rfrfrfr

Energy Markets _Networks)

From:
Sent: 16 August 2012 11:26
To: Coyne Matthew (Energy Markets and Networks)
Subject: Centrica Response to PPA Call for Evidence

This contains confidential customer/commercially sensitive information and should not be disclosed to any other party without the express consent of Centrica. You should inform us immediately if you receive any request for disclosure under the Freedom of Information Act or equivalent legislation.

Dear Matt,

With regard to the PPA Call for Evidence, we are aware DECC would find it helpful to have more quantitative evidence to supplement our response to the Call for Evidence. We are therefore able to provide the information below only on a confidential basis; this information is incredibly sensitive to Centrica so we are sharing this information only on the proviso this information is not shared outside of DECC.

- Since July 2010 we have tendered for over 80 PPAs
- these PPAs have been offered to nearly 50 different developers and for all renewable technologies (even including wave and tidal)
- We offer a variety of structures, terms (up to 15 years) and pricing (including fixed price and with floor prices) to developers
- We have approximately a one in ten success rate for executing a PPA that we tendered for
- 10% of the developers have never provided feedback to us, despite chasing from us
- In our experience, PPA negotiations can take up to two years from the initial term sheet to execution due to the length of time it takes for developers to line up finance; it is not uncommon even for onshore wind with experienced developers for this to be a twelve month process.

I hope our comments are useful. Please do not hesitate to contact me if you have any further questions.

Best Regards

rfrfrfr

Centrica plc

Registered office: Millstream, Maidenhead Road, Windsor, Berkshire SL4 5GD

Registered in England and Wales No 3033654

centrica
energy

Centrica Energy Limited
Millstream
Maidenhead Road
Windsor
Berkshire SL4 5GD
Telephone 01753 494000
Facsimile 01753 431090
www.centrica.com

Matt Coyne
Department of Energy and Climate Change
3 Whitehall Place
London SW1A 2EW

August 16th 2012

Dear Matt,

A call for evidence on barriers to securing long-term contracts for independent renewable generation investment

Thank you for the opportunity to respond to the above call for evidence. We have been active in the PPA market for several years, with a dedicated team in place since 2010. We believe that this market is competitive, and we are concerned that the threat of regulatory intervention might crowd out market-based initiatives that could meet the needs of independent generators more effectively.

Appendix 1 to this letter provides detailed answers to your questions, and we would like to emphasise the following points.

- **There is no evidence that competition in the PPA market is ineffective**—Over the past three years, we have seen a significant amount of new entry, a greater diversity of structures being offered, and a growing pressure on prices. There are no obvious barriers to entry in this market: all that is needed to offer PPAs is a trading and forecasting capability, and the ability to meet the credit requirements of the financing banks. It is telling that the most successful provider of PPAs at the moment has no involvement in supply or thermal generation in GB. Overall, this is a dynamic market that has the potential to innovate and meet the needs of independent developers.

- **The completion of EMR and the cash out review will further strengthen competition in the market**—By transferring the price risk of new projects to consumers, CfDs will remove the need for floor prices in PPAs, a key risk for offtakers. This means that PPAs will become 'simpler' products that can be offered by more counterparties. The cash out review might further encourage new entry by making balancing costs more predictable and more transparent.

- **Regulatory intervention at this stage might be counterproductive**—We believe that regulatory intervention in this environment (or even the threat of regulatory intervention) could deter potential offtakers from entering the market. If this is the case, then competition might become *less* effective, leading to a greater need for intervention.

More generally, we would encourage DECC to use a more rigorous approach to its competition assessment, covering market shares, barriers to entry, pricing policies, etc. It is not enough to argue that renewable developers are not getting the terms that they would like. DECC should only intervene in this market if it has demonstrated the existence of serious market failures.

At this stage, we see no evidence of such structural defects. As such, we believe that DECC should focus on encouraging market-based initiatives to facilitate contracting. The most promising option in our opinion is to design a PPA contract model that is compatible with the CfD scheme (once the details of this scheme are known). Such a model would make PPA offers more easily comparable for developers, while 'streamlining' the contracting process and reducing legal costs.

I hope these comments are useful. Do not hesitate to contact me if you have any questions.

Yours sincerely,

By e-mail

Head of Power Origination

Centrica Energy Limited
Registered in England and Wales No 2877398
Registered Office: Millstream, Maidenhead Road, Windsor, Berkshire SL4 5GD

Appendix – specific questions asked in the call for evidence

Identifying the problem

1. **Please could you provide a summary of your experiences with the PPA market over the past three years? Specific areas for which detailed information would be particularly helpful are set out in the Annex.**

   Since July 2010 we have tendered for a significant number PPAs, offering a variety of structures, terms and pricing to developers. The confidential note that accompanies this response provides more detail on our recent activity in this market (and our answers to questions a. to e. below provide more qualitative information).

2. **Have you seen significant changes to the PPA market over the past three years, and if so, what do you think has driven this? If you have asked PPA providers for explanations of why changes have occurred, what reasons have been provided?**

   We have seen a number of changes in the PPA market over the past 3 years, and we believe that most of these developments have been positive for competition and innovation in the market.

   - **New entry by European companies**—a number of European utilities (eg Statkraft, Gazprom) and aggregators (eg Nordjysk Elhandel) have started to offer PPAs in GB. Statkraft have acquired a large share of the market in a short period of time.

   - **New entry by end-users**—a number of end-users have started to offer PPAs to renewable developers. These users are typically large retailers (or other consumer-facing businesses) seeking to purchase 'green energy' to meet corporate social responsibility goals.

   - **More diverse demand**—traditionally, the bulk of the demand for PPAs has come from independent developers who need long-term contracts with floor prices to underwrite key project risks and obtain bank finance. More recently, a new type of demand has emerged from European utilities who build renewable plants on-balance sheet and do not wish to trade all the output themselves. These utilities require shorter-term PPAs to cover the offtake and balancing risks of their projects; these PPAs are 'simpler' products which can be offered by a broader range of market participants. We are also increasingly able to offer these structures to older assets which have already been debt financed (these new structures are more akin to what we believe will develop with FIT CfDs).

   We hold that the PPA market is changing but is dynamic and competitive, as evidenced by the fact that both new banks and new offtakers have entered the market over the last few years.

   One change in the market is that there has been both greater regulatory uncertainty in the electricity market and a tightening in banks' ability to lend. As a result, PPA negotiations have increasingly focus on the balance of risks between the parties. The increase in risks being taken on by offtakers through offering long term bankable pricing is not always readily understood by developers and their banks. Change in Law provisions, credit requirements and termination rights are all hard to negotiate and require a deep commitment by all three parties to developing a solution and maintaining a long-term partnership.

Offtakers incur significant costs in developing each offer so it meets the needs of each project, which is why offtakers typically require exclusivity in the negotiation process before engaging in detailed negotiations. This constraint is not always understood by developers, who often seek to obtain contracts forms from several bidders without granting exclusivity. This contracting approach by developers could limit the amount of potential offtakers available.

We also expect that the proposed limit on the use of biomass ROCs for compliance might hinder some ability of certain offtakers to offer PPA structures that buy these ROCs.

3. **How does the GB market for PPAs compare to other international markets? If you operate in other markets, how do PPA structures and terms differ? If terms differ what are the drivers behind the differences?**

   We have limited knowledge of PPA markets outside GB. However it seems to us that, by removing long-term price risks, fixed Feed-in-Tariffs (which are the dominant form of renewable support in continental Europe) might facilitate competition in PPA markets. We believe that CfD-FiTs will provide the same benefits in GB.

4. **What are the factors preventing or encouraging participation in the GB market? How (and why) do you expect these to change over time?**

   We do not see any major barriers to entry in the PPA market. The most important requirements for offtakers is to have a forecasting and trading capability in the GB market and to be able to meet the credit requirements of the financing banks.

   At the moment, companies who want to offer long-term PPAs to independent developers must be willing to take the price risk associated with PPA price floors. This requirement might exclude certain participants from this segment of the market. However, it will become irrelevant when EMR is implemented and this should enable a broader range of counterparties to participate in the long-term PPA market.

   A common misconception is that large utilities have a competitive advantage in the PPA market due to vertical integration, and that this advantage makes entry more difficult for independents. In reality, large utilities dispatch their thermal plants based purely on day-ahead and intra-day prices; they do *not* use their generation portfolio to balance contracted assets. We do not think that the ownership of thermal generation provides any advantage in the PPA market. If it did, then we would expect independent generators like Drax or International Power to be more active in this market.

   Another common misconception is that suppliers currently have an obligation to buy ROCs and therefore enter into PPAs. In reality suppliers can meet their obligations under the RO by buying ROCs in the open market or paying the cash alternative.

5. **Do you expect the EMR package to change the PPA terms that you might offer/receive and if so how do you believe they will change? What do you think is the primary driver for these changes?**

   Yes, CfDs will transfer the long-term price risk from developers to consumers, which will remove the need for floor prices in PPAs, a move we welcome as an offtaker. This means that PPAs will become 'simpler' instruments (dealing solely with the offtake risk and the balancing risk) and that offtakers will compete more on price, and less on other terms. This will make it easier for small aggregators to enter the market. This will also make it easier for developers to compare offers in tenders. In addition, CfDs might also remove or mitigate Change of Law risks for renewable projects, which in the past have also been an obstacle for certain offtakers. Overall we believe that the implementation of EMR will further strengthen competition in the market and allow companies to innovate further to offer different products and structures.

More generally, the regulatory uncertainty surrounding cash-out review and EMR do make it challenging to guarantee pricing levels in long-term contracts.

6. **What has been the determining factor in selecting a preferred PPA and PPA provider?**

   We respond to all requests that we receive and we are happy to contract with all developers willing to accept our terms. However, because we invest significant time and resources in understanding the needs of our clients, we find it easier to deal with developers who are willing to commit time and effort to form long-term partnerships. This approach allows us to develop deals that work for all parties and can be replicated for other projects.

7. **Have you seen a change in investment returns as a result of the changing nature of PPA terms and can you provide an example, including how this has been calculated? Do you expect the EMR package to change investment returns, and if so what is the driver for this?**

   This seems to be a question for independent developers. However, as a matter of principle we believe that CfD strike prices should include an allowance for the cost of balancing renewable generation, whether this is done in-house or outsourced through a PPA. The pricing in PPAs reflects the risk we are being asked to take on and covers our costs.

Options to achieve the Government's objective

8. **What are your views (costs, benefits and risks) on the potential options discussed in this call for evidence that may be necessary to achieve the Government's objectives?**

   We believe that DECC should focus on market-led initiatives. We are not convinced that DECC's 'competition measures' will have any significant effect on the market, and we have some strong reservations about the 'regulatory measures' put forward in the call for evidence.

- **PPA contract model**—we believe that this is the most promising option. Such a model would make PPA offers more easily comparable for developers, while 'streamlining' the contracting process and reducing legal costs. It would also reassure banks and financing partners, who are often unwilling to invest time and resources to understand 'bespoke' contracting models. We do not think this is a practical suggestion prior to the introduction of CfDs since the terms of CfDs will condition the structure of the PPA contract model. We do though support developing a standard PPA model to work with the CfD as soon as the CfD details are known. This would also enable the industry to understand the rating agencies' view of the PPA.

- **Improving liquidity**—we do not see any obvious link between the liquidity agenda and the PPA market. Firstly, improved liquidity is unlikely to entirely remove the need for PPAs. A number of developers do not have the trading and forecasting capability needed to access the wholesale market and balance their assets. When EMR is completed these developers will still require a PPA to sell their output and manage their balancing risk.

Secondly, improved liquidity is unlikely to have an effect on the competitiveness of the PPA market or on pricing. PPA providers require a sufficient degree of liquidity in the *day-ahead* and *intra-day* markets, but these market segments are already considered to be sufficiently liquid by Ofgem (and by market participants more generally). The liquidity of long-dated products, which is the focus of Ofgem's work, is practically irrelevant for wind PPAs.

– **Cash-out reform**—we agree that cash-out is relevant and that some of the options contemplated by Ofgem could facilitate balancing for small parties (notably reducing the cash out spread and consolidating trading accounts). However, as a matter of principle, we believe that cash-out should be designed to produce meaningful price signals and minimise the *overall* costs of balancing the system. It should *not* be designed to promote the interests of a particular constituency of generators or investors. The current uncertainty is a challenge to be overcome by offtakers.

– **Measures to support independent aggregators**—this concept is extremely vague. DECC does not specify who these independent aggregators are (is this concept based on ownership of generation, or on size?), and why they need support. We do not believe that the ownership of generation capacity in GB is relevant (see our answer to question 4). Unless these measures are effectively removing an undue barrier to entry in the market, they will, by definition, stimulate inefficient entry and increase costs.

– **Large supplier obligation**—This suggestion reflects a misunderstanding of what PPAs are about and what is needed to provide them. The main purpose of a PPA is *not* to buy power; it is to provide a range of services to developers including market access and the management of key risks (including the balancing risk, the offtake risk, and the basis risk). There is no reason why large suppliers should be particularly well-placed to provide such services. Generators, financial intermediaries, or independent brokers are equally well-placed to participate in this market. It is telling that the most successful entrant in this market over the past few years, Statkraft, is not involved in the supply market at all.

  This option appears to be based on a presumption that the 'Big 6' are somehow foreclosing this market and should be the focus of any remedies. There is no evidence that vertically integrated companies are behaving anti-competitively, and, as such, any policy measure based on such an erroneous assumption is bound to be arbitrary and inefficient. We would further argue that this option might in fact be counterproductive if it strengthens the role of large suppliers in the PPA market.

  Moreover, we do not think that this option would be practicable. Obligated parties could easily evade the requirement by submitting uncompetitive offers. This obligation could only be effective if DECC were to regulate the terms of the offers, which would be an unacceptable degree of intervention in the market. As a rule, we believe that it is preferable to incentivise willing sellers and buyers to negotiate terms together.

  Finally, we would like to stress that there has never been an obligation on suppliers to purchase low-carbon energy in GB. Under the RO, suppliers can meet their obligations by buying ROCs in the open market or paying the cash alternative. We do not see any benefit in imposing such an obligation now.

– **Offtaker of last resort**—our main concern with this approach is that the offtaker of last resort might end up crowding out 'unregulated' PPA providers. This would, in turn, lead to greater concerns about the competitiveness of the market and a 'slippery slope' of regulatory intervention.

The fundamental issue with this approach is that it will be very difficult to ensure that the 'regulated PPAs' offered by the offtaker of last resort will be offered on terms that are cost-reflective. Without an accepted evidence base and methodology to price PPAs, the temptation will be to under-price regulated PPAs to meet broader policy goals. Such a regulatory pressure on PPA prices (or the mere threat of such a regulatory pressure) will deter new entrants.

A further concern with this approach is that it could remove market competition as both developers and banks credit committees may only be willing to accept the offtaker of last resort standard pricing and terms as this is what they are familiar with. They could have no interest in understanding or negotiating different terms with other offtakers as this will be a further complication which they may not be interested in engaging in as the PPA is just one element of the development process.

Part of the rationale for using CfDs instead of FiTs under EMR was to incentivise low-carbon generators to fully participate in the wholesale market (either directly or through PPAs), with a view to improving liquidity and encouraging the development of risk-management products. We believe that this remains the right approach, and we are concerned that a regulated offtaker would negate part of these benefits.

9. What are your views of the potential for market distortions and possible impact on the wider market?

See our answer to question 8 above. We believe that DECC's proposed regulatory measure are very likely to distort market outcomes.

10. Can you identify and explain any other viable options (voluntary, competition based, regulatory or otherwise) that should be considered?

We believe that DECC should focus on delivering EMR and monitoring the cash-out reform. We are confident that competition will further improve as and when regulatory uncertainty is reduced and the CfD scheme is operational and understood in detail by developers and investors.

For PPA providers

a. Have you seen an increase in the number of requests that you have received for the provision of PPAs?

We have seen a steady stream of PPA requests since July 2010 (which is when we restructured our Origination activity). We have also seen a slight increase in requests following the announcement of the RO banding review as developers are keen to construct before the change in banding.

b. Have you have been able to respond to a larger or smaller proportion of the PPA requests for tender? If your ability to offer PPAs has increased or decreased over this period what have been the drivers (commercial or otherwise) for this change?

We have replied to all the requests we have received over the past 2 years. We have an approved strategy for our PPA activity which allows us to pursue opportunities and conditions the terms we can offer.

c. Have the terms that you have been able to offer in response to PPA tenders changed, and if so how have they changed? What are the drivers for this?

Centrica Energy Limited
Registered in England and Wales No 2877398
Registered Office: Millstream, Maidenhead Road, Windsor, Berkshire SL4 5GD

We have reduced our discounts over time to reflect our greater experience of the market and our improved forecasting capability.

d. Have you been able to win more or fewer PPA tenders based on the terms you have offered?

We have won more PPA tenders.

e. How do you think EMR and the CfD will influence the terms that you are able to offer in response to PPA tenders?

CfDs will allow us to offer better terms as it will remove the need for us to take part of the price risk for new projects.

We have never considered ROCs to be the main source of value in PPAs, so the phasing out of the RO will not diminish our appetite for new deals in this market.

Centrica Energy Limited
Registered in England and Wales No 2877398
Registered Office: Millstream, Maidenhead Road, Windsor, Berkshire SL4 5GD