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Dear Sir/Madam

Response to 'Consultation on implementing an exemption for Energy Intensive Industries from the indirect costs of the Renewables Obligation and Feed-in Tariff Schemes'

Thank you for providing us with an opportunity to comment on your proposals to implement an exemption for Energy Intensive Industries ('EIIs') from the indirect costs of the Renewables and Feed-in Tariff Schemes. This submission is non-confidential and may be published on your website.

The main substantive effect of these proposals is to alter the support provided to eligible EIIs from a retrospective compensation scheme paid for by departmental funds (i.e. through taxation) to a real-time exemption scheme paid for by other electricity users (i.e. through bills).

We are very conscious of the concerns expressed by large industrial users that UK electricity prices may put them at a disadvantage compared to international competitors. But we are uncomfortable with these proposals, both because of the alteration in the funding mechanism and because we consider that, notwithstanding how it is paid for, the underlying scheme design is itself weakly evidenced in places.

The proposals would move costs from eligible EIIs onto all other electricity consumers, both households and the vast majority of (non-exempt) businesses. The proposition is that doing so would alleviate costs that could put 'certain EIIs at a competitive disadvantage where they are operating in internationally competitive markets.' You note in several places that other countries such as Germany, the Netherlands and France have such mitigation schemes in place.

Eurostat data, included in your impact assessment as Chart 2, does indeed suggest that UK industrial consumers face higher than (EU) average electricity costs, although notably they are lower than two of the four largest economies in europe, Germany and Italy. However, it also shows that the proportion of these costs that relate to taxes and levies is very small. Even if these were entirely removed, UK industrial consumers would still be paying some of the highest prices in europe.

Separately, estimates by the Committee on Climate Change suggest that only around 6% of integrated steel producers blast furnace costs relate to electricity costs, and that only

around a third of these costs - so 2% of their total production costs - relate to policy costs.[1] This figure appears to be accepted by the industry itself, who view these costs as a contributory factor, but not the main factor, causing the steel industry to struggle in international markets.[2] The evidence suggests that exempting EIIs from these policy costs may, in many cases, make a marginal, rather than a profound, difference to their international competitiveness - that other factors such as the cost of raw materials and import/export tariffs may affect them more significantly.

In the case of a company, or industry, operating on the very edge of commercial viability compensation for, or exemption from, policy costs could make the difference between staying open or closing. In such cases, and particularly where there could be considered to be a case for that company, or industry, being a strategic national asset, we can see a public policy case for acting to mitigate their costs. But in many cases, this proposal may not be enough to make a difference, or may simply result in windfall gains at the expense of other consumers. For example, it may improve the position of a loss making firm (or sector) *without* stopping it from being loss-making (or conversely increase the profitability of a firm that would have been profitable anyway.) While recognising that *some* EIIs are in difficulty, we note that the proposals would effectively treat *all* EIIs as in difficulty - providing compensation to firms where it would not make a difference, as well as to those where it would. While recognising that a more targeted approach might make the application of the policy more difficult, we encourage you to look again at whether support can be narrowed to only cover those firms where it genuinely affects their viability. For those where it does not, it would constitute a deadweight loss. In any event, this proposal does not alter the net cost of energy that eligible businesses face - it changes the form of the 'cashback' they receive, but not its level or who qualifies. As such, no credible argument can be made that it would materially improve the prospects for EIIs.

Although the overall level of funding provided to EIIs would not be changed by this proposal, its implications are significant because of the distributional impact of how these proposals are funded; the avoided costs of EIIs are pushed on to household and non-eligible business consumers. For non-eligible business consumers - the vast majority of business consumers - their energy input costs will increase. They may or may not be able to pass these additional costs on to their consumers depending on the level of competitive intensity in their sector. Many of these non-eligible businesses will be operating in competitive international markets in the same way as EIIs do. As with EIIs, in many cases the cost implications of this proposal may not materially alter their prospects of success or failure, but, as with EIIs, in some cases it may.

In short, it remains ambiguous both whether the proposal will save any jobs or economic activity within EIIs, whether it will cost any jobs or economic activity at non-EIIs, and the net picture across the two. The impact assessment does not present a picture of any

[1] 'Technical note: low carbon policy costs and the competitiveness of UK steel production,' Committee on Climate Change, November 2015. http://tinyurl.com/h2bfrvs
[2] For example, see the Engineering Employers Federation comments in 'Factcheck: the steel crisis and UK electricity prices,' Carbon Brief, 8 April 2016. http://tinyurl.com/oa886yx

estimated gain to UK plc from putting this exemption in place (indeed, the NPV presented is small and negative). Given their materiality, we would like to see a stronger evidential basis for these proposals saving jobs and creating wealth, in aggregate, before they are taken forward.

At household level, the proposals would result in consumers facing additional costs on their electricity bills. You estimate these at, on average, £5 per household per year in the period to 2026/7 ('best estimate' from Table 7, non-discounted, 2016 prices). We would expect there to be some variation around that central figure, and that households who are dependent on electricity as their principal source of heat will see a higher impact than dual fuel customers. We understand that you will produce a revised impact assessment as you move from consultation to final proposals, and ask that this revised assessment include a separate assessment of the impact on consumers who depend on electricity to heat their home as well as the impact on the notionally 'normal' dual fuel customer. We would also like to see an explicit assessment of the impact of these additional costs on the depth of fuel poverty. We note, and agree with, the observations of National Energy Action in its response that the current assessment is insufficient in that regard.

The movement of these costs from departmental funding to bill funding is presented as being net zero cost, but the case for this is not entirely convincing. There are reasonable grounds for believing that the cost of servicing government debt is lower than the cost of servicing household debt. While government debt is very significant at around 82.5% of GDP, household debt is even more significant at 144% of income.[3] Households are more indebted than government is, and they will be paying more for their borrowing - 10 year gilts are currently trading at around a 1.4% yield; very few households could borrow at such a low rate. We think it is likely that trying to fund this exemption through bills rather than taxation is likely to result in a higher total cost to consumers because of this debt financing gap.

Moving these costs from taxation to bills will also have a regressive effect on who pays these costs, pushing the burden on to lower income deciles. As the Energy and Climate Change Committee has highlighted, 'the use of levies on bills to fund social and environmental programmes will add to the burden faced by energy bill payers, particularly in low-income households. Public spending is less regressive than levies in this respect.'[4] We encourage DECC to heed ECCC advice on this matter, and not to push further costs on to low-income households.

We understand from discussions with the department that it would be its intention to review the effectiveness of the exemption in around 2020, though the consultation and impact assessment are less clear on this point.[5] Given our concerns both that the

[3] Office for Budget Responsibility figures contained in 'Spending review and autumn statement,' Treasury, 27 November 2015. http://tinyurl.com/qbud6el

[4] 'Prices, profits and poverty,' Energy and Climate Change Committee, 29 July 2013. http://tinyurl.com/pwwerdp

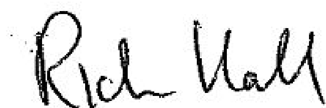
[5] Paragraph 50 of the impact assessment highlights that BIS had intended to conduct an evaluation of the existing scheme in 2020, however it is not clear whether this commitment would transfer from BIS to DECC with the change in scheme design envisaged in this consultation.

targeting of the exemption is imprecise, and that it will result in additional costs for non-eligible businesses and households, we would like to see a more explicit written commitment that DECC will conduct a thorough review of the effectiveness (or not) of the exemption by the end of the decade. We would also like to see any exemption regime that is brought in contain a sunset clause, such that it will automatically expire on a given date - we suggest no later than 2020, to coincide with the review. We think this would be useful in ensuring that any continuation of the scheme into the medium or long term would require a new decision to be taken, rather than happening by default. It would also underline the government's commitment to review the scheme after it has been in place for a few years.

If the department goes ahead with this proposal we encourage it to ensure that there is a reasonable lag time before its introduction in order to mitigate the risk that uncertainty on its timing causes bill inflation. Suppliers decisions on how to price tariffs will be influenced by their expectations on forward input costs, particularly where those tariffs are fixed term, fixed price - which are the principal acquisition product in the market. This means there is a risk that, if they are uncertain on the timing of its introduction, that suppliers may start pricing through the cost of this exemption to their non-eligible customers before it actually takes effect.[6] This could be a severe unintended consequence that materially disadvantages non-eligible consumers without helping eligible consumers. We therefore suggest that at least 18-24 months notice[7] should be given before this exemption is applied and that this clock should not start ticking until after State Aid approval has been granted (assuming it is granted, and it may not be). This should allow suppliers sufficient forewarning to avoid the risks that the cost of the exemption is incorrectly applied to domestic consumers, and that these proposals distort the market for fixed term fixed price retail tariffs.

We trust this submission is clear, but if you would like further detail on any point, or to discuss any issue it raises in greater depth, please do not hesitate to get in contact.

Yours sincerely



Richard Hall
Director of Strategic Infrastructure, Consumer Futures team

[6] Eg if a supplier is selling a two year fixed term fixed price deal they will need to make an assumption on what policy costs they may face during those two years when setting the price. If it does not know whether, or when, the exemption will take effect during those two years, this will complicate that price setting process. If it incorrectly estimates the timing of the introduction of the exemption, this may result in that supplier pricing that retail tariff at a level that over or under recovers the cost of the exemption. In order to avoid being 'out of the money', we think it is likely that most prudent suppliers would take a conservative approach and, if in doubt, pass through the cost of the exemption sooner rather than later than non-eligible customers.
[7] In our experience the vast majority of fixed term fixed price tariffs are between one and two years in duration.