Department of Energy & Climate Change

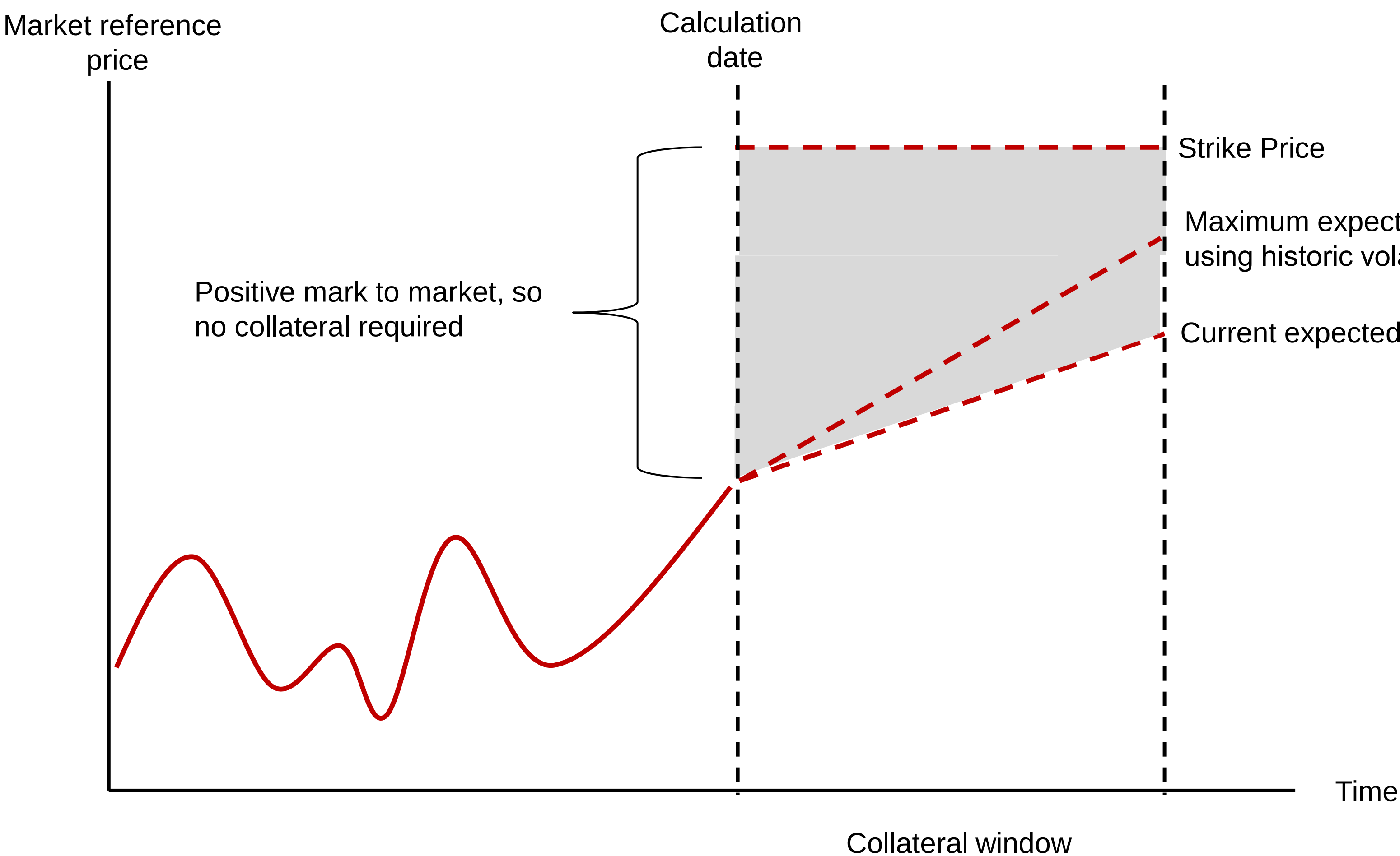
# Direct Agreement and Collateral

## Contracts for Difference

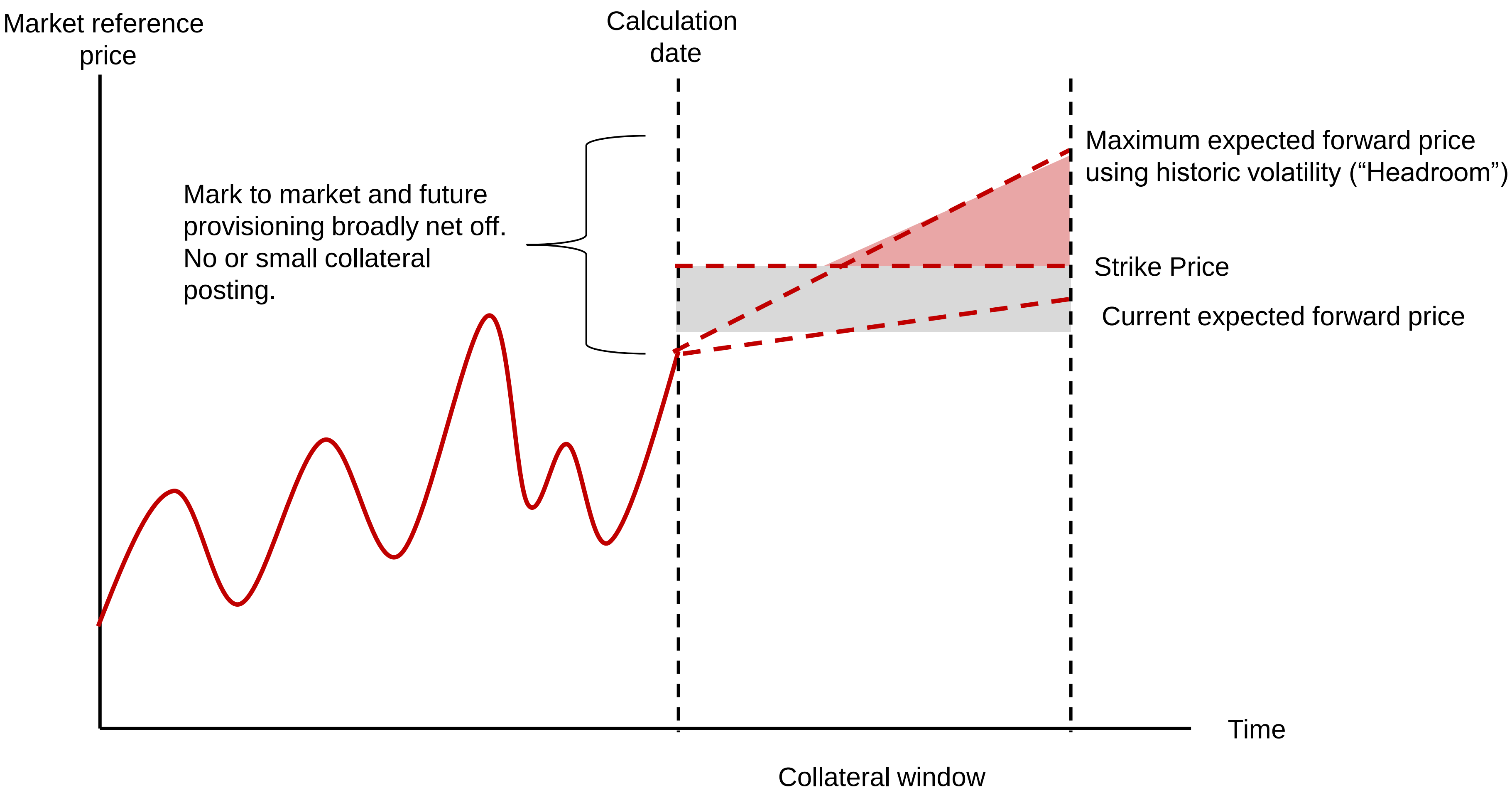
Department of Energy and Climate Change, October 2013

# Generator Collateral

# Methodology 1: Generator “in the money”



# Methodology 2: Generator "at the money"



# Methodology 3: Generator “out of the money”

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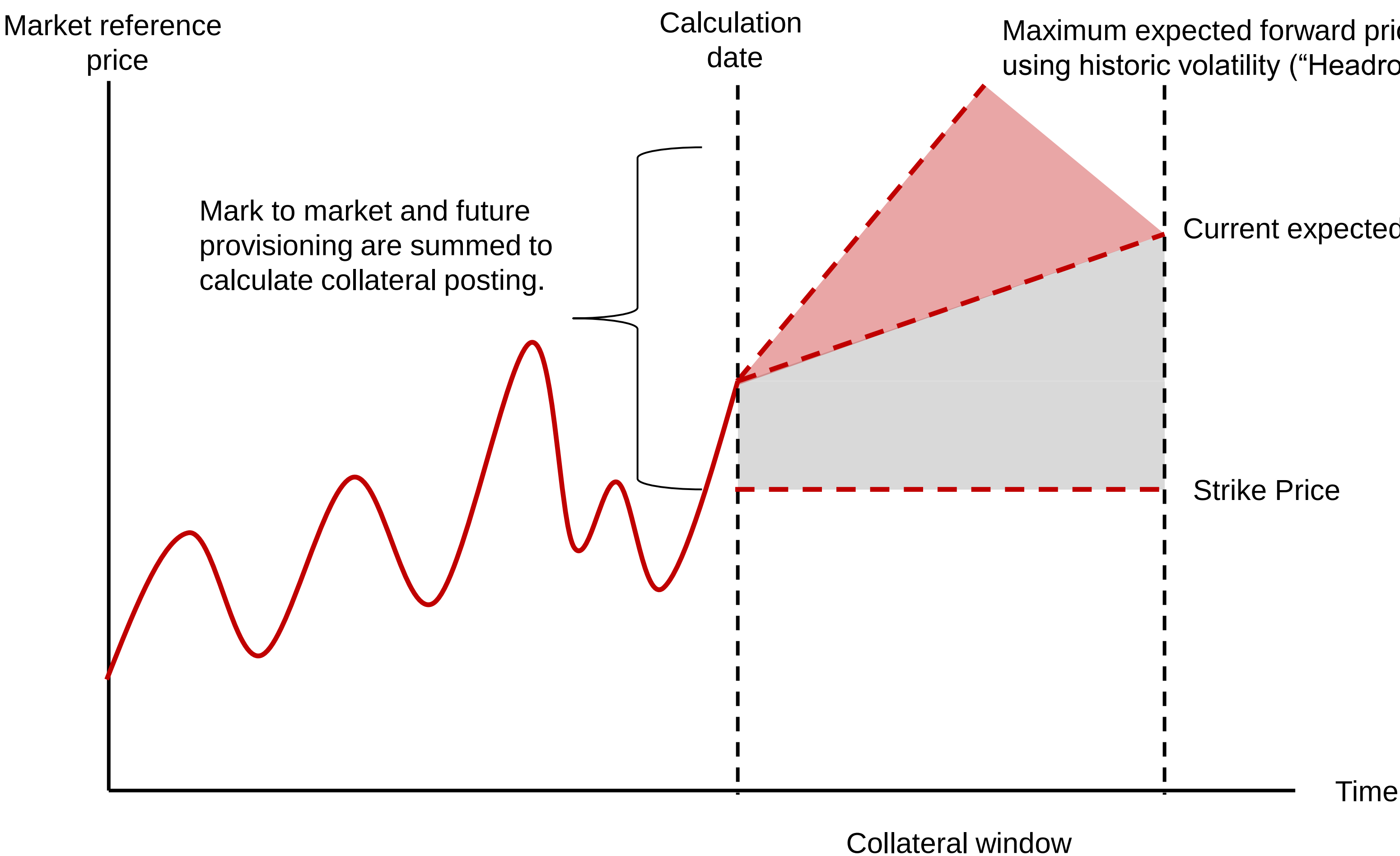

# Methodology

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- On the first business day of each week, the Counterparty will calculate the collateral required by;
  - calculating the current **expected forward price** via the current futures curve;
    - formula to be set out in the contract for intermittent and baseload calculation;
  - calculating the plausible range of deviation from the expected forward price, based on historic volatility **(headroom);**
    - **volatility** X expected forward price X **collateral window**
  - calculating the **mark to market** of the CfD;
    - expected forward price – **strike price**;
  - calculating the **expected output** of the Generator over the collateral window with reference to historic generation;
- Then;
  - summing the maximum expected forward price and the mark to market; and
  - multiplying it by the expected output over the collateral window.

**Is this methodology broadly in line with expectations?**

# Forms of acceptable collateral

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- Generators may post collateral in;
  - cash; or
  - irrevocable standby Letter of Credit (LC)
- A Parent Company Guarantee (PGC) would not be an acceptable form of collateral.

- Collateral must be posted within [5] business days of deemed receipt of a notice to provide collateral.

**Is 5 business days long enough?**

Is it assumed that a provision for collateral posting will be intrinsically linked to the initial financing package i.e. pre-approved. Considering this, is 5 business days long enough to notify, arrange and draw on a working capital facility or receive an LC for a Generator acting reasonably?

# Letters of Credit

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- An LC must be issued by a financial institution rated A- (or better) by Standard and Poor's or equivalent;
- If the FI drops below an A- during the term of the LC, the LC will be called and the cash held by the Counterparty, until an adequate replacement LC is provided.

# Letters of Credit

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- Further, the LC must be;
  - valid for a minimum term of 3 months;
  - replaced  more than 10 business days prior to expiry; and
  - issued in the name of the Counterparty, but must be able to be called by service providers of the Counterparty i.e. the Settlement Agent.
- If the LC does not meet the criteria, the Generator will have 2 business days to rectify the situation.
- Failure to provide adequate replacement collateral within 2 business days would result in the existing LC being called as cash.

**Are the LC timeline criteria achievable?**

# Cash collateral

- Cash collateral would be held in a Reserve Account by the Counterparty;
- The Reserve Account would be separate to the settlement accounts of the Counterparty, and could only be utilised in a circumstance of payment default or under the right of set-off in a Termination Event; and
- The Generator would have no ability to draw on funds in the  account but could request the Counterparty to return Reserve Account cash collateral where it exceeds the Required Sum.

# Payment failure

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- The Generator is obliged to continue to make settlement payments through ordinary channels;
- Where payment has not been made by the end of the payment cure period, collateral will be called on for the relevant outstanding amount;
- The Generator will be required to replenish its collateral with the amount of the called collateral within 2 business days;
- If a Generator relies on their collateral for payment 3 times in any 12 month period, the assumed volatility in their Headroom provision will become 20% higher than the original determination;

**Are the payment failure mechanics broadly as expected?**

| **Payment Period** | | |
|---|---|---|
| Billing Period | 1.00 | Days |
| Billing Period - Billing Date | 7.00 | Days |
| Billing Date - due date for payment | 5.00 | Days |
| NPA Payment Cure Period | 5.00 | Days |
| 2 days collateral posting time | 2.00 | Days |
| Weekend days | 8.00 | Days |
| **Total collateral required** | 28.00 | Days |

# Termination



- The need to post collateral gives rise to several areas in which a Termination Event must be a possibility for breach of the collateral provisions;

  - Where collateral has not been posted after 5 business days of notification that it is due.

  - Where collateral is called due to a payment default; **and**
  - Collateral is not replaced within 2 business days.

  - Where the Generator fails to post Acceptable Collateral; **and**
  - Does not replace the collateral with Acceptable Collateral within 2 business days of notification by the Counterparty.

  - Where the Generator has posted an LC as collateral; **and**
  - They do not replace the LC with a replacement LC or inform the Counterparty it will be replaced with cash 10 business days prior to expiry of the LC.

**Is it reasonable that these repeat failures represent termination events?**

# Netting of collateral

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- Should netting apply between contracts for a Generator (ie where the same generator has contracts that are both in and out of the money due to differing Strike Prices?), specifically;
  - How could we manage the company status ie SPVs, JVs?

- Should netting apply between the Supplier Obligation and Generator Collateral where collateral is required on both sides at the same time (infrequent, but possible)?
  - How could we manage the company status ie ring fenced supply companies?

# Direct Agreement

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# The CfD Direct Agreement

11 October 2013

# Slide Contents

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- Context
- Purpose
- Form
- Content
- Questions

# The Context of the Direct Agreement

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- We appreciate the importance of the CfD including the legal mechanisms to operate within the context of debt financed projects and project owners.

- For this reason:

  - the CfD allows for the generator to assign its rights and benefits, by way of security, to any bank or financial institution funding the generator; and

  - the CfD will incorporate a standard form funder direct agreement between (1) the relevant security trustee on behalf of the funders, (2) the CfD counterparty, and (3) the generator.

# Direct Agreement Broad Purpose

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- Detailed proposed terms and timescales of the direct agreement will be covered later in the presentation.

- The purpose of the Direct Agreement is to allow:
  - temporary step  in; and/or
  - to allow for the novation of the CfD.

- This would work in tandem with the relevant funder's rights under its facilities agreement.

- The direct agreement is fundamentally likely to be of most importance to funders. We will therefore be testing the proposed terms of the CfD with funders as well as with the expert group.

# Direct Agreement Form

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- Form of direct agreement will be a schedule to the CfD.
- Entered into as a separate agreement to the CfD.
- Entered into by:
  - the CfD Counterparty;
  - the CfD Generator; and
  - the CfD Generator’s secured lender (or a security trustee acting on behalf of a group of lenders).
- Standard form.
- Therefore it is important that the direct agreement is in a form that will be acceptable to funders.
- We believe our proposed approach is relatively market standard.

# Direct Agreement Content

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**Process for funder stepping-in:**

- Where the CfD Counterparty plans to exercise a right to:
  - terminate the CfD Contract;
  - suspend payments under the CfD Contract; or
  - take insolvency proceedings against the generator
- The CfD Counterparty must inform the funder.
- Similarly, the funder must inform the CfD Counterparty if it plans to enforce an event of default under the facilities agreement

# Direct Agreement Content

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- From the point of this notice, the lender then has 45 days to decide whether to:
  - step-in;
  - novate; or
  - do nothing.
- During the 45 day period the CfD Counterparty’s right to take the relevant enforcement action is suspended.

# Direct Agreement Content

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- Where an entity steps-in, that entity must:
  - ensure outstanding sums are paid to the CfD Counterparty;
  - ensure any other generator performance obligations which had arisen during the 45 day pre step-in period or pior to this are fulfilled; and
  - take on on-going generator CfD obligations.
- Where the entity stepping-in does not comply with the above, and the CfD Counterparty therefore has a continuing right to take the original enforcement action, the CfD is then free to take this enforcement action..

# Direct Agreement Content

**Process for funder stepping-out:**

- The step-in period can come to an end in the following circumstances:
  - the funder simply steps-out and the original generator remains the generator under the CfD;
  - novation of the CfD to a permanent new generator entity;
  - the date when all debts are paid under the relevant facilities agreement; or
  - the date of expiry or termination of the CfD.
- Any entity to whom the CfD is novated must fulfil specified acceptability criteria.

# Direct Agreement Content

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- During the step-in period, in practice we would expect the funder to be evaluating whether:
  - the issue can be resolved with its existing borrower or the borrower can refinance the project;
  - the lender wishes to enforce its right under its facilities agreement, and thereby (in most cases) to trigger administration whereby the administrator will look to achieve maximum value from the sale of the relevant generation facility (likely to be along with the CfD); or
  - to allow the CfD to be terminated.

# Direct Agreement Process and Timescales Summary

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- CfD Counterparty or funder plans to take enforcement action.
- CfD Counterparty or funder must notify the other of this.
- 45 day period for the funder to either: do nothing, step-in, or novate the CfD.
  - where the funder does nothing the CfD may then be terminated by the CfD Counterparty; and
  - where the funder is able to novate the CfD then the CfD resumes with the party to which it has been novated.
- Where the funder exercises its right of step-in, the step-in continues until the earlier of:
  - all debts being paid under the facilities agreement;
  - expiry/termination of the CfD;
  - step-out, through the funder giving the CfD Counterparty 10 days' notice; or
  - novation of the CfD to a new generator entity.

# Any questions?

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- Our priority is to include a standard form direct agreement which is bankable. We will therefore be testing the direct agreement with funders next week.

- However, we very much would welcome any questions or comments..