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Subsidy-Free CFDs – Stabilising the industry?

By Robert Ede, political consultant, The Whitehouse Consultancy

As solar market cools, what are the prospects of subsidy free CfDs? Robert Ede, political consultant at The Whitehouse Consultancy, explores

Last summer, I attempted to make ice cream. Starting with plenty of enthusiasm, I blended everything together but found following the recipe challenging, and in my rush ended up missing out a vital ingredient – the stabiliser.

Stabilisers are an ever-present feature in shop bought ice-cream. They effectively delay the formation of crystals as the product freezes, whilst at the same time boosting volume and shelf-life. The result is soft scoop ice-cream that has a smooth, consistent taste.

Many within the UK renewables sector are advocating a similar ingredient to ease the transition to grid parity. 'Subsidy-free CfDs', now termed 'market stabilising', have been a popular topic of debate since influential centre-right think tank *Policy Exchange* published a report in August 2015 outlining how such a mechanism could make it possible for onshore wind (and potentially solar PV) to compete on equal footing with conventional generation. The Department of Energy and Climate Change (DECC) was then purportedly looking carefully at the proposals, intrigued by the potential to deliver capacity under low levels of price support. But what exactly is market stabilising, how would it work, and what are the prospects of implementation against the backdrop of Conservative Party politics?

The case for stabilisers

It's widely understood that the falling cost of wholesale energy means market signals are no longer sufficient enough to deliver new energy that is clean, secure and affordable. This is problematic for a government that will need to find up to 20GW of new capacity in the 2020s to replace retiring coal and nuclear plants.

Under the Coalition, DECC tried to pre-empt these challenges through the implementation of Electricity Market Reform (EMR). Two flagship policies were developed to drive decarbonisation whilst ensuring the lights remained on – Contracts for Difference and the Capacity Market. But nearly five years in, both schemes are mired in problems. CfD auctions have been postponed amid cost concerns, whilst the Department has recently consulted on a major overhaul of the Capacity Market that has thus far failed to usher in new gas.

CfDs were of course intended to replace the Renewables Obligation (RO) subsidy mechanism. But the CfD has a number of characteristics that make it a more attractive and cost effective route to decarbonisation.

Most importantly, a CfD does not constitute a subsidy in the conventional sense. As stated by Ben Caldecott, Associate Fellow at think tank Bright Blue, price setting mechanisms serve a vital function in guaranteeing future cash flows. Without these, capex-infrastructure would never be financed and constructed. Therefore, rather than viewing CfDs as a subsidy, they are in fact a necessity of delivering a modern energy system. This perhaps was understood by the team writing the Conservative 2015 Election Manifesto, which pledged to "end any new public subsidy" for onshore wind – leaving enough wiggle room to allocate future capacity under a CfD.

So if the CfD mechanism is not a subsidy, does that mean that Hinkley Point C (which has a guaranteed strike price £92.50/MWh for 30 years) is subsidy free? The answer is no, because what counts as a subsidy is dependent on the cost relative to other technologies.

What would market stabilising look like

If the Government seeks to allocate on a technology-neutral basis (as it proclaims to do), market stabilising CfDs will be limited to a level equivalent to building and operated new unabated gas. Policy Exchange estimates the cost of a CCGT plan is currently around £60/MWh – with payments under the Capacity Market making up the difference between this figure and the wholesale price.

Such a strike price would set a stern challenge to the solar industry. Cost reductions would have to be found, whilst the small amount of funding available would lead to intense competition. Importantly, there is already a strong evidence case indicating both onshore wind and mounted solar farms will be cheaper than gas generation by 2020 (see graph 1). As the unstoppable march towards grid parity continues for these technologies, the industry must work closely with the Government to ensure any stabilising mechanism creates a genuinely level playing field.

Until recently, the government had maintained radio silence since a 'bonfire of policies' last summer. In last month's budget, George Osbourne finally provided some clarity for the green economy; announcing £730 million in CfD auctions for "less established" technologies such as offshore wind this parliament. However this will be of scant consolation for the solar industry facing reduced deployment prospects for the rest of 2016. Ministers have promised to confirm the future size of the levy control framework in the Autumn – but will the announcement include the market stabilising CfD?

The politics matter here. Officials in DECC recognise cheaper technologies should not be excluded, but have to be careful in crafting a mechanism that appeases those within the Conservative Party who have fought to end green levies. There's little appetite within the Conservative leadership for policies that could be perceived to renege on manifesto commitments.

The industry therefore has until October to exert pressure on DECC to deliver a market stabilising CfD. It could prove vital for the entire renewables UK outlook and boost a domestic solar industry already feeling the pinch as investors begin looking at markets that pose less regulatory risk.

Back to that ice-cream analogy. If Ministers at DECC wants to make renewables subsidy-free without melting the market in the process, they'd be well advised adding a little stabiliser. ■