REA Response to Renewables Obligation: changes to mutualisation arrangements, BEIS Consultation

Background

This BEIS consultation is regarding changes to the Renewables Obligation (RO) mutualisation arrangements – the issue impacts RO registered renewable power generators (the scheme is now closed to new entrants) and licenced energy suppliers large enough to be eligible for participation in the scheme. REA submit a high-level response to this consultation below raising key concerns and questions.

The RO features a mutualisation mechanism which recovers obligations which have not been met from other suppliers once they collectively exceed a threshold (currently fixed at £15.4m). The threshold was created to avoid the administration of applying the mutualisation process for small amounts. However, whilst the administrative burden is not linked to the size of the RO, the threshold was linked to the fixed trajectory of the RO targets (as 1%) so grew each year until 2015. Since then it has remained at £15.4m, while the cost of administration is much lower than this. The cost of the RO is around £6bn per annum.

Supplier RO payment default has emerged in the past few years: In 2017/18, 12 suppliers defaulted (on £53.4m), in 2018/19 it was 21 suppliers (and £88.1m) and in 2019/20, it was 13 suppliers and £31.4m.

BEIS propose to re-establish the link to 1% of the RO market value, creating a new threshold for 2022/23 of £64M. Each generator is currently exposed to ca. £0.15/ROC of value loss before mutualisation kicks in. The proposed increase to the mutualisation threshold will increase this to £0.64/ROC.

This would mean a retrospective change to the scheme and a loss of value to generators that will be permanent – although a small amount relative to the total ROC values, this is **a retrospective change of the type a 'grandfathered' policy should not deliver**.

The call for evidence goes further. Currently if mutualisation is triggered the full shortfall is recovered. BEIS proposes that this be limited to just the value above the threshold. While recognising that this could create an administrative burden of applying the mutualisation process for di minimis amounts, they also propose a threshold above the current level.

<u>Impact on Generators</u>

The impact on generators would be the difference between the existing threshold (£15.4m) and the new proposed threshold (£62.1m):

"Government's proposal to link the threshold to scheme cost would increase this to a possible 55p per ROC (determined as the new threshold of £62.1m divided by the 2020/21 ROC forecast of 112.9m ROCs). This is equivalent to an increase from about 0.25% to 1% of the £55 "notional value" of a ROC5. For further context, we note that recycle payments have varied between £0 and £7.82 per ROC since 2011"

So taking 2020/21 as an example a generator would have received 41p/ROC less (55p - 14p) and this would increase year on year based on the 1% mutualisation threshold.

REA response

These proposals reallocate risk towards generators, but do not address the underlying issue of energy suppliers defaulting on their RO payments due to the long period provided between payments (falling annually).

In 2027 the scheme will move to fixed price ROCs – as this means a quarterly redemption process will be adopted then, many of our members believe more frequent supplier redemption periods beong put in place immediately, alongside changes in the Ofgem Supplier Review could address this.

This crucial issue is not considered in the consultation or call for evidence, despite the fundamental impact it has on the mutualisation regime and wider sector.

Our key concerns:

- The proposals put at risk the grandfathering of the scheme (i.e. that retrospective changes should not be made) which was always understood to be the case following scheme closure.
- Creating a new threshold of c.£64M for the threshold is disproportionate as the threshold was created to avoid the administrative burden of applying the mutualisation process for di minimis amounts. The cost of the administration is not linked to the size of the ROC market and as set out in the BEIS consultation is significantly smaller than the proposed 1% link.
- The proposal increases the annual cost of suppler default on RO generators with absolutely no way for RO generators to recover those costs and when taken with other policy changes since scheme closure (ie the TCR and LEC exemption removal) adds up to a material loss of income for such RO genrators (from up to £0.15/MWh to up to £0.64/MWh from the ROC change).
- The proposed solutions simply move the risk from suppliers to generators, they do not address the underlying structural problem of supplier default. Under the proposals consumer money would continue to be lost from the system, with some newer entrant, perhaps under capitalised suppliers not engaging with the ROC market and often defaulting on the final payment. The annual cycle of the RO leads to suppliers accruing a very large liability and multiple suppliers failing at the same point in the annual cycle, creating problems for Ofgem and the Supplier of Last Resort process.
    - The cost of administering the scheme is around £5m annually. This cost is recovered from the buyout fund and therefore feeds through to the generators as a reduced ROC price. Only a fraction of this cost relates to the ROC

redemption process, however even if it was 50% of the cost a quarterly redemption would create a administration consideration to generators of just £10Mp.a. against the proposed £64Mp.a. exposure.

- Government is committed to introducing quarterly redemption periods before 2027, to enable Fixed Price ROCs - introduction now could both address the supplier default issue and be a first step in that transition.
- The annual reconciliation of the RO is currently out of line with the FiT and CfD mechanisms, both of which require quarterly reconciliations. Therefore a move to quarterly redemptions would also align and simplify procedures for suppliers,

Conclusion

There must be an enduring solution adopted for the supplier default issue and this could either be for more frequent RO redemption periods, as the scheme has to move to quarterly redemption periods before the implementation as planned of fixed price ROCs, or for suitable new supplier provisions to be considered in the Ofgem Energy Supplier Review.

Our members are also concerned regarding the shifting of risk from suppliers onto generators and the subsequent depression in ROC values – something which could be seen as a retrospective change, in contradiction to the established grandfathering of the RO mechanism.

Our members believe a move to quarterly RO redemption, if adopted, could create a cost to generators of just £10m per year, compared to the proposed £64m each year exposure under the proposals and therefore the consumer could save and the market benefit, from such a change.

REA, January 2021