

# Reforming UK energy policy to live within its means

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In the July Spending Review 2015 the Chancellor set out the task for the UK economy of living within its means and repairing public finances. The Budget aims to repair public finances while the Spending Review aims to control public expenditure. Energy policy impacts both sides of the budget balance – taxes and charges generate revenue while support for decarbonisation, energy efficiency and renewables requires financial support, much of which is directly funded by charges or taxes levied on energy consumers. The present pattern of taxation, charging, and providing support has accumulated over time in a haphazard way without the kind of strategic thinking that a long-term economic plan requires. This briefing note sets out the sound economic and public finance principles that could guide the reform of energy taxes and supports.

## **EMR, the LCF and reforming renewables support**

This note concentrates on the electricity sector as that has been the subject of the Electricity Market Reform (EMR) in the recent Energy Act 2013 and is where the fiscal problems are most immediately apparent. Support to zero-carbon electricity (until the end of the decade entirely renewables) is escalating rapidly, and has more than trebled from £(2012) 992 million in 2007/8 to £3,138 m. in 2013/14 and is projected to treble again to £9.100 m. in 2020/21. These amounts would be considerably lower if the Renewables Obligation (RO) Scheme had been ended with the introduction of Contracts for Difference (CfDs) under the EMR, and the RO scheme should be replaced as soon as possible with CfD auctions, perhaps with just a single pot (or perhaps two if off-shore wind is necessary to meet targets). The 2015 CfD auction demonstrated that the weighted average cost of capital (WACC) could be lowered by 3.3% real, potentially saving £2.5 billion per year by 2020 and thereafter for 15 years, and perhaps more if the RO scheme is ended earlier than 2017. Properly funding a development bank on the German KfW model could leverage private capital and lower

the cost of capital, and it is disappointing that the Green Investment Bank never achieved scale and is likely to be privatized.

The contracts can be further improved by paying only up to a limited number of MWh/MW capacity either per year or over a 10-15 year period. In the longer run a move to capacity auctions with payment on availability might better suit the objectives behind the renewables support programme.

Similarly, the Feed-in Tariff schemes, which have grown from £(2012)15 m. to £690 m. in four years, should be either replaced by CfD auctions for larger schemes, or massively scaled back for smaller schemes to cost parity with the revealed CfD prices, avoiding further regressive transfers to wealthier households for whom they are an excessively generous financial investment that should logically be subject to the same taxes as interest and dividends.

### **Reforming energy taxation**

UK energy charges and taxes are a mess and need reform according to standard good public finance practice. Energy (both gas and electricity) should be subject to standard rate VAT, and all charges for environmental purposes (climate change mitigation, R&D and deployment support) should be financed from general taxation (whose receipts will be adequately enhanced by raising energy VAT from 5% to 20%). This would avoid subjecting production to distortive revenue raising charges and restore competitiveness, as production does not bear VAT costs and lowering environmental charges will reduce their costs. Now is an excellent time to do this as energy prices have fallen. The Carbon Price Support (CPS) should ideally be reinstated on its original trajectory, and its adverse competitive impact will be offset by exempting industry from environmental charges. Clearly it would be desirable if other EU countries also accepted the logic of the CPS, failing which it is understandable that the CPS may need moderating, and the shortfall in carbon pricing addressed through higher supports to low-carbon energy.