evidence from DESNZ that proposes changes to the Renewable Obligation Scheme. Energy UK has worked in collaboration with our members on our response, and we aim to make it clear that this is not the appropriate time for the proposed changes within this Call for Evidence. There are serious concerns that a move to either model's options would impact investor confidence even further and that the supposed benefits would be incredibly limited. This letter will lay out the reasonings below, which have support from both suppliers and generators.

Edward Jones
Senior Policy Manager
Energy UK
020 7747 1835
edward.jones@energy-uk.org.uk

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Dear Ms Richardson,

The Renewable Obligation (RO) scheme has been an exceptionally effective mechanism, which has enabled the deployment of significant volumes of low-carbon generation since the early 2000s. Whilst the Contracts for Difference (CfD) has overtaken this scheme for new projects, the RO remains a critically important mechanism that works well for both generators and suppliers and continues to contribute to the Government's Net Zero agenda. It also allows generators to be paid as quickly as possible for their product and provides suppliers with a high degree of flexibility to sell products as per their business requirements.

Suppliers and generators are seriously concerned that the changes proposed in the Call for Evidence on introducing Fixed Price Certificates (FPC) would result in one being a clear beneficiary at the expense of the other. As a result of our significant concern about the direction of policy in relation to the RO scheme, we have taken the decision to respond to this Call for Evidence with this letter, as opposed to a full and direct response to the questions posed. This decision has been based on feedback from members who agree that now is not the appropriate time to bring in FPCs to achieve the benefits hoped. This letter outlines Energy UK's main concerns with a fundamental change to the RO scheme, though we remain committed to constructive dialogue with the Government on this issue.

Given that no further RO contracts are to be awarded, the scheme will naturally become smaller and smaller over the coming years. This will result in a smaller financial impact to implement any changes, as well as a reduced administrative cost. Should these proposals go ahead, there will be a significant administrative burden brought on by a change to the RO scheme. This will be particularly acute in Northern Ireland where microgeneration is both funded through the RO scheme and manually metered and will come to the rest of the UK because of a move to FPCs.

Government already set the level of FPC as buyout plus headroom, as shown initially in the 2011 white paper and repeated since. If the proposals in this Call for Evidence were implemented, they would run contrary to some of the key commitments made in the 2011 white paper. These proposals to the RO scheme represent retrospective changes which alter the basis on which significant investments were made. They go against previously published government commitments in 2011 and Ofgem RO guidance in 2019 which created legitimate expectations across industry that have informed views on future cash flows and hence asset values. In the following Technical Update, it was also said that “the Fixed ROC price would remain inflation-linked from 2027, in the same way that the buyout price is currently inflation-linked”. In addition to the 10% headroom, the change to indexation (particularly the removal of compounded inflation) would have a significant negative impact on the ROC price.

These commitments were the basis for significant investments and if carried out would represent a major retrospective change further undermining the hard-earned stability and policy certainty of UK regulation. The removal of the headroom would bring in more political uncertainty in the UK market, and investors would factor in the risk premium in future investment which would increase the cost of capital. In the current economic climate in which the UK is struggling to compete with more attractive markets in the US and EU for clean investment, and several major renewables projects have been either delayed or cancelled in part due to Government policy, we believe that the

proposed changes to RO will cause further concern that the UK is no longer the right place to allocate capital. Given the recent results from AR5 of the CfD scheme, this concern is extremely warranted.

There were four key arguments made on the need for a change to the RO scheme. The principal argument made was that the removal of the 10% headroom would be a cost saving for end consumers. The four arguments are presented below along with a counter response to each.

1. **Reducing the cost of the scheme.** Reducing the 10% headroom will result in some cost savings to consumers, however, it is not clear how much it would save. The headroom is predominantly used to cover risk, it is estimated at least half of that saving would be lost due to increased risk premiums. Additional costs such as administrative needs would have to be factored into potential savings. Generators will lose this 10% but consumers would not receive the full difference. This removal of the headroom would add administrative and significant risk burdens for generators, shaking investor confidence further, for a very minimal and potentially unnoticeable saving to consumers.
   The change to the indexation, in particular the removal of compounded inflation, would have significant impacts on the ROC value and further dampen investor confidence. The headroom and RPI indexing have been included in modelling for the initial investment in these assets, but also included in divestment models.
   If these are removed, key elements of the RO support will certainly impact asset valuation. This could have the opposite effect in the medium-term, by shaking investor confidence and reducing funding for renewable energy which will not aid in reducing consumer bills.
2. **Price Stability**. In 2011 it was expected that there would be significant price volatility in the early 2020s. This was due to two factors, firstly the increase in intermittent generation. Whilst renewable generation has gone up it hasn't impacted the RO prices. The second factor was due to the size of the scheme and uncertainty in how long it would remain sizeable. With a significant number of ROCs having been awarded towards the end of the scheme, between 2015-2017 has meant that this price volatility is unlikely to now be seen until 2032-34 according to research by industry and by Government. No company wants this volatility, but the scheme will be much smaller giving cheaper and simpler solutions. A solution to a 2032 problem does not need to be implemented now, when the pricing landscape is fundamentally different. A more thorough assessment needs to be undertaken by Government to understand the optimal time to transition to
3. **Rebalancing electricity costs.** The CfE is correct in identifying that the FPC could facilitate the rebalancing of costs from electricity to gas bills and Energy UK supports the objectives of rebalancing. However, there are other options to facilitate this potential rebalancing without the need to move to FPC. As is laid out in this letter, it is not the opportune time to introduce FPC, for either customers or industry. Moving RO costs from electricity to gas could be viewed as a potential outcome in the short to medium term if a cost-benefit analysis demonstrates this viability. This could then support the transition to Net Zero and improve the commercial viability of heat pumps for a greater number of customers.
4. **Reducing the risk of supplier payment default and mutualisation.** The CfE does not factor in the recent changes that have already been implemented in the RO to address this risk. The requirement for suppliers to ringfence RO payments received so that these will still be accessible in the case of supplier insolvency has resolved these concerns. With these arrangements now in place, the remaining risk of supplier payment default is very low. The introduction of the FPC will not make a significant difference to this risk, so this is not a benefit that supports a move to FPC in 2027 rather than the early 2030s.

It is critically important to acknowledge that the current scheme mechanism offers the greatest flexibility of all options and so both proposed models would be inferior when compared to current arrangements. This system is functioning effectively for the UK and for industry's current and near-term needs, there is no reason given to industry to justify an intervention.

The choice between model 1 & 2, as mentioned above, would lead to generators and suppliers no longer being on an equal footing. All options presented in this CfE are worse than the status quo and involve additional cost. Additionally, variations within and between Models 1 and 2 and further complexity and do that differently to each other.

For generators, the preference would be for the shortest settlement interval, in the examples provided that is monthly which is only available through Model 1. If this monthly settlement interval is not possible then, generators would likely prefer Model 2, rather than Model 1. Model 2 offers more flexibility than Model 1, as it includes the option of trading.

Suppliers are typically going to prefer Model 2 in most situations due to the greater flexibility on offer, which is highly valuable to their business model.

To summarise, the **industry does not see any material evidence substantiating any of the four arguments on the need for the changes proposed within this Call for Evidence**. The best outcome would be that this Call for Evidence is not cancelled, but delayed until later in the 2020s, when the situation around price volatility becomes clearer and the scheme begins to shrink. This will have a myriad of benefits, not least solidifying the UK's renewable investment landscape at a testing time. Every reason must be provided to industry to demonstrate the UK is committed to renewables and net zero.

We are looking forward to hearing from you.

Kind regards,

Edward