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Rt Hon Ed Davey MP
Secretary of State
Department of Energy and Climate Change
3 Whitehall Place
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10th June 2014

Dear Ed

Investment in energy generation

Which? supports the drive to secure £110 billion of investment in energy generation, but for consumers footing the bill for subsidies to low carbon generators it is imperative that the Government delivers value for money.

It is vital that any measure that adds costs to consumers' bills is closely scrutinised at a time when energy prices are the top financial concern for consumers. Whilst there has been a lot of welcome attention given to tackling the immediate cost of energy bills, Which? believes that more needs to be done to address energy costs in the long term.

The present Electricity Market Reform plans could result in expensive generation projects being prioritised over cheaper, more cost effective options. The absence of full competition from the Contracts for Difference (CfD) process at the outset risks priority being given to investment that may not deliver value for money for consumers.

Urgent consideration should be given to driving price competition not only between technologies, but also within technologies. Our proposal for doing this is set out in the attachment to this letter.

We also urge you to commit to a review of the allocation process in 2015 to establish whether it is delivering value for money.

I am copying this letter to Michael Fallon and to Andrea Leadsom and Geoffrey Spence at HM Treasury.

Richard Lloyd
Executive Director

Which? Proposals for Competition in Contracts for Difference Allocation

Policies to promote investment in low carbon energy, paid for through bills, must deliver value for money for consumers. The Government estimates that by 2020 Contracts for Difference (CfD) subsidy costs alone will add around £30 to the average annual household electricity bill[1], (and this is before the cost of paying for any exemptions for energy intensive companies and assuming average household consumption falls). Government data suggests EMR costs will be around £85 for the average household by 2030 (again before any exemptions)[2], having been even higher in the mid-2020s.

We welcome the increased role for competition in subsidy allocation but the Government should go further still

The Government's increased focus on a competitive process for CfD allocation is welcome[3] and is something we have argued for over the course of the past year. However, competition should not be seen as an end in itself. Its purpose here is to deliver the most 'bang for buck' from consumer subsidy. The Government should do more to ensure competition helps deliver this ultimate objective. Our concerns with the current direction of travel of the Government are as follows:

1. The Government has said that to help promote competitive allocation it will set the size of the budget available for the established, cheaper technologies, such that some projects will not get subsidy.[4] This will inevitably mean some cheaper projects will lose out to more expensive technologies in the 'less established pot' (or the less established pot and the Scottish Islands pot). Clearly this is not good news for consumers as it will not deliver best value for money from the subsidy spent.

2. The Government has said that there may be competition for contracts from day one for technologies in the 'less established technologies' grouping, but it has not yet committed to a competitive process.

3. Offshore wind is within the less established technologies group, even though deployment is already significant in GB. In 2013 there was around 3.5 GW of installed offshore wind capacity, with more in construction.[5] Offshore wind looks set to play an important role in the UK meeting its 2020 renewables target and in the UK's longer term plans for power sector decarbonisation. For example, even the National Grid's Slow Progression scenario would see 7.5 GW of total installed offshore wind capacity by 2020, and 15.9 GW of capacity by 2025.[6] Deployment on this scale means significant amounts of subsidy are at stake so it is crucial consumers get the best value for money from it. It is unclear how there will be any price competition for offshore wind under the current arrangements, unless it is the marginal technology within the less-established technologies group. In our view it is not appropriate to shield offshore wind developers from competitive cost pressure. We see no compelling reason why offshore wind developers should not at least compete with other offshore wind developers for subsidy to help drive down support costs. There are a wide range of costs across offshore wind projects but accurate cost

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[1] DECC, *Estimated Impacts of Energy and Climate Change Policies on Energy Prices and Bills*, March 2013

[2] Figures derived from DECC data in *Estimated Impacts of Energy and Climate Change Policies on Energy Prices and Bills*, March 2013

[3] For example a guarantee of competition for contracts from day one for technologies in the established technologies grouping.

[4] DECC *Electricity Market Reform: Allocation of Contracts for Difference. Govt Response on Competitive Allocation*, May 2014: 6

[5] National Grid, *Electricity Ten Year Statement 2013*, Appendix F - Generation Data

[6] The National Grid's more ambitious Gone Green scenario would see 12.1 GW of installed offshore wind capacity by 2020, with this rising to 28.6 GW in 2025. National Grid, *UK, Future Energy Scenarios: UK Gas and Electricity Transmission*, July 2013: 75

information is hard to come by. Allocating subsidy competitively is the best way of revealing this information.

4. The Government has not set out a timeframe or means by which competition will be extended to other low carbon technologies to drive cost reductions and value for money.

A two-stage allocation process to drive price competition both within and between technologies

In our response to the Government's most recent consultations on CfD allocation in December 2013 and February 2014 we set out a two-stage allocation process for how competition could work, which we developed with the energy consultancy Baringa. We continue to believe this model - which seeks to drive price competition both within and between technologies - is worthy of serious consideration and has advantages over the Government's approach. It is also compatible with increasing competition over time. The detail of our proposed approach is set out below.

Stage I - Technology specific auctions (or an 'established technologies pot' and technology specific auctions).

Under this approach, the available annual CfD Budget would be divided into an amount to be allocated on a technology specific basis, and an amount to be allocated on a generic basis, i.e. where different technologies compete for contracts (similar to the government's latest proposals for biomass conversion plants and Scottish islands onshore wind projects). The technology specific amount would be sub-divided by technology according to a modest, minimum volume requirement for each technology for the delivery year or years in question.

For all but the least mature technologies, i.e. tidal and wave, auctions would take place from Year 1. This would include onshore wind, large-scale solar photo-voltaics, offshore wind, large-scale hydro, landfill gas, biomass and energy from waste.[7]

Stage II: Secondary generic auctions

The objective of the secondary generic auctions would to allocate the remaining budget to the lowest cost projects that are available for the delivery year in question.

The generic secondary auctions would be run after the technology specific allocation process. These would be open to developers of technologies that have exceeded their respective budget pot and who had bids that were unsuccessful in the first stage of allocation.[8] Any budget left over from under-subscribed technology specific auctions would be re-allocated to the secondary auctions.

To mitigate the potential gaming risk that developers could try to achieve a higher clearing price in the secondary auctions than in their technology specific auction, our model advocates the transfer of bids[9] from the initial auctions into the generic auctions. The outcome of the secondary

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[7] Baringa, *Approaches for Allocating Contracts for Difference - Report for Which?*, December 2013; Policy Exchange, *Going, Going, Gone: The Role of Auctions and Competition in Renewable Electricity Support* December 2013

[8] Potentially those parties who wish to appeal the outcome of the initial allocation process could also participate in the secondary auction.

[9] In the case of a descending clock auction this would be the last price before the project was withdrawn from the auction.

auction should therefore be pay-as-bid rather than pay-as-clear.[10] Paying-as-bid would reduce the risk that some technologies simply default to their administrative strike price, because the marginal project (i.e. the project that sets the price) in the auction is a higher-cost technology. For example, in the established technologies pot, it is likely that if solar sets the price that there will be no price pressure or competition on onshore wind developers who will get the administrative strike price for that technology.

The proportion of the CfD budget available for secondary auctions should be increased progressively over time, preferably annually, with the timeline for this clearly set out by the Government. Ultimately the goal is full competitive auctioning across all technologies, including nuclear and CCS projects, and those renewable technologies which are currently less mature.

A technology specific auction would also seem the most viable approach for competition for nuclear and CCS in the short term, given the varied structure of CfDs across technologies (e.g the different contract lengths and reference prices). However, we want to see all forms of low carbon electricity competing for subsidy as soon as possible, and a clear plan is needed from the Government setting out how this will be introduced.

As already stated, alongside this a few of the least mature technologies, such as tidal, would initially be allocated on a first-come, first-served basis. These technologies currently have very high costs and correspondingly very high subsidy levels, paid for by consumers. Wave and tidal stream, for example, have an administrative strike price of £305/MWh throughout the period 2014/15-2018/19. This is around six times the current market price. Unless there are significant reductions in the cost of these technologies over the next decade, subsidy for new developments should not be paid for through consumer bills. Clear and realistic targets for cost reduction should be developed for these technologies now.

The Government should commit to publish a review of the allocation process in Summer 2015

Irrespective of the approach taken to allocation, we want the Government to commit to publishing a review in 2015 setting out whether allocation has delivered value for money. A clear set of criteria for assessment should be developed now to inform this review. For example, the Government should publish data on the volume (in terms of MWs) worth of projects within the cheaper, established technology pot that missed out on a CfD to those technologies in more the less established/more expensive technology pot(s). This review should set out how much more investment in low carbon electricity could have been delivered with the same subsidy, had it gone to cheaper technologies. This analysis will be important for helping determine whether the auction design is delivering value for money for consumers and for identifying reforms. We recognise there will be limits to how much detail can be published on individual bids however we see no reason why information of this kind cannot be aggregated. Alongside this review the Government should commit to publish key auction data annually, for example on the number and spread of bids for each technology.

[10] This does not mitigate the risk completely since participants may be able to anticipate the potential clearing prices in its technology specific auction and the secondary auctions, and bid accordingly. However, given imperfect information the risk of missing out on CfD allocation may be too great to bid strategically in this way. Also, Government would ultimately have the option of not running a secondary auction if it felt that is was unlikely to achieve value for money for consumers by doing so.