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Scottish Renewables Evidence

Barriers to securing long-term contracts for independent renewable generation investment

1.0 Introduction

As set out in the call for evidence, independent developers have played a significant role in supporting the growth of renewable capacity in the UK electricity market, responsible for 45% of existing operational onshore wind capacity. Independents will also play a key role in ensuring future progress towards the 2020 targets.

Under existing market arrangements, PPAs have served both as the main route to market for independent generation and as a guarantee to banks or other sources of debt finance. Typically, developers require a 15 year PPA with indexing brown power floors (ie guaranteed minimum prices) to secure non-recourse debt finance. Indeed, we are not aware of any project that has been financed on a non-recourse basis without a long term Power Purchase Agreement.

There has been anecdotal evidence for some time of a 'tightening' in the PPA market, with fewer companies offering terms, and terms creating greater risk and lower returns for generators

Scottish Renewables therefore commissioned Quayle Munro, a financial advisor, actively engaged on renewable energy projects, most notably in the onshore wind market, to report on their experience of changes in the Power Purchase Market in August 2010 and February 2012 (see Annex1).

Their professional opinion is consistent with the feedback that we have received from independent generators, and demonstrates significantly fewer companies offering terms, and a significant deterioration in the terms being offered from the viewpoint of independent generators.

In August 2010 Quayle Munro received terms from seven of the potential off-takers that were initially approached. All the terms received were for 15 year PPAs with indexing brown power floors.

In February 2012 Quayle Munro received responses from six of the potential off-takers that were approached. Of these, only one provided a solution that would be acceptable to both senior funders and equity investors. One withdrew from the market to undertake an internal review of expected exposure to ROCs (as significant amounts of offshore wind is shortly to come online), and the remaining four offered un-bankable positions - one in relation to imbalance risk and three due to issues related to the floor price for brown power.

Quayle Munro's main findings were:

1. Fewer companies offering terms
2. Passing of imbalance risk to generators
3. Removal of floor price
4. Less certainty over Changes in Law
5. Reducing commitment to ROC and LEC Purchase

The impact of these changes is summarised as follows:

> "We have seen significant adverse changes in the PPA market between 2010 and 2012, to the extent that projects are being severely impacted by the very limited number of credible PPA players who are able to offer bankable PPAs.

With continuing lack of clarity on the level of ROCs going forward beyond April 2014 and large gaps in understanding of the financial implications of the Contract for Difference, investors face increased uncertainty over investment return. When taken together with the limited PPA market this makes ongoing development investment decisions difficult."

Independent generators are facing increasing challenges to access finance for their projects. Given the scale of the independent sector, this could become a threat to progress to government targets. It will also do little to assist the Government's other objective of bringing in market entrants and new investors.

As argued later, we therefore believe that some form of time-limited and focused intervention is essential to reassure independent investors and to manage the transition to new market arrangements. Failure to do so could lead to a significant investment hiatus.

Drivers of market changes

The change in the PPA market appears to be attributable to a number of different sources of uncertainty over the future of the wholesale electricity market, including:

1. Policy change, including EMR
2. Ofgem's reviews of liquidity
3. Ofgem's review of cash out
4. The GB market's growing proportion of variable generation

In addition, the delays from UK Government on announcing the new bandings, along with reports of potential cuts to financial support for onshore wind, added to the uncertainty within the sector and also created concern over its future. Project TransmiT will also impact on costs for generators.

All of this has led to suppliers changing the terms on which they are willing to enter into contractual arrangements that leave them exposed to the volatility in wholesale electricity price. Whilst this is perfectly 'rational' behaviour on the part of suppliers it means that independent generators are finding it increasingly difficult to negotiate PPA's with terms which allow them to debt finance their projects. If this continues, there will come a point when investment slows down.

This uncertainty has also coincided with an overall contraction in the global financial market.

Whilst it is important not to underplay the impact that investment uncertainty has had on the PPA market, it is important to point out that the planned closure of the Renewables Obligation has had a sizeable consequence on the decision making processes of the electricity supply industry. We explore this point in the following section.

2.0 Impact of Electricity Market Reform on the Power Purchase market

2.1 An explicit incentive to purchase renewable power will be removed

The Renewables Obligation is a statutory instrument specifying the amount of electricity to be supplied from renewable electricity with an option to pay the buy-out price if this requirement is not met. Electricity suppliers are incentivised to purchase renewable electricity by the buy-out price, which evidence suggests has exceeded the value of purchasing ROCs since the inception of the Renewables Obligation in 2002.

As an incentive instrument, the Renewables Obligation has provided a stable and challenging demand for renewable generation and has created a well signposted route to market for the country's renewable resource. Under Electricity Market Reform, there are no targets placed on companies to encourage them to progress towards national targets and contract with renewable generation.

2.2 The removal of the Renewables Obligation is affecting the current PPA market

The planned closure of the Renewables Obligation in 2017 has had an effect on future expectations, costs and long term decision making within the electricity industry. In the case of an electricity supplier, the decision to enter a long term contractual arrangement with an independent renewables generator will be based on its view of commercial obligations under the Renewables Obligation, which are essentially a function of obligated cost multiplied by expected volume and then multiplied by an expectation of time. The volume of obligation will not increase post 2017,therefore, an electricity supplier may choose to balance the short terms costs of purchasing ROC's on the open market with longer term costs associated with potentially unnecessary long term contractual agreements with an independent renewable generators. It could be argued that such a strategy creates a business model for an offtaker to purchase ROC's and sell them on at a premium in the open market to those obligated to comply with the system until its closure in 2017, and then on a declining basis post 2022.

In place of an explicit incentive, Government has stated their belief that commercial opportunities will be incentive enough for offtakers to provide a PPA to independent renewable generation in the medium to long term. This may very well be true once the various market reforms have 'bedded in', but there are no guarantees that this will be the case, and the uncertainty created by the factors outlined above is being priced into PPA's today, meaning smaller returns and greater risk for the independent sector, which is in turn impacting on the sector's ability to finance projects.

What is clear is that long term uncertainty over the wholesale market is translating into short term constraints and impacts on the PPA market and we therefore believe that some form of intervention is necessary if the independent sector is to maintain investment and if the UK Government is to meet its ambition of bringing in new developers and sources of finance to the renewables sector during the ongoing transition from the RO to EMR.

However, it is important that any intervention does not simply pass the risks associated with the uncertainty outlined above to suppliers, as they will be forced to price in this risk to their customers, pushing up costs to consumers. Likewise, any intervention must be time-limited, reviewed at regular intervals and clearly focused on achieving an appropriate balance of risk and reward for different parts of the electricity market.

3.0 The Options for Government

3.1 Market Led Initiatives

We believe that contract models and codes of practice are unlikely to result in a change of practice by electricity suppliers, given that the terms they are offering are designed to and must be designed to balance risks and rewards to their own companies.

However, we believe there is merit in government exploring whether some degree of industry consensus can be achieved and whether this could translate into the market delivering sufficient capacity of PPAs on terms which allow developers to access debt finance.

3.2 Banking Reforms

It is important to note that it is not the independent generation sector that requires long term PPAs of the type that have been standard for some time – it is their financiers and bankers that require the security provided by a long term PPA of this nature.

As such, many of the problems outlined above could be overcome if banks and other sources of finance develop a clearer understanding of the rebalancing of risks and rewards, and the delivery of greater revenue certainty that could be achieved through EMR. However, this will again only apply in the medium to longer term.

3.3 Competition Measures

3.3.1 Liquidity

It is clear that successful implementation of the Contract for Difference will require a liquid wholesale market to ensure a pricing structure that can enable the market to continue to deliver projects. Measures to improve liquidity are an important means of increasing competition and trading options where clear price signals and the ability to effectively manage trading risks are essential. As stated above, the Retail Market Review and other reforms may contribute to a situation where there is greater competition amongst suppliers to offer PPAs, however, this will only happen in time, if at all.

3.3.2 Cash Out Reform

Any measure that can produce more certainty and predictability with respect to the costs of balancing should enable the costs of managing the risks associated with imbalance to be reduced. Again, however, the benefits of these reforms are still very much in the future It is also questionable whether any of the benefits to be derived from cash out reform measures will be delivered early enough to address the concerns regarding the current PPA market, and the PPA market as Electricity Market Reform takes effect.

3.3.3 Measures to support independent aggregators

Any measures which act to increase the number of aggregators and PPA providers in the market (and thereby increase competition) will be welcome, but again these are only likely to have an impact in the medium to longer terms, and after the implementation of EMR proposals and liquidity measures.

We believe that the introduction of such measures should be considered alongside regulatory measures that would directly facilitate a route to market for independent renewable generation investment whilst appropriate market led initiatives take hold and the independent aggregator market develops.

3.4 Regulatory Measures

Whilst not the unanimous view of our membership, Scottish Renewables supports the introduction of some form of regulatory intervention given that the ongoing reforms of the electricity market are unlikely to help strengthen the PPA market in the short term, and the threat that this poses to investment and build out rates. However, it is important that this does not simply transfer risk and therefore cost to suppliers as this will simply be passed on to consumers.

The proposal for an Offtaker of Last Resort has the potential to ensure that the PPAs are offered on terms that are 'bankable'. Whilst this may be a short term intervention it will only facilitate investment if it offers terms over time frames which are required by the finance community.

Costs and credit exposure could be mutualised across all licensed electricity suppliers in much the same way it is proposed that the counterparty to the Contract for Difference would be. Likewise, it should not be overlooked that this measure could actually result in a positive financial outcome if electricity purchased were to be traded at an overall net profit.

At this stage we are keen to explore the relative costs and benefits of these proposals further with suppliers, generators, government and financiers in order to develop a shared understanding of how we best foster a stable and competitive PPA market now and in the future as the various ongoing market reforms take effect. Given the importance of this issue to achieving targets, and the potential impact of reforms, we believe that ministers and officials must continually monitor and review the PPA market, as well as any intervention that is ultimately introduced.

4.0 Conclusions

Scottish Renewables consider there to be a clear and pressing need for government to address the issues we have raised in this submission. Given the need to support ongoing investment and development while the new market structures are developed and implemented, we support the introduction of a transitionary, time-limited regulatory intervention, with our favoured option some form of 'buyer of last resort'. We recommend the intervention be regularly reviewed to assess its continued requirement, with the mechanism rescinded at the appropriate point in the electricity market's development.

Scottish Renewables is committed to working with DECC on the detail of this intervention and the necessary market led reforms required to supplant the intervention in the longer term.