

REFORM OF THE RENEWABLES OBLIGATION

PART 1 – PRELIMINARY CONSULTATION ON THE REFORM OF THE RENEWABLES OBLIGATION

Response by E.ON UK

Executive Summary

- Our preference is for no change to the Renewables Obligation plus additional grant support for emerging technologies.
- A single durable price of carbon is the best driver to ensure we make the right investments that move us towards a low carbon economy. We must focus on getting a sustainable EU ETS to deliver this.
- If government renewable energy targets are to be met, more money needs to be introduced to the industry. Banding on its own is unlikely to deliver government targets.
- However, in the absence of new money being available to deliver the Government’s renewables targets, we support banding by technology provided it is established using evidence of current costs.
- Banding will only stimulate the delivery of more installed renewables capacity if ‘banding up’ is applied, but is unlikely to deliver government targets.
- Pre-commercial technologies are best stimulated by additional capital support.
- Changes to the regulatory framework should be minimised to mitigate the fact of intervention through RO reform, and reduce the perception of the extent to which the Government is prepared to intervene in key market rules in the future.
- Grandfathering protection needs to be strengthened by ensuring RPI indexation of the buy-out price continues to be applied to 2027.
- A guaranteed headroom in the level of the RO should be applied to protect value within existing and future investments. We propose that it should be triggered whenever the gap from the target is likely to be less than 3%.
- New and emerging technologies that are operational or under construction need additional grandfathering protection and should be “banded up”.
- Onshore wind requires a full ROC which will simplify grandfathering issues.



- We acknowledge that co-firing from non-energy crops does not require a full ROC to be economic, but this is not the case for Energy Crops. We would prefer energy crops to receive the necessary additional financial support from outside the RO.
- We reject the ski slope proposals as there are sufficient mechanisms in place to manage the risk of over-compliance.

Detailed response to the questions set out in consultation

Q1 – Is banding the Renewables Obligation the best available option for adjusting the RO to provide more targeted support for a range of renewable technologies?

Leaving the current RO arrangements unchanged and providing additional targeted support for new and emerging technologies outside of this funding mechanism remains our preferred approach. We welcome the creation of the Environmental Transformation Fund for supporting investment in renewable and other low carbon technologies, and believe this appears to be the most appropriate vehicle for targeting support to offshore wind, bio-mass and marine. It would also be consistent with the broad proposals set out in the Stern Report which rightly argued for the need for additional funding for emerging technologies.

If support outside the RO is not forthcoming, E.ON UK believes that banding can be used to re-allocate support to influence investment decisions in favour of certain more expensive and emerging technologies. However this requires the bands for each technology to be set at the right level. Furthermore the introduction of banding provides us with concerns for existing operational projects because of the limitations to the protection that ‘grandfather rights’ can provide to investment returns under a banding approach.

The funds within the RO are finite and without increasing the value of the RO pot, extra money to provide support for more expensive technologies can be appropriated from only two sources using banding:

- Redistribution of returns between new projects.
- Redistribution of returns from existing projects to new projects.

Scenarios

To illustrate these further, we discuss some scenarios which are based on our modelling.

Under a condition of ‘broad balance’ (being on average 1 ROC approximating to 1 MWh generated) being imposed, banding is unlikely to result in a net growth in renewable electricity generated beyond that which would be achieved without banding. It will only achieve a change in technologies used from the more cost competitive to the less. This is at best a zero sum game and therefore the case for banding is undermined. Meanwhile, a significant increase in complexity and Government intervention will have been introduced.



A worse scenario, and we believe this to be a significant risk, is ‘broad balance’ banding both disincentivising further investment in existing technologies, whilst not providing sufficient additional funding for offshore wind. The result could be no growth in renewables generation, and therefore a reduction in that which would have been achieved without banding. In our view, this risk can be mitigated by increasing the funding in the RO or by providing additional sources of funding for new and emerging technologies from outside the RO.

There are scenarios where banding could potentially deliver significantly higher renewables output, primarily from offshore wind, but this requires the abandonment of the broad balance constraint. By accepting significant ‘banding up’ for offshore wind relative to other technologies (we propose 1.8 ROCs), whilst holding onshore wind at one ROC, a greater amount of renewable energy could be delivered, but not sufficient to meet Government targets. Additional money within the RO is likely to be required if these targets are to be realised.

The outcome of successfully using the RO Mechanism to both support more expensive technologies and increase the renewables capacity installed, is that in the absence of additional funds, grandfather protection can only be partial and existing projects undermined. “Banding up” reduces the level of future recycled buy-out receipts, effectively appropriating value from existing projects.

The redistribution of returns from existing projects to new projects has significant implications for grandfathering. Whilst some appropriation of value might be tolerated in order to support emerging technologies, the principle of grandfathering must not be diluted. Existing projects still require an acceptable return and any redistribution must be reasonable and equitable in order for E.ON UK’s support for banding to be retained.

We propose that this additional protection is provided by way of a guaranteed headroom which would provide a floor price on the value of recycled buy-out.

Differentiating between commercial and pre-commercial technologies

In the light of having devised and analysed a range of scenarios, E.ON UK believes that the RO Mechanism is not a suitable means of support for all stages of technology development. We believe that banding the RO should only aim to provide more targeted support for those technologies that are sufficiently advanced to be used in commercial scale generation projects. Where technologies are at a pre-commercialisation stage, a greater emphasis should be placed on grant support to facilitate development to a stage where incentives provided by market signals become more appropriate.



Therefore a banded RO, whilst continuing to support onshore wind, co-firing of energy and non-energy crops, landfill gas and new hydro, should provide extra targeted support to offshore wind and dedicated biomass. For technologies at pre-commercialisation stage such as wave and tidal generation we believe support from the RO should be the same as for the maximum “banded up” commercial technology and that any funding shortfall should be met via grant support. We discuss this further in our response to Question 12.

Q2 – Before making a decision on whether and how to band we are seeking views on the impact banding the RO would have on investment decisions.

For investment to be stimulated, investors will require an appropriate return for the risk undertaken. Technology bands which receive recycled receipts as a relatively significant proportion of the RO support, will face greater risk from future changes to banding support. This additional risk is likely to be an investment disincentive unless the support within these bands provides compensating higher returns. Given this complex dynamic interplay of the relative support given to each band, accurately setting the bands will be challenging.

Political risk

The corollary to the difficult challenge of band setting, in our view, will be an increase in political risk manifested through Government (or regulators) being obliged to micromanage the bands to achieve desired ends. Banding necessarily requires Government to become more involved in the functioning of the RO mechanism; suggesting that investment decisions will be influenced to an increased extent by interventionist signals with a corresponding dilution of market signals.

As discussed above, the erosion in the benefit of grandfather rights for existing projects flags to investors that the political risks of investing under the RO have significantly increased. At the same time the Government seeks to make marginal projects viable and encourage additional investment under the RO through these reforms. This conflict is discussed further in our response to Questions 6 and 7.

Overall, we judge that banding is likely to materially increase the amount of political risk for investments relying on the RO mechanism, but these risks could to some extent be mitigated by:

- Minimising the level of future intervention (e.g. aspire to set the bands once)
- Ensuring stronger grandfather protection is provided for existing investments by:



- Incorporating a guaranteed RO target headroom of 3% to provide a floor price on recycled buy-out value.

Headroom imposes no additional cost to the consumer unless the industry has broadly delivered stated targets. In this situation we believe that the cost would be an acceptable cost, as a clear link is drawn between the consumer paying more, and additional volume being stimulated. Introducing headroom of 3% before 2015 is supportive of meeting the government's 2020 aspirations which E.ON UK has welcomed

Alternative grandfather protection approaches which also have the potential to deliver greater renewable volume but at a greater cost and possibly with less acceptability to the consumer include:

- Raising the buyout price to introduce more funds into the RO.
- Increasing ROC targets in proportion to the extent of banding up.

Market risk

Banding introduces complexity. Markets work best when the system is simple and clear signals are sent. Banding inevitably increases the complexity of the RO, making long term prices harder to predict and thus increasing the market risk. Again, by minimising the number of bands and the frequency of intervention, market risk can be reduced and better confidence provided to investors.

Effect on investment decisions

The proposed reforms to the RO mechanism increase both political risk and market risk. In practical terms, there is a price for risk, and it therefore follows that without adequate protection arrangements such as the 3% headroom which we have recommended, the proposed RO reforms will increase the risk level ascribed to the RO Mechanism by investors, resulting in an increase in the cost of a project. At the margin, otherwise viable schemes will be cancelled.

When making an investment decision, it is a key requirement of the RO mechanism that there is certainty that the support provided will last for the lifetime of the asset in real terms. Confidence of this will be signalled by robust grandfather protection.



Q3 – Do you agree that a multiple ROC approach is the most appropriate option for banding the RO on a UK wide basis?

As simple an RO mechanism as possible is required to provide clear market signals.

E.ON UK has a very strong preference for a Multiple ROC approach. A Multiple Obligation approach introduces yet more complexity and intervention and in particular sets generation targets for technologies, not all of which may be economically viable.

The RO should comprise:

- Single Obligation, ROC buyout and recycle price
- Market (rather than government) choice of generation mix

Q4 – Do you agree with these key principles as the basis for the development of a UK-wide banded Obligation?

We support the principles of grandfathering, notification, transparency and reliability. In addition to these four key principles listed, we would like to see two more:

- An overarching principle of independent regulation of the RO mechanism. A regulator could have a statutory duty, independent of ministers to defend the key principles; to set bands in a reliable and transparent manner whilst protecting the interests of existing investors.
- Simplification and market signals - The net effect of any changes to the existing RO mechanism should seek to simplify the mechanism and strengthen market signals.

Q5 – How important are these principles for the successful operation of a banded system?

We believe the six principles of grandfathering; notification; transparency; reliability; independent regulation of the RO; and simplification and market signals are very important for successfully operating a banded RO Mechanism.



Q6 – Do you agree with the above discussion of how a banded Obligation might work in practice?

In question 2 we highlighted the conflict between erosion of grandfather rights of existing projects to release additional support for new investments, and a desire to encourage investment in new projects to increase renewable capacity.

We acknowledge the trade off being attempted by the proposals. Clearly if investor confidence is to be retained to get investments in new projects made, it is essential that an equitable balance be struck between adequately protecting existing investments and incentivising new investments sufficiently to meet Government targets.

Not only is there a limit to the erosion of grandfather rights that will be tolerated if investor interest is to be maintained, but banding should be based on a realistic set of cost and volume assumptions to provide confidence to investors in new projects. We would suggest that the current cost of projects in construction should be the basis for understanding the economics of renewable technologies. For example E.ON UK's investment in the Robin Rigg offshore development implies that a capital cost of £1.8m/MW is the relevant benchmark for forecasting future installed capacity in this sector.

Q7 – Do you agree that it will be important to maintain a broad balance between banding up and banding down?

We do not support the concept of maintaining 'broad balance' as we believe it undermines the case for introducing banding in the first place; that of increasing total renewable capacity installed.

Under a banded obligation, the annual target will need to be converted from MWhs to ROCs. Our modelling analysis already discussed in our response to Question 1, has suggested that constraining the banding levels to achieve broad balance will not deliver higher renewable volumes as desired by government. A ratio that results in more than 1 ROC equating to 1 MWh (banding up) is required to deliver higher volumes compared to the current RO methodology. However to provide sufficient protection to existing investments, in particular from the impact this approach would have on the recycle benefit, we propose that a guaranteed headroom of 3% is also introduced to provide the necessary additional protection for investments.



Our modelling suggests that if banding down is applied, previously economic projects will no longer be viable. Only if banding up is applied does it seem likely that an increase in the total volume of renewable capacity will be realised and as discussed elsewhere, this is because returns to existing projects are appropriated through a reduction in the recycle price.

Q8 – Do you agree with the proposals to set bands by technology?

E.ON UK agrees with setting bands by technology.

Q9 – How many bands should there be in a banded Obligation?

Too many bands will introduce excessive complexity, will represent micromanagement and will obscure market signals. Too few bands will risk technologies being disproportionately over, or under rewarded. Clearly there is a balance to be struck here.

Our preference is for one band per technology type with Marine being allocated the same level of support as the highest support band.

We propose six bands representing different levels of support:

- Offshore (wind and marine)
- Dedicated biomass (including micro biomass)
- Onshore wind (including micro wind)
- New Hydro (including micro hydro)
- Landfill and sewage gas
- Co-firing

We recognise that the fuel costs of energy crops are substantially greater than for non-energy crops. Our preference for supporting this emerging industry is to provide support from outside the RO. In the absence of this, a separate band for energy crops, both under co-firing and dedicated biomass plants would be required.

Marine technologies are insufficiently well developed to be fully supported within the RO mechanism and should receive additional grant support to meet any funding shortfall.

Any new technology should be independently assessed to ascertain the support needed and assigned a separate band.



Q10 – Should bands also be set to cover subsets of technologies?

Too many bands will introduce excessive complexity, represent micromanagement and will obscure market signals. Instead the band for each technology should be set to deliver the 75 percentile of available UK resource.

Q11 – Views are invited on the best approach to setting bands. Do you support the principles outlined above?

We support the approach for setting bands as set out in the consultation document, provided the key principles discussed in Q4 and Q5 are adhered to. In particular the bands should take account of all project costs including project attrition rates for each technology.

We believe an important pre-condition for setting bands effectively is the absence of complexity in the banding rules as we have already discussed. In addition to this, we do not support capacity limits for a given band. This would cause a rush to delivery and gaming. In addition, capacity limits lock out the more promising technologies because initially, they are less advanced.

Our experience with onshore wind suggests that learning economies have yet to materialise and we believe that care is needed when using cost curves to assume that they will be realised as new technologies proliferate. Learning economies will, at some stage be achieved, but high demand competing for the supply chain seems likely to offset the potential benefits; at least in the near future for offshore wind. For the avoidance of doubt, we do not support learning economies being factored into the equation over the short to medium term.

The concept of ‘broad balance’ between banding up and banding down (being 1 ROC approximately equating to 1 MWh) is relevant to the levels at which the bands are set. Our response to Q6 and Q7 has already discussed this. In essence, we do not believe that a net growth in renewables capacity can be achieved if ‘broad balance’ is maintained.

Q12 – What should be the approach for emerging technologies? Do you support the idea of limiting higher levels of support for emerging technologies to a given level of installed capacity with reductions as capacity increases?

We believe that emerging technologies should only receive the same level of support as the most costly commercialised technology (Off-shore Wind) and that additional grant support should be made available to meet any funding shortfall. At present, for example, the marine renewables industry has no devices that are both commercially proven generators and are (freely) available to be purchased by project developers. When there is a market in devices, it may be appropriate to establish a separate marine band fully funded under the RO.

Marine renewables require grant support to bridge the funding gap. From a utility investor perspective, revenue support is inefficient. A £1 of revenue support provided to an unproven technology is necessarily uncertain, received in the future and is discounted, whereas a £1 of capital support is certain and received at the time of investment. It can be seen that RO revenues for a new technology such as marine will be discounted, requiring disproportionately high banding up and representing a less efficient use of funds than capital support.

We believe that marine renewables should be included within the RO as we support success in generating electricity being rewarded and suggest that an ‘offshore band’ which is pitched to support offshore wind is also available to reward marine renewables. This will leave a requirement for additional support for marine renewables, either from the MRDF or from a successor support scheme.

The absence of a separate band for marine renewable technologies will avoid introducing any more complexity through banding than is necessary.

Q13 – Would you support a process which sought to give an early indication of likely bands – perhaps prior to the passage of legislation through Parliament?

Yes - it would provide confidence to investors to continue to develop a project. In addition, we would like an assurance that the actual bands and support given will not differ more than a specified amount from the provisional bands and support.

Our preference is for ministers to make a “minded to” statement giving, for each technology, the range within which its band will be set and stating that the bottom of the range is a firm minimum. This will enable key investment decisions to be made during the parliamentary process rather than be delayed.



Q14 – Should there be a statutory limit on how often the bands can change? Should this be expressed in terms of time or installed capacity? What should this limit be?

There should be an aspiration to keep changes to a minimum and in practical terms the timetable of the RO Mechanism provides limited scope for changing bands in order to influence investment decisions. We therefore believe that the bands should ideally be set only once. However, we recognise the instability that co-firing could bring to the RO following the removal of the cap and believe that more frequent adjustments may be necessary for this technology which will inevitably have an impact on other technologies.

We believe that any future changes in the level of support must be transparent and industry be given sufficient notification to protect projects in development and construction. We believe that oversight of the RO should be made the responsibility of an independent body. This body should conduct a health check of the RO at the end of each compliance period against predetermined criteria. If the need for a change in support is triggered, then implementation should take effect in the 3rd compliance period following the criteria breach. We believe that this approach would provide transparency and the necessary period of notification to protect development investment on projects which typically take 5 years from inception to commissioning.

Q15 – Should there be a caveat to allow an early review in extreme cases?

This question admits the inherent difficulty of setting the bands and Government's natural desire to be able to correct drastic problems inadvertently created; but at the same time, clearly illustrates the increased likelihood of micromanagement, the consequently raised political risk and the dilution of the existing market mechanism.

We do see that a case might be made for a tightly defined safety valve mechanism that allows an 'interim determination' to be made or applied for by industry, a regulator or Government for review by an independent panel. Such a process should be governed by a robust set of rules which trigger intervention but prevent micromanagement. It is worth noting that such mechanisms already exist in the regulated water sector.



Q16 – Do you agree that projects should be guaranteed that their band would not be reduced, once operational?

Yes. This is essential to minimise the extent to which political risk is discounted by investors through an inflated investment hurdle rate.

Q17 – Is the point of first supply of electricity the most appropriate for grandfathering? Is there any other legally robust point that would be better?

We agree that first supply of electricity could be a good trigger point for ‘grandfathering’. We believe that with current planning and grid constraints that April 2011 would be a reasonable trigger point. However as the majority of the projects affected by planning and grid constraints are onshore wind, maintaining the current 1 ROC for new onshore projects post 2010 will remove this issue.

If banding up for the technology concerned occurs after the grandfathering trigger point, the project should benefit; if banding down occurs after the trigger point, grandfather rights are conferred for the reasons discussed earlier in the response to this question.

Q18 – Are there any other ways in which we could protect investments?

Investments currently being made in new and emerging technologies

We have already discussed and acknowledged the trade off being attempted through banding between adequate protection of existing investments and sufficient incentivisation of new projects. However, we strongly reject this trade off being made where the effect undermines recent investment decisions in relation to projects under construction, particularly in new and emerging technologies.

E.ON UK is currently constructing the UK’s largest dedicated biomass plant at Stevenscroft (Lockerbie). The investment decision was made on the basis of grant funding and 1 ROC per MWh from an un-banded RO mechanism, and a buy-out price that would remain constant in real terms. The inevitable reduction in the recycle price under banding requires this investment to be protected. If we had known of these changes, our investment decision would have been different.

We therefore believe that the RPI indexation should continue to apply post 2015 to protect the value of the buy-out, and that existing dedicated biomass projects should be “banded up”. This would ensure that the changes being proposed do not harm our



decision to invest in this flagship project. We recognise that the majority if not all operational dedicated biomass and off-shore projects have received grant support, and we believe that this should be repaid as a condition for “banding up” of the project.

Q19 – Do you agree that co-fired plant should not be grandfathered?

We accept that non-energy crop co-firers do not require one full ROC to provide reasonable investment returns. Going forward, bands for energy and non-energy crop cofiring should be set at a level to continue to incentivise the inclusion of such capability within the UK coal fleet and to incentivise co-firing investment when new coal plant is being constructed.

Q20 – Do you agree that projects in emerging technologies that become operational (first supply electricity) before the introduction of banding but had not yet begun construction when the Energy Review Report was announced should move up to their new bands when those come into force, to prevent delays?

We believe that operational projects and projects in construction which are “banded up technologies” should also be banded up. In the event that an operational or construction project will be banded up, grant support received should, as a pre-condition, be repaid.

Q21 – Is there anything else we can do to prevent delays?

The planning regime needs to become both more efficient and more responsive to Government Energy Policy and we welcome the proposals contained in the Energy Review report that the planning process should be reformed. The other area needing to be addressed is that of grid constraints preventing consented projects from gaining connections.

Q22 – Would this method of estimating generation and raising Obligation levels work in practice? Are there any alternatives? Should the requirement to raise Obligation levels be made a statutory one?

We broadly agree with the example scenarios given but would like as much advance notice as possible to be provided. In addition, we see no reason why the headroom



mechanism should not commence prior to 2015 in the event that industry has been successful in meeting Government targets. It would be perverse for new projects to be deferred until the target provided some headroom whilst the 20% aspirational target is outstanding.

Q23 – Is a guaranteed headroom of 1% adequate, given the ability of suppliers to bank ROCs and our intention to also remove the risk of a ROC price crash through a “ski-slope” type mechanism?

If the industry successfully stimulates new capacity such that guaranteed headroom is introduced we believe the recycle price should have a reasonable floor in line with the principles of grandfathering. Our assessment is that a 1% headroom would not strike an appropriately equitable balance between existing and new investments and believe that 3% is more appropriate. In striking this proposed balance, we strongly believe that the headroom mechanism should have the capability of being triggered before 2015.

We strongly reject the proposal to remove the automatic RPI indexation post-2015 at the time when guaranteed headroom could feasibly be introduced. This not only removes money in real terms from the RO, it also undermines the concept of grandfathering. E.ON UK has made significant investments on the basis that the buy-out price would remain constant in real terms. In our view this materially rewards those companies that did not invest significantly in renewable energy projects.

For the avoidance of doubt, RPI must continue to be applied to the buy-out price to 2027.

Q24 - Do you support the introduction of a ski-slope mechanism for ROC prices?

We do not support the ski-slope mechanism.

The ski slope mechanism introduces yet more complexity to the RO mechanism over and above that created by banding. Complexity dilutes market signals and raises risk with the result that revenues projected from sales of ROCs are discounted through an increased hurdle rate. In the context of investment decisions, increased complexity makes explaining the RO mechanism to shareholders more difficult than is already the case.

Current banking arrangements (25% between years) combined with the Electricity



Suppliers' ability to negotiate contracts and self-build to meet their obligation should ensure that targets are not exceeded in the long term. If targets are capable of being exceeded then Government should be minded to increase RO targets to help further deliver its climate change agenda

Q25 - Are the mechanisms discussed above viable approaches?

We have no comment to make as we do not support the concept.

Q26 – Which do you think is the best approach?

We have no comment to make as we do not support the concept.

Q27 – Is there any other way to remove the risk of a steep fall in ROC prices in a situation of over-supply?

In our view, the market will not deliver oversupply. Targets from 2010 to 2015 are already announced, and in the light of new information could be revised upwards to increase headroom and reduce the risk of oversupply.

Q28 – Is it possible to identify a mechanism that works appropriately alongside mutualisation in the event of a supplier default?

We do not agree with the analysis presented in the consultation document. In practice, a series of difference accounts would set off the monies owed to and from the mechanism, as described in the virtual payment 'solution'. Any default could be rolled forward to be paid for by participants in the following compliance period. This would allow the default to be accounted for in the pricing of ROCs in the marketplace.

Q29 – Do any of these mechanisms raise problems that have not been discussed here?

We have nothing more to add to the comments already made.



Q30 – What would be the likely consequences of introducing any of these options

We have nothing more to add to the comments already made.

Q31 – Do you agree that co-firing should be considered a long term part of our renewable energy and carbon abatement strategies?

E.ON UK is committed to investing in clean coal technology as part of securing the UK's longer term security of supply. No single technology can meet this objective, but it is clear to us that coal will have a long term future. In this context, it is important that co-firing is incentivised over the long term so that new coal plants are built on the basis of co-firing being a core activity in order to minimise carbon emissions.

Q32 – Do you agree with this approach of uncapping co-firing and reducing its support through banding?

Co-firing is essentially an operational decision made by companies, and is very responsive to gas and coal price signals. Co-firing incentives do not, and should not dictate whether a coal plant is running. However where the gas/coal price leads to coal stations being operated, it is important that these emissions are abated through co-firing. We therefore welcome the continued incentives for co-firing post 2016, and accept that the economics of non-energy crop co-firing are different to other technologies. Moreover we believe it is appropriate to reduce the support going to this area via banding. Reducing support for energy crop co-firing is less clear cut, particularly at current fuel prices. We comment further on this in Q 36.

The volumes that could be produced from co-firing are substantial, volatile and dependent upon largely external factors. Removing the cap on co-firing, whilst supported by E.ON UK, could make a major contribution to targets. The implication for other renewable technologies is obvious, with the potential for a sharp downturn in the recycle value and the adverse impact this would have on future investment decisions.

Given the instability that cofiring creates for other technologies, we believe that some protection is required to encourage investors to commit funds to new renewable projects, and to provide adequate grandfathering protection to existing projects. Our solution is to use the principle of headroom, which can be triggered at a point in time when performance against target is likely to be below a predefined



percentage, which we believe should be set at 3%. This means that whilst the targets to 2015 are already set out, under the above condition, headroom could be introduced before 2015.

Q33 – Are there likely to be any significant negative consequences?

As we have suggested above, reducing support to co-firing may lead to such activities being scrapped by generators if the fractional ROC is set too low. This will have unintended consequences of increasing emissions from such plant. However we recognise the difficulty in setting such a band for co-firing, because if it is too generous, there is a risk that such investment will be at the expense of new technologies. This highlights the need to set the bands correctly.

Notwithstanding our comments in response to Question 14 that bands should ideally be set once, the presence of co-firing within the RO may require that an annual review of co-firing bands is more appropriate. This will inevitably have a contingent impact on the other bands and the strength of investment signals sent to the corresponding technologies. However, if there is a trigger for introducing headroom earlier than 2015 to deal with these kind of issues, the impact could be substantially reduced.

The key point is whether the government wants substantially more co-firing (i.e. new investment) or is happy to set bands at a level sufficient to encourage existing assets to co-fire, but too low to encourage further investment.

Q34 – Views are invited on the reports on the sustainability and economics of co-firing that are being published alongside this consultation document?

Our comments on sustainability are provided in Questions 37 to 40.

In terms of the economics, we believe that the report does not fairly reflect the current market prices for a range of biomass fuels. Furthermore, the cost of direct injection of co-firing appears to be at the very low end of our current understanding. We would therefore be concerned if the analysis was not updated for the purposes of setting future co-firing bands.

Q35 – Views are invited on options for addressing any remaining barriers in the Obligation to the burning of wastes?

We have no comments to make.

Q36 – Do you agree with the approach of putting the co-firing of energy crops in a higher band than other forms of co-firing Is there an alternative way to continue to support energy crops

At present, energy crops are more expensive to procure in the traded market compared with non-energy crops for the purposes of co-firing with coal. Our investment analysis of potential co-firing schemes using energy crops suggests that extra support is needed to make such schemes economic. E.ON UK strongly prefers that such support should come from outside the RO. In the absence of this, we would expect co-firing from energy crops to receive a higher banding within the RO than non-energy crops to reflect the cost differential.

Q37 – Views are invited on how to ensure the sustainability of co-firing over the long term.

At present, it is difficult to enter into longer-term supply contracts due to the huge uncertainty that exists over how the RO legislation will develop. The sustainability of co-firing is contingent on having a framework that rewards co-firers and that will give co-firers the ability to enter fixed-price supply contracts over longer periods. Such a framework will also attract more suppliers into the market and enable greater focus on areas such as environmental sustainability. Suppliers are only going to put more costly environmental processes and schemes in place if they are going to receive business over the longer term. It would also make it easier for generators to include clauses in biomass supply contracts, as E.ON UK is currently doing, to ensure sustainable supplies. In addition, it would encourage suppliers to join up to such organisations as FSC, RSPO and GAFTA, if it would support the gaining of long term business.

Q38 – Would you support the development of an accreditation based approach to sustainability issues for biomass use?

E.ON UK would very much support the development of an accreditation based approach to sustainability issues for biomass use. Such an industry-wide scheme



would give greater support to the efforts of individual generators to ensure sustainable supplies. WWF are lobbying for an EU-wide scheme that would also encompass carbon reporting along the whole production and logistics chain. One should, however, bear in mind the workload and cost in administering such a scheme and in ensuring the standards of sustainability are audited appropriately.

Q39 – Would you support a requirement on generators claiming biomass or co-fired ROCs to publish information on the sources of biomass used in their power stations and any relevant sustainability information?

In principle, we would support this objective. Biomass supply contracts could require suppliers to provide any relevant information to support this. It should be noted however that biomass is a traded market and such information is commercially sensitive. Releasing such information may prejudice our commercial position. Again the cost and workload associated with such a reporting mechanism should be carefully considered.

Q40 – Are there any alternative approaches for ensuring sustainability in the biomass sector?

In addition to UK/EU/International standards and an audited accreditation scheme, the key way to ensure that supplies of biomass are sustainable is to have clauses to that effect in biomass contracts. Failure to comply with such clauses would be a terminable event. E.ON UK now includes clauses in new biomass contracts that cover sustainability, genetic modification and child labour. From what we understand, E.ON UK is the first generator to include clauses on sustainability and genetic modification. If others followed suit, it would force traders/suppliers to act in a sustainable manner. It would also encourage suppliers to join such bodies as RSPO, Gafta, IFC etc. Whilst membership of these bodies is no guarantee of sustainability, it at least demonstrates a willingness on the behalf of the supplier to move in that direction.

Q41 – Views are invited on this approach for meeting the costs of administering the RO.

Introducing complexity to the renewables obligation through banding will require improvements to Ofgem's IT systems in order to administer the new system efficiently. We recognise that this will cost money, but believe that there should be



adequate incentives placed on Ofgem to ensure that best value is achieved in meeting their objectives. For example, has due consideration been given to putting the administration role out to tender? The administration of the RO would appear to be independent of Ofgem's regulatory role and therefore need not be carried out by the same organisation. It would appear to us that Elexon have more expertise in data handling compared with Ofgem.

Our preference is for the funding of additional administration costs to be provided from outside the revenue pot of the RO. Using the recycle fund to reimburse Ofgem will add another layer of complexity to predicting the recycle price which is an essential calculation when considering investment decisions. Moreover on a point of principle, we do not accept a support mechanism to incentivise renewable projects also being used to fund, in this case, the overhead costs of the administration of the Renewables Obligation. It sets an unhealthy precedent.

Q42 – Are there any alternative approaches for funding these administration costs?

An alternative approach is for a fee (albeit small) to be levied on each ROC registered. This has the virtue of being transparent and equitable. It is also consistent with the practice in other markets where analogous fees are raised by for example, the London Clearing House and LIFFE.