EXPLANATORY MEMORANDUM TO

THE RENEWABLES OBLIGATION (AMENDMENT) (ENERGY INTENSIVE INDUSTRIES) ORDER 2017

2017 No. 1289

1. Introduction

1.1 This explanatory memorandum has been prepared by the Department for Business, Energy and Industrial Strategy and is laid before Parliament by Command of Her Majesty.

1.2 This memorandum contains information for the Joint Committee on Statutory Instruments.

2. Purpose of the instrument

2.1 This instrument makes statutory provision for exempting eligible Energy Intensive Industries (EIIs) from a proportion of the indirect policy costs of the Renewables Obligation (RO) scheme[1]. The RO scheme is a policy designed to encourage investment in large scale renewable electricity generation to contribute to meeting the UK's EU target to produce 15% of our energy from renewable sources by 2020 and low carbon goals. However, the costs of funding this policy expose EIIs to high electricity bills. As EIIs operate in international markets, these costs place them at a competitive disadvantage and increase the risk of investment leakage through businesses choosing instead to make investments in countries with less ambitious climate policies.

2.2 This instrument seeks to exempt eligible EIIs from a proportion of these costs by making adjustments to the supplier obligation mechanism under the RO.

3. Matters of special interest to Parliament

Matters of special interest to the Joint Committee on Statutory Instruments

3.1 We consider that that the exception in section 28(3)(a) of the Small Business, Enterprise and Employment Act 2015 applies to this instrument. This is because article 7 of the Renewables Obligation Order 2015[2] ("the 2015 Order") which is amended by article 3 of this instrument imposes a requirement on suppliers in England and Wales to produce a certain number of Renewables Obligation Certificates ("ROCs") to the Gas and Electricity Markets Authority, Ofgem ("the Authority") or make a payment by 1 September following an obligation period. The cost this imposes on suppliers is passed onto bill payers who do not have a choice as to whether they make this payment – it is compulsory. On this basis the RO has been classified as a notional or imputed tax by the Office for National Statistics and as a result, it is subject to the Levy Control Framework.

3.2 This instrument is intended to come into force on the day after the day on which it is made. This is to ensure that it comes into force as far ahead as possible of 1 January

[1] We estimate that the average value of the exemption over the ten years of the policy is around £360m per annum (2016 prices, central estimate, RO only).

[2] S.I. 2015/721, as amended by S.I. 2016/457, S.I. 2016/992, S.I. 2016/1108 and S.I. 2017/1234.

2018, which is when the exemption is intended to take effect (subject to Parliamentary approval). This is intended to give EIIs and electricity suppliers certainty about the legal framework for the introduction of the exemption.

3.3 The RO places an obligation on licensed electricity suppliers to submit the relevant number of ROCs to the Authority for each megawatt hour (MWh) of electricity that they supply during a specified period known as an obligation period (which runs from 1 April to 31 March each year), with the obligation being set six months ahead of the start of each obligation period (by 1 October). Implementing the exemption from 1 January 2018 entails adjusting the obligation for the 2017/18 obligation period (running from 1 April 2017 to 31 March 2018), which was published on 1 October 2016[3]. To provide certainty and notice to EIIs and suppliers, it is important to announce the adjusted obligation level as soon as possible ahead of the introduction of the exemption. This will ensure that the necessary guidance and administrative processes are in place to administer the exemption and that suppliers, especially smaller independent companies, have a chance to adapt their systems. The underlying policy has been the subject of consultation, as described in section 8 below.

Other matters of interest to the House of Commons

3.4 This entire instrument applies only to England and Wales.

3.5 In the view of the Department, for the purposes of House of Commons Standing Order 83P the subject matter of this entire instrument would be within the devolved legislative competence of the Northern Ireland Assembly if equivalent provision in relation to Northern Ireland were included in an Act of the Northern Ireland Assembly as a transferred matter.

4. Legislative Context

4.1 The RO is provided for in relation to England and Wales by the 2015 Order and in relation to Scotland by the Renewables Obligation (Scotland) Order 2009[4]. There is also an RO in Northern Ireland, which is provided for by the Renewables Obligation Order (Northern Ireland) 2009[5]. These complementary Renewables Obligation orders together in effect create a UK-wide RO.

4.2 This instrument makes a number of amendments to the 2015 Order to provide the legislative basis for exempting eligible EIIs from a proportion of the indirect costs of the RO scheme (the RO exemption). In particular, the Order:

- makes changes to the methodology for calculating the obligation, and to the scope of the obligation, to take account of the amount of electricity likely to be supplied to eligible EIIs during an obligation period; and
- imposes additional obligations on electricity suppliers to provide information about the supply of electricity to eligible EIIs to the Authority.

4.3 Eligibility for the RO exemption is intended to reflect eligibility for a related exemption which is provided for, in respect of the Contracts for Difference (CFD) scheme, by the Electricity Supplier Obligations (Amendment & Excluded Electricity)

[3] It will also entail adjusting the obligation level for the 2018/19 obligation period (running from 1 April 2018 to 31 March 2019) – see section 7.15 for further details.
[4] S.S.I. 2009/140.
[5] S.R. 2009/154.

Regulations 2015[6] ("the 2015 Regulations"). The CFD scheme is a policy designed to encourage investment in large scale renewable generation by providing market stability and the 2015 Regulations provide for eligible EIIs to be exempted from a proportion of the indirect costs of that CFD scheme. Alongside this instrument, the Government is seeking to make a number of changes to the 2015 Regulations through the Electricity Supplier Obligations (Amendment & Excluded Electricity) (Amendment) Regulations 2017 which were laid in draft on 28 March 2017 before Parliament was dissolved, and the subject of a continuation motion in this Parliament on 22 June 2017[7].

5. Extent and Territorial Application

5.1 The extent of this instrument is England and Wales.

5.2 The territorial application of this instrument is set out in Section 3 under "Other matters of interest to the House of Commons".

5.3 The RO exemption is intended to be implemented on a Great Britain basis. An Order making equivalent provision in relation to the RO in Scotland is expected to be laid before the Scottish Parliament in parallel with this instrument[8]. The RO exemption scheme will not be introduced in Northern Ireland from the outset. However, it may be extended to Northern Ireland from a future date, subject to Ministerial direction to consult on making equivalent changes to the Northern Ireland RO. Any legislation to implement an exemption in respect of the RO in Northern Ireland would be made by the Northern Ireland Department for the Economy.

6. European Convention on Human Rights

6.1 The Minister of State for Climate Change and Industry has made the following statement regarding Human Rights:

"In my view the provisions of the Renewables Obligation (Amendment) (Energy Intensive Industries) Order 2017 are compatible with the Convention rights".

7. Policy background

How the RO works

7.1 The RO was introduced in 2002 as the Government's main policy measure to incentivise the deployment of large-scale renewable electricity generation. It plays a major role in helping the UK meet its target under the Renewables Directive to obtain 15% of energy from renewable sources by 2020.

7.2 The RO places an obligation on licensed electricity suppliers. Suppliers must produce, by a specified day, a certain number of ROCs in respect of each MWh of electricity supplied during an obligation period. This number – called 'the obligation level' – is set six months ahead of the start of each obligation period.

7.3 The RO is administered by the Authority, who issue ROCs to generators accredited under the scheme in relation to the renewable electricity they generate and the

[6] S.I. 2015/721.
[7] This reflects the position at the time this instrument was laid in draft. The Electricity Supplier Obligations (Amendment & Excluded Electricity) (Amendment) Regulations 2017 have since been made – S.I. 2017/1051.
[8] This reflects the position at the time this instrument was laid in draft. The Renewables Obligation (Scotland) Amendment Order 2017 has since been made – S.S.I. 2017/432.

technology type. Generators can sell ROCs to suppliers or traders, with or without the electricity generated, as tradable commodities. Their value is a matter for negotiation between the generator and supplier/trader. Suppliers present ROCs to the Authority to demonstrate their compliance with the obligation. Suppliers failing, or choosing not, to present enough ROCs to meet their obligation make a payment per ROC into a buy-out fund. The money collected by the Authority in the buy-out fund is recycled on a pro-rata basis to suppliers who presented ROCs, after the Authority's administration costs have been deducted. Suppliers pass on the costs of meeting the obligation to domestic and business electricity users through their bills.

Impact of RO on EIIs

7.4 EIIs are those businesses in sectors where electricity costs are a high proportion of their Gross Value Added (which is a measure of the value of the goods and services they produce). The costs of the RO are passed through in bills to EIIs from energy suppliers and, as they operate in global markets where commodity prices are set internationally, they are often unable to pass these costs through to the end customer. Therefore EIIs that face higher electricity costs are placed at a competitive disadvantage. Typical EIIs in the UK include chemicals, steel, cement, aluminium, glass, paper, plastics and ceramics.

Objectives of the EII RO exemption

7.5 A compensation scheme for eligible EIIs for the policy costs arising from the RO and Feed-in Tariffs (FITs) schemes, funded by the then Department for Business, Innovation and Skills, opened in January 2016[9]. In respect of the RO, we are proposing to move from compensating to exempting eligible EIIs from up to 85% of the policy costs of the scheme, in order to improve long term investment certainty for EIIs (as the exemption will provide real-time support and will not be contingent on Departmental budgets, which can fluctuate). This increased certainty can lower production costs and thereby help maintain competitiveness of EIIs, which could reduce the risks of investment leakage and may, in turn, have beneficial impacts on output and employment. This move will also reduce Government spending and is in line with Government's long term economic plan. The costs of the RO exemption (valued at around £200m per year over 2017/18 to 2027/28 in 2016 prices) for EIIs will be redistributed to non-eligible domestic and business users, increasing their bills between 2017/18 and 2027/28:

- for the average dual fuel household, this is likely to be an increase of around £2.3 per year;
- for electricity-only households, this is likely to be an increase of around £3.9 per year;
- for a small business energy user, this is likely to be an increase of around £160 per year;
- for a medium-sized business energy user, this is likely to be around £6,700 per year; and
- for a large-sized business energy user, this is likely to be around £62,900 per year.

All estimates are in 2016 prices and based on the central case scenario.

[9] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/620636/compensation-indirect-costs-renewables-obligation-small-scale-feed-in-tariffs-guidance.pdf

Implementation of the EII RO exemption

7.6 To implement the RO exemption, changes are required to (i) the methodology for calculating the obligation level and (ii) the scope of the obligation to take into account the volume of electricity supplied to eligible EIIs ("EII excluded electricity").

7.7 The methodology for setting the obligation level in respect of electricity supplied in England and Wales is set out in Part 2 (articles 7 to 13) of the 2015 Order. This requires the Secretary of State to carry out two specified calculations (referred to as Calculation A and Calculation B) to determine the total obligation[10] (in terms of number of ROCs) and then carry out a further calculation to determine the obligation level that applies to electricity supplied in England and Wales (in terms of ROCs per MWh supplied). The RO in Scotland contains identical provisions for the calculation of the obligation in respect of electricity supplied in Scotland, which when combined with the provisions in the 2015 Order enable us to set a single obligation level for Great Britain.

7.8 To implement the exemption we do not intend to change the methodology for calculating the total obligation, but this instrument provides for adjustments to be made to the way that we calculate the obligation level to reflect the fact that it will be applied to a narrower consumption base (i.e. it will not apply to up to 85% of electricity supplied to eligible EIIs). The Scottish Government are intending to make equivalent changes in respect of the RO in Scotland that will enable us to continue to set the obligation level on a Great Britain basis after the exemption is introduced.

7.9 These changes to the calculation of the obligation level will result in a proportionately higher obligation for non-EII excluded electricity to offset the exemption. It will ensure that the availability of ROCs continues to match demand, and therefore will not affect the value of the ROC nor the operation of the ROC market.

7.10 The second stage of implementation of the RO exemption involves changing the scope of the obligation to exclude EII excluded electricity. This means the obligation level (ROCs/MWh rate) for electricity supplied in England and Wales will be applied to:

- 100% of electricity supplied by licensed electricity suppliers to non-EIIs;
- at least 15% of the electricity supplied by licensed electricity suppliers to eligible EIIs (whilst in most cases we expect EIIs will be eligible for the full 85% exemption, there may be cases where the level of relief is lower).

7.11 Again the Scottish Government intends to make equivalent changes in respect of the RO in Scotland.

7.12 This instrument also includes a new requirement for licensed electricity suppliers to submit information to the Authority and the Secretary of State on the volumes of electricity supplied to eligible EIIs as part of the RO's end of year supplier compliance process (in addition to the information they already provide on total volumes of electricity supplied to all customers).

7.13 It is our intention that the exemption will come into effect in Great Britain from 1 January 2018, subject to State aid clearance[11] and Parliamentary approval of this instrument and publication of a revised obligation level to take into account the

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[10] the **"total obligation"** means the total estimated demand for ROCs in the UK during an obligation year.

[11] State aid approval was granted on 12 June 2017 – Commission case number SA45155.

changes needed to implement the exemption. As required under the 2015 Order, we published on 1 October 2016 the obligation level for the 2017/18 obligation period, calculated in accordance with the current methodology (i.e. not taking into account the changes needed to implement the exemption)[12] . This obligation level will apply from 1 April 2017 until the exemption comes into effect. We have published, as part of the Government Response to the consultation on this policy (referred to in section 8 below), an estimate of how the 2017/18 obligation level would be adjusted to account for the EII exemption. Assuming the necessary approvals are received, we intend to publish a revised 2017/18 obligation level which has been calculated in accordance with the exemption methodology.

7.14 If the implementing legislation has not come into force and the revised version of the 2017/18 obligation level has not been published by 31 October 2017, the exemption will not come into effect from 1 January 2018. In this case, we intend to bring it into force from the start of the fourth month after we have received approvals and published a revised obligation level. For example, if we publish the revised obligation level before the end of November 2017, this would mean it would come into effect from 1 March 2018.

7.15 Introducing the exemption will also entail adjusting the obligation level for the 2018/19 obligation period (running from 1 April 2018 to 31 March 2019). The 2018/19 obligation level will be calculated in accordance with the current methodology (i.e. not taking into account the changes needed to implement the exemption) and will be published by 1 October 2017. To aid understanding and provide advance notice, when we publish the 2018/19 obligation level, we will also provide an estimate of how the 2018/19 obligation level would be adjusted to account for the EII exemption[13]. We then intend to publish the final revised 2018/19 obligation level alongside the revised 2017/18 obligation level.

7.16 The RO exemption is intended to be available to the same EIIs that are eligible for the CFD exemption. Administration of the RO exemption, including the EII application and certification process, will be carried out through processes set up in respect of the CFD exemption.

Consolidation

7.17 This is the fifth amendment to the 2015 Order. No consolidation of the Order is proposed at this time.

8. Consultation outcome

8.1 A consultation[14] on implementing the RO (and FITs) exemption ran for eight weeks between 1 April 2016 and 27 May 2016. It looked in detail at the changes that would need to be made to the operation and administration of the RO (and the FIT) scheme.

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[12] The Renewables Obligation for 2017/18-Calculating the Level of the Renewables Obligation for 2017/18 (October 2016) at: https://www.gov.uk/government/publications/renewables-obligation-level-calculations-201718

[13] This reflects the position at the time this instrument was laid in draft. The obligation level for the 2018/19 obligation period has since been published - https://www.gov.uk/government/publications/renewables-obligation-level-calculations-201819

[14] Consultation on implementing an exemption for Energy Intensive Industries from the indirect costs of the Renewables Obligation and Feed-in Tariff Schemes (April 2016) at; https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/513029/EII_condoc_20160401.pdf

We received 69 responses to the consultation from EIIs, energy suppliers, consumer groups, non-eligible businesses and individuals. Feedback was also collected through stakeholder events (in London and Cardiff) and meetings with interested groups.

8.2 The majority of respondents who replied to the 6 specific questions on the RO agreed with the proposals for implementing the RO exemption through changes to the methodology for calculating the obligation level and to the scope of the obligation. One respondent suggested an alternative methodology for calculating the obligation level. We concluded that this would be an equally robust but slightly more straightforward option than that originally proposed, so have decided to adopt this approach. The majority of respondents also agreed with the proposals for requiring suppliers to provide the Authority with additional information on the volumes of electricity supplied to eligible EIIs as part of the end of year RO compliance process.

8.3 Several respondents, mainly suppliers, were concerned about the speed at which the exemption was being introduced and the uncertainty resulting from the fact that the obligation level for the 2017/18 obligation period, published on 1 October 2016, would be revised to account for the exemption, with potentially little notice, ahead of 1 April 2017 (the date initially proposed in the consultation for introduction of the exemption). It was suggested that this uncertainty would make forecasting policy costs very difficult and could result in risk premia being added to bills. Having reviewed these points, Government's assessment is that it remains essential to bring the exemption into force as soon as practicable in order to provide long term certainty to the EIIs and to support their competitiveness.

8.4 To mitigate the uncertainty for suppliers and other non EII electricity customers we have published, in the Government Response to the consultation, details of how we would expect the obligation level for the 2017/18 obligation period to change if it had been calculated in accordance with the revised exemption methodology. It is our firm intention to bring in the exemption from 1 January 2018 if the legislation is passed such that we are in a position to publish a revised 2017/18 obligation level by 31 October 2017. However, we have also decided that we do not intend to bring in the exemption from 1 January 2018 if the implementing legislation has not come into force and an adjusted 2017/18 obligation level has not been published by 31 October 2017. In this case, we have provided for a lead in time of at least 3 months before the exemption takes effect.

8.5 This instrument implements the decisions set out in the Government Response to the consultation published on 19 July 2017[15]. The consultation set out proposals for implementing an exemption for EIIs from the indirect costs of the RO and FIT schemes. The Government response relates to implementing an exemption for EIIs from the indirect costs of the RO scheme only. We will respond on implementing an exemption for EIIs from the indirect costs of the FIT scheme in due course.

8.6 Several wider issues were raised by respondents including concerns about the impact of the exemption on consumer bills and fuel poverty, and requests to introduce new legislation to make it mandatory for suppliers to pass through savings to EIIs. Responses to these points are set out in the Government Response but do not impact on this draft instrument.

[15] https://www.gov.uk/government/consultations/implementing-an-exemption-for-energy-intensive-industries-from-the-indirect-costs-of-the-ro-and-the-fits

8.7 We also received responses from the trade associations and companies in the glass, ceramics and cement sectors, in particular, which called for a widening of eligibility for the exemption to direct competitors of EIIs to address competitive distortions within their respective sectors. We submitted a State aid notification to the European Commission with a proposal to provide State aid to direct competitors in December 2015, however, we currently do not have European Commission approval for the approach set out in the proposal. We are therefore considering options that may be available to us within the scope of the 2014 environmental and energy State aid guidelines. Resolving the issue depends on appraisal of alternative options, which may lead to a revision of our State aid notification and further discussions with the European Commission to obtain State aid approval.

9. Guidance

9.1 The Authority, as administrator of the RO, intends to publish draft guidance on the implementation of the exemption for consultation[16]. A final version of the guidance will then be made available once this instrument comes into force.

10. Impact

10.1 The impact on eligible EII businesses will be an exemption from a proportion of the indirect costs of RO through their electricity bills which will save an average EII over £3.2m[17] per annum by 2027/28 (in 2016 prices). All other electricity users including charities or voluntary bodies, households, non-eligible EIIs and other business users will cover the costs of this exemption through rises in their electricity bills. Indicative annual costs by 2027/28 are summarised in section 7.5 above.

10.2 The impact on public sector electricity users will be as set out for all other electricity users in paragraph 10.1 above.

10.3 We recognise that the Government's business level test[18] may lead to intra-sectoral competitive distortions where one company qualifies for aid, but its direct competitor does not. We submitted a State aid notification to the Commission with a proposal to provide State aid to direct competitors in December 2015. As mentioned in paragraph 8.7, we are considering options within the scope of the 2014 environmental and energy State aid guidelines.

10.4 Introduction of the exemption will result in some additional administrative costs to energy suppliers and to the Authority. There is a small impact on fuel poverty as well as a potential short term impact on the competitiveness of non-exempt business and energy suppliers.

10.5 An Impact Assessment on the impact of the RO exemption is submitted with this memorandum and will be published alongside the Explanatory Memorandum on the legislation.gov.uk website.

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[16] This reflects the position at the time this instrument was laid in draft. Draft guidance for suppliers has since been published for consultation on the Ofgem website - https://www.ofgem.gov.uk/publications-and-updates/draft-renewables-obligation-guidance-suppliers

[17] This assumes an average annual consumption of 220GWh, a pre exemption RO cost of £17.4/MWh and an RO post-exemption cost of £18.2 MWh (2016 prices).

[18] Individual businesses need to show that their implied mean electricity costs amount to 20% of their mean Gross Value Added (GVA)

11. Regulating small business

11.1 The legislation applies to small businesses as it is expected that some suppliers and EIIs could fall into this category. However, the RO does not apply to unlicensed electricity suppliers.

11.2 We expect eligible EIIs to benefit from the exemption primarily through suppliers passing on their reduced RO payments via the setting of lower electricity prices.

11.3 Overall, we do not expect that this instrument will have a disproportionate effect on small suppliers in the medium to long term as we expect that they will pass the additional costs of the exemption onto their customers. However, in the short term it may be difficult for some smaller suppliers with a high proportion of customers on fixed term tariffs to manage these increased costs. This could affect their competitiveness.

11.4 To minimise the impact of the requirements on firms employing up to 50 people, we have taken an approach which aims to balance the benefits to eligible EIIs of introducing the exemption as soon as practicable with the need to provide as long a lead in time as possible to give some certainty to suppliers and other business. We have also decided that where possible, processes already in place for the CFD exemption will be used to administer the RO exemption, so that duplication is avoided.

11.5 The final decision on what action to take to assist small business was based on analysis of the consultation responses.

12. Monitoring & review

12.1 A review of the RO exemption policy is planned for January 2023.

13. Contact

13.1 Julie Whiting at the Department for Business, Energy and Industrial Strategy (Tel: 0300 068 6194 or email: julie.whiting@beis.gov.uk) can answer any queries regarding the instrument.