This paper is for discussion and does not represent government policy or policy intent

OFFTAKER OF LAST RESORT ADVISORY GROUP DISCUSSION PAPER 1: ALLOCATION MECHANISM

Introduction

This paper describes two potential methods for allocating generators seeking backstop power purchase agreements (PPAs) amongst eligible backstop offtakers, and considers the key benefits and risks.

The options considered are:

(a) Regulatory allocation – Ofgem allocates backstop PPAs amongst available backstop offtakers according to a set of pre-defined rules.

(b) Competitive allocation – prospective backstop offtakers bid a £/MWh fee to purchase and manage a generator's output under the terms of the Backstop PPA.

This paper will cover the following topics:

a. A description of the allocation options
b. An appraisal of each option against the assessment criteria

1. Assessment Criteria

The process for allocating generators to offtakers should be assessed against the following criteria:

(a) Practicality and cost of implementation and administration - The process needs to be practically possible, keep set-up resourcing and administrative costs to a minimum, and ensure that backstop PPAs are allocated to offtakers quickly.
(b) Impact on suppliers' credit ratings – The mechanism should spread the burden of backstop PPAs evenly or efficiently across the market, and minimise the impact on suppliers' balance sheets and credit ratings.
(c) Impact on cost to consumers – Minimising costs to consumers, for example by matching generators to offtakers able to manage the power at least cost.
(d) Legal risk and potential compliance cost – The allocation mechanism should minimise the risk of legal challenge by being objective, fair, and transparent.
(e) Potential for market distortions - The allocation mechanism should not impact the capacity or desire of suppliers to offer PPAs in the open market.
(f) Bankability of the OLR mechanism – Generators and lenders should be confident that the mechanism will deliver a backstop PPA with an appropriate offtaker when needed.

Question 1:

Do you agree that these are appropriate criteria? Are there any criteria missing?

2. Assumptions

2.1 For the purposes of this paper we will assume that there is a set of mandatory backstop offtakers that are obliged to participate, with other suppliers able to opt to be voluntary backstop offtakers subject to meeting certain criteria (e.g. credit rating). This is explored further in the accompanying paper on 'Offtaker Identity'.

2.2 We also assume that a fully-termed Backstop PPA (including the discount to the market price) has been determined and is grandfathered from the date of CfD signing.

2.3 We assume that the costs to offtakers of taking on the backstop PPA are levelised across all suppliers in proportion to market share.

2.4 This paper does not make specific assumptions about the tenor of backstop PPAs, but notes that the choice of allocation mechanism may affect choices about the appropriate tenor.

2.5 We assume that generators could exit backstop PPAs on the same conditions (e.g. the same notice period) under either mechanism. However, competitive allocation adds additional inflexibility since early exit could (a) incur costs to offtakers that were not factored into bids and (b) reduce the attractiveness of offering backstop PPAs (and therefore the level of competition in the backstop market).

3. Regulatory allocation

3.1 Under regulatory allocation, Ofgem would allocate generators to available backstop offtakers, and would assess the costs / benefits experienced by offtakers that are party to backstop PPAs ('regulated cost assessment') which would be socialised across the market.

3.2 The Baringa paper '*Backstop PPA Proposal*' considered three variants of regulatory allocation: (a) generators choosing the offtaker from a list maintained by Ofgem; (b) as (a), but with a capped obligation on individual offtakers; and (c) Ofgem allocating generators to offtakers aiming to evenly distribute backstop PPAs and matching generators with offtakers to achieve the 'best fit'.

3.3 On further analysis, we are not convinced of the merits of a mechanism involving 'generator choice' (i.e. (a) or (b) above). Since backstop PPAs will be on prescribed terms, we judge that the only material factor that is likely to affect a generator's choice of offtaker is the offtaker's credit rating – generators (and their lenders) will prefer the most credit-worthy offtaker. Consequently, all generators would be likely to choose the same offtaker, which would quickly lead to a disproportionate burden on that entity. If Ofgem capped the obligation on individual offtakers, then generators would simply turn to the next most credit-worthy offtaker once the preferred offtaker's cap was reached, and generators accessing the backstop PPA arrangements later would have a reduced choice of offtaker, which could create perverse incentives in the market.

3.4 We therefore favour a form of administrative allocation by Ofgem (option (c) above). However, we do not think it is feasible for Ofgem to attempt to directly assess the 'fit' between a generator and available offtakers. The efficiency with which an offtaker can manage the output from a generator is likely to depend on factors such as the offtaker's existing portfolio, technical ability (e.g. forecasting and trading), cost of capital, etc. These are not matters that can be easily and objectively assessed by Ofgem, so any attempt to do so would be likely to involve significant exercise of discretion, with associated legal risk, and it is not obvious that there would be material benefits to consumers from such an exercise.

3.5 Our preferred administrative allocation mechanism would work as follows:

- Ofgem would initially allocate backstop PPAs to eligible backstop offtakers according to a rota (e.g. random order, or ordered by market share) until each eligible offtaker had been allocated one backstop PPA.

- Subsequent backstop PPAs would be allocated to the offtaker with the lowest "backstop burden" (either the total volume of backstop PPAs allocated to the offtaker, or a ratio of backstop volumes / volume of electricity supplied).

3.6 This process has a number of benefits:

- **Simplicity and speed**: it is a clear, objective process that can be carried out quickly (reducing the risk premiums and credit cover in generators' PPAs) and efficiently, minimising administrative costs to Ofgem.

- **Minimise impact on offtakers**: it would distribute backstop PPAs as evenly as possible amongst available offtakers, minimising offtaker burden.

- **Low risk of challenge:** Ofgem would not be required to exercise any discretion, so there would be little risk of legal challenge.

3.7 However, as there is no attempt to 'match' generators with offtakers, this process could result in a generator being allocated to an offtaker with limited ability to manage the generator's output (for example, a wind generator could be allocated to an offtaker that does not currently manage wind power, and therefore does not have the necessary forecasting ability or data links). If, as is likely, the regulated cost assessment process is based on estimated average costs, this could lead to some offtakers being disadvantaged relative to others – although such offtakers could seek to subcontract management of the power to a third party.

3.8 We therefore think there might be merit in allowing an offtaker that is at the top of the rota to nominate another offtaker (by mutual agreement) to take on a backstop PPA on its behalf. Such agreements could potentially involve offtakers agreeing to make payments to each other to take on their backstop responsibilities.

3.9 We believe this has potential advantages, as it could further reduce the risk faced by individual offtakers that may not be best placed to manage a generator's output. Furthermore, it could provide a signal to Ofgem of whether it might be appropriate to move to competitive allocation, since a high level of swapping between offtakers might indicate that there is potential for significant savings if all generators were allocated to the 'best' offtaker.

Question 2:

Do you agree that 'generator choice' is not an appropriate method of allocation?

Question 3:

Do you agree that it is not feasible for Ofgem to attempt to 'match' generators with the offtaker that represents the best fit, in terms of ability to manage the power efficiently?

Question 4:

Do you agree with our proposed methodology for administrative allocation, consisting of a rota that takes into account 'backstop burden'?

Question 5:

Do you think there is merit to allowing a backstop offtaker to nominate (by agreement) another offtaker to take on a backstop PPA? What issues / risks might this present?

4. Competitive Allocation

4.1 Under competitive allocation, Ofgem would solicit bids from offtakers for the fee (probably in the form of £/MWh) that they would need to be paid (or would pay) to enter into a backstop PPA of a fixed tenor (e.g. 1 year) with a generator. The supplier that enters the lowest bid would be required to offer to enter into a backstop PPA with the generator. Certain suppliers may be required to enter bids in the auction (mandatory backstop offtakers) to provide certainty of offtaker, whilst other suppliers might be able to choose to do so (voluntary backstop offtakers) (see OLRAG paper 1.02 on offtaker identity for further discussion, and Annex X for illustrative steps and timings under competitive allocation).

4.2 This option would have the benefit of:

(a) Allocating backstop PPAs to offtakers that are able to manage the associated risks at the lowest cost, with such costs being reflected in the levelisation process, thereby reducing costs to consumers.

(b) Avoiding the imposition of a PPA on a reluctant offtaker, which might have implications for the behaviour of the offtaker under the PPA.

(c) Eliminating the need for a complex cost assessment process as offtakers will assess this internally as part of their management fee.

(d) For suppliers, potentially eliminating the balance sheet impacts associated with a cost assessment process as they can determine the fee they would receive for entering into a backstop PPA.

(e) Providing greater certainty for suppliers on levelisation payments.

4.3 However, there are a number of potential risks or downsides, including:

(a) Increasing the time between a generator seeking a backstop PPA and being allocated one, which would increase credit cover requirements (and, therefore, costs) in open market PPAs.

(b) Risk that the auction is uncompetitive, resulting in high fees (and therefore higher levelisation payments and greater costs to consumers).

(c) Risk that offtakers prefer to operate in the backstop PPA market (where they can make their desired margin), and therefore withdraw from the open market.

Question 6:

What level of competition is necessary to ensure 'cost reflective' pricing of bids in the auction, and how can this be ensured?

Question 7:

What is the likely impact on the open market for PPAs?

Question 8:

How long will offtakers need to assess their bids?

Question 9:

Does the tender process (e.g. sealed bids, open descending clock auction) need to be set out in legislation, or can it be left to Ofgem's discretion?

Question 10:

Is it really necessary to require certain suppliers (mandatory backstop offtakers) to bid, or will competitive pressures be sufficient to ensure they take part?

5. Hybrid Option

5.1 Considering the pros and cons of each of the options (set out above and further in in Annex 1) an ideal method may be one which combines the main advantages of both:

(a) Regulatory allocation – being simple, certain and fast for all parties and:

(b) Competitive allocation – in which the impact on offtakers' credit ratings is lower and generators are matched to the offtaker that can carry out the function at lowest cost, reducing costs for consumers.

5.2 We would therefore like the Group to consider whether there is potential for the development of a hybrid allocation mechanism under which regulatory allocation is used when generators first enter backstop PPAs, but competitive allocation is used to retender such PPAs after a certain period of time and / or if total volumes of generation requiring backstop PPAs breaches a given threshold.

Question 11:

Is there merit in exploring a hybrid allocation method that twins regulatory and competitive approaches?

Annex 1: Options vs Assessment Criteria

Practicality and cost of implementation and administration

Any process would need to be practically possible, seek to keep set-up resourcing and administrative costs to a minimum, while ensuring that a bankable PPA contract could be allocated to an offtaker quickly.

	Regulatory allocation	Competitive allocation
Pros	• Simple and fast - increases generator confidence and reduces time for contractual arrangements	• Eliminates need for complex cost assessment as offtakers assess that internally within their bid "management fee".
Cons	• Complex levelisation process, which will place administrative burden on Ofgem	• Ofgem would need to run regular tenders, take on functions to administer the bidding process, evaluate bids and manage appeals with the associated costs that arise from that. • Potentially increases the time needed to allocate the backstop PPA when a generator enters the backstop arrangements. • Likely to require regular re-tendering of backstop PPAs as it would not be practical or cost-efficient to tender PPAs of long tenors.

Question 14:

How long will the tendering process take, and how burdensome is it likely to be on Ofgem and offtakers?

Impact on suppliers' credit ratings and ability to offer PPAs in the open market

Any allocation mechanism would ideally avoid burdening one particular offtaker with a disproportionately high number of backstop PPAs while minimising any impact on suppliers' balance sheets and credit ratings.

	Regulatory allocation	Competitive allocation
Pros		• Allows suppliers to determine the price at which they can take on Backstop PPAs, potentially eliminating the balance sheet / business impacts associated with "estimated cost assessment". • Provides greater certainty for suppliers over likely levelisation payments, allowing them to better price them into tariffs • More likely that smaller suppliers will opt to participate, spreading the burden over a greater proportion of the market.
Cons	• Requires Ofgem to assess and estimate offtakers' costs, which may not necessarily reflect the true costs. This could uncertainty could have a negative effect on offtakers' credit ratings and reduce the willingness of offtakers to offer PPAs in the open market. • It is less likely the smaller suppliers would wish to become voluntary offtakers, and therefore concentrates the burden on mandatory offtakers.	

Question 15:

How material is the impact of regulatory allocation on offtakers?

Capacity for 'best fit' and impact on consumer cost

It's important that, wherever possible, offtakers are matched with generators to give the best outcomes for consumers.

	Regulatory allocation	Competitive allocation
Pros		• Competition between offtakers should allocate a generator with the supplier that can manage the output at the lowest cost to consumers, which is then passed through in lower levelisation costs.
Cons	• Less likely to be able to match generators to offtakers who are best suited for them. This could result in a less efficient partnership which would in turn increase costs to consumers. 'Swapping' may allow some matching of offtakers with generators, but would not reduce the levelisation costs.	• Low levels of competition (arising from, for example, high entry costs, low volumes of power being auctioned, or smaller suppliers / aggregators exiting the market) could lead to offtakers placing very high bids leading to large levelisation payments and profits. [Note, we believe the nature of the levelisation process will incentivise cost-reflective bidding, particularly if volumes increase.] Given that there is no cap on bids, and therefore no cap on consumer costs, Ofgem would have to closely monitor supplier behaviour and intervene if necessary.

Question 16:

How important is ensuring a 'best fit' between generators and offtakers in terms of cost to consumers?

Question 17:

How significant is risk that offtakers place very high bids under a competitive approach?

Legal risk for Ofgem and potential compliance cost

Any process will need to be objective, fair and transparent, while also minimising legal challenge to any allocation judgement.

	Regulatory allocation	Competitive allocation
Pros	• Low legal risk to Ofgem in allocating generators to offtakers, as it would be rule-based.	• Backstop Offtakers self-select avoiding the need to impose offtake on a reluctant offtaker. This should avoid compliance issues around whether an imposed contract is legally enforceable; and the need for Ofgem to exercise any discretion over allocation or cost assessment which reduces the judicial review risk.
Cons	• Potential legal risk to Ofgem if they have to exercise discretion in calculating levelisation payments • Difficult to accurately reflect the actual value and cost accruing to a Backstop Offtaker under the Backstop PPA without risking over or under compensation • Any regulatory allocation, i.e. without a competitive element, would be less likely than competitive allocation to comply with the EC's state aid rules.	

Question 18:

Do you see any significant legal risks under either option?

Question 19:

Which process would provide greater transparency for consumers and generators on costs breakdown?

Question 20:

To what extent could negative issues arise as a result of forcing an offtaker into a backstop PPA?

Potential for creating market distortions

Independent of the allocation mechanism, Government aims to design the OLR so that the obligation to offer backstop PPA has no effect on the capacity or desire of a supplier to enter into PPAs in the open market. This risk may be affected by the relative attractiveness to suppliers of backstop PPAs compared with offering PPAs in the open market, and the degree of competition in the open market and the backstop market.

	Regulatory allocation	Competitive allocation
Pros	• The potential for profit under backstop PPAs is limited to the regulatory cost assessment carried out by Ofgem – offtakers would face a risk that levelisation may not fully compensate them for costs of being party to backstop PPAs. Offtakers would therefore have a strong incentive to offer PPAs in the open market to make profit and avoid these potential costs.	• Competitive pressures and access for voluntary offtakers should lead to cost-reflective bidding in competitive tenders, thus encouraging participation within the open market.
Cons	• Could affect retail competition as uncertain levelisation payments may be more difficult for smaller players to absorb. This could reduce suppliers' willingness / ability to offer PPAs in the open market.	

Question 21:

How significant is the risk that competitive allocation would affect offtaker behaviour in the wider PPA market?

Impact on bankability of the OLR mechanism

It is important that all parties have confidence that the mechanism will deliver a PPA with an appropriate offtaker.

	Regulatory allocation	Competitive allocation
Pros	• Confidence for all parties that a backstop PPA will be allocated in a timely fashion.	
Cons	• (Potentially) greater risk of legal challenge, which, if the PPA allocation needed to be scrutinised, could lead to a delay in generator and offtaker entering into the PPA. • Ofgem would be at greater risk of legal challenge than under a competitive process, including whether such a contract would be legally enforceable	• (Perceived) risk (if not mandated) that no offtakers will bid for the PPA • Timing risk as the PPA needs to be tendered to the market (increasing cost to generators of credit support provided by offtaker in the open market).

Question 23:

Is there a significant difference in bankability between the two options?

Annex 2: Illustrative step-by-step process for different options

Table 1: Regulatory allocation

	Step	Detail	Indicative timings
1	The generator alerts Ofgem to its desire to enter into a backstop PPA		1 day
2	Ofgem checks the circumstances under which the generator is applying, depending on the eligibility criteria	Length of time depends on the nature of the checks required (to be covered in a later paper).	1 week?
3	Generator provides information to Ofgem	This may include name, technology type, ultimate owners, expected output, nominated backstop offtaker (if relevant), installed capacity and SCADA integration.	In tandem with step 2. 1 week?
4	Ofgem alerts offtakers that a backstop PPA is being processed	Ofgem will need to allow suppliers time to prepare to take on a backstop PPA and incorporate it into their business planning/info relevant interested parties.	tbc
5	Ofgem allocates the generator to an offtaker against set criteria	If obligated parties are given the option of 'swapping', they may need additional time at this stage to reach agreement.	1 week?
6	Ofgem informs offtaker and generator of decision and notice period for suppliers to enter into the backstop PPA	Contracts would be non-negotiable, so this is unlikely to take a long time.	1 week
7	Supplier and generator enter into backstop PPA	Similar to any standard PPA contract. Depends on time to register meters, set up SCADA links, etc.	tbc

Table 2: Competitive allocation

	Step	Action	Length of time
1	The generator alerts Ofgem to its desire to enter into a backstop PPA		1 day
2	Generator sends information to Ofgem on the nature of the project and further details	Generator should provide as much of the minimum information as possible including, but not exclusive to name, technology type, ultimate owners, expected output, installed capacity and SCADA integration.	1-2 weeks?
3	Ofgem notifies the market and organises a tendering process, sharing generator information with suppliers and inviting bids	Mandatory offtakers would be obliged to participate	1 day
4	Ofgem begins administrative preparations for auction		2-4 weeks?
5	Suppliers evaluate project and tender bids	Length of time for this step will depend on a number of factors, such as size of the project and potential risk, as well as levelisation concerns. Also an opportunity to query the generator on any aspects of project.	4 weeks? (in tandem with step 4)
6	Successful offtaker wins the auction, administered by Ofgem	Ofgem would have to quality assure the bids and run the administration process for allocating, according to its own processes.	3 weeks?
7	Generator and Supplier enter into a PPA contract.		

Question 24:

Are these steps and timings appropriate and accurate?