

## **Response to the preliminary consultation on reform of the renewables obligation (RO)**

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### **General points**

1. In his foreword to the consultation document, the Minister writes:

*We will consult extensively on our proposals for the RO. It's vitally important that we get the details of any new approach right and this document sets out what we think are the key issues and invites views on them. (Our emphasis.)*

We strongly agree with this statement, not least because the decisions to be taken will affect energy and carbon markets for many years to come, and they have the potential, if poorly made, to either (a) impose substantial, unnecessary costs on energy consumers and/or taxpayers, or (b) to deliver substantially smaller reductions in CO2 emissions than should be feasible for a given real resource cost, or (c) some combination of these two effects. The costs of mistakes can be expected to be high for the simple and obvious reason that the scale of the potential problem to be addressed is huge.

2. Notwithstanding the opening Ministerial sentiments, there is, so far as we can see, nothing in the consultation document that could substantiate a claim that the proposals for banding the Renewables Obligation along the lines suggested should be the preferred way forward for the Government. We are aware that the proposals first emerged from the Energy Review process, but there is no evidence that a regulatory impact assessment (RIA) of the required degree of scope or specificity was carried out during that process. Neither the assessments conducted during the Energy Review nor the Partial RIA document accompanying the consultation document comes anywhere close to the kind of policy analysis that is, on grounds of proportionality (to the high seriousness of the issues at stake), appropriate.
3. We therefore strongly urge the Government to first pause, and then engage in the clear and imaginative policy thinking that will be required to develop effective and efficient environmental policies for the energy sector (and beyond). In other commentaries on regulatory impact assessment we have argued consistently that failure adequately to 'frame' the relevant policy issues at the outset is a factor leading to costly and avoidable errors at later stages. In its various reports, the NAO has also made similar points. Such an exercise need not be protracted – it is improvements in the *quality* of thinking that is

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<sup>1</sup> The views expressed are those of the authors. The Regulatory Policy Institute provides a forum for the consideration of regulatory policy issues, but does not itself take an institutional position on policy questions.

deployed, not in the quantity of RIA documentation accumulated, that have the potential for creating substantial value added (or, perhaps more realistically, avoiding the imposition of unnecessarily large burdens on energy consumers and/or taxpayers).

4. Among other things, regulatory impact assessment going forward should pay greater attention to (a) clarification of policy objectives, (b) the clear identification and specification of the policy problems to be addressed, (b) the overall design of renewables policies which takes full account of economic interactions with other, wider policies (most specifically the EU Emissions Trading Scheme (ETS)), and (c) the full range of feasible, alternative approaches that might be adopted to meet the policy objectives, including options that have been suggested by other energy sector analysts and commentators but that have not yet been considered in detail during the course of the limited RIA conducted to date.
5. Even setting aside these general weaknesses in the way in which reform of the RO has been considered to date, the much more limited exercise of assessing the potential impacts of implementing the ‘banding option’ has not yet been performed to any acceptable standard. For example, the likely distorting effects on competition, the implications for regulatory uncertainty and the cost of capital, the history of performance deficiencies in ‘administered markets’, and the tendencies toward ‘politicisation’ of markets susceptible to administrative interventions are all aspects of the proposal that are either ignored or glossed over in the Partial RIA document published with the consultation.
6. It is not feasible in this response to cover all of the points that might be relevant in reconsidering the future of the RO. We will instead attempt to do two things:
  - Set out, in summary form, some of the high level objections that can be levelled at the current banding proposals, as an indication as to why this type of approach should be considered to be a deeply unattractive option.
  - Provide some indications of the characteristics that might be expected to feature in a better, alternative way forward.

### **Non-neutrality and discrimination**

Notwithstanding the statement at paragraph 2.3 of the consultation document that “*The RO was devised as a technology-neutral instrument designed to bring on the most economic forms of renewable generation*”, the RO is manifestly not a technology-neutral instrument. As a simple matter of fact, it privileges certain forms of electricity generation technology, and certain methods of contributing to carbon emissions abatement, over others. What is true is that, within certain categories of technologies, the RO has, to date at least, been neutral as between different techniques of electricity generation (e.g. between onshore and offshore wind facilities).

The current proposals for banding the RO effectively drive the non-neutrality (or discrimination) in public policy to a yet more micro-economic level. For reasons given below, we think that this would be unwise as a matter of good policy making but, quite apart from such reservations on economic grounds, there must at least be some doubt about the legality of what is being proposed.

The central argument deployed in favour of banding appears to be that some renewable technologies or techniques are more costly than others, and that it is appropriate, in order to keep the RO payment levels down, to pay less for the less costly alternatives. It is unclear, however, how this differs from the argument that might be advanced by a discriminating monopsonist (or dominant buyer) that, faced with an upward sloping supply curve, it can keep costs down – at least in part to the ultimate benefit of its own customers – by pursuing discriminatory procurement policies.

There can, of course, be efficiency arguments in favour of such price discrimination; but there are also arguments against (e.g. in terms of impacts on competition and on supply-side incentives generally), and such conduct has come to be viewed sceptically, at least on a *prima facie* basis, by competition authorities. At a minimum, therefore, any satisfactory regulatory impact assessment would need to address the relevant, negative aspects of such discrimination – which principally concern distortions of competition and of supply-side incentives – in a very careful way, to assess legality.

### **Assessment of effects on competition**

The Partial RIA document appended to the consultation is, however, disproportionately thin when it comes to assessing effects of the proposals on competition. The full extent of the assessment is contained in one, short paragraph as follows:

*“5.1 The Renewables Obligation is a market-based instrument that operates in a competitive market for electricity. The rules of the RO apply in a non-discriminatory way to all participants in the renewables industry and electricity sector. The Government’s intention is that this will remain the case with all the amendments to the ROO (sic) and there are no changes that will be likely to have any material impact on competition in the electricity market.”*

We set this out in full because to read it is to be immediately aware of its inadequacy. Thus, the *rules* of, say, Apartheid might have been said to “apply in a non-discriminatory way” to all citizens of South Africa, but the *effects* of those rules were manifestly discriminatory. It is *effects* that matter and, when evaluating them, the relevant market to consider is not the electricity market. The RO itself creates a distinct relevant market since, by virtue of the rules, electricity generated from a coal or gas or nuclear station is not a good substitute (for an electricity supplier) for electricity from a renewable source.

Given this, it is obvious that the banding proposals do have the potential to give rise to material impacts on competition in the relevant market (for electricity generated by the defined renewable technologies). The expected impacts depend upon the extent of

the discrimination – which would be determined by the detail of the banding proposals if such proposals were to be implemented – and it is those impacts that stand to be assessed.

The *prima facie* distortions of competition that would be caused by banding should be acceptable to the Government only if they are either (a) not appreciable or (b) indispensable for the achievement of key policy objectives.<sup>2</sup> Given that the UK Government has argued in other European policy contexts that indispensability tests should be applied with some rigour – so as to prevent EU policy on competition and state aids from being undermined by Member State governments keen to subsidise domestic industries or to otherwise interfere with markets for local political advantage – we think that the DTI faces a special responsibility to ensure that this aspect of the regulatory policy assessment is performed with due diligence. At a minimum, that should involve analysis of the full spectrum of policy options that have been put forward, or that will be put forward in the course of this consultation. If this were done, it would in our view be surprising if, at the end of this exercise, it could be concluded that there was no other option that could be expected to have a less distorting effect on competition in the relevant market than the banding proposals.

### **Indispensability: taking stock of the RO**

The renewables obligation itself was something of a departure from key principles that have guided UK energy policy for over two decades now. However, when first introduced, there were at least some defensible arguments to the effect that the indispensability test was satisfied.

Even considering just the basic scheme (i.e. putting aside for the moment the new, banding proposals), recent experience and evidence suggest that similar arguments deployed in today's market conditions are less plausible. The RO has, for example, been criticised by more than one public body on grounds that it achieves abatement of CO<sub>2</sub> emissions at a substantially higher cost than alternative policy instruments; and there has been no great rush to copy the scheme in other jurisdictions, where alternative paths have been followed. Perhaps most fundamentally, we now have the EU Emissions Trading Scheme (ETS) in place, implying that any assessment of RO proposals against criteria such as indispensability, necessity or proportionality must be framed in a way that takes account of the interactions between these two aspects of public policy.

We are where we are, and in accordance with the principles of good regulation (in particular, with the principle of consistency) there should be no question of resiling on past policy commitments in relation to existing renewables projects. On the other hand, looking forward it would be advisable to re-set the policy direction by reference to the general principles that have successfully informed UK policy for many years now (e.g. the maintenance and promotion of undistorted competition). The current banding proposals would, in our view, take UK policy much further down a different

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<sup>2</sup> These are necessary, but not sufficient, conditions: a policy that causes the minimum necessary distortion of competition may nevertheless be rejected because the harm to competition is assessed to be greater than the benefits of meeting the relevant policy objective.

and uncertain (because more detached from established principles) path, strewn with potential distortions of relevant markets.

### **Regulatory certainty and administrative burdens**

In consequence of being a further, more radical breach of any principle of technology neutrality, we believe that the banding proposals would have a number of highly undesirable consequences for the future conduct of environmental and energy policies, including:

- Increased administrative discretion, exercised in setting both bands (which specify which technologies are in a particular band and which are not) and ROC rates, can be expected to increase regulatory uncertainty, with, among other things, potentially adverse consequences for investment.
- Increased administrative influence over outcomes can be expected to attract increased resources to political lobbying for and against particular options. The general tendency will be toward re-politicisation of energy markets, reinforcing problems of regulatory uncertainty.
- The complexity of the proposals can be expected to increase the administrative burdens of regulation, both in government and among electricity generators and suppliers.
- The costs of administrative complexity can be expected to go beyond the immediate cash costs of additional human resources. A substantial fraction of the administrative tasks associated with the RO is allocated to Ofgem, an organisation whose (very different) primary duties and responsibilities lie elsewhere. This ‘tagging on’ of extra responsibilities to the regulator could, via loss of organisational focus, hinder other aspects of Ofgem’s work.

There are other points that could be made, but it will suffice here to point out that these (and related) weaknesses of the banding proposals are simply the classic weaknesses associated with policies that seek to substitute administrative decision making for market decision making. The UK was ill-served by the ‘administered markets’ approach in the past, and it is difficult to conceive of benefits that could emerge from its resurrection.

### **Policy objectives and identification of issues**

Part of the problem with the policy assessment to date may have arisen from lack of any clear discussion of the objectives of the policy, which in turn may be linked with a certain fuzziness about the issues at stake. Clearly, abatement of carbon emissions is a very major policy goal for the Government, but is it the only goal of relevance in the current context? Much of the reasoning in the consultation document proceeds as if the answer to this question is in the affirmative – e.g. the analysis of ‘costs’ of different technologies works with a relative narrow definition of costs – but there are good reasons to think that other objectives can or should be relevant also.

Consider, for example, what may be the most important single factor driving the current review of the RO – the differences between onshore and offshore wind. There are certainly significant capital cost differences between the two, such that, other things equal, onshore locations would tend to be preferred. The fact that the Government is keen to promote offshore developments indicates, therefore, that other factors (i.e. not just a concern with achieving maximum abatement of carbon emissions for a given level of expenditure) must be at work. Thus, for example, the expansion of onshore wind-farms may be limited because of local resistance to the construction of such facilities.

To the extent that the issues at stake concern certain forms of externalities or social costs, it is reasonable to argue that public policy should seek to incorporate allowances for such costs into the decision making process. Or, put another way, the externalities or social costs are potentially capable of providing an ‘objective justification’ for differences of approach between onshore and offshore facilities.

It should be noted, however, the differences here are not really to do with technology: rather they are related to *locational* variations in social costs. Further, there is no reason to think that the social cost differences will be at all well reflected by an approach that relies upon variation in RO Certificate (ROC) allocations, and which leads to the financial differentials in payments (as between locations) being linked to the market price of ROCs (which will tend to vary over time as a result of changes in non-locational factors in the market).

If carbon emission abatement is all there is to the RO, the problem of discrimination, identified above, becomes acute: the Government then needs to be clear as to why much more should be paid for a unit of abatement achieved via one technology than via some other technology, given that this appears to be a recipe for inefficient abatement decisions and for distortions of competition? On the other hand, if (as we think is the case) there is more to renewables policy than carbon abatement, it is important to specify clearly what the relevant objectives are, as has been repeatedly indicated by the Government’s own guidance on best practice in regulatory impact assessment. Is it the intention to support high-cost alternatives on the basis of ‘infant industry arguments’ or is it to support technologies which, by virtue of their location, impose fewer social costs. It matters which.

If objectives are specified more precisely, the way will be clear for the difficult exercise of crafting policy options that are potentially capable, in their different ways, of contributing to the achievement of the policy goals. If there are multiple goals, the better policy options will likely be multi-dimensional also. For example, measures to address locational variations in the social costs of wind-farms might better be unbundled from measures to reduce carbon emissions. Such targeting of policy is one of the high-level principles of better regulation, but it is another of those principles that seems to have got lost along the way in the development of the banding proposals.

### **Questions of policy design: the RO and the ETS**

The thing that we found most surprising about the consultation was the lack of any analysis of how, in the future, the RO is expected to dovetail with the ETS, which, as

of now, must be regarded as the primary policy component of the Government's carbon strategy. Such an omission was understandable at the time that the RO was introduced, but is incomprehensible in current conditions.

In the original set up, the RO was designed to provide renewables facilities with a premium over the market price of electricity, *whatever that price may be*. That is, the effective subsidy is added to, and is not contingent upon, the market price, and the current proposals retain this feature of the approach. Given that wholesale electricity prices have risen substantially since the RO was introduced, the effect has been that renewables have enjoyed effective prices for their output that have been significantly higher than originally anticipated.

Although this is not necessarily a problem in abstract – if wholesale electricity prices are as likely to fall as to rise, it is largely a matter of the allocation of price risk – it is a real issue in the relevant factual context. The trend of electricity prices has been upward, and that trend can be expected to continue, *not least because of the prospect of an increasing influence on prices from the ETS*. Higher carbon prices can be expected to be reflected in higher wholesale electricity prices, and the latter can therefore be expected to reward renewables generators directly and to an increasing extent for their contribution to carbon abatement, quite independently of any payments under a revised RO scheme. The higher the carbon price, the higher the reward to renewables.

Since the original rationale for the RO depended in part upon the absence of effective, alternative policy instruments – the indispensability argument – the more effective the ETS the lower should be the effective contribution of the RO. That is, the two arms of policy should operate in a complementary way, *not independently*.

The continuation of the RO, over such an extended timescale, can only be interpreted as a signal that the Government does not expect that the ETS will be fully effective within the relevant time horizons. That may well be a correct judgment, but it is a position that could cause substantive difficulties for future policymaking if the linkage between the rationale for the RO and any limitations of the ETS is not recognised.

The effectiveness of the ETS will not likely be a 0-1 matter: it will be more or less successful, depending upon a range of factors, many of them political. One of our concerns about the proposals is that, since they are framed to maintain the *additivity* of the RO to the ETS, they actually provide disincentives for the UK to press hard for improved EU ETS effectiveness. The more effective the ETS, the more likely it is that UK consumers will be faced with excessive electricity prices as a result of the RO payments (set in a period when the ETS was less effective).

We believe therefore that, if the RO approach is to be continued, a more sensible way forward would be to index the (ROC) buy-out price to either the wholesale electricity price or, at a minimum, to the carbon price, such that the buy-out price falls as the wholesale electricity (or carbon) price rises. If the market price of wholesale power increases, particularly if that increase is driven by higher carbon prices, then the level of support provided to renewables should fall.

A number of alternative policy options have this feature; which could also be used in a banding system (although all the objections to the latter, set out in the above sections, would remain). Thus, proposals that contemplate the offering of fixed-price or fixed-payment (e.g. take-or-pay) contracts to renewable generators, or that are based on competitive tendering for contracts – whether they be supply contracts or financial contracts-for-differences (CFDs) – are characterised by the fact that the RO payments are not additive to the wholesale electricity price.

Fixed-price/payment or CFDs are not the only options, since indexation can also be partial. For example, there could be full (negative) indexation of the ROC buyout price to the carbon component of wholesale electricity prices (which is suggested by the logic of the RO and ETS policies), but only partial indexation to other components of wholesale prices. These are the some of the detailed aspects of policy design that should be covered in a more rigorous and focused RIA exercise.

### **In conclusion**

Whilst we can understand the reluctance of the Government to rely exclusively on the EU ETS framework in seeking to constrain CO2 emissions, we think it nevertheless advisable to put first things first, which means recognising the ETS's lead role in future policy. The RO has, at most, a supporting role, which needs to be defined in relation to the ETS. In our view, that implies, as a minimum, that RO payments should be determined in ways that are inversely related to carbon prices. Such linkage is not a feature of the current banding proposals.

More generally, the banding proposals appear to incorporate a range of features that are quite contradictory to the principles upon which recent UK energy policy has been based. The proposals involve the administrative determination of categories of generators, the administrative determination of prices on the basis of relative costs (mimicking the cost-plus or cost-of-service approach associated with utility regulation in olden times), the development of renewables policy in isolation from other aspects of public policy for energy and the environment, the contravention of pretty well all the principles of better regulation, and substantially increased administrative burdens associated with implementation.

Speaking generally, consultation (and the regulatory impact assessment process more generally) can only be of value if they sometimes lead to changes in policy. There is inevitably a considerable amount of scepticism around as to whether the Government's 'better regulation agenda' actually has any effect (other than adding a further layer of bureaucracy) but, given the points made, we believe that the DTI now has an opportunity to show that intelligent regulatory impact assessment can have substantial value added.

The current proposals are not well thought through, particularly in terms of their relationship to EU ETS; they could cause future administrative nightmares; and are characterised by an unnecessarily high risk that electricity customers (or taxpayers) will end up paying substantially in excess of a reasonable market price for the level of carbon emissions abatement achieved. We strongly advocate some basic rethinking, focused on: clarifying policy objectives (what, in addition to carbon reduction, is renewables policy about?); more vigorous development of alternative policy options:

unbundling policy option components (e.g. distinguishing locational issues from aggregate CO2 emission issues); achieving better harmonisation with the ETS; avoiding distortions of competition and of supply-side incentives; and keeping administrative burdens to a minimum.

Precisely because the stakes are so high in this area, unintelligent policy design could be very costly indeed.

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