POLICY NOTE

THE RENEWABLES OBLIGATION (SCOTLAND) AMENDMENT ORDER 2023

SSI 2023/103

The above instrument was made in exercise of the powers conferred by Sections 32, 32A, 32G, and 32K of the Electricity Act 1989. It is subject to affirmative procedure.

1. **Summary Box**

The purpose of this instrument is to amend the 'mutualisation threshold' set out in article 48(3) of the Renewables Obligation (Scotland) Order 2009. The threshold is currently set at a fixed level (£1.54m) and this instrument will alter it to a variable level, set at 0.1% of the total cost of the RO scheme across the UK. In practice, this will raise the level of the threshold, meaning the likelihood of mutualisation being triggered in any given obligation year is reduced. It will also ensure that the Scottish Order is aligned with the Order which covers England and Wales.

2. **The Renewables Obligation and Mutualisation**

<u>Renewables Obligation</u>

The Renewables Obligation was first introduced in 2002 by a Renewables Obligation (Scotland) Order, alongside an equivalent Order covering England and Wales, and later, an Order covering Northern Ireland. The policy supported most of the renewable capacity built in the following 15 years and closed to new generating capacity in 2017. In 2037, the scheme will end, ceasing its support of renewables generators.

The Renewables Obligation (Scotland) Order 2009 (ROS) imposes obligations on electricity suppliers in Scotland, and the Renewables Obligation Order 2015 (RO) does the same for suppliers in England and Wales. Both Orders work by requiring electricity suppliers to purchase a set volume of Renewables Obligations Certificates (ROCs) - or SROCs in Scotland - which are awarded to eligible renewable generators, for each unit of renewable power they produce. Generators sell the ROCs and SROCs 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/SROCs to the scheme administrator (Ofgem) or alternatively make a 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/SROCs that each has presented.

<u>Mutualisation</u>

An issue occurs when there is a shortfall in the buyout fund due to suppliers failing to meet their obligations under the relevant Order. Suppliers who have met their obligation with ROCs receive less in recycled payments than would otherwise have been the case. This impacts upon both suppliers and generators. Mutualisation is the mechanism used to prevent excessive shortfalls in recycled payments from occurring. Once the shortfall exceeds a certain threshold, suppliers who have met their obligation are required to pay the unmet obligations of suppliers who did not. The mutualisation payments are then recycled back to suppliers who met their obligation in full, in proportion to the total number of ROCs/SROCs that each had presented. This protects SROC/ROC prices.

For each of the past five years, mutualisation has occurred under the RO and ROS, often due to numerous energy suppliers exiting the market. Since the 2015/16 obligation period, the threshold at which mutualisation is triggered had been set at £1.54m in Scotland and £15.4m for England and Wales. Below this threshold, any shortfall is left unrecovered.

3. Legislative and Policy Background

The renewables obligation is given legal effect in Scotland by the Renewables Obligation (Scotland) Order 2009, whilst The Renewables Obligation Order 2015 is the relevant legislation in England and Wales. Both Orders are made under Section 32 to 32M of the Electricity Act 1989. A similar Order exists in Northern Ireland but it is made under the Energy (Northern Ireland) Order 2003.

From 1 April 2021, the Department for Business, Energy and Industrial Strategy (BEIS) altered the mutualisation threshold for England and Wales so that it is now set at 1% of total renewables obligation scheme costs, rather than a fixed figure of £15.4m. For the 2022/23 obligation year this meant a threshold of £65.8m. This created substantial divergence between Scotland, and England and Wales for the first time. This SSI will amend the mutualisation threshold in the ROS to restore alignment between the two schemes.

BEIS consulted on this change to the mutualisation threshold in England and Wales from 11 December 2020 to 11 January 2021, to allow for the required legal changes to be made before the 1 April 2021, when the next Obligation year started. Parallel consultation exercises and legal changes were not taken forward by the Scottish Government at that time due to the timing of the Scottish Parliament elections in May 2021 and the pre-election period.

Following a public consultation in late 2021, the Scottish Government took the decision to delay the change for a further year to allow for monitoring of payment shortfalls under the RO over this period. Consequently, this change to the mutualisation threshold is instead being implemented ahead of the 2023/24 obligation period beginning on 1 April 2023.

4. Policy Objectives

The mutualisation threshold set in the ROS has failed to keep pace with the growth in the scheme and is now considerably smaller in proportion to the total cost of the scheme than it was when first introduced. This has tilted the balance of risk associated with supplier payment default away from generators and towards suppliers. This instrument amends the current mutualisation provisions to link the threshold to the annual size of the UK scheme, setting it at 0.1% of the forecast size each year (rounded to the nearest £100,000). This would have given a threshold of roughly £6.6m for the 2022/23 obligation year had it been in place, a significant increase on the current fixed sum of £1.54m.

Setting the mutualisation threshold at 0.1% of the total UK scheme re-establishes the threshold under the ROS at one tenth of the threshold for England and Wales, which is set at

1% of the total UK scheme. This is the proportion it had been since being introduced, with, for example, the thresholds from 2015 onwards set at £1.54m in Scotland and £15.4m in England and Wales, until BEIS introduced the 1% threshold under the RO in 2021. This restores the proportionality of risk associated with mutualisation in GB. Moreover, it ensures continuity in the scheme for industry who are well accustomed to the mutualisation threshold under the ROS being one tenth of the threshold set in England and Wales.

The threshold will now shift in future years as the cost of the scheme changes, restoring the original balance of risk between generators and suppliers. It also ensures that compliant suppliers are not unduly exposed to the unmet obligations of their competitors. It is possible that this will be of benefit to customers of compliant suppliers too as they are less likely to face pass-through costs.

This SSI restores alignment between the mutualisation threshold under the ROS and the RO, ensuring a consistent and cohesive subsidy scheme is delivered throughout Great Britain. This makes the operation and administration of the scheme simpler but is also crucial in ensuring a level-playing field across GB where suppliers are not exposed to a disproportionate level of risk under the ROS in comparison to the RO. The restored alignment of the schemes with regards to mutualisation will help facilitate a smooth, effective and free-flowing market for renewable generation and supply.

5. Consultation

When making or amending a Renewables Obligation Order, Section 32L of the Electricity Act 1989 sets specific statutory consultation requirements. These requirements have been met through this Scottish Government consultation, which ran from 11 November 2021 to 23 December 2021.

A total of 8 responses to the consultation were received and 4 respondents agreed to have their responses published. The responses came from a range of stakeholders including energy companies, a Local Authority and a statutory body. The responses were mixed, with four respondents not fully supporting the proposal to increase the mutualisation threshold under the ROS, citing concerns that it would not address the issue of supplier default. They also raised concerns that some risk would transfer from suppliers to generators because of this change. This is because the new threshold could increase the frequency of shortfalls not being recovered, potentially lowering ROC prices as a result.

However, as these comments do not necessarily dispute the objectives of amending the mutualisation threshold (i.e. reducing risk/costs faced by suppliers and consumers vis-à-vis the rest of Great Britain and ensuring a consistent regulatory regime through GB), the Scottish Government determined that it would be appropriate to proceed with this SSI. The views of these respondents have been noted and will be fed into continued discussions with BEIS and Ofgem on the issue of supplier payment default and protecting ROC/SROC prices.

Indeed, in addition to mutualisation the consultation also sought views on several options proposed by BEIS and Ofgem to tackle the issue of supplier default more directly. Whilst the renewables obligation is not the cause of supplier payment default in the GB market, several respondents noted the lack of adequate checks and balances in the administration of the scheme. Scottish Government officials will take these views into discussions with BEIS and Ofgem in relation to finding a substantive solution to the issue of supplier payment default.

A full summary of responses can be found on the Scottish Government website.

6. Impact Assessments

There is little to no impact on the Scottish Government or the broader public sector. Furthermore, there is expected to be no impact on Local Authorities and the voluntary sector.

The Scottish Government do not deem a strategic environment assessment necessary as this amendment only alters the ROS mutualisation threshold from a numerical limit to a percentage of the overall scheme. It therefore falls within the description of Section 4(3)(b) of the Environmental Assessment (Scotland) Act 2005, and consequently be outwith the scope of the Act as being a financial or budgetary plan.

Following screening, the Scottish Government determined that no impact assessments were necessary in relation to child rights and wellbeing, data protection, equality, human rights, Fairer Scotland or island communities.

7. Financial Impacts

The Cabinet Secretary for Net Zero, Energy and Transport has confirmed that a Business and Regulatory Impact Assessment is not necessary for this SSI.

Direct financial impacts for suppliers and generators are likely to be minimal. However, this SSI may have financial benefits for electricity suppliers as the prospect of mutualisation and its associated costs are reduced. These benefits may potentially be felt by consumers in a reduction of pass-through costs. Generators could feel a negative impact if mutualisation is triggered less and more money is left unrecovered. This may negatively impact the returns they receive via the ROS. However, this restores the original balance of risk between generators and suppliers that was established when the mutualisation mechanism was first introduced. Moreover, if mutualisation is not triggered next year, it is likely that wider energy market conditions will have played a bigger role than the impact of this SSI.

There is deemed to be no financial impact on the Scottish Government, Ofgem (the scheme administrator) or any other public sector body. There are also expected to be no financial impacts on the voluntary sector.

Scottish Government
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