

# Energy and Climate Change Committee Scrutiny of Draft Energy Bill

## Submission by E3G<sup>1</sup>

### Overview

It is widely accepted that the UK Government will not be able to deliver its energy policy objectives without electricity market reform. In particular, the current market framework is unlikely to attract the levels of investment needed to decarbonise the power system and maintain security of supply. Moreover, where investment can be attracted, it is likely to incur high financing costs as a result of the significant inherent risks and this, therefore, would apply further upward pressure on electricity prices. **Electricity market reform should therefore remain a high priority policy initiative.**

Proposals for electricity market reform were originally designed with the intention of attracting a wider range of investors and reducing financing costs through mechanisms to transfer financial risks from investors to consumers (or taxpayers). However, the manifestation of these proposals in the Draft Energy Bill appears extremely unlikely to fulfil this objective and it may even lead to deterioration in investment conditions. There is, therefore, an **extremely high probability that this draft legislation will lead to policy failure and significant amendment is required** to avoid this situation.

### The Problem

The draft legislation appears to be based upon the follow logic:



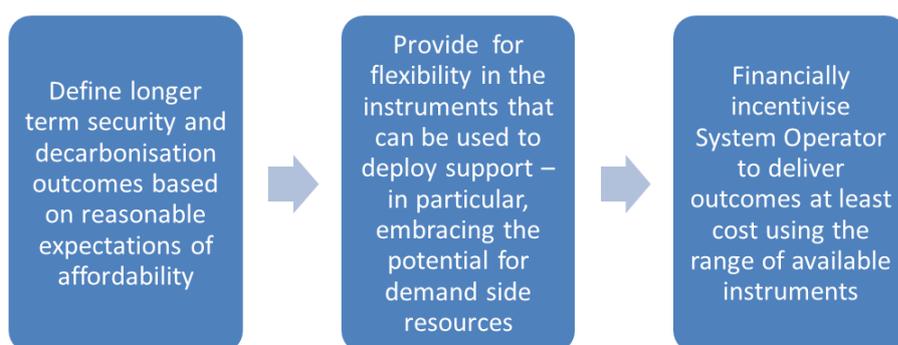
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<sup>1</sup> E3G is an independent, non-profit European organisation operating in the public interest to accelerate the global transition to sustainable development.

This logic is flawed in that:

1. It infers a clear hierarchy in the policy objectives of affordability, security and decarbonisation,
2. Involves over-prescriptive and inflexible legislation,
3. Provides no clear long term signals to investors,
4. Will lead to in-efficient and costly deployment of support, and
5. Creates a high risk of policy failure.

A more appropriate logic would be:



This approach would have many advantages, including:

1. A more transparent and explicit debate about the trade-offs between affordability, security and decarbonisation,
2. Clear signals for investors to make longer term investment decisions,
3. A regulatory framework that drives efficient deployment of support and helps manage short term cost risks for suppliers and their customers,
4. A more appropriate balance between the contents of primary and secondary regulation, and
5. Low risk of policy failure.

The draft Energy Bill can be adapted to incorporate this policy logic although **a major reworking is required**. The following sections highlight the important changes that are required and explain why they would be beneficial.

### Defining outcomes

Recommended change	Rationale
Insert new paragraph (3) in Chapter 8,	These outcomes should include overall

<p>Section 40 that states that:</p> <ul style="list-style-type: none"> <li>• The outcomes must include those that should be delivered by the System Operator over the forthcoming delivery plan period,</li> <li>• The Secretary of State must obtain confirmation from the Committee for Climate Change that these outcomes are consistent with delivery of currently approved carbon budgets.</li> <li>• The Secretary of State must confirm the minimum reliability standard that is acceptable.</li> </ul>	<p>emission reductions for the power sector, minimum levels of deployment for key technologies and a reliability standard (expressed either in terms of risk of enforced disconnection due to generation shortage or a deemed consumer value of lost load). It will provide a clear framework for the System Operator to develop a draft low carbon contracting delivery plan and to calculate the resources required to maintain security of supply. It will also provide clarity over longer term policy trajectory for investors and assurance for Parliament that Government policy is in line with statutory obligations.</p>
<p>New clause (d) in paragraph (2), Section 8:</p> <ul style="list-style-type: none"> <li>• Emissions reductions for the power sector required to meet the carbon budgets set out in the Climate Change Act 2008.</li> </ul>	<p>It is worth explicitly mentioning the possibility of targets for power sector emissions reductions since this is likely to be the key driver for letting contracts.</p>

## Flexibility in instruments

<b>Recommended change</b>	<b>Rationale</b>
<p>New section 1, sub-section 1 in Chapter 1:</p> <ul style="list-style-type: none"> <li>• The Secretary of State may make regulations about contracts for the purpose of encouraging low carbon electricity resources</li> </ul>	<p>This avoids restricting the form of the contract. For example, it may emerge that the CfD form is ineffective in attracting investment for renewable generation and a payment for output (fixed feed-in-tariff) is more appropriate. Also, the use of the term 'resources' allows for demand side investments to be considered alongside generation. Attracting demand side investment may require very different contract structures.</p>
<p>Major re-working and simplification of remainder of Chapter 1 in line with new section 1. For example, sections 4, 5, and 6 would be removed completely.</p>	<p>Allows for more appropriate balance of detail between primary and secondary legislation. For example, sub-section 4, section 1 in Chapter 1 would simply state: 'The obligations referred to in subsection (3) may in particular include an obligation for the parties to make payments to or for the benefit of each other'. This would allow payments to be made on the basis of generator output rather than just the difference between market price and strike</p>

	price.
<p>New section 20, sub-section 1 in Chapter 3</p> <ul style="list-style-type: none"> <li>The Secretary of State may by regulations make provision for the purpose of securing the resources that will deliver the required reliability standard for electricity consumers in Great Britain</li> </ul>	<p>This avoids restricting the mechanisms to the procurement of firm capacity since this may be an inefficient way to deliver reliability in a power system with significant volumes of intermittent and inflexible generation. In particular, the term 'resources' allows for the procurement of energy and flexibility capabilities from both supply and demand side sources.</p>
<p>Major re-working and simplification of remainder of Chapter 3 in line with new section 1.</p>	<p>Allows for more appropriate balance of detail between primary and secondary legislation. For example, sub-section 3 of section 20 in Chapter 3 would state: 'In subsection (1) "resources" means having the capability to deliver changes in energy consumption or production in such a way that minimises the overall costs of delivering reliability'</p>

## Demand side resources

Recommended change	Rationale
<p>Introduce new section to Chapter 1 stating that: 'Within 6 months of the Energy Bill receiving Royal Assent, the Secretary of State must lay before Parliament proposals for minimum volumes of demand reduction that the System Operator must procure during the first delivery period'. It may also be appropriate to establish a similar section in Chapter 3 relating to minimum volumes of demand response.</p>	<p>Demand reduction will be critical if Government policy objectives are to be achieved and stimulating new markets in customer facing products and services should lie at the heart of the EMR proposals. Current markets for electricity efficiency are diffuse and immature and the overall levels of efficiency delivered can be difficult to quantify. Therefore, a positive incentive is required to ensure that the Government, Regulator and System Operator apply the necessary focus to establish these new markets such that they can become self-sustaining. In particular, demand side resources have the potential to minimise the costs associated with implementing the delivery plan and, once initial implementation barriers have been overcome and with appropriate incentivisation in place (see below), it is expected that demand side resources will become an increasingly important component of System Operator actions.</p>

## Incentivisation framework

Recommended change	Rationale
<p>New sections 7: Functions of the Authority:</p> <ul style="list-style-type: none"> <li>• The contract regulations may make provision conferring functions on the Gas and Electricity Markets Authority for the purpose establishing new regulations for the financial incentivisation of the System Operator in the implementation of the delivery plan and the stabilisation of short term cost exposures for suppliers and their customers.</li> <li>• The Gas and Electricity Markets Authority must establish such a mechanism ahead of the publication of the first draft delivery plan.</li> </ul>	<p>Much of the draft energy bill is devoted to managing concerns arising from requiring a privately owned, profit making entity to fulfil functions of critical importance for the public good without any alignment between the business objectives and required outcomes. This position is unsustainable. Implementation of an appropriate profit incentivisation framework has multiple advantages:</p> <ul style="list-style-type: none"> <li>• Establishes a more sustainable institutional framework.</li> <li>• Reduces the need for primary legislation to cater for a change in delivery institutions.</li> <li>• Is likely to lead to lower cost and more efficient delivery of support.</li> <li>• Will stabilise short term financial risks for Suppliers and their customers by ensuring a more appropriate sharing of cost risk between System Operator and Suppliers. Indeed, it is possible that the costs of delivering EMR support can be largely fixed at the start of the delivery plan period.</li> </ul> <p>However, such incentivisation requires that the System Operator has flexibility in the form of instrument used such that it is incentivised to innovate to identify the most appropriate approach to adopt.</p>