National Audit Office

Report
by the Comptroller
and Auditor General

Department of Energy & Climate Change

Early contracts for renewable electricity

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Summary

1 The Department of Energy & Climate Change (the Department) implements energy policy, with three main objectives:

- provide a secure energy supply;
- decarbonise the energy supply; and
- ensure affordable energy for consumers.

2 The Department is responsible for achieving UK climate change commitments. The UK is committed under an EU directive to ensuring that 15 per cent of the energy it uses comes from renewable sources by 2020. To meet this commitment the Department estimates that in 2020 at least 30 per cent of UK electricity needs to come from renewable sources. The Climate Change Act 2008 also commits the government to reduce UK greenhouse gas emissions in 2050 by at least 80 per cent from 1990 levels.

3 To help achieve these objectives, the Department has used the Renewables Obligation to encourage investment in renewable generation. The scheme requires electricity suppliers to pay for Renewables Obligation Certificates. These give renewable generators a premium over the wholesale price for each unit of electricity they supply.

4 As part of its plans for electricity market reform the Department is establishing the Contracts for Difference scheme to replace the Renewables Obligation. Contracts for Difference will set a price for the electricity low carbon generators generate (known as the 'strike price'). A newly formed 'Counterparty Body' will pay generators the difference between the market price and the strike price for the electricity they generate, where the strike price is higher. If the market price is higher than the strike price generators will pay the difference to the Counterparty Body. To enable it to make payments, the Counterparty Body is funded by electricity suppliers which may pass their costs on to consumers. The Department expects to award the first contracts under the main Contracts for Difference regime in December 2014. The Renewables Obligation will close to new projects in April 2017.

5 While developing the main Contracts for Difference scheme in 2011, the Department recognised that developers of low carbon electricity plants, particularly of new nuclear power stations, might delay final investment decisions until they could receive a contract in late 2014. It therefore included in the 2012 Energy Bill the potential for the Secretary of State to award early contracts for difference to enable developers to take these final investment decisions as soon as possible.

6 In March 2013, the Department launched a distinct scheme to award early contracts to renewable generation projects at risk of delay. This scheme was called Final Investment Decision enabling for Renewables (FIDeR). The Department received 57 applications for FIDeR and signed contracts with eight projects in May 2014, subject to European Commission state aid approval. Two of the contracts are for power plants converted from burning coal to biomass, five are for offshore wind farms and one is for a purpose built biomass plant providing heat as well as power.

Scope

7 Our audit addresses the value for money of the contracts awarded under the FIDeR scheme. We evaluated the FIDeR scheme on the following criteria:

- Were the Department's rationale and selection of projects, to award contracts, clearly defined and informed by robust evidence?
- How well has the scheme met the Department's objectives, and achieved good value for money for consumers?

Our methodology is set out in Appendix One.

Key findings

8 The Department's early contracts are part of its transition to a reformed UK electricity market, designed to attract investment in low carbon generation while offering improved value for money and better cost control. Contracts for difference under the full electricity market reform regime will be available to nuclear and fossil fuel plants with carbon capture and storage as well as renewables. They should offer better value for money than the existing Renewables Obligation, primarily by guaranteeing the price for each unit of electricity generated which should lower financing costs. For industry the change involves transition from automatic entitlement for Renewables Obligation support for eligible projects, to applying for contracts awarded from a set budget. This gives the Department better control over the costs of support. Early contracts are a component of the transition to this reformed electricity market (paragraphs 1.5 to 1.7).

9 The Department consciously chose to seek applications before deciding how much renewable generation it wanted from early contracts or whether to cap the budget it would allocate to them. The Department announced its intention to provide transitional support arrangements in 2011. It launched the scheme in March 2013 to identify the projects that industry considered were at risk of an investment hiatus, making clear that it was making no firm commitment as to the scale of the scheme. At this stage the Department was aware that if all projects which had expressed interest were awarded early contracts, this could commit nearly half the available budget for renewables contracts for difference in 2020. The Department did not determine how much capacity it was seeking from the scheme, nor did it set a budget at this stage. It set the budget for the scheme in November 2013 to enable contracts to be given to the top quarter of qualifying projects in each technology (paragraphs 2.5 to 2.9).

10 **The early contracts for eight projects have given those developers certainty of support at least five months earlier than under the full Contracts for Difference regime.** The Department's rationale for the scheme was to prevent a hiatus in investment in renewable electricity, enabling developers to take significant or final investment decisions ahead of the full Contracts for Difference regime, the timing for which was uncertain. When the Department invited applications in March 2013, it expected to award early contracts in autumn 2013, a year ahead of the first contracts under the full regime. But the Department subsequently delayed awarding early contracts until April 2014. If the European Commission gives state aid approval for early contracts for the eight projects in July 2014, their developers will be certain of consumer funded support at least five months before award of contracts under the first round of the full regime, currently planned for December 2014. Developers' binding applications stated that without early contracts their projects would be cancelled or delayed by at least 12 months and in one case 24 months (paragraphs 3.2 to 3.5).

11 **The Department's assessment of applications tested risks of delay or cancellation, prospects of timely delivery, contributions to development of renewable technology, and affordability.** The Department reviewed applicants' statements of the risks to their projects if they did not get an early contract. The Department used its own staff and those from the Department for Business, Innovation & Skills and external consultants to score projects on deliverability and contributions to development of renewable technology. The Department's heads of specialism then moderated those scores. The Department's process obliged it to award contracts to all projects it judged eligible and affordable (paragraphs 2.13 to 2.22).

12 **We estimate that the early contracts have committed up to £16.6 billion or 58 per cent of the funds available for renewable contracts for difference to 2020-21. This has given the UK's renewables industry greater confidence in the near term but increased the risk of obtaining support for later projects.** Early contracts have given certainty of support to a range of projects and investors in offshore wind and biomass. They are likely to have helped secure other projects' progress and supply chain jobs and investment, including Siemens' investment in wind turbine production and installation facilities in Yorkshire, valued at £160 million. They have also proved the commercial viability of contract terms and conditions for major renewables developers. But the scale of the early contracts has increased the risk for later investors of not getting support (paragraphs 3.9 to 3.12).

13 **The early contracts support generation which will help meet the UK's 2020 renewable energy targets, but it is not clear that the full scale of these commitments was needed so soon.** The early contracts can provide 5 per cent of total electricity in 2020, though developers may reduce their initially planned capacity by up to 36 per cent without penalty. It is possible that the combination of capacity already operating or with planning consent, and early contracts would more than meet the total capacity from wind and biomass conversion that the Department considers necessary by 2020 to meet the renewables target. But this will depend on attrition rates for projects with planning consent. Even had some capacity been lost or delayed because it did not receive an early contract, the Department might still expect to meet its targets (paragraphs 3.6 to 3.8).

14 **The early contracts have been awarded with administratively set strike prices which may provide higher returns than needed to secure the investment.** The Department set the strike prices to align them with the support available under the Renewables Obligation drawing upon independent advice and reduced strike prices for five technologies following public consultation. The Department considered these prices represented value for money because at that stage they were the same prices it expected to set for the full Contracts for Difference regime. However, administratively set prices may be higher than needed because:

- The Department set strike prices for early contracts at a level designed to encourage the investment needed to meet its decarbonisation objectives. Strike prices are set for each technology rather than negotiated with individual projects. They are designed to offer an acceptable return to the most expensive viable project (the marginal project) needed to meet decarbonisation objectives (paragraphs 3.14 to 3.17).
- Developers are likely to progress those projects offering the most promising returns first, so these early projects may well be those that will benefit most from administrative prices (paragraph 3.14). The Department did not ask for information on estimated project costs and returns, for its own evaluation, since it was not setting project-specific strike prices. It sought that information from applicants to enable the European Commission to consider the risk of over-remuneration as part of its 'state aid' review. The Department has not required contract holders to give information about actual costs and returns (paragraph 3.28).
- The Department offered the same strike price to all phases of offshore wind projects, denying consumers the opportunity to share in any benefit for developers as technological innovation reduces costs. Developers of offshore wind projects have stated that they undertake procurement for all phases of a project at the start of the first phase and do not expect to benefit from cost reductions in later phases (paragraph 3.19).
- The Department has not included provisions to clawback a share of any excessive returns in early contracts. It considered that to do so might deter prospective investors (paragraph 3.27).

15 **The Department's decision to award up to £16.6 billion of early contracts without price competition limits the budget available for later allocation rounds that can use price competition.** The Department proceeded with the scheme while recognising that it did not bring a clear monetised benefit and acknowledging that competitive pricing might reveal subsequently that some administratively set strike prices were too high. It considered early contracts would bring wider benefits to the industry; and the contracts were designed to offer better value than the Renewables Obligation. The Department told us it now expects to apply price competition to up to 40 per cent of the total budget for contracts for difference for renewables between now and 2021 (paragraphs 3.31 to 3.33).

16 The contracts contain provisions that require active management to protect value for money for consumers. Their design includes provision for adjusting strike prices, validating power output, and reviewing measures of market prices. The Counterparty Body which will manage these contracts is currently being formed. Under a Framework Agreement, the Department will require the Counterparty Body to "seek to maintain investor confidence in the Contracts for Difference regime and minimise costs to the consumer." Active and effective management of these provisions is essential to ensure contract costs are minimised for consumers (paragraphs 3.23 to 3.25).

Conclusion on value for money

17 Early contracts for renewables have helped industry confidence in the near term and the projects they support can make a significant contribution to meeting the UK's 2020 renewable energy target. The contracts themselves are designed to offer better value for money than the Renewables Obligation they replace. But the contracts have been awarded without price competition and with administratively set strike prices which may provide higher returns than needed to secure investment. We are not convinced that it was essential to award so much consumer support to early contracts in order to meet the 2020 renewables target. Awarding so many early contracts of this scale in this way has limited the Department's opportunity to secure better value for money through competition under the full regime which will start to award contracts in December of this year. The value from the early contracts is in part the learning they can deliver to help transition towards a competitive regime for contracts for difference but this value will be lost if the Department does not get competition into place while a substantial part of the funding remains available.

Recommendations

18 The Department should ensure that it maximises the opportunity for price competition under the Contracts for Difference scheme. It could do this by dividing the available budget between technologies and commissioning years, so it is likely to be less than demand, and trigger competitive auctions. Where it has good evidence that the continued availability of support under the Renewables Obligation is preventing genuine competition for strike prices, it should consider reducing the availability or level of Renewables Obligation support.

19 The Department should include clauses in future Contracts to enable it to clawback excessive returns achieved by individual projects. It should also consider including provision for reducing strike prices for multiphase projects, for example where there is clear evidence of a significant fall in financing, capital or operating costs since the first phase.

20 **The Department should require holders of all contracts for difference – including early contracts – to give information on their actual costs and returns.** This will let the Department judge whether strike prices are giving expected returns, and use clawback provisions where returns exceed set limits.

21 **The Department should get information from developers on how projects which have been awarded early contracts have contributed to developing the renewables industry in the UK.** The Department evaluated developers' applications for an early contract partly against how they contribute to developing renewable industry supply chains, workforce capacity and renewable technology. It plans to collect information from developers as part of its benefits management strategy. It should ensure it assesses how and whether these claims were realised. It can use this information to help evaluate future contract bids.

22 **The Department should ensure the Counterparty Body actively manages contracts to minimise their costs to consumers while meeting its objectives.** The Department should resource the Counterparty Body to review and challenge generators' claims for increases in strike prices, identify opportunities to reduce strike prices, and check metered output and indices of market prices.