

# **EXPLANATORY MEMORANDUM TO THE RENEWABLES OBLIGATION ORDER**

**2005 No. 926**

## **1. (i) Title of the instrument:**

The Renewables Obligation Order 2005

## **(ii) Laying Authority and purpose:**

This explanatory memorandum is laid before Parliament by Command of her Majesty. This memorandum contains information for the Joint committee on Statutory Instruments.

## **(iii) Department responsible:**

Department of Trade and Industry

## **2. Description**

- 2.1 The Renewables Obligation Order 2002 (SI 2002/914 – the “2002 Order”), as modified by the Renewables Obligation Order 2004 (SI 2004/924 – the “2004 Order”), is the Government’s main policy measure to encourage the development of electricity generating capacity using renewable sources of energy in the UK. This Order, the Renewables Obligation Order 2005 (the “2005 Order”), will revoke and re-enacts the 2002 Order and also make some substantive changes to the renewables obligation system. The principal changes include increasing the amount of the obligation, providing for the interaction of the obligation with an analogous being set up in Northern Ireland, protecting against financial default by electricity suppliers, protecting against regulatory arbitrage between different obligations and making it easier for small electricity generators to benefit from the obligation.

## **3. Matters of special interest to the Joint Committee on Statutory Instruments or the Select Committee on Statutory Instruments**

- 3.1 None. However, owing to the complexity of the legislative and policy background to the Order, the “Policy Background” contains a relatively detailed summary of the main elements of the renewables obligation system and the changes to it proposed by the 2005 Order. The Department is also including for the Committee’s reference a version of the Order showing tracked changes from the 2002 Order (as amended by the 2004 Order).

## **4. Legislative Background**

### **a) General**

- 4.1 The 2005 Order is made under sections 32 to 32C of the Electricity Act 1989 and applies in relation to suppliers of electricity in England & Wales. It

revokes and re-enacts the 2002 Order (as amended by the 2004 Order). It also makes some substantive changes to the renewables obligation system, both in the five main policy areas summarised in section two above and in some more minor technical areas.

- 4.2 Following executive devolution of the relevant powers, in 2002 an Order for Scotland was made in terms virtually identical to the 2002 Order. It has subsequently been amended and has now been consolidated as the Renewables Obligation (Scotland) Order 2004 (S.S.I. 2004/170) (the “ROS”). The ROS applies in relation to suppliers of electricity in Scotland. Corresponding amendments are now being proposed to the ROS and are intended to come into force on the same date as the 2005 Order.
- 4.3 Article 54 of the Energy (Northern Ireland) Order 2003 (2003 No 419, NI 6), as amended by section 120 of the Energy Act 2004, contains provisions analogous to section 32B of the Electricity Act 1989 and applicable in Northern Ireland. It is intended that a Northern Ireland Renewables Obligation Order, made under the Northern Ireland Energy Order, will come into force on 1 April and will establish a renewables obligation in Northern Ireland, the main features of which will be analogous to those in the obligation in Great Britain.

#### **b) EU Legislation**

- 4.4 As previously stated, this order revokes and re-enacts the 2002 Order as amended by the 2004 Order.
- 4.5 The 2002 Order transposed certain requirements in article 3 of Directive 2001/77/EC (“the Directive”) of the European Parliament and of the Council. A transposition note in respect of the 2002 Order was prepared and submitted to the Committee and a copy of that note is annexed.
- 4.6 This Order takes the same approach to transposition and does not raise any new transposition issues as compared with the 2002 Order.
- 4.7 Paragraph 2 of the transposition note submitted in respect of the 2002 Order referred to the requirement of the Directive that member states establish a certification system for renewables electricity. This requirement has in fact been transposed by a different set of regulations, the Electricity (Guarantees of Origin of Electricity Produced from Renewable Energy Sources) Regulations 2003 (S.I. 2003/2562).

#### **5. Extent**

- 5.1 This instrument extends to England and Wales only.

#### **6. European Convention on Human Rights**

- 6.1 The Minister for Energy and E-Commerce, Mike O'Brien, has made the following statement regarding Human Rights:

“In my view the provisions of the Renewables Obligation Order 2005 are compatible with the Convention rights”.

## **7. Policy Background**

- 7.1 The Renewables Obligation Order 2002 (SI 2002/914 – the “2002 Order”) is the Government’s main policy measure to encourage the development of electricity generating capacity using renewable sources of energy in the UK. It is intended to provide an impetus for new generating capacity that will be required to meet our current targets for electricity generated from renewable energy sources (“renewables electricity”) of 10% by 2010, and as a basis for further reductions in carbon dioxide emissions. The Obligation is supported by more than £500m of funding announced between 2002 and 2008 for research and development and demonstration projects for longer term renewables and low carbon energy generation technologies.
- 7.2 The 2002 Order, as amended, requires all licensed suppliers of electricity in England and Wales to provide the Gas and Electricity Markets Authority (Ofgem) with certificates<sup>1</sup>, issued under the 2002 Order<sup>2</sup> or under the ROS, demonstrating the supply of a specified quantity of renewables electricity to customers. The quantity is set as an increasing percentage of the electricity supplied by each supplier (see articles 3(1(a)), 6(1) and (2), and Schedule 1). As an alternative to providing these certificates, suppliers can pay a ‘buyout’ price to Ofgem for all or any part of that percentage which is not covered by the presentation of certificates (article 7) or they can combine the two options.
- 7.3 A power generating station generating electricity from qualifying renewables sources as detailed under the Order (see in particular article 11) receives one Renewables Obligation Certificate (ROC) for each one megawatt hour (MWh) of renewables electricity generated from those sources (article 4(13)(d)). These ROCs can then be sold to (and indeed traded amongst) suppliers who present them to Ofgem in compliance with their obligations under the order. A similar scheme for issuing certificates operates in Scotland, and these certificates (Scottish ROCs, or “SROC”s) can be presented to Ofgem under the 2002 Order<sup>3</sup>.
- 7.4 The level of the buyout price was set at £30.00 per MWh in the 2002 Order and is adjusted annually in line with the Retail Prices Index (article 7(2)). Under the 2005 Order this figure will be £32.33. All proceeds from buyout payments are recycled to those suppliers who complied (in any part or in full) with their renewables obligation by presenting ROCs, in proportion to the

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<sup>1</sup> See article 3(2)

<sup>2</sup> See article 4(7)

<sup>3</sup> Because the reference in article 3(2) to section 32B of the Act includes certificates issued under the ROS

number of ROCs they present compared to the number presented by all suppliers ( article 15 see section (c) below on single recycling mechanism).

- 7.5 The 2005 Order makes some technical changes to the Obligation following representations from industry, and problems caused by supplier failure. The changes are intended to strengthen the Obligation and encourage investor confidence. In brief the principal changes are:
- (a) Recognition of Northern Ireland Renewables Obligation Certificates (NIROCs) in Great Britain on the same basis as ROCs and SROCs (article 8);
  - (b) Enabling the issue of certificates equivalent to ROCs under section 32B(2A) of the Act in respect of electricity not generated on land in Northern Ireland but supplied to customers there, and the use of such certificates by suppliers (article 9
  - (c) Introduction of a “single recycling mechanism” so that suppliers throughout the UK who comply with their renewables obligation will receive a share of the buyout fund established under renewables obligation in England and Wales (article 15);
  - (d) Introduction of measures to secure the buyout fund (specifically, a system for “late” payments into the fund and for “mutualisation” to mitigate the impact of future shortfalls in the fund) (articles 17 and 18);
  - (e) Introduction of more flexibility for the operators of “small” generating stations (article 4(15)); and
  - (f) A progressive increase in the amount of the renewables obligation from 2010 onwards. (article 6 and schedule 1)

These changes are explained in greater detail below.

**a) Recognition of Northern Ireland Renewables Obligation Certificates (“NIROCs”)(article 8)**

- 7.6 It is intended that the Northern Ireland Renewables Obligation Order will come into force on 1 April and will establish a renewables obligation in Northern Ireland, the main features of which will be analogous to those of the obligation in Great Britain. (see consultation at <http://www.detini.gov.uk/cgi-bin/downutildoc?id=800>). This will include a market in Northern Ireland Renewables Obligation certificates, or NIROCs. In theory, NIROCs will be able to be traded between generators, suppliers and traders in Northern Ireland in the same way that ROCs and SROCs are traded in Great Britain. However, in practice it appears unlikely that a market in NIROCs will function effectively in Northern Ireland alone. It appears that, because of the small size of the Northern Ireland electricity market and its domination by one supplier, NIROCs are more likely to realise a reasonable price if they have access to purchasers in Great Britain as well as in Northern Ireland.

- 7.7 In order to create a market for NIROCs in Great Britain, the 2005 Order therefore seeks to implement a policy (reflected in section 32BA of the Electricity Act 1989, as amended by the Energy Act 2004) that NIROCs be redeemable on the same basis as ROCs in discharge of the renewables obligation of electricity suppliers in Great Britain. The Scottish Order when amended will contain analogous provisions. The NIRO Order is expected to mirror these provisions so that ROCs and SROCs will be redeemable in Northern Ireland in discharge of the renewables obligation of Northern Ireland suppliers.
- 7.8 Article 8 of the 2005 Order therefore provides that instead of producing “certificates” (that is, ROCs or SROCs) to the regulator pursuant to article 3, a designated electricity supplier (that is, a supplier in England and Wales) may produce “eligible NIROCs”. Eligible NIROCs are defined in article 2(1) as those satisfying the criteria for eligibility in schedule 3. These criteria are analogous to the criteria for establishing that electricity has been generated from “eligible renewable sources” applicable to ROCs under article 11, with appropriate amendments reflecting the fact that the electricity in question is generated in Northern Ireland.
- b) Certificates issued under section 32B(2A) of the Electricity Act 1989 (article 9)**
- 7.9 Article 54 of the Northern Ireland Energy Order, as amended by section 120 of the Energy Act 2004, contains provisions analogous to section 32B of the Electricity Act 1989 and applicable in Northern Ireland. As amended, article 54 does not enable a NIRO order to authorise the Northern Ireland Authority for Energy Regulation (“Ofreg”) to issue NIROCs in respect of electricity that is generated by generating stations situated in any part of the territorial waters of the UK. As a result the NIRO Order 2005 will only enable Ofreg to issue NIROCs in respect of electricity that was generated by stations situated on land in Northern Ireland (“article 54 stations”). However in practice there is some renewables electricity that is generated by offshore generating stations in UK territorial waters and supplied to customers in Northern Ireland. This is set to increase as more such stations are built. The policy intention is that this electricity be eligible for ROCs on the same basis as if it had been generated and supplied in Great Britain. Section 32B(2A) of the Electricity Act 1989 and article 9 of the 2005 Order implement this policy.
- 7.10 Section 32B(2A) allows for the issue of ROCs in respect of this electricity. It provides that a certificate issued under section 32B and which relates to electricity that was not generated by an article 54 station may certify that that electricity was supplied to customers in Northern Ireland. These ROCs are known as “section 32B(2A) certificates”. Section 32B(4) of the Act allows an order made under section 32B to provide that section 32B(2A) certificates may be tendered to Ofgem in discharge of a supplier’s renewables obligation.
- 7.11 Article 9 of the 2005 Order allows suppliers to produce section 32B(2A) certificates in full or partial discharge of their renewables obligation. Under

article 9(1) the certificates must relate to electricity generated from eligible renewable sources as specified in article 11.

**c) Single Recycling Mechanism for the UK Buy-out Funds (article 15)**

- 7.12 Section 32C of the Electricity Act 1989 allows an order made under section 32 to provide for suppliers to make payments to Ofgem in discharge of their obligation as an alternative to producing evidence under section 32(3). Section 32C(3) provides that these payments (“the buyout fund”) must be paid (“recycled”) to electricity suppliers in accordance with a system of allocation specified in the order. This is currently implemented in article 12 of the 2002 Order. Section 32C(5), introduced in 2004, provides that Northern Ireland suppliers shall be included amongst the suppliers eligible for distribution of the buyout fund. Article 15 of the 2005 Order, discussed below, gives effect to these provisions and comprises the “system of allocation” contemplated by section 32C(3).
- 7.13 It is expected that the Scottish and Northern Ireland Orders will contain provisions analogous to article 15.
- 7.14 As a result, under the three orders each supplier in the United Kingdom (“UK supplier”) will be potentially eligible for a share of three buyout funds: the England and Wales buyout fund established under the RO 2005; the Scottish buyout fund established under the ROS, and the Northern Ireland buyout fund established under the NIRO Order. This system is known as the “single recycling mechanism”.
- 7.15 Under article 15, in order to qualify for a share of the England and Wales buyout fund a UK supplier must meet at least one of the conditions applicable to it in articles 15(4), (5) and (6). In summary, the conditions require the supplier to have complied wholly or partly with the renewables obligation applicable in the market or markets in which it operated by producing “qualifying certificates” to the relevant authority. “Qualifying certificates” are defined in section 2(1) to include ROCs, SROCs and eligible NIROCs. This definition will also include certificates issued under section 32B(2A) of the Electricity Act 1989 and referred to in article 8 (see section 2 of this document).
- 7.16 Article 15(7) specifies the basis on which the England and Wales buyout fund is to be allocated amongst UK suppliers who meet one or more of the applicable conditions. A simplified example which refers to all three Renewables Obligation Orders and buyout funds may help to illustrate how this article will operate in practice.
- 7.17 Assume that a total of 100 “qualifying certificates” (the relative proportions are immaterial) have been produced by suppliers to the relevant authorities in the three UK electricity markets. Assume also that there is £100 in the Northern Ireland buy-out fund, £200 in the Scottish buy-out fund and £300 in the England and Wales buy out fund, a total of £600. In practice these proportions may of course vary.

- 7.18 Under the NIRO Order, assuming that it contains provisions analogous to article 15, the Northern Ireland buy-out fund will be divided between the suppliers who produced the 100 certificates, with the result that each supplier will get £1 per qualifying certificate so produced. The same system of distribution will be adopted for the Scottish and England and Wales buyout funds. These funds will distribute £2 and £3 respectively per qualifying certificate tendered to the supplier who tendered it.
- 7.19 To continue the example, if a hypothetical Scottish supplier “A” tendered 10 SROCs to Ofgem in discharge of its renewables obligation under the ROS (and tendered no qualifying certificates in any other capacity), it would receive £10 from the Northern Ireland buy-out fund and £30 from the England and Wales buy-out fund (even though it had no obligation in either of those two markets) and £20 from the Scottish buy-out fund, giving it a total of £60.
- 7.20 The end result is, as intended, the same as taking the total of the three buy-out funds (£600), dividing it by the total number of qualifying certificates tendered and then paying all UK suppliers £6 per certificate.
- 7.21 In policy terms, the single recycling mechanism is intended to address the potential problem that suppliers who are dominant in one market and who are also active in another could have an incentive to move qualifying certificates between markets in order to benefit from the resulting effect on certificate prices and buyout fund payments. This could occur under the existing order because ROCs are portable and can be redeemed in either Scotland or England and Wales without the need to prove the physical flow of electricity. The mechanism achieves the policy result whilst avoiding the necessity to combine the three buyout funds into one fund.

**d) Securing the buy-out fund: “late payments” (article 17)**

- 7.22 Although the current Order (article 12(4) to (6)) has a provision dealing with late payments made to Ofgem, changes have been made to the enabling provisions in the Electricity Act 1989 (see in particular sections 32C(1) to (3)), and these are being implemented as described below.
- 7.23 Suppliers must comply with the renewables obligation by producing certificates<sup>4</sup> or making a “buy out” payment to Ofgem (see article 7) by the specified day, (i.e. 1 October immediately following the end of an obligation period – article 2(1)). An obligation period runs from 1 April in one year to the following 31 March in the next calendar year. If suppliers do not comply by the specified day, they will nevertheless be able to be treated as if they had discharged their renewables obligation in full (and therefore avoid enforcement action being taken by the regulator, Ofgem), if they make a late payment.

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<sup>4</sup> As described above, there will be several types of certificate that may be used for this purpose.

- 7.24 A late payment is calculated after the specified day by:
- assessing how much of the supplier’s renewables obligation is still outstanding;
  - working out what size buy-out payment that supplier would have made in accordance with article 7, to discharge that part of its renewables obligation; and
  - adding interest to the sum for every day from the specified day until the date on which Ofgem receives the late payment. The interest rate is five percentage points above the base rate of the Bank of England, calculated on a daily basis.

The late payments and surcharges make up the late payment fund which is recycled to suppliers holding certificates, in accordance with article 17(4) in the same way as the buy-out fund (see details of the single recycling mechanism in section c of this note).

### **Securing the buy-out fund: “mutualisation” (article 18)**

- Background
- 7.25 Mutualisation is being introduced to try to mitigate the impact of any future shortfalls on the market for certificates. The idea behind mutualisation is that where a shortfall of a particular size occurs, suppliers are required to contribute sums to help make up the shortfall. Those sums are paid to Ofgem, who then recycles these payments to those suppliers which held certificates for the obligation period in which the shortfall occurred. In this way, suppliers who hold certificates receive, through mutualisation, the further sums they were expecting from the buy-out and late payment funds.
- 7.26 As mentioned above, if a supplier does not comply with its renewables obligation by producing certificates, it must make a buy-out payment in accordance with article 7 of the Order. If the supplier does not do that before the specified day, it can make a late payment, but such a payment carries interest.
- 7.27 If a supplier makes a late payment then all the suppliers presenting certificates for that obligation period, receive recycled payments from the late payment fund. Therefore, although some of the money those suppliers were expecting to receive from the buy-out fund has been delayed, they do eventually receive the full amount they were expecting, plus the interest payments.
- 7.28 However, if a supplier who has not fully discharged its renewables obligation by the specified day also does *not* make a late payment, it means that the suppliers presenting certificates receive less from the buy-out and late payment funds than they were expecting. In this situation we say there is a shortfall in the buy-out fund. As Ofgem have strict enforcement powers that can be used against a supplier who does not comply with its renewables obligation, it is extremely likely that the only reason a supplier would not make a late payment for the full outstanding amount of its renewables obligations, is because it was insolvent and therefore incapable of any further payments. Such a supplier shall be referred to as a “failed supplier” for the rest of this note.



- 7.29 Depending on the size of the shortfall, this could impact on certificate prices and also on confidence in the ROC / NIROC market. At the moment there is not enough electricity generated from renewable sources to enable all suppliers to comply in full with their renewables obligations by producing certificates. That means that some suppliers have to make buy-out payments and therefore there will always be a buy-out fund to be distributed to those suppliers who do produce certificates.
- 7.30 The price that suppliers will pay for certificates takes into account (1) that the supplier does not need to make the buy-out payment in accordance with article 7 and (2) that the supplier will receive a sum of money from the buy-out and late payment funds. However, if there is a possibility of a shortfall in the buy-out fund, suppliers will not be willing to pay as much for certificates because they will discount the price to take into account the risk of a shortfall.
- 7.31 At this point in time, the money that renewable generators receive for their ROC and SROCs ensures that such renewable generation is financially viable. If certificate prices drop, this could affect the financial viability of certain renewable generators and also therefore the confidence that investors have in these types of projects.
- 7.32 The provisions of the draft Order relating to mutualisation implement sections 32C(2A) to (3) of the 1989 Act, and are found in article 18 of the draft Order.

- When is Mutualisation Triggered?

- 7.33 A shortfall for the purposes of the Order is defined in article 18(23)(1) and is calculated by adding to the buy-out and late payment funds for that period (less the interest paid on the late payments), the late payment that a defaulting supplier would have made to be treated as having complied with its renewables obligation in full (again excluding any interest that the supplier would have paid on that late payment).
- 7.34 Only shortfalls over a certain level will trigger the mutualisation process because very small shortfalls will not affect certificate prices and the expenses of the mutualisation process will outweigh the amounts recovered. A shortfall which triggers mutualisation is defined in article 18(23)(i) as a “relevant shortfall” and it is a shortfall which is greater than the amount set out for that obligation period in Schedule 4. As the level of the renewables obligation increases, so does the trigger level for mutualisation.
- 7.35 Mutualisation is potentially an expensive process for suppliers and much of the cost will be passed onto electricity consumers. To prevent electricity bills rising significantly and to avoid the possibility of pushing more suppliers into insolvency, a cap has been set on the amount that will be recovered through mutualisation. Article 18(3) states that the “specified amount” shall be recovered from certain suppliers and this is defined in article 18(23)(n). Only the first £200,000,000 of a relevant shortfall will be recovered. The figure of £200,000,000 is linked to the retail prices index and will be adjusted annual to take into account any changes in the index.

- Which Suppliers Make Mutualisation Payments?

- 7.36 Only certain suppliers (defined in article 18(23)(j) as “relevant suppliers”) are required to make mutualisation payments. A relevant supplier is any supplier which, at the end of the late payment period, has discharged or is treated as if it had discharged all or part of its renewables obligation. There is no point requiring further payments from a defaulting supplier, as such a supplier is likely to be insolvent.
- 7.37 A relevant supplier does include a supplier who has only discharged part of its renewables obligation. Experience with the renewables obligation so far shows that if a supplier becomes insolvent and therefore unable to comply with its renewables obligation, it will default on the whole obligation and not attempt to comply in part. Such a supplier would not be required to make mutualisation payments.
- 7.38 The definition of relevant supplier includes suppliers who partially comply to prevent a supplier complying with most of its renewables obligation but leaving a small part outstanding so as to fall outside the class of suppliers required to make mutualisation payments. This would save the supplier a significant amount of money and Ofgem would only be able to take enforcement action in respect of the small part of the renewables obligation which was not discharged.
- 7.39 How much each relevant supplier is required to pay is dependant upon the proportion which that supplier’s renewables obligation for the obligation period in question, bears to the total renewables obligations of all the relevant suppliers. A supplier’s renewables obligation is linked directly to its market share, so ultimately, the larger a supplier’s market share, the larger its mutualisation contribution.
- 7.40 In accordance with article 18(4) each relevant supplier makes a payment to Ofgem which is the same proportion of the sum to be recovered as the proportion which that supplier’s renewables obligation bears to the total renewables obligation of all the relevant suppliers. Only the renewables obligations of the relevant suppliers are taken into account because those are the only suppliers required to make mutualisation payments and to include the renewables obligation of a failed supplier would mean that part of the specified amount would not be recovered.

- Which Suppliers Receive Recycled Payments from the Mutualisation Fund?
- 7.41 Relevant suppliers are required to make their mutualisation payment in equal quarterly instalments in accordance with article 18(7). Mutualisation payments are then recycled to suppliers on almost the same basis as the buy-out and late payment funds relating to that obligation period were paid out. However, mutualisation payments are not paid out to any suppliers holding certificates who have failed to comply in full with their renewables obligations (these suppliers are defined as “non-compliant United Kingdom suppliers” in article 18(23)(e)). In reality this is unlikely to occur often because, if a supplier is in financial difficulty and therefore unable to comply with its renewables obligation, it is likely to sell any certificates it holds as they are valuable as a separate asset.
- 7.42 Following this concept through, when the mutualisation fund is divided amongst those compliant United Kingdom suppliers (defined in article 18(23)(a)) who produced certificates, any certificates presented by a non-compliant United Kingdom supplier are disregarded for the purposes of assessing how much each compliant United Kingdom supplier should receive. If this were not done, and certificates presented by a non-complaint United Kingdom supplier were taken into account when the mutualisation fund was divided up, a corresponding proportion of the mutualisation fund would not be recycled.
- 7.43 Example
- Shortfall of £100 and therefore mutualisation fund of £100.
  - Suppliers A and B have produced 10 ROCs each and are compliant United Kingdom suppliers. Supplier C has also produced 10 ROCs but is a non-compliant United Kingdom supplier and is therefore not entitled to recycled payments from the mutualisation fund.
  - If the mutualisation fund were divided amongst those compliant United Kingdom suppliers who produced ROCs, in the same proportion that their ROCs bear to the total number of ROCs produced, suppliers A and B would each receive 1/3 of the fund.
  - That would leave 1/3 of the fund undistributed.
  - By disregarding the ROCs produced by supplier C, suppliers A and B each receive 1/2 of the mutualisation fund instead.
- 7.44 Mutualisation is intended to compensate those suppliers which held certificates during the obligation period in which the shortfall occurred, as they received less from the buy-out fund than they were expecting. But because a non-compliant United Kingdom supplier who produced certificates is not entitled to any recycled mutualisation payments, it is not necessary to require relevant suppliers to recover that proportion of the specified amount which would otherwise be paid to the non-compliant United Kingdom supplier.
- 7.45 This is dealt with by article 18(5) and (6) which requires Ofgem, when calculating the sum to be recovered from the relevant suppliers, to deem the

specified amount to be reduced by the sum which would otherwise have been paid to the non-compliant United Kingdom supplier. As the sum which would have been payable to such a supplier is dictated by the proportion which the certificates they produced, bears to the total certificates produced, that calculation is used when working out how much the specified amount is deemed to have been reduced by.

#### 7.46 **Example (using scenario from above)**

- Assuming a shortfall of £100, this means that as suppliers A, B and C each produced 1/3 of the total ROCs, they were expecting to receive 1/3 of the shortfall i.e. £33.33 each.
- As the mutualisation fund will be equal to the amount of the shortfall, £100 will be recovered from all relevant suppliers.
- The mutualisation fund will be divided between suppliers A and B meaning that they would receive £50 each. This is actually more than the £33.33 they were expecting to receive from the buy-out fund.
- To prevent this over-recovery, the specified amount (i.e. the amount to be recovered from all relevant suppliers) is reduced by 1/3 (being supplier C's proportion of the total ROCs produced).
- The specified amount and therefore the mutualisation fund would then be £66.66, meaning that suppliers A and B each get £33.33

- Recalculation During Mutualisation Process

7.47 As mentioned previously, mutualisation is designed to compensate those suppliers who held certificates in the period in which a shortfall occurred. Therefore, in the event that those suppliers receive payments directly from the supplier whose failure to comply with its renewables obligation triggered mutualisation, less money needs to be raised through mutualisation. If a supplier holding certificates received both the direct payment and the full amount of the recycled mutualisation payments, it would actually receive more money than if there had not been a shortfall.

7.48 Although it may seem unlikely that a supplier which failed to comply in full with its renewables obligation will have the money to make payments to the suppliers holding certificates at a later date, this has recently occurred in practice.

7.49 Paragraphs (14) to (20) of article 18 deal specifically with this situation. Where Ofgem receives notification of such a direct payment, before 1 August in the second obligation period following an obligation period in which the shortfall occurred, it must recalculate the specified amount. This is done by treating the specified amount as if it had been reduced by the total amount which all the suppliers holding certificates received directly from the failed supplier.

7.50 The notification must be received by Ofgem before 1 August on the second obligation period following the obligation period in which the shortfall occurred because this is the date when Ofgem recycles the mutualisation fund

for the last time. After this date, all the mutualisation payments have been paid out and we do not require Ofgem to “claw back” any money from those suppliers which received recycled payments from the mutualisation fund.

- 7.51 As the amount to be recovered from all of the relevant suppliers is recalculated, so is the amount required from each relevant supplier individually. A breakdown of the future instalment payments (defined in article 18(16)(b)(ii)) is also notified to each relevant supplier. Taking into account how much the relevant supplier has already paid in instalment payments before the recalculation, the supplier is required to make instalment payments on the remaining instalment dates as set out in article 18(7).
- 7.52 Where the amount in the mutualisation fund is insufficient to repay to each relevant supplier the difference between what they have already paid and the new recalculated amount (defined as the “recalculated supplier payment” in article 18(16)(b)(ii)), the amount that each relevant supplier receives is reduced in equal proportions. Where suppliers end up paying more than their recalculated supplier payment and there is either no mutualisation fund (because it has already been recycled) or the mutualisation fund is insufficient to repay each relevant supplier in full, suppliers are not entitled to claim the excess payment back from Ofgem.
- 7.53 This Order covers a shortfall in the buy-out fund under this Order. The Renewables Obligation (Scotland) Order (“Scottish Order”) will also provide for mutualisation to occur when there is a shortfall in the buy-out fund established under that Order. However, this Order only applies to suppliers supplying electricity in England and Wales (defined in article 2(1) as designated electricity suppliers) and therefore it cannot impose obligations on suppliers supplying electricity in Scotland (“Scottish supplier”).
- 7.54 Where a mutualisation occurs under the Scottish Order, any direct payment made by a Scottish supplier in respect of its failure to comply with its renewables obligation under the Scottish Order will be paid to United Kingdom suppliers who held certificates for the relevant obligation period (as, due to the single recycling mechanism it is those suppliers who will have received less than they expected from the buy-out fund established under the Scottish Order). However, as the Scottish Order cannot require designated electricity suppliers to notify Ofgem of the direct payments they receive, that requirement is imposed in this Order.
- 7.55 There will be a reciprocal provision in the Scottish Order requiring Scottish suppliers to notify Ofgem when they receive direct payments from a designated electricity supplier. There will also be similar provisions in the Northern Ireland Renewables Obligation Order, although no reciprocal provisions are required in this Order as there is not intended to be mutualisation under the Northern Ireland Renewables Obligation Order and therefore information on direct payments will not be required by the Northern Ireland Regulator.

**e) Flexibility for Small Generators (article 4(15))**

7.56 The 2005 Order 2005 will allow the operators of generating stations of up to 50kW capacity to elect for annual or monthly calculation of their output for the purposes of issuing ROCs. To limit the opportunity for benefiting from the effects of rounding, these operators will only be able to change the basis of calculation once per obligation period. They will be required to notify Ofgem of their wish to switch not less than one month before the beginning of an obligation period.

**f) Increase of the amount of the Renewables Obligation (article 6 and schedule 1)**

7.57 In response to calls from the renewables sector to give confidence that the level of the obligation would increase beyond 2010, in December 2003 the Government proposed progressively to raise the level of the Renewables Obligation beyond 2010/11 to 2015/16. As the Obligation is currently framed, the set percentage will increase each year to reach 10.4% in 2010/11, remaining at that level through to 2026/27. The 2005 Order will extend the profile of the Obligation as follows:

2011/12	11.4%
2012/13	12.4%
2013/14	13.4%
2014/15	14.4%
2015/16	15.4%

7.58 It is currently intended that the level of the obligation will then remain at 15.4% from 2015/16 through to 2026/27.

**8. Impact**

8.1 A Regulatory Impact Assessment is attached to this memorandum.

8.2 The changes will affect all licensed electricity suppliers. They will also affect generators of renewables electricity who claim Renewables Obligation Certificates (ROCs).

8.3 The Electricity Act requires us to consult, before the Order is made, with certain bodies, the statutory consultees, comprising The Gas and Electricity Markets Authority, the Gas and Electricity Consumer Council, electricity suppliers to whom it would apply and generators of electricity from renewable sources.

8.4 The Draft Renewables Obligation Order 2005 went out to consultation for a period of 12 weeks starting on 8 September 2004 and a total of 56 responses were received. A summary of how the consultation affected the policy can be found in the regulatory impact assessment. A summary of the responses received and also copies of all the non-confidential responses can be found at [www.dti.gov.uk/energy/renewables/policy/roo2005.html](http://www.dti.gov.uk/energy/renewables/policy/roo2005.html)

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Signed by the Minister for Energy and E-Commerce

***Mike O'Brien***

Date

***5th February 2005***

# Regulatory Impact Assessment

## The Renewables Obligation Order 2005

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## **1. TITLE OF PROPOSAL**

1. Regulatory Impact Assessment for the Renewables Obligation Order 2005

## **2. PURPOSE AND INTENDED EFFECT OF MEASURE**

### **The Objective**

2. The purpose of this Regulatory Impact Assessment (RIA) is to assess the impact of proposed changes to the Renewables Obligation Order. These changes reflect the Government's announcement that the Renewables Obligation profile will be extended to 2016 and views expressed by industry on the need for a single UK recycling mechanism as well as new enabling powers set out in the Energy Act 2004. The new powers amend the Renewables Obligation provisions of the Electricity Act 1989.

3. Through these changes the Government seeks to:

- a) **achieve tradeability between ROCs issued under the Renewables Obligation Order and NIROCs issued under the Northern Ireland Renewables Obligation Order;**
- b) **reduce the impact which any further shortfalls would have on the renewables buy-out fund;**
- c) **enable the establishment of a single recycling mechanism for the three UK buy-out funds;**
- d) **achieve an extension of the Renewables Obligation profile;**
- e) **provide more flexibility for small generators.**

***Devolution:*** The changes affect the UK and these effects are detailed later in the RIA.

### **The Background**

4. The Renewables Obligation ("Obligation") is the Government's main policy measure to encourage the development of electricity generation capacity using renewable energy sources ("renewables") in Great Britain. The Obligation has already provided and will continue to provide, an impetus for the new renewables generating capacity that will be needed to meet the UK's current 10% 2010 target for electricity produced from renewable energy

sources (“renewables electricity”) and as a basis for further reductions in carbon dioxide emissions.

5. The details of the Obligation are contained in the Renewables Obligation Order 2002 (“the 2002 Order”) in England and Wales and the Renewables Obligation (Scotland) Order 2004 (“the Scottish Order”) in Scotland. The 2002 Order was made under section 32 of the Electricity Act 1989 and applies to suppliers of electricity in England and Wales. The 2002 Order was modified by the Renewables Obligation Order 2004 (“the 2004 Order”). This Order, the Renewables Obligation Order 2005 (“the 2005 Order”), revokes and re-enacts the 2002 Order (as modified by the 2004 Order), and makes some substantive changes to the obligation.

6. Taken together the England and Wales and Scottish Orders require all licensed electricity suppliers in Great Britain to provide the Gas and Electricity Markets Authority (Ofgem) with certificates, issued under the 2002 Order or under the Scottish Order, demonstrating the supply of a specified quantity of renewables electricity to customers. The quantity is set as an increasing percentage of the electricity supplied by each supplier (see articles 3(1)(a), 6(1) and (2) and schedule 1). As an alternative to providing these certificates, suppliers can pay a ‘buyout’ price to Ofgem for all or any part of the percentage which is not covered by the presentation of certificates (see article 7) or they can combine the two options.

7. A generating station generating electricity from qualifying renewables sources as detailed in the Order (see, in particular, article 11) receives one Renewables Obligation Certificate (ROC) for each MWh of renewables electricity generated. These certificates can then be sold to (and indeed traded amongst) suppliers, either together with or independently of the underlying electricity. The Scottish Order operates on a similar basis. Certificates issued to generators in Scotland under that Order (Scottish ROCs, or “SROCs”) can be presented to Ofgem under the 2002 Order, and vice versa.

8. The ‘buy-out’ price payable by suppliers as an alternative to presenting certificates was set at £30 per MWh in 2002/03 and is adjusted annually according to the Retail Prices Index. All proceeds from buy-out payments are recycled to those suppliers who complied in part or in full with their obligation by presenting ROCs, in proportion to the number of ROCs they present compared to the number presented by all suppliers (article 12).

9. As well as increasing the level of the obligation for the years after 2010/11, and achieving a UK ROC market by including Northern Ireland (see paragraph 14), the 2005 Order seeks to address a number of issues that have arisen with the current legislation. These include problems associated with shortfalls in the buy-out fund, different recycling values for ROCs under the Renewables Obligation Order and Renewables Obligation (Scotland) Order; and a lack of flexibility for small generators.

10. The proposed changes are being mirrored in Scotland by changes to the Scottish Order, to be considered by the Scottish Parliament.

11. The changes in the 2005 Order have been subject to a statutory consultation, prior to the consolidated Renewables Obligation Order 2005 being laid before Parliament. RIAs were produced for the implementation of the Obligation in 2002, for the amendment to the Obligation in 2004 and for the new powers set out in the Energy Act 2004. RIAs for the Obligation order 2002 and the Energy Bill 2004 can be found at [www.dti.gov.uk/access/ria/index.htm#energy](http://www.dti.gov.uk/access/ria/index.htm#energy)

### **Risk Assessment**

12. If the proposed changes to the Obligation were not made, it is likely that the market for renewable electricity in the United Kingdom would not operate as efficiently as it otherwise could do. This would tend to limit the probability that the Government will meet its targets for the amount of electricity generated from renewable energy sources.

### **3. OPTIONS**

13. The options for each of the changes are outlined below, alongside the intended effect, benefits, costs and alternative options.

#### **Objective (a)**

#### **Tradeability between ROCs and NIROCs**

##### **What is the proposal?**

14. That we move from operating a system of tradeable certificates for renewable electricity in Great Britain to one which operates UK wide. The Northern Ireland Renewables Obligation (“NIRO”) will be introduced from 1 April 2005 and the Energy Act 2004 provides for the full tradeability of ROCs with certificates issued to generators under the NIRO . These are referred to as NIROCs and are certificates, issued by or on behalf of NIAER, in respect of eligible renewables electricity generated on land (including inland waters) in Northern Ireland and supplied to customers there.

15. This system is known as “mutual recognition”. Subject to Parliamentary and State Aids approval we would aim that the 2005 Order) will come into force from 1 April 2005.

16. The NIRO will be similar or identical to the 2005 Order in terms of the technologies covered and the level of the ‘buy out’ price although the size of the obligation will differ.

17. With the proposal for a single recycling mechanism for the 3 UK buy-out funds (see Objective C for details), it is necessary to allow Northern Ireland suppliers access to the recycling of the two other funds. Taken together, this will allow NIROCs to have the same value as other qualifying certificates and allow them to play a full part in the development of a true UK-wide ROC market.

18. To ensure the smooth and fair operation of the issue of ROCs for electricity generated in Great Britain but supplied to customers in Northern Ireland (“GB/NI electricity”), Ofgem and NIAER will need to be able to exchange information relevant to compliance by suppliers and generators and the issue and revocation of ROCs.

19. To provide for mutual recognition, changes are necessary to the obligation and the amendments proposed are:

- To expand Article 2 to include the definition of new terms for the purposes of the Order, including NIROCs, NI supplier and the Northern Ireland Renewables Obligation Order.

- To allow Ofgem to issue ROCs in respect of GB/NI renewables electricity.
- To allow NIROCS and/or ROCs to be used (as an option) to comply with the Renewables Obligation in England and Wales. Only NIROCs issued in respect of electricity that would have been eligible for ROCs had it been produced in Great Britain will be able to be used towards compliance with the obligation in England and Wales.

### **Why is it being proposed?**

20. This change will fulfil a commitment given at the time of the introduction of the Renewables Obligation in 2002.

21. Certificates relating to renewables electricity supplied in Northern Ireland will be able to be used towards compliance with the renewables obligations of electricity suppliers in England and Wales and suppliers in Scotland.

### **What are the benefits?**

22. UK-wide trading would principally benefit renewables generators in Northern Ireland because a NIROC market limited to Northern Ireland would be too small to be viable or competitive.

23. For instance, one company (Northern Ireland Electricity) dominates the Northern Ireland electricity supply market, which will not be fully open to competition before July 2007. This means that a separate NIROC market in Northern Ireland would be characterised by monopsony for several years. A distorted NIROC market may result in artificially low prices received by local renewables generators which would stunt the growth of renewable electricity in Northern Ireland compared to a more competitive NIROC market.

24. Mutual recognition of NIROCs and ROCs will benefit renewables generators in Northern Ireland, as they would gain from trading in a much larger and more competitive market for ROCs and NIROCs than would otherwise be the case.

25. All UK suppliers will benefit from the ability to trade ROCs and NIROCs in a wider and more liquid UK market, although most of the gains would accrue to those suppliers based in Northern Ireland. It is very difficult to estimate the size of this hypothetical benefit, but it could conceivably be in the order of several million pounds per year.

### **What are the costs?**

26. The effect on the existing ROC market should be minimal given that Northern Ireland accounts for only 2.5% of the potential UK market. Renewables electricity generation in Northern Ireland is forecast to be around 1.4 TWh by 2010.

27. The Department for Enterprise, Trade and Investment (Northern Ireland) is setting the amount of the obligation on Northern Ireland electricity suppliers at 6.3% by 2012 whereas the obligation on suppliers elsewhere in the UK is set at 10.4% by 2010. It is possible that individual companies may benefit from this divergence in ways that we cannot foresee.

28. The reason for this lower obligation is that electricity prices for NI consumers (including businesses) are considerably higher than the other nations of the UK. If the level of the obligation in Northern Ireland was the same as in the UK, there would be significantly increased Northern Ireland electricity prices when they are already higher than in the UK. The proposed lower level of obligation will mean that the price rises for NI consumers as a result of a renewables obligation should not have a greater impact than that on consumers in the rest of the UK. At present, price rises for Northern Ireland consumers as a result of the Obligation are estimated at under 3% compared with 4.4% for GB.

### **What are the alternative options?**

29. ***Do Nothing:*** This would mean the powers set out in the Energy Act 2004 relating to the Northern Ireland Renewables Obligation would not be exercised.

30. A NIROCs market limited to Northern Ireland would be too small to be economically viable and would make it unlikely that Northern Ireland could put in place an effective obligation. In such circumstances, alternative measures for reaching renewables targets would be sought.

## **Objective (b)**

### Measures to Secure the Buy-Out Fund

#### **What is the proposal?**

31. It is proposed that two measures are taken which together will mitigate the impact of any future shortfalls in the renewables buy-out fund.

32. The proposed measures are:

- **Surcharges on late payments**
- **Mutualisation**

#### **Why is it being proposed?**

33. The failure of two suppliers (including one of the majors) in 2002-03 led to a shortfall of nearly 20% in the expected buy-out fund and caused a temporary loss of confidence in the renewables market, with a corresponding fall in the values of ROCs.

34. Shortfalls in the renewables buy-out fund currently result in lower than expected recycled payments to those suppliers who hold ROCs, and in turn to the generators who actually produce the electricity in relation to which the ROCs were issued. This makes ROCs less valuable and therefore reduces confidence in the market. It also introduces a level of uncertainty (since no one knows whether or when a failure will occur). If the impact of shortfalls is not addressed, it is likely that investors will be less willing to put money into renewables generation projects and less renewable electricity generation capacity will be built with a consequent impact on the Government's ability to meet its renewables target of 10% by 2010.

#### **What are the benefits?**

35. These measures will, taken together, reduce the impact of any future supplier shortfalls. The monetary benefit to suppliers that are (largely) compliant with the Obligation and to renewable generators of avoiding buy-out fund shortfalls is very difficult to predict. However, when TXU Europe unexpectedly went into administration during 2002/03, the buy-out fund was reduced by some £23 million and ROC prices temporarily fell by £3/MWh.

#### **What are the costs?**

36. Collectively the proposed measures to secure the buy-out fund form a package of sensible steps to mitigate the effects of any future shortfall in the buy-out fund. These measures will not remove the risk of a shortfall but seek to strike a balance between reducing the impact of a shortfall and placing undue additional burdens on consumers, who ultimately pay for any form of protection. The detail of each measure is discussed below.

## Details

- ***Surcharges on Late Payments***

**37. Proposal:** The amendment will allow suppliers, who have not discharged their renewables obligation by the specified day to be treated as having discharged their Obligation in full, by making a late buy-out payment together with an escalating surcharge. All the late payment fund and surcharges will form the late payment fund. The late payment fund will be distributed, in a similar way to the buy-out fund, to those suppliers who produce ROCs/NIROCs in that obligation period. We are proposing that the surcharge rate should be linked to a published interest rate so that it moves in line with general interest rate movements and are proposing 5% over the Bank of England base rate, calculated on a daily basis and charged for every day for which the payment is overdue (i.e. everyday past the specified day of 1 October). The late payment period would run for 2 months after which late payments can no longer be accepted. Recycling of the late payment fund will take place at the end of the late payment period or sooner if all payments are received before the late payment period ends.

**38. Benefits:** A surcharge on late payments should encourage suppliers to pay on time and so prevent a delay in the recycling of payments. As the surcharge will be at a higher level than borrowing from the bank this should encourage prompt payment.

39. In addition the surcharges will also be paid into the late payment fund and will ensure that holders of ROCs get some compensation for the time delay in recycling late payments.

**40. Costs:** There would be a cost to suppliers paying the surcharges. It is not possible to quantify this. In 2002/03, a total of 7 suppliers failed to produce the required number of ROCs or make the full buy-out payment before 1 October. Of these, one made a late payment, so would have been subject to the surcharge, as would a further four who either submitted evidence of ROCs late or claimed for ineligible ROCs. (The other two suppliers were in formal insolvency proceedings). In 2003/04 4 suppliers failed to produce the required number of ROCs or make the full buy-out payment before 1 October. One supplier submitted payment after the deadline. One supplier made an insufficient buy-out payment. Both of these would have been subject to a surcharge. The remaining two were in administrative receivership. However, they will only bear this cost if they do not comply with their obligation in full.

- ***Mutualisation***

**41. Proposal:** The amendments to the Electricity Act 1989 contained in the Energy Act 2004 give the Secretary of State the power to require suppliers to make payments to Ofgem in the event of a shortfall in the buy-out fund. Where a supplier has failed to comply with its renewables obligation and there



is a shortfall in the buy-out fund, each supplier (excluding a supplier which, by the end of the late payment period, has not complied at least in part with the Obligation – “defaulting supplier”) is required to contribute a sum to make up the shortfall. These sums make up the mutualisation fund. The mutualisation fund is then distributed in much the same way as the buy-out fund for that obligation period (see paragraphs 54 and 62 on the single recycling mechanism). However, a supplier which has not complied in full with the Obligation, is not entitled to recycled mutualisation payments.

42. The Energy Act 2004 modifications allow flexibility as to whether those suppliers in the market at the time of the shortfall should make mutualisation payments or whether suppliers in the market at the time the mutualisation payments are required to be made should make these payments. After careful consideration of responses received to the consultation exercise it is proposed that mutualisation payments should be made on the basis of share of the market at the time of the shortfall, since new suppliers would not have been directly affected by the shortfall and could not have benefited from the protection offered by mutualisation in that obligation period.

43. We propose that the trigger for starting the mutualisation process should be linked to the level of the Renewables Obligation at £1m for every 1% of the level of the Obligation. So in 2005/06, the level of the trigger will be £5.5m.

44. The need to restore confidence following a shortfall must be balanced with having proper regard to the increase in costs to consumers both industrial and domestic. We therefore consider that a cap is necessary and propose that this be set at £200m linked to RPI. At this level a shortfall of such a size as to exceed the cap would mean at least one of the major suppliers failing which would be likely to lead to wider problems for electricity supply which would be beyond the ROC market.

45. The Order must also set out the period over which mutualisation payments should be made. It is proposed that payments should be made over quarterly instalments, with the first payment due before the beginning of September in the second obligation period following the obligation period in which the default occurred and the final payment due before the beginning of the following June. This would mean that if a default occurred in 2005/06, the first payment would need to be made by 1 September 2007 and the final payment by 1 June 2008.

46. Ofgem will also be required to publish a formal information notice to stakeholders when mutualisation is triggered.

**47. Benefits:** As those suppliers with ROCs/NIROCs will receive the sums they expected to receive (although after a delay), ROC and NIROC prices and investor confidence should be protected.

**48. Costs:** Each supplier bears some of the cost in the short term, regardless of whether or not they are to receive any sums from the recycling

of the mutualisation fund. This cost depends on the level of the shortfall and the proportion that would be recovered. However, since the mutualisation fund is recycled, there is no additional cost to the industry as a whole, although some suppliers will gain at the expense of others. Those suppliers who met their obligation requirements through ROCs/NIROCs would receive payments from recycling. In some cases, these may exceed their costs, although these are likely to be in a minority. Based on the Ofgem report on the first year of the Obligation, out of 38 suppliers with an obligation in England and Wales, we estimate that, had there been mutualisation of the TXU and Maverick shortfalls, 12 suppliers would have received more from the recycling of the mutualisation fund than they would have paid into it. The extent of the net amount received depends on the size of the supplier's obligation and the extent to which it was met by producing ROCs/NIROCs.

### **What are the alternative options?**

**49. Do Nothing:** If the powers to secure the buy-out fund are not given effect through the Order it will leave the renewables buy-out fund vulnerable in the event of further shortfalls. This problem, which has already caused a loss of confidence in the ROC market, will not have been addressed. However, suppliers may now be factoring this risk into the prices they pay to generators even if they did not do so before.

#### **50. Variations to the detail of the current proposals:**

**Trigger Level:** In the Government's Statutory Consultation on the Renewables Obligation Order 2005 it was proposed that the trigger level would be linked to the expected size of the buy-out fund and at a higher level than now proposed. Many responses to the consultation suggested that linking the trigger to the expected size of the buy-out fund was not transparent (as the expected size is only known at the end of the late payment period) and that as long as administration costs are covered, mutualisation should be triggered whenever a shortfall occurs. The Government accept the argument on transparency and that the initial proposal set the trigger at too high a level. The Government therefore now proposes a trigger at £1m per 1% of the Obligation.

51. **Cap:** In the Government's consultation document it was proposed that the cap for mutualisation be linked to the expected size of the buy-out fund and at a lower level than now proposed. Many responses argued for no cap at all or a much higher, more transparent level. We accept the arguments about the need for a more transparent cap and it is now proposed that the cap is a cash figure linked to RPI. The current proposal also sets the cap at a slightly higher level than that proposed in the consultation document.

52. **Basis of assessing suppliers' mutualisation payments:** 63% of respondents to the Government's Statutory Consultation opposed the proposal to assess payments on the basis of market share at time of default, and favoured using share at the time of recovery. We have not changed our proposal on this issue but do acknowledge the potential impact on suppliers

as this approach gives new suppliers entering the market an advantage. However, we accept the arguments put forward by consumer bodies that to levy mutualisation payments on new suppliers (from which they could not benefit) would both seem unfair, and would tend to act as a barrier to market entry. Given the relative lack of competition in the electricity industry, we have to have regard to protecting consumers through promoting competition, and therefore cannot justify taking measures that add to existing barriers to entry.

53. Timing of mutualisation payments: The current proposal takes on board arguments put forward in responses to the consultation that mutualisation payments should be made over 1 year in quarterly payments. The alternative to this would be for the entire mutualisation payment to be paid in full on one occasion only.

54. **Securitisation:** An alternative to the mutualisation process is securitisation. This is where suppliers would be required to make interim payments on account to Ofgem to cover some or all of their share of the Obligation, or to provide some other form of security such as a letter of credit.

55. We see securitisation as overly costly since it requires additional costs whether or not there is a shortfall. Securitisation is also likely to bear disproportionately on smaller suppliers.

56. **Shorter Obligation Periods:** We considered reducing the length of obligation periods from a year to 6 months in order to reduce the impact of future shortfalls (since the size of the fund would be smaller and any shortfall correspondingly reduced). There are other advantages to shorter obligation periods. Recycled payments would be made earlier, to the benefit of generators and it is also arguable that shorter obligation periods could provide a greater incentive for suppliers to meet their obligations through ROCs rather than the buy-out fund. This is due to suppliers having less time to collect the money from customers to make the buy-out payments. They are then more, likely to buy ROCs instead. However, a report by Cornwall Consulting into the impact of shorter obligation periods and mutualisation concluded that, while mutualisation would make a significant contribution to restoring confidence in the renewables market following a shortfall, shorter obligation periods, while having some impact by themselves would not add any significant value when combined with mutualisation.

57. In addition there are some disadvantages in that shorter obligation periods have adverse impacts on the cash flow of smaller suppliers, and may act as a barrier to market entry. The seasonal nature of some renewable sources may also mean that obligation periods of less than a year introduce rigidities into the market. Shorter periods also introduce more complexity and therefore greater compliance costs. On balance we do not propose to reduce the length of obligation periods but this issue will be looked at further in the 2005/06 Review of the Renewables Obligation.

**58. *Netting Off of Supplier Defaults Against Recycling Payments:*** We considered providing for the regulator, Ofgem, to net off any default in a supplier's obligation against the supplier's entitlement to a share of the recycled buy-out fund. However, there are risks that netting off could lead to "gaming" by suppliers, if it were in their commercial interest to fail to meet the whole of their share of their obligation and have the remainder netted-off. There would also be difficulties in co-ordinating netting-off with late payments without delaying the recycling of the buy-out fund.

## **Objective (c)**

### **Single Recycling mechanism for the UK Buy-Out Funds**

#### **What is the proposal?**

59. To enable the establishment of a single recycling mechanism for the 3 UK buy-out funds.

60. The Government would like to retain the three existing and separate UK buy-out funds, but to handle the recycling mechanism on a UK wide basis to prevent arbitrage between the funds. This would work by each of the three funds being distributed to every supplier in any one or more of the three UK markets who produced ROCs or NIROCs, even though the supplier might not be active in the market to which the specific buy-out fund relates. In this way, a supplier will receive separate amounts from each of the three different funds which together will total what that supplier would have received had there been one single buy-out fund across all three markets, recycled on the basis of all the ROCs and NIROCs presented in total. Therefore, it will make no difference in which market the supplier produces its certificates because the single recycling mechanism will act to produce a single recycling value for all certificates.

61. However, if a shortfall were to occur in one of the buy-out funds (due to failure of a supplier) then even if the failed supplier does not supply customers in the other two markets, a single recycling mechanism could lead to certificate holders in those other markets suffering losses.

62. A merged mutualisation process across the three Obligations is not possible at this stage, since it is premature to introduce mutualisation in Northern Ireland until the Northern Ireland Renewables Obligation has become established. We therefore propose recovering a shortfall from those in the market where it has occurred but recycling the mutualisation payments made across all certificate -holding suppliers in the three markets.

63. If, for example, the failed supplier was only involved in the England and Wales market, and that market provided 85% of all ROCs/NIROCs presented that year, then 15% of the total mutualisation payments would be recycled to suppliers in the other funds. So, in effect the mutualisation payments are allocated in the same way as was the recycling of the buy-out and late payments funds.

64. This approach overcomes the problem of ROC/NIROC holders receiving lower than expected recycling payments because of a shortfall in another fund.

### **Why is it being proposed?**

65. Following representations from industry the Government is committed to ensuring that the requirements on all licensed suppliers and all accredited generating stations are the same across the UK. There is at present one buy-out fund for England and Wales and another for Scotland. With the introduction of the Northern Ireland Renewables Obligation a third fund will be added.

66. ROCs are portable and can be redeemed in either Scotland or England and Wales without the need to prove the physical flow of electricity. The Government is concerned that the current arrangements may offer an opportunity for a supplier with a large share of one of the smaller markets to under-present ROCs/NIROCs there (thus forcing the recycling payments per ROC/NIROC in the smaller market to rise) and to present extra ROCs/NIROCs in England and Wales. It wishes to remove any such arbitrage opportunity and believes that it would be fairer for all parties if, while the separate buy-out funds for England and Wales and Scotland and the proposed Northern Ireland fund should remain, the recycling mechanism should be handled on a UK-wide basis. In this way, the value of recycled payments for each ROC presented will be the same in England and Wales, in Scotland, and Northern Ireland.

### **What are the benefits?**

67. The opportunity for arbitrage is removed.

### **What are the costs?**

68. In considering this approach however, we have identified a potential problem. If a shortfall were to occur in one of the buy-out funds (due to failure of a supplier) and the failed supplier does not supply customers in the other two markets, then a single recycling mechanism could lead to ROC/NIROC holders in those other markets suffering as they would receive lower recycling payments.

69. We believe though that by introducing a merged mutualisation process this problem could be overcome. However, this will not be possible at this stage, since it is premature to introduce mutualisation in Northern Ireland until the Northern Ireland Renewables Obligation has bedded in. The proposal above does instead allow for mutualisation payments to be spread across the 3 obligations so that certificate holders in the market where a shortfall has not occurred do not lose out through mutualisation not being triggered in their market. However, where a shortfall were to occur in the Northern Ireland buy-out fund, then certificateholders in the other 2 markets would suffer lower recycling payments without the benefit of mutualisation payments from the suppliers in the Northern Ireland market. However, given the lower level of the Obligation in Northern Ireland and the smaller size of the Northern Ireland

market, a significant shortfall is unlikely and if it did occur, the impact on recycling values would not be significant.

### **What are the alternative options?**

**70. Do Nothing:** The current arrangements could remain in place but the potential to take advantage of arbitrage opportunities would remain. The potential for unfairness could undermine the smooth operation of the Obligation.

**71. Defer the issue:** The Government remains committed to avoiding arbitrage between the different buy-out funds. To wait for merger mutualisation would see the problem of arbitrage not being addressed and no certainty as to when this problem could be dealt with.

### ***72. Alternative Single Recycling Mechanism Scenarios:***

**73. Option (i): Under this option, the mutualisation payments are only recycled to suppliers in the market where the shortfall occurred and where the payments were raised. So, for a shortfall in England and Wales, mutualisation payments are recycled to suppliers who held certificates in the England and Wales market at the time of the shortfall, but not to certificate-holding suppliers in the other markets. It is only suppliers in the affected market that contribute to the shortfall.**

74. Since the impact of the shortfall was reduced through the single recycling mechanism (because the reduced certificate prices were spread across all three markets), then (using the same assumptions as above, ie 85% of ROCs being presented in the market affected and a shortfall of £20m in the buy-out fund), only £17m need be recovered.

75. This avoids the problem of consumers in one market subsidising those in another. However it means that suppliers in the other markets suffer lower than expected recycling payments with no means of redress following a market failure in a separate power market. This may mean that some incentive for arbitrage remains.

**76. Option (ii): Under this option, the single recycling mechanism would work on the basis of the amount that should have been in the three buy-out funds had there not been a shortfall. This sum would then be the recycling value for the unaffected funds. For the fund that suffered a shortfall, the recycling payments would be reduced. Only the suppliers in the affected market pay for the shortfall. The recycling payments in the fund affected would be reduced by a larger proportion than under either Option A or B, because only that fund would bear the reduced certificate prices.**

77. This option would not eliminate arbitrage altogether as suppliers may decide to put their ROCs in the fund where there is no shortfall or a smaller shortfall.

78. *Option (iii):* **Under this option the process of mutualisation is spread over the three obligations. Suppliers in the three markets contribute to the shortfall and also receive a percentage of the amount recovered through mutualisation in return, depending on their percentage of their overall market. This option assumes that mutualisation is applied to all three Renewables obligations and does not work unless this is the case.**



## **Objective (d)**

### **The Extension of the Renewables Obligation Profile.**

#### **What is the proposal?**

79. To extend the level of the Renewables Obligation beyond 2010-11 to 2015-16 as follows:

2011/12	11.4%
2012-13	12.4%
2013-14	13.4%
2014-15	14.4%
2015-16	15.4%

80. The level of the Obligation would then remain at 15.4% from 2015-16 through to 2026-27.

81. The level of the Renewables Obligation was 3% when it was introduced in April 2002. It now stands at 4.9% for 2004-05 and will increase each year to reach 10.4% in 2010-11.

#### **Why is it being proposed?**

82. The Government announced on 1 December 2003 proposals to raise the level of the Renewables Obligation in response to calls from the renewables sector.

#### **What are the benefits?**

83. The extension of the Obligation will give further stability beyond 2010 and encourage investor confidence. This increases the probability of meeting the Government's 2010 target for renewable energy. In addition an increasing obligation provides more incentive to build renewables capacity in order to meet this target since, with a higher obligation level, there is less risk that the value of ROCs will fall as the target is reached.

#### **What are the costs?**

84. An increase in the Obligation from 10% to 15% would increase costs to electricity consumers. The size of this increase would depend on the assumed buy-out price and the amount of additional supply represented by the 5% increase in the Obligation. At the current 3p/kWh buy-out price the additional cost of electricity to domestic consumers by 2015 compared with 2010 would be around 2% and to the industrial sector about 4%. If the buy-out price were set at 4p/kWh then these price increases might be correspondingly higher at 2.5% and 5% respectively.

85. For 2003 the average annual bill for domestic customers paying by credit card was £250, by direct debit £250 and prepay £266. Bills for

domestic customers might therefore increase by £5-6 per annum by 2015 compared with what they would otherwise have been assuming an unchanged Obligation.

**What are the alternative options?**

**86. *Do Nothing:* If the Government's announced extension of the Obligation to 2016 is not put into effect by an amendment to the ROO the encouragement given to investor confidence will be undermined.**

87. Developers of renewables projects, seeking financial backing, have made the point repeatedly that they need assurance of a viable certificate price ten years ahead.

**88. *Extend the profile beyond 15.4%:*** Some of the responses to the statutory consultation on the Renewables Obligation Order 2005 suggested that the profile should be extended beyond 15.4%. This matter will be looked at in the 2005/06 Review of the Renewables Obligation.

## *Objective (e)*

### *Flexibility for small generators*

*What is the proposal?*

89. We propose to amend the Order to allow existing generating stations up to 50kW to elect for annual or monthly declarations and to switch on one occasion only per obligation period. The change can take effect only from the start of an obligation period or from the start of generation.

#### **Why is it being proposed?**

*90. Under the Renewables Obligation 2002, generators were required to produce a minimum of 0.5MWh in any one month to qualify for 1 ROC. The Obligation was amended in 2004 to permit small generating stations (up to 50kW) to accumulate output and be awarded ROCs on the basis of their annual, rather than their monthly, output. However, the effect of this provision in the Renewables Obligation (Amendment) Order 2004 is that small generators must opt for annual declarations. We are proposing to allow them to switch once at the start of each obligation period.*

#### **What are the benefits?**

91. Small generators are given a useful level of flexibility with regard to when they declare their output.

#### **What are the costs?**

92. The costs are likely to be zero or negligible.

#### **What are the alternative options?**

**93. *Do Nothing:*** If this amendment is not made small generators will continue to have to make annual declarations and are not offered any flexibility to proceed differently.

94. Allow switching between monthly and annual declarations more than once a year: *Since output of 0.5MWh or more qualifies for a ROC, more frequent changes could enable very small generators to claim more ROCs than their output justified.*

#### 4. *BUSINESS SECTORS AFFECTED*

95. Electricity suppliers and generators in the UK and, by implication, all UK consumers of electricity.

#### 5. *ISSUES OF EQUITY AND FAIRNESS*

96. The Government believes that all sectors must play their part in contributing to improving energy efficiency and reducing emissions of greenhouse gases to contribute to meeting our Climate Change targets. The Renewables Obligation is one of the main components of the UK Climate Change Programme specifically designed to assist the power sector in continuing to achieve greenhouse gas reductions. Allowing mutual recognition of NI ROCs and ROCs, introducing measures to safeguard the buy-out fund and extending the profile of the Obligation to 2016 supports this programme.

97. The proposal to have a single recycling mechanism for the 3 UK buy-out funds removes a potential source of unfairness whereby the current arrangements may offer an opportunity for a supplier with a large share of one of the smaller markets to under-present certificates there (thus forcing the recycle payments per certificate in the smaller market to rise) and to present extra certificates in England/Wales.

98. During the statutory consultation on the Renewables Obligation Order 2005 arguments were put forward that the basis of assessing suppliers' mutualisation payments should be using their share of the market at the time of recovery rather than based on market share at the time of default as proposed in the consultation document. An issue of equity and fairness arises if the payments are based on market share at the time of recovery. This is because to do so would be unfair and tend to act as a barrier to market entry as new entrants would have to make mutualisation payments from which they could not benefit. We have to have regard to protecting consumers through promoting competition and therefore cannot justify taking measures that add to existing barrier to entry.

99. The remaining measures raise no new equity and fairness issues for the energy industry or for the businesses as consumers. However, the increase in the level of the Obligation post 2010/11 will result in increases in electricity retail prices which will have a proportionately larger adverse impact on the welfare of poorer members of society who tend to spend a bigger share of their incomes on electricity than other consumers.

#### **6. CONSULTATION WITH SMALL BUSINESS: THE SMALL FIRMS' IMPACT TEST**

100. There are a number of impacts for small electricity businesses especially with regard to mutualisation. Further details are outlined below.

### **Tradeability between ROCs and NIROCs**

101. Although the cost of electricity in Northern Ireland may rise as a result of the introduction of an obligation, the costs of electricity to small firms in Northern Ireland should not increase as a result of this proposal for mutual recognition of NIROCs and ROCs. Indeed this proposal for mutual recognition should provide greater stability to the certificate market in NI, minimising fluctuations in the price of electricity in NI.

### **Measures to Secure the Buy-Out Fund**

**102. Surcharges on Late Payments:** The costs to small firms will not increase as a result of the proposal to introduce surcharges on late payments to the Renewables buy-out fund as this will only take effect where suppliers do not comply with the renewables obligation in full.

**103. Mutualisation:** DTI and the Scottish Executive have funded a study by Cornwall Consulting which looked at the impact of mutualisation. The study incorporates both quantitative methodologies and qualitative judgement. The qualitative element of the study has been facilitated by a series of interviews with key stakeholders including small business as well as written comments from those stakeholders.

104. The Cornwall Consulting study developed a financial model to look at the quantitative elements. Using the model the financial consequences of a series of scenarios for the following participants within the ROCs market were examined:

- a large supplier (60TWh);
- smaller supplier (30TWh);
- a small supplier (2TWh);
- renewables generator
- customers; and
- Ofgem as the Renewables Obligation administrator.

105. Mutualisation will have an impact on small business, but the study by Cornwall Consulting found that the final cashflow impact for suppliers of mutualisation “is expected to be marginal”, while its introduction “has a positive impact on generator cashflows”. The costs of mutualisation on smaller suppliers will depend on the extent to which those suppliers met their share of the Obligation through certificates, through payments to the buy-out fund, or a combination of the two. It will also depend on the size of the supplier’s obligation which is directly related to its share of the electricity market.

106. To take an extreme case, there will be no additional cost on those suppliers who met their share of the obligation entirely through presenting certificates. At the other extreme, the cost to smaller suppliers who met their obligation entirely through payments to the buy-out fund have been estimated on the basis of mutualisation being applied to the shortfalls that occurred in the first year of the Obligation. Based on Ofgem's report into the first obligation period, the costs to three such small suppliers would have been some £75,000, £25,000 and £1,500.

107. In addition when balancing the costs and benefits of mutualisation against the costs and benefits of shorter obligation periods Cornwall Consulting found that "under the existing application of the Renewables Obligation, introduction of shorter compliance periods would represent a major issue for a growing or new entrant supplier, and possibly a loss of capacity to grow the business to the extent it would otherwise have been able to, due to a reduction in its working capital. A change to six month obligation period would have a more adverse impact on supply competition than mutualisation and act as a barrier to entry in a market where new entry is already considered difficult."

108. The Cornwall Consulting report also notes that mutualisation offers benefits as small suppliers seeking to enter the "green" electricity market (and therefore comply with the Obligation by presenting ROCs/NIROCs) should be better able to compete since the Renewables Obligation would be more secure with mutualisation, so they can obtain the full value of recycled payments.

### **Single Recycling mechanism for the UK Buy-Out Funds**

109. The introduction of a single recycling mechanism for the UK buy-out funds will benefit large and small firms alike as it removes the opportunity for arbitrage which puts those not undertaking this practice at a disadvantage.

### **The Extension of the Renewables Obligation Profile**

110. An increase in the Obligation from 10% to 15% would increase costs to electricity consumers. The size of the increase would depend on the assumed buy-out price and the amount of additional supply represented by the 5% increase in the Obligation. At the current 3p/kWh buy-out price the additional cost of electricity to the industrial sector would be about 4%. If the buy-out price were set at 4p/kWh then this price increase might be correspondingly higher at 5%.

111. The table below highlights the potential increase to electricity bill of customers of different levels of consumption if the level of the Renewables Obligation is increased from 2010 to 2015.

	No of kWh used	Current buy-out price at 3p/kWh (4% increase)	If buy-out price rises to 4p/kWh (5% increase)	If buy-out price rises to 5p/kWh (6% increase)
<b>Consumer A</b>	100	£3.00	£4.00	£5.00
<b>Consumer B</b>	500	£15.00	£20.00	£25.00
<b>Consumer C</b>	1,500	£45.00	£60.00	£75.00

### **Flexibility for small generators**

112. The Obligation was amended in 2004 to permit small generating stations (with an generating capacity of up to 50kW) to accumulate output and be awarded ROCs on the basis of their annual, rather than their monthly, output. However, the effect of this provision in the Renewables Obligation (Amendment) Order 2004 is that small generators must make annual declarations. We are proposing the facility to switch once a year only at the start of an obligation period; since output of 0.5MWh or more qualifies for a ROC, more frequent changes could enable very small generators to claim more ROCs than their output justified.

113. A RIA was completed for the 2004 amendment order which concluded that the change would be seen as a positive move but may involve the generators in installing metering to measure output and perhaps negotiating new contract arrangements with electricity suppliers. This proposal properly puts into effect the amendments intended by the 2004 amendment order.

## **7. COMPETITION ASSESSMENT**

### **Tradeability between ROCs and NIROCs**

114. The mutual recognition proposals will allow suppliers to trade NI ROCs in a viable UK market, as opposed to being restricted to a smaller NI market. NI legislation is expected to allow GB ROCs to be traded in NI. The NI obligation will apply to the same technologies as the GB obligations do.

115. The proposals will impact on all electricity generators, and electricity suppliers operating within NI and GB.

116. We do not anticipate that there will be any significant impact on competition in any of the affected markets (beyond any that may have already resulted from introduction of a renewables obligation in the UK, or that might result from its extension to NI). The inclusion of NI in a ROCs scheme that applies to the whole of the UK should mitigate potential barriers to trade between NI and GB markets that might result were it not to be included.

## **Measures to Secure the Buy-Out Fund**

117. The measures to address future shortfalls will apply to all electricity suppliers. The impact on competition has been assessed by Cornwall Consulting's report. The key findings are that introduction of shorter obligation periods would represent a major issue for a growing or new entrant supplier. While mutualisation also increases barriers to entry (as it has the potential to increase the costs of operation), it has a lesser effect than shorter obligation periods.

118. The basis for assessing suppliers' mutualisation payments also raises competition issues. We have considered the arguments for seeking payments on the basis of a supplier's share of the fund at the time of the default, or their share at the time of recovery. We recognise that there are arguments on both sides. The main argument in favour of using market share at the time of the shortfall is that of equity – only suppliers who were in the market at the time of the shortfall were directly affected. To involve new suppliers would mean that such suppliers would contribute to the costs but would not have been directly affected by the shortfall and could not have benefited from the protection offered by mutualisation in that obligation period. In addition the levying of mutualisation payments on new suppliers who cannot benefit from them may act as a further barrier to entry. New entrants may defer their entry until after the mutualisation process is complete.

119. The main argument against this approach is that a supplier's market share may have changed substantially since the default and any supplier with a declining share would be disadvantaged and put at risk of failure through the requirement to pay on the basis of their former market share.

120. On balance, we consider that the equity and barrier to entry argument is stronger and so intend to seek payments only from those suppliers who were licensed at the time the shortfall occurred and who had an obligation.

121. There are also offsetting benefits as Cornwall Consulting found that small suppliers seeking to enter the "green electricity" market should be better able to compete in a scenario where the Renewables Obligation is secure and where they can enjoy the full value of recycling.

## **Single Recycling Mechanism for the UK Buy-Out Funds**

122. The introduction of a single recycling mechanism for the UK buy-out funds will remove the opportunity for arbitrage which puts those not undertaking this practice at a disadvantage.

## **The Extension of the Renewables Obligation Profile**

123. The extension of the profile of the Renewables Obligation should have no competition implications within the renewables sector since it provides a



common benefit to all renewables generators and suppliers. However it does not appear to benefit other generators or suppliers.

### **Flexibility for Small Generators**

124. The proposal to allow small generators to make monthly or yearly declarations presents no competition issues.

## **8. ENFORCEMENT AND SANCTIONS**

125. The 2002 Order and the Scottish Order are administered and enforced by Ofgem. Non-compliance with either Order is considered as a breach of a 'relevant requirement' of a supplier's licence and Ofgem may impose appropriate sanctions. Ofgem reports annually on the progress of the Obligation. There will be a full review of the Obligation in 2005/6.

126. Mutual recognition of ROCs in Northern Ireland and GB will be monitored by the relevant Regulator – NIAER in Northern Ireland and Ofgem in Great Britain. There is no enforcement as such as the use of NIROCs in Great Britain and GB ROCs in Northern Ireland are options for electricity suppliers rather than requirements. The appropriate issue and use of such certificates will be a matter for the Regulators.

## **9. MONITORING AND REVIEW**

127. There will be a Review of the obligation in 2005/06 and the terms of reference for the Review can be found at [www.dti.gov.uk/energy/renewables/policy/terms\\_of\\_reference.shtml](http://www.dti.gov.uk/energy/renewables/policy/terms_of_reference.shtml).

## **10. CONSULTATION**

### **Within Government**

128. DTI officials have consulted carefully with colleagues in HMT, DETI (Northern Ireland), the Scottish Executive, Ofgem, NIAER, Energy Watch, OFT, Insolvency Service and the Small Business Service on the current amendments.

129. State Aids Clearance and clearance from the Domestic Affairs Cabinet Committee has been obtained.

### **Public Consultation**

130. The DETI Northern Ireland undertook a formal public consultation, *Towards a New Energy Strategy for Northern Ireland* and the issue of mutual

recognition was included in the consultation. Feedback from this and earlier consultations on other aspects of the Renewables Obligation Order and Scottish Renewables Obligation , plus on-going discussions with the renewables industry have informed our proposals on mutual recognition. A preliminary consultation on the Northern Ireland Renewables Obligation was issued in June 2004 and a further statutory consultation in October 2004.

131. The measures to safeguard the buy-out fund have been informed by ongoing discussions with the renewables industry. The proposed extension of the Renewables Obligation to 2016 is a response to specific calls from the renewables sector to give stability beyond 2010. The proposed merger of the buy-out funds has been requested by the industry.

132. These proposed amendments have been the subject of a statutory consultation exercise. 56 responses were received from a variety of organisations including suppliers, generators, NGOs, public bodies and trade associations. There were also a number of responses from private individuals.

133. In addition to the written responses received the DTI held 2 seminars during the consultation period and met with a number of companies and trade associations to seek views and set out the Government's proposals. A further seminar was held following the end of the consultation to inform industry of the Government's decisions.

134. A summary of the responses to the Statutory Consultation is published on the DTI website at [www.dti.gov.uk/energy/renewables/policy/roo2005.shtml](http://www.dti.gov.uk/energy/renewables/policy/roo2005.shtml) .

### **How Consultation Contributed to the Policy**

135. The statutory consultation on the Renewables Obligation Order 2005 demonstrated wide support for the following proposals:

- Extending the profile of the Renewables Obligation from 2010/11 to 2015/16
- Permitting mutual recognition of NIROCs in Great Britain on the same basis as GB ROCs
- Introducing a single recycling mechanism for the three different buy-out funds
- Introducing more flexibility for small generators

136. However, on the issue of measures to secure the buy-out fund alternative proposals have been put forward in responses received to the consultation. We have considered these suggestions and in some cases amended the Government's proposed policy. These changes are detailed below.

### *Late Payments*

137. In the consultation document the Government proposed that the late payment period should run for 3 months with recycling of this fund taking place 2 months after the end of the late payment period. The majority of respondents considered the proposed duration of late payment period too long at 3 months and favoured a one month period.

138. The Government now proposes that the late payment period should run for a maximum of two months with the late payment fund being recycled earlier if possible.

### *Mutualisation*

139. *Trigger:* The consultation document proposed that the trigger for mutualisation should be 10% of the buy-out fund. Many of the responses argued that the trigger should be lower and more transparent either linked to a cash figure or the level of the Obligation. We accept these arguments and propose linking the level of the trigger to the level of the Renewables Obligation, at £1m for every 1% of the level of the Obligation. So in 2005/06, the level of the trigger will be £5.5m.

140. *Cap:* Just over half of respondents disagreed with the need for a cap. However, the majority felt that if there was a cap it should be more transparent and higher. We need to balance the need to restore confidence following a shortfall with having proper regard to the increase in costs to consumers. We therefore consider that a cap on mutualisation is necessary. However, we accept the arguments about the need for a more transparent cap. The consultation document proposed that the cap should be 10% of the buy-out fund. We are now proposing that the cap is set at £200m and linked to RPI.

141. *Timing of Mutualisation Payments:* The majority of respondents agreed with our proposal that mutualisation payments should be made over 1 year. However, most favoured quarterly payments rather than a single one. We accept the arguments for mutualisation payments to be made in quarterly instalments and have now proposed this.

142. *Shorter Obligation Periods:* 61% of respondents disagreed with the proposal not to introduce shorter obligation periods. As this issue has implications which go wider than the scope of the Statutory Consultation exercise it will be taken forward separately in the 2005/06 Renewables Obligation Review.

## **11. SUMMARY AND RECOMMENDATION**

143. The proposed amendments are intended to strengthen the Renewables Obligation and improve investor confidence.

144. We believe that the proposals for mutual recognition of NIROCs and GB ROCs, will create a bigger certificates market, with benefits for suppliers

and the renewables industry across the UK but at no additional cost to NI and GB consumers, or risk to the market. (Additional costs to the Northern Ireland consumer can be expected from the introduction of the Obligation there, rather than from the mutual recognition of ROCs and NIROCs.) Overall, the proposals support UK's progress towards the Energy White Paper renewables targets and the wider Climate Change targets to cut CO<sub>2</sub> emissions.

145. The measures to safeguard the buyout fund will mitigate the effects of a shortfall without placing undue additional burdens on consumers.

146. The extension of the Renewables Obligation profile to 2016 provides the renewables market with further stability and will encourage investor confidence.

147. The proposal to have a single recycling mechanism for the 3 UK buy-out funds will remove the possibility that advantage could be taken of arbitrage opportunities.

148. The proposal to amend the Order to allow existing generating stations up to 50kW to elect for annual to monthly declarations will provide smaller generators with more flexibility.

149. The Government intends to lay the Renewables Obligation Order 2005 so that it will come into force on 1 April 2005.

**I have read the Regulatory Impact Assessment and I am satisfied benefits justify the costs.**

**Signed by the Minister for Energy and E-Commerce**

**Mike O'Brien**

**Date**

**5th February 2005**

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## TRANSPOSITION NOTE

### THE RENEWABLES OBLIGATION ORDER 2002 (“The Order”)

1. This transposition note addresses the elements of European Directive (2001/77/EC) (OJL 283/33) on the promotion of electricity produced from renewable energy sources in the internal electricity market transposed by the Order.

2. The purpose of the Directive is:

‘to promote an increase in the contribution of renewable energy sources to electricity production in the internal market for electricity and to create a basis for a future Community framework thereof.’

**The main elements of the Directive, in doing so, set out national indicative targets for renewable energy consumption and requires Member States to address administrative and grid system issues to facilitate the achievement of those targets. It also requires Member States to ensure that the origin of electricity generated from renewable sources can be guaranteed as such through a system of certification.**

3. The Order places an obligation on electricity suppliers to sources a certain proportion of their total sales from eligible renewable sources. As such, it is one of a number of measures being undertaken by the UK Government to comply with the purpose and objective of the Directive.

4. The Order specifically addresses Article 3(1) of the Directive:

*‘Member States shall take appropriate steps to encourage greater consumption of electricity produced from renewable energy sources in conformity with the national indicative targets referred to in paragraph 2. These steps must be in proportion to the objective to be attained’*

5. Further legislation will be brought forward in due course to transpose other specific provisions within the Directive.