EXPLANATORY MEMORANDUM TO

THE RENEWABLES OBLIGATION (AMENDMENT) ORDER 2021

2021 No. [XXXX]

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 The Renewables Obligation scheme supports the generation of renewable electricity and it is paid for by electricity suppliers. When suppliers fail to pay their share of the costs, the value of the debt is recovered from compliant suppliers in a process called mutualisation – mutualisation is currently triggered when the debt equals or exceeds a £15.4m threshold. This instrument amends that mutualisation threshold to be 1% of the forecast annual cost of the scheme for the obligation year in question (rounded to the nearest £100,000).

3. Matters of special interest to Parliament

Matters of special interest to the Joint Committee on Statutory Instruments

3.1 This instrument is intended to come into force on 31 March 2021, which is likely to be soon after it is made. This is to ensure the provisions are in force before the 1 April 2021 start of the 2021/22 obligation period, in the interests of reducing as soon as possible the costs that mutualisation imposes on suppliers (and hence their customers).

Matters relevant to Standing Orders Nos. 83P and 83T of the Standing Orders of the House of Commons relating to Public Business (English Votes for English Laws)

3.2 This entire instrument applies to England and Wales only because it applies only to licensed electricity suppliers supplying customers in England and Wales.

3.3 The instrument has effects outside of England and Wales which the Department considers to be minor or consequential. This is because mutualisation funds collected from complaint suppliers in England and Wales are redistributed to all UK compliant suppliers, even though those in Scotland and Northern Ireland do not contribute to the mutualisation fund in England and Wales. As the measures in this instrument are likely to mean that mutualisation occurs less frequently in England and Wales, suppliers in Scotland and Northern Ireland will receive less in redistributed funds.

3.4 In the view of the Department, for the purposes of Standing Order No. 83P of the Standing Orders of the House of Commons relating to Public Business, 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, and the Scottish Parliament if equivalent provision in relation to Scotland were included in an Act of the Scottish Parliament.

3.5 The Department has reached this view because it considers that the purpose of the instrument is the promotion of renewable energy, which is within the devolved legislative competence of the Northern Ireland Assembly and the Scottish Parliament. The instrument does not relate to a reserved matter and is not otherwise outside the legislative competence of the Northern Ireland Assembly or Scottish Parliament.

4. Extent and Territorial Application

4.1 The territorial extent of this instrument is England and Wales.

4.2 The territorial application of this instrument is set out in Section 3 under "Matters relevant to Standing Orders Nos. 83P and 83T of the Standing Orders of the House of Commons relating to Public Business (English Votes for English Laws)".

5. European Convention on Human Rights

5.1 Anne-Marie Trevelyan MP has made the following statement regarding Human Rights:

"In my view the provisions of the Renewables Obligation (Amendment) Order 2021 are compatible with the Convention rights."

6. Legislative Context

6.1 This instrument amends the Renewables Obligation Order 2015 (S.I. 2015/1947) ("the 2015 Order") which is the present legal basis for the Renewables Obligation ("RO") scheme in England and Wales.

6.2 There are separate RO schemes in Scotland under the Renewables Obligation (Scotland) Order 2009, and in Northern Ireland under the Renewables Obligation Order (Northern Ireland) 2009. These complementary schemes effectively create a UK-wide RO. Responsibility for policy as it relates to the operation of the RO in Scotland and Northern Ireland is devolved to the Scottish Government and Northern Ireland Assembly respectively. Mutualisation does not apply in Northern Ireland.

7. Policy background

How the RO works

7.1 The RO scheme was introduced in 2002 and supports the generation of renewable electricity. It is now closed to new generating capacity but existing generating stations accredited under the scheme receive support for 20 or 25 years, depending on when they accredited. The scheme finally closes in 2037.

7.2 The scheme does not provide direct cash payments. Instead, it operates as a market-based mechanism through a system of tradable green certificates called Renewables Obligation Certificates (ROCs). ROCs are issued to generators free of charge by the scheme administrator in relation to the renewable electricity they generate. Generators sell the ROCs to suppliers or traders, which gives generators a premium in addition to the wholesale price of their electricity. Electricity suppliers are under an obligation to present a certain number of ROCs to the scheme administrator or instead pay a fixed cash payment into a buy-out fund. After the scheme's administration costs have been

deducted, the cash payments are recycled back to suppliers in proportion to the total number of ROCs that each has presented, so giving ROCs additional value.

7.3 The price of a ROC is not fixed and is a matter for negotiation between the generator and supplier/trader. However, the notional value of a ROC is considered to be the buy-out price, plus the value of the recycled cash payments. In 2019/20 the notional value was £54.43 per ROC. The total value of this support to generators in England and Wales in 2019/20 was estimated at £4.5bn.

7.4 When suppliers fail to discharge their obligation (most commonly because they have exited the market, or are in the process of doing so), there is a shortfall in the buy-out fund. Suppliers who met their obligation with ROCs will then receive less in recycled payments than would otherwise have been the case. This will have an impact on both suppliers and generators. To prevent excessive shortfalls in recycled payments from occurring, the scheme has a mutualisation mechanism. Once the shortfall exceeds a threshold (currently fixed at £15.4 million), suppliers who met their obligation in part or in full are required to pay the unmet obligations of those suppliers who did not meet theirs. The mutualisation payments are then recycled back to suppliers who met their obligation in full, in proportion to the total number of ROCs that each had presented. This protects ROC prices.

What is being done and why?

7.5 The mutualisation threshold has failed to keep pace with the growth in the scheme. When the threshold was introduced in 2005, it was equivalent to about 1% of the cost of the scheme. It is now equivalent to about 0.25%, which means that the balance of risk associated with supplier payment default has shifted away from generators and towards suppliers. Mutualisation has been triggered in each of the last 3 years (with shortfalls of £53.4m, £88.1m and £31.4m respectively).

7.6 This instrument amends the current mutualisation provisions to link the threshold for mutualisation to the annual cost of the scheme to suppliers, setting it at 1% of the forecast cost of the scheme each year (rounded to the nearest £100,000). In the first instance, this will increase the threshold in 2021/22 to around £62 million, but it will rise or fall in future years as the cost of the scheme changes. This new arrangement restores the balance of risk between generators and suppliers that was established when the mutualisation mechanism was first introduced. It ensures that suppliers that met their obligation are not unduly exposed to the unmet obligations of their competitors. It is likely that this will be of benefit to their customers too as they are less likely to face pass-through costs.

8. European Union (Withdrawal) Act/Withdrawal of the United Kingdom from the European Union

8.1 This instrument does not relate to withdrawal from the European Union/trigger the statement requirements under the European Union (Withdrawal) Act.

9. Consolidation

9.1 The Department has no plans to consolidate the 2015 Order.

10. Consultation outcome

10.1 A public consultation on changes to the mutualisation arrangements was published on 11 December 2020 and closed on 11 January 2021. The statutory consultees under the

RO, including all licensed electricity suppliers, accredited generators, and relevant trade associations, were contacted directly to alert them to the consultation. The consultation document was also available on www.gov.uk. The proposals were discussed with the devolved administrations in Wales, Scotland and Northern Ireland before the consultation was launched.

10.2 In total, 39 responses were received from electricity suppliers, generators, energy industry trade associations, ROC brokers, Power Purchase Agreement off-takers, a charity and the Energy regulator, Ofgem. The responses strongly correlated with respondent type. Those responsible solely for electricity supply mostly supported the proposals. Those with an interest in generation mostly disagreed with the proposals.

10.3 Of the respondents who were solely concerned with electricity supply, the vast majority (14 out of 15 respondents) agreed with the proposal to link the mutualisation threshold to the cost of the scheme. The key reasons for agreement were that the proposal: restored the original balance of risk between compliant suppliers and generators; and would reduce the likelihood of mutualisation occurring, reducing costs for compliant suppliers (and their electricity customers).

10.4 Of those with an interest in generation, whether that was solely as a generator, as a generator/supplier or a trade association, the majority (14 out of 19 respondents) disagreed with the proposal. The main reasons given for disagreement were that: the proposals did not address the underlying problem caused by poor financial management by some suppliers and ultimately their market exit; it was unacceptable for generators to bear additional risks when they had no influence or control over supplier compliance; there could be a detrimental impact on ROC prices which would undermine generators' business models built on the current arrangements; and investor confidence in both the RO and other government schemes could be undermined. The remainder of the 19 either agreed with the proposal (2 respondents) or their position was unclear (3 respondents).

10.5 Of respondents who were neither suppliers nor generators, 3 agreed with the proposal and 2 disagreed.

10.6 The consultation also asked whether the changes to the threshold should be introduced in respect of the 2021/22 obligation year. All those who supported the change to the threshold wanted it in place as soon as possible (19 respondents). Of those who did not support the introduction, 7 suggested it would reduce the adverse impact if there was a longer lead-in time.

10.7 After careful consideration, the Department has decided to proceed with its proposal to link the RO mutualisation threshold to the annual cost of the scheme as no robust evidence was submitted to justify changing the proposal. This new arrangement will have the effect of lowering the likelihood of mutualisation being triggered in the event of supplier payment default.

10.8 The Department has considered the concerns of respondents and recognises that the new arrangement will increase the sum that might remain unrecovered in the event of supplier payment default – in its consultation, the Department determined this to be equivalent to an increase from about 0.25% to 1% of the £55 notional value of a ROC. The Department notes that this will have a small impact on generator returns and that some generators might be unable to recover these potential losses. Nevertheless, the Department remains of the view that the proposed measure is justified and represents the restoration of an arrangement that was introduced in 2005 to secure the scheme's

buy-out/late payment funds (i.e. to the advantage of generators), and which has since been unintentionally eroded to the detriment of electricity suppliers and their customers. On balance, the Department considers that the benefits for suppliers and their customers of proceeding outweigh the costs.

10.9 There was support across all the categories of respondents for further work to ensure supplier compliance. BEIS and the energy regulator, Ofgem, will be taking this forward separately.

11. Guidance

11.1 The scheme administrator will amend their existing guidance on the mutualisation arrangements to reflect the changes made by this instrument. This guidance will be made available once this instrument comes into force.

12. Impact

12.1 The impact on business, charities or voluntary bodies depends on whether they are a generator or supplier. Raising the threshold could reduce compliance costs for suppliers. This is because mutualisation will be less likely to be triggered and the administration costs of dealing with it might not be incurred. Suppliers will also be less likely to have to make mutualisation payments. However, the increased mutualisation threshold will increase the sum that might remain unrecovered in the event of supplier default: this will have a negative impact on the returns of generators.

12.2 Taking the 2020/21 obligation year as an example, the maximum amount at risk under existing arrangements is about 14p per ROC (determined as the £15.4m mutualisation threshold divided by the 2020/21 ROC forecast of 112.9m ROCs). Restoring the balance of risk between generators and suppliers that was established when the mutualisation mechanism was first introduced, by linking the threshold to scheme cost, increases 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 around £55 notional value of a ROC. To put this in context, it should be noted that recycle payments have varied between £0 and £7.82 per ROC since 2011.

12.3 There is no, or no significant, impact on the public sector.

12.4 An Impact Assessment has not been prepared for this instrument because the RO scheme has been classified as a notional or imputed tax by the Office for National Statistics and is not a regulatory provision.

13. Regulating small business

13.1 The legislation applies to activities that are undertaken by small businesses.

13.2 Small suppliers will benefit from the measures in this instrument through reduced compliance costs. Overall, we do not expect that there will be a disproportionate effect on small generators. Hydro power, anaerobic digestion, solar PV and wind generating stations at or below 50kw are not eligible for support under the RO.

14. Monitoring & review

14.1 The approach to the monitoring of this legislation is that it will be carried out by the scheme administrator to ensure compliance by electricity suppliers with their obligations. The administrator publishes an annual report into the operation of the RO

scheme in the preceding obligation year (as required by article 86(1)(f) of the 2015 Order).

14.2 The regulation does not include a statutory review clause. The Department considers 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 imposes a requirement on electricity suppliers to fund the costs of supporting renewable electricity generated under the RO. The cost this imposes on suppliers is passed on to domestic and business electricity users through their electricity bills. Bill payers do not have a choice as to whether they make this payment. On this basis, the RO has been classified as a notional or imputed tax by the Office for National Statistics. As a result, it is subject to the Levy Control Framework until 2020/21, and the Control for Low Carbon Levies from 2021/22 onwards.

14.3 However, the Department will informally review the impact of the measures each year following the publication of the Authority's annual report mentioned in paragraph 14.1 above.

15. Contact

15.1 Sean Hayward at the Department for Business, Energy and Industrial Strategy Telephone: 020 7215 1954 or email: sean.hayward@beis.gov.uk can be contacted with any queries regarding the instrument.

15.2 Vicky Dawe, Deputy Director for Clean Power Strategy and Deployment, at the Department for Business, Energy and Industrial Strategy, can confirm that this Explanatory Memorandum meets the required standard.

15.3 Anne-Marie Trevelyan MP at the Department for Business, Energy and Industrial Strategy, can confirm that this Explanatory Memorandum meets the required standard.