SCOTTISHPOWER

Director of Regulation

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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 your call for evidence of 5 July on barriers to securing long-term contracts for independent renewable generation investment.

ScottishPower has been active in the PPA market for many years and has worked with renewable developers to create appropriate PPA terms that have enabled them to gain finance from banks during extremely challenging times. We are operating in a competitive market, and would not have been able to secure these PPAs without offering developers a fair share of risk and reward. Although we have seen a sharp fall in the number of PPA tenders brought to market, the terms we have offered have not changed significantly over the last three years.

Looking ahead, we anticipate that EMR, principally the introduction of Contracts for Difference, will make it easier for independent renewable generators to sign long term offtake contracts. The CfD strike price mechanism will deal with the financial support and with the risk in the electricity wholesale price up to the day-ahead stage. All the developer needs to do is sell the power into the day-ahead market, where there has recently been a considerable improvement in liquidity.

Any PPAs that developers or their financiers require will therefore benefit from simpler terms reflecting only the short term wholesale electricity price. Unlike the RO regime, there will be no implicit ceiling on the amount of renewable generation that suppliers will be prepared to purchase.

The main risk that will remain under EMR is the imbalance risk. We will continue to respond to PPA opportunities on a competitive basis and will be prepared to offer two alternative commercial models to provide assurance that the terms offered in respect of imbalance risk are reasonable:

- the terms could follow the current approach to PPAs where ScottishPower takes on the imbalance risk in exchange for a fixed discount to the power price; or

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- where the renewable developer is willing to take on imbalance risk from trading the power, we would be prepared to offer PPA terms incorporating only a management fee for providing a route to market.

The cost of imbalance risk is a real cost that should be quantified and allowed for in the CFD strike price. This will achieve the optimum economic efficiency. We do not see any need for regulatory intervention around PPAs, and indeed we would be concerned that such intervention could have significant distortionary effects, with adverse consequences for the cost passed to the consumer.

Adequate market liquidity will be critical to the success of CfDs and PPAs, and it is appropriate that Ofgem is keeping a close eye on developments in liquidity. However, in our view, market-led initiatives to improve liquidity and provide model PPAs are the most likely to attract independent renewable generation investment into the market without distorting the market for other investment.

We have set out below our answers to the detailed questions in your call for evidence.

I hope this provides you with the information you are seeking. Should you wish to discuss any of these points further then please do not hesitate to contact me.

Yours sincerely,

Director of Regulation

CALL FOR EVIDENCE ON BARRIERS TO SECURING LONG-TERM CONTRACTS FOR INDEPENDENT RENEWABLE GENERATION INVESTMENT

SCOTTISHPOWER RESPONSE

ScottishPower is a major UK energy company with network, generation, renewables and retail supply interests. It is the UK's leading wind power developer and a leader in the development of new marine technologies. ScottishPower is part of the Iberdrola group, a major international utility and the world's leading renewables developer.

1. **Please could you provide a summary of your experiences with the PPA market over the past three years?**

   ScottishPower has been active in the PPA market for many years and has worked with a range of renewable developers to create PPA terms that have enabled developers to secure finance for their projects. Our share of the independent PPA market continues to be above our share of the GB supply market. Since 2009 we have successfully concluded approximately 130MW of new PPAs with independent renewable generators, with these new PPAs expected to deliver output of some 330GWh per annum. We believe that this indicates that the PPA terms offered continue to be attractive and competitive.

   Over the last three years we have observed a sharp decline in the number of PPA tenders received from independent generators. Over 30 tender requests were received in 2009, falling to 12 in 2011 and only 4 in 2012 to date, two of which were received immediately following the announcement of the banding review. The majority of PPA tender requests we have received have been for onshore wind farms and ScottishPower has responded to most of these with an indicative bid. The few instances where no indicative bid was provided were mainly due to the timescales required being too tight to enable ScottishPower to complete its evaluation process.

   The PPA terms offered by ScottishPower have not changed significantly over the last three years. We have made adjustments to respond to changes in our view of the future risks arising from the UK generation mix and margin, market conditions, and the prevailing economic climate. In making such changes we have worked with renewable developers to achieve a solution that provides the appropriate balance of risk and reward for both parties, an example being a move away from annual power price indexation to include an element of within-year price reference so as to preserve the level of the discount to the power price offered to the developer.

   We are very aware that we are competing with other organisations in seeking to provide independent renewable developers with terms that make it attractive for them to sign a PPA with us. Our competitive approach to PPAs has enabled us, in very challenging economic conditions, to close PPA contracts that meet our own requirements and those of project developers and the banks providing the project finance.

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?

As set out in our response to Question 1, there has been a downward trend in the number of PPA tenders brought to market over the past three years. General economic conditions have undoubtedly been a major factor in this reduction with banks/investors withdrawing from the market or seeking greater risk premiums to secure funding. As a consequence, banks' credit committees are seeking more assurance in terms of due diligence and have enhanced requirements with regard to financing terms and covenants prior to approving funding decisions. Increasing levels of financial regulation and changes to capital adequacy rules are likely to bring further challenges.

With regard to renewable market conditions in recent years, these have been characterised by significant consolidation with a number of smaller independent developers having been acquired by larger UK and foreign owned utilities, some of whom have a UK based supply business. Following integration, this has contributed to the reduction in the number of PPA tender requests made.

Whilst the above can explain to an extent the progressive reduction in the number of PPA tenders presented over the last three years they do not explain the dramatic fall off in the first half of this year. We believe that the PPA market activity was adversely affected by the need to await the results of the Renewables Obligation banding review. Prior to the announcement of the new support levels, the market endured a period of uncertainty and therefore developers were not able to progress with financing and PPA arrangements in respect of new projects. Following the publication of the RO banding review outcome in July there was an immediate rebound of interest from independent developers with two new onshore windfarm PPA tenders brought to market.

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?

Many factors such as project financing and contract timeframe are common to the GB market and other international markets in which the Iberdrola group operates. However the intricacies of support mechanisms in both the current GB market under the RO and in the future GB market under EMR make it difficult to meaningfully compare GB PPA price terms with other international markets.

In Italy new legislation coming into force in 2013 may encourage development of a PPA market. Under this new legislation, imbalances will become an issue for intermittent renewable generators as they will be required to pay imbalance costs from which they are currently exempted. Therefore there may be a requirement for PPA providers to effectively manage this risk for independent developers to assist in financing. This would be similar to the GB market approach to allocation of risk/reward within a competitive framework.

Iberdrola is also active in the German PPA market where there is no quota obligation for retailers, as would be the case under EMR in GB. Short term premium tariffs were introduced in 2012 allowing developers to switch to and from the long term FiT scheme on a monthly basis while being responsible for imbalance risks. The PPA market is most active in this sector but tends to be short term contracts for 2-3 years.

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

Under the RO, suppliers are able to avoid the need to purchase any volume of ROCs by paying the buy-out price and are thus not obligated to sign PPAs to procure ROCs. In our view, the main benefits currently for a supplier to sign PPAs with independent renewable developers are therefore:

(i) increasing the proportion of renewable generation in the supplier's overall fuel mix;

(ii) the procurement of LECs in support of sales contracts with industrial and commercial customers; and

(iii) the long-term procurement of ROCs, if they can be obtained more advantageously than paying the buy-out.

The fact that the RO is named an "Obligation" does not create any requirement to purchase ROCs. Suppliers' incentives to make such purchases depend on the economics of the transaction.

However due to the low levels of liquidity in the ROC market and the fact that only obligated suppliers can redeem ROCs, suppliers may be reluctant to contract for more than their full obligation. This could limit the volume of ROCs they may wish to procure via PPAs. We do not anticipate significant improvements in ROC market liquidity and we therefore expect this situation to persist.

Where an independent developer seeks to transfer all risks relating to the output generated by their projects, negotiations to reach terms agreeable to all parties can be protracted. Agreement must be reached on the ROC buy-out value, any recycling benefits, and risk sharing on the wholesale price. In some cases, the supplier may be asked to provide a guaranteed floor price for the power to help mitigate long term wholesale price risk.

Improved day-ahead liquidity enables shorter term indexing of these contracts and thus can reduce the wholesale price risk to be managed under the contract. ScottishPower has voluntarily committed to place at least 30% of its tradeable output in the day-ahead market thereby contributing to enhanced liquidity. Other vertically integrated utilities have also done likewise and this has had a significant effect on market traded volumes.

As market conditions improve and risks reduce there will be more opportunities for renewable developers and suppliers to sign PPAs.

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?**

On the basis of the key principles underpinning EMR, and more specifically the CfD system, we anticipate that independent renewable developers will continue to be able to secure PPAs with suppliers. These PPAs will benefit from simpler terms because many of the key risks will be carried by the CfD strike price mechanism. In particular, the CfD will carry not only the subsidy payments, but also all wholesale price risk up to the day ahead stage. In combination with improvements in day-ahead market liquidity, this will serve to reduce the risk of wholesale market prices.

Improved market liquidity allows the PPA to be based on day-ahead prices giving the renewable developer a reduced level of risk in capturing the reference price and topping up to the strike price. Provided the crucial CfD issues of counterparty, credit robustness, enforceability and underwriting can be resolved then the renewable developer is only likely to be seeking to use the PPA provider as a route to market for their power and potentially to fix imbalance risk.

We are committed to evaluating PPA opportunities and responding with terms set on a competitive basis that appropriately allocate risk and reward with the aim of signing mutually beneficial PPAs with renewable developers. We can anticipate two alternative commercial models:

- the terms could follow the current approach to PPAs where ScottishPower takes on the imbalance risk in exchange for a fixed discount to the power price; or

- where the renewable developer is willing to take on imbalance risk from trading, we would be prepared to offer PPA terms incorporating only a management fee for providing a route to market.

Under EMR, the implicit ceiling for the volume of contracted renewable energy for a supplier which applies under the RO would no longer apply.

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

While this question appears to be directed mainly at independent developers, ScottishPower, as a PPA provider, believes that the determining factor in the PPAs we have signed has been the competitiveness of terms we have offered compared to the terms being offered by our competitors.

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?

While this question also appears to be directed mainly at independent developers, ScottishPower as a PPA provider has not seen a significant change in return levels over the last three years. Over this period we have sought to maintain the same level of return from PPAs despite changes in our view of the type and level of risk posed to such arrangements by future changes to the UK generation mix and market conditions.

Under EMR we will seek to achieve a reasonable level of return, with an appropriate allocation of risk/reward given the introduction of CfDs. We will continue to evaluate PPA opportunities, responding with terms set on a competitive basis and would expect to continue signing mutually beneficial PPAs.

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 agree that market-led initiatives to improve transparency and availability of PPAs are likely to deliver benefits more quickly than any regulatory approach and are likely to be the least distortionary. In our view, markets can price risks better than regulatory measures and will provide the most efficient route to market. We believe our standard PPA terms, covering the construction, commissioning and operating periods could be used as a basis for developing a simpler model PPA consistent with the CfD regime under EMR. The availability of such a model PPA would be particularly attractive to potential new entrants seeking to evaluate opportunities.

We agree that measures promoting competition in the wholesale market, improving transparency and efficiency, will be less distortionary than specific measures directed solely at the PPA providers. Recent significant improvements in day-ahead liquidity, achieved by market-led initiatives, should enable the day-ahead price to be used as the basis for the CfDs. There is evidence that further market-led initiatives, including plans by some of the large suppliers to further increase futures volumes traded, are leading to improved liquidity further along the curve and this should encourage increased confidence in the market.

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

We believe that regulatory measures directly targeting PPA providers are likely to distort the market with the potential for higher costs to consumers. An obligation on large suppliers or an off-taker of last resort to offer standard administratively set terms to renewable developers carries an almost certain risk that the terms will be mis-priced, leading to inefficient market decisions and increased risk and cost to suppliers, and therefore consumers.

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

We believe that we will have commercial incentives under EMR to offer PPAs to independent renewable developers and that market-led initiatives to improve liquidity and provide model PPAs are the most likely to attract independent renewable generation investment into the market without distorting the market for other investment.

ScottishPower
16 August 2012