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10 March 2011



Our Ref EFM - EMR

Dear Sirs

ELECTRICITY MARKET REFORM CONSULTATION

We refer to the Consultation Document on Electricity Market Reform (EMR), published by DECC on 16 December 2010 (the Consultation Document) which invites responses to DECC's proposed options for reforming the electricity market.

McGrigors is a top 50 full-service commercial law firm, with one of the UK's largest dedicated teams of energy lawyers. Our expertise spans the entire energy spectrum, including the traditional areas of upstream and downstream oil and gas, electricity and gas transmission, as well as the newer areas of renewables, carbon capture and storage (CCS), gas storage projects and asset decommissioning.

Within the renewables sector we have extensive experience, both in the UK and a number of jurisdictions across Europe, of advising developers, stakeholders, investors and funders on onshore wind, offshore wind, wave, tidal, landfill gas, biomass, biofuel, hydro and waste-to-energy projects. We have advised on UK wind projects having a combined capacity in excess of 8,000 MW – a substantial percentage of the proposed capacity for wind farms according to industry statistics.

The comments we set out below relate to issues which we consider to be of significant importance to differing stakeholders in the electricity market. Our comments also take account of issues which we believe are important from a funder/investor perspective.

Much of the EMR agenda is, quite rightly, driven by the desire to increase the level and speed of investment and financing of electricity generation across a number of technologies whilst at the same time lowering the cost of finance.

The required investment will not, however, materialise unless the reforms take due account of the views and concerns of the financing and investment community. This is particularly so in light of the competitive and international nature of the market where finance and developers are very mobile.

It is important that the reforms are designed in a way which mitigates the risk that the availability of finance is impaired or that finance will only be available at high cost or with inappropriate gearing. If

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the reforms do not do that, one of the consequences will be that certain target sources of finance, for example pension fund/debt capital markets, will not be as accessible as would otherwise be the case. We would encourage the Government to seek coordinated responses from the finance and investment industry before finalising the reform package.

We note that one of the primary purposes of the EMR is "to strike a balance between the best possible deal for consumers and giving existing players and new entrants in the energy sector the certainty they need to raise investment". In our practice, we are acutely conscious our clients' need for clarity and certainty in the electricity market to enable them to raise investment and to give them confidence to develop projects in the energy sector.

We are strongly of the view that the Government's proposed package requires a great deal of work before such clarity and certainty can be achieved.

Current Market Arrangements

- 1 Do you agree with the Government's assessment of the ability of the current market to support the investment in low-carbon generation needed to meet environmental targets?**
 - 1.1 We agree that the current market will find it difficult to attract the investment required to allow meaningful deployment of new nuclear and CCS, alongside significant further renewable energy.
 - 1.2 Aspects of the current market have, to date, been unattractive to certain lenders and investors. Historically, the Renewables Obligation (RO) has been perceived by some lenders to be less attractive than a FIT regime. Latterly however, we have seen wide market acceptance of the RO model, which is flexible enough to allow different incentivisation for different technologies, locations and stages of maturity.
 - 1.3 We would counsel against Government reforms being implemented in a manner which may not encourage financed solutions for some early projects in the emerging technologies and industries. For example, in encouraging offshore wind development we believe the early "first mover" projects should benefit from strong incentivisation, properly reflecting the market making risks that developers, financiers and investors will be taking in those projects. At this stage of the market development, it is critical that the level of risk that developers are required to assume is duly recognised to stimulate the required acceleration of investment.
 - 1.4 We share the view that there is, and in both the short and medium term will continue to be, significant global competition for capital. We believe that it must be a primary objective of the proposed EMR to deliver an environment which will attract that capital and which will do so on an efficient basis. There is a risk that the proposed reforms will not do this and may either increase the overall cost of capital to the sector or will detract or at least defer investment in the necessary infrastructure.

- 1.5 We also agree that the investment required to deliver networks capable of accommodating the new generation capacity contemplated in the Consultation Document will be significant. The investment required for that could be attracted in different ways to that required for new generating capacity – while outside the scope of this Consultation Document, we would be happy to discuss this further.

2 **Do you agree with the Government's assessment of the future risks to the UK's security of electricity supplies?**

- 2.1 Broadly, yes.

Options for Decarbonisation

Feed-in Tariffs

3 **Do you agree with the Government's assessment of the pros and cons of each of the models of feed-in tariff (FIT)?**

- 3.1 Before turning to this question, we should consider whether a FIT of any sort is the only viable model. Many of the Government's objectives in respect of the Consultation Document could be met by making adjustments to the scope of the existing RO. In our experience, the RO is now widely understood by both the development and the financial community. The reluctance of some parts of the financial community, e.g. pension funds, to invest in UK renewables has largely been attributable to reluctance to take exposure to wholesale price risk (*cf.* the German market). This aspect can, however, be addressed through a suitably designed low carbon obligation.
- 3.2 In our view, the Government's assessment does not adequately address the cons of a FIT with CfD. In particular, the proposal to structure the CfD around the difference between an "average market wholesale price" and the agreed tariff level (or strike price) leaves the generator with the risk that it will not be able to sell its output at a price which matches the market wholesale price. This risk represents a significant qualification to the revenue certainty which a FIT with CfD is capable of delivering for a generator using wind or other intermittent generation.
- 3.3 A Premium FIT will not, of course, deliver certainty on revenue levels either. Nevertheless, the impression we have (based on the soundings taken from our clients and other contacts over the period since the issue of the Consultation Document in December 2010) is that the absence of a track record for, and the relative complexity of, a CfD based FIT as a means of promoting new investment in the energy sector is likely (if a FIT with CfD model were to be adopted) to create a climate in which new investment will be slower to materialise than would be the case if a Premium FIT model were adopted.
- 3.4 Although a Premium FIT, (in the same way as a FIT with CfD), leaves the generator (absent a suitable PPA) with revenue uncertainty, we believe that - for the reasons given in other

responses below - developers and their financiers would find a Premium FIT a more attractive form of support than a FIT with CfD.

- 3.5 We believe that the incentive which the current ROC regime gives to suppliers to source electricity from renewable generation provides significant reassurance to wind and other renewables developers, that electricity suppliers will be incentivised to enter into long term PPAs. We believe that a similar incentive should be built into the new FIT support mechanism.

4 Do you agree with the Government's preferred policy of introducing a contract for difference based feed-in tariff (FIT with CfD)?

- 4.1 No. As indicated in the response in question 3 above (and in other responses below), we have a serious concern that the introduction of a FIT with CfD structured in the way outlined in the Consultation Document would impede the rate of investment in renewable generation and make investment in the required additional capacity more difficult to achieve.

- 4.2 On balance, we believe the FIT with CfD model may also have the effect of increasing the overall cost of capital to the sector because there is a greater likelihood of exposure to short term wholesale prices than with other models. Given the scale of investment and the competitiveness of the funding markets at the moment, we would favour a mechanism which is more attractive to investors and lenders, particularly where it applies to new projects, technologies or markets.

- 4.3 The preference for the FIT with CfD model is based on some assumptions that we believe should be challenged:

- (a) that power purchase agreements from appropriate participants in energy trading markets will be available (see answer to question 10 below);
- (b) that all generators will be able treat the opportunity to sell output above or below average electricity wholesale price as "valuable": many forms of generation that will help deliver the decarbonisation goal do not have sufficient control over despatch conditions in order to take advantage of this. Wind, hydro-electric generation, certain models of Biomass (and other) Combined Heat and Power plants and anaerobic digestion are among those where other technical and commercial pressures will require despatch regardless of whether price in any Settlement Period is likely to be greater or less than the average yearly wholesale price;
- (c) that the FIT with CfD will be more attractive to a wider group of investors including institutional investors and independent generators. Many of our discussions with independent generators have indicated that they will find the risks of the FIT with CfD model difficult to manage; and

- (d) that exposure to short-term electricity price will be manageable if there is protection against exposure to long-term electricity price: it is quite possible that there will be increased volatility in wholesale prices, particularly where "capacity" is being rewarded by a separate payment stream. Even where volatility is no greater than in the current system, exposure to within year deviation from average could cause significant financial problems for individual projects and may deter investment.
- 4.4 If the FIT with CfD model is to be taken forward as the preferred model, the White Paper should seek to address the risks associated with liquidity/availability of PPAs. The separate Ofgem review on liquidity is not sufficient in this regard. More work should be carried out to find a model which will more closely compensate for differences between actual prices received for sales of electricity, while still incentivising generators to achieve the most attractive and risk-adjusted price possible. Of course, the better the price the generator receives, the higher the cost to the consumer.
- 5 **What do you see as the advantages and disadvantages of transferring different risks from the generator or the supplier to the Government? In particular, what are the implications of removing the (long-term) electricity price risk from generators under the CfD model?**
 - 5.1 The question is largely a policy one of whether the costs should be borne by the consumer (as under the current system) or by the taxpayer, where Government assumes the risk of long-term electricity price.
 - 5.2 The assertion that the FIT with CfD model would protect a generator against long term electricity price risk must be viewed in the overall context. Taken as a whole, it would leave the generator with the risk that the price it achieves for its output is lower than the market index benchmark - which sets the level of payment under the CfD. It would also leave the generator with other risks such as, in the case of wind or other intermittent generation, an increased exposure to imbalance costs. Although these risks would also reside with the generator under a Premium FIT model, we believe that a Premium FIT is conceptually a more straightforward and readily understandable instrument than a FIT with CfD. Also, if coupled with a statutory mechanism which incentivises suppliers to source electricity from renewable generation, the Premium FIT would be embraced more readily by developers and their financial backers than a FIT with CfD.
- 6 **What are the efficient operational decisions that the price signal incentivises? How important are these for the market to function properly? How would they be affected by the proposed policy?**
 - 6.1 There is a critical difference here between intermittent forms of generation (such as wind and tidal) and other forms of generation. The scope for efficient operational decision making is very limited or non-existent with most forms of intermittent generation. The owner of flexible generation capacity, e.g. gas fired, acting in an economically rational manner (who recovers both his fixed costs, including original investment costs, and variable costs

solely from revenues derived from sales of electricity) would be incentivised to take steps at the operational level to maximise output at times when prices are high.

- 6.2 We can see that a generator receiving a payment under the capacity payment mechanism outlined in the Consultation Document, may be motivated by factors which differ from those which motivate a generator who is not receiving a capacity payment. The former will be recovering his fixed costs (or the bulk of them) through the capacity payment mechanism. Overall, it is difficult to express an informed view as to the likely impact on operational decision making until a settled position is reached on the design of the capacity payment mechanism. In particular, one key issue in the design of the mechanism is whether capacity payment recipients will be allowed to participate in the market in a way which allows them to respond to short term price signals, or whether they will be required to forego the potential upside which may accrue from such participation as a quid pro quo for the revenue certainty which is implicit in the capacity payment mechanism.

7 Do you agree with the Government's assessment of the impact of the different models of FITs on the cost of capital for low-carbon generators?

- 7.1 It is often easy in this debate to overlook the fact that, although a measure of certainty around the long term electricity price will undeniably have a beneficial impact on the cost of capital, there are other factors at play which have a much more significant impact on the cost of capital (and indeed on the availability of capital). Based on our own experience of acting for clients (both developers and financiers) in the renewables sector over the past two decades, the risks which have the most impact on the cost of capital are those related to development, construction and technology. The technology risk is particularly acute in the offshore wind sector because the turbine and related equipment which is deployed does not yet have a sufficient operational track record in a deep water marine environment.
- 7.2 The proposals in the Consultation Document are not, of course, designed to lead to the development of mechanisms which will protect against these non-price risks. However, the fact that these risks are present and real impacts upon the overall return expectations that developers, investors and funders require.
- 7.3 In our view, which is borne out of the experience mentioned above, neither the FIT with CfD nor the Premium FIT models are likely to lead to any appreciable reduction (by comparison with the position under the existing ROC regime) in the cost of capital for most forms of renewable generation, specifically wind.
- 7.4 By contrast, a Fixed FIT would protect the generator against some of the risks (critically the electricity price risk - both long term and short term - and imbalance risk) which would continue to reside with the generator under a FIT with CfD or Premium FIT model. The resultant certainty in the level of the long term revenue stream which can be achieved via a Fixed FIT is therefore more likely to have an appreciable impact on the cost of capital than a FIT with CfD or Premium FIT model. However, as we have said above, we think that this impact, while undoubtedly positive, will do little to alleviate the much more significant cost impact of the development, construction and technology risks mentioned above.

- 7.5 In any event, and for reasons which are well articulated in the Consultation Document (not least the unavoidable diminution in operational efficiency incentives which would result from a Fixed FIT scheme), we very much doubt that a Fixed FIT model is a viable approach. In particular, we think that the loss of potential upside to a generator (through forgoing the ability to profit from rises in wholesale prices) which is implicit in a Fixed FIT model – while at the same time leaving the generator to shoulder the burden of unforeseen costs through the life of the project, with no opportunity of recovering the cost from additional revenues – will be at odds with the investment objectives of many types of developer and their debt and equity backers.
- 7.6 A further challenge that faces the market at the moment is that there is a hesitancy to commit large amounts of risk capital and finance to develop sizeable projects when it is not clear that this finance can be refinanced or recycled upon the project becoming operational. An incentive regime that provides some support for refinancing and perhaps shares or mitigates the costs and risks of refinancing, would go a long way to encouraging investment in development projects in the first place.
- 8 **What impact do you think the different models of FITs will have on the availability of finance for low-carbon electricity generation investments from both new investors and the existing the investor base?**
- 8.1 As will be evident from a number of the responses given above, we are not convinced (certainly as far as wind and other forms of intermittent generation are concerned) that any of the proposed FIT models, by comparison with the levels of investment which have been made in the renewables sector in recent years, will accelerate the rate of new investment from existing or new investors, or lead to an appreciable reduction in the cost of capital. On the contrary, we think that great care will need to be exercised to ensure that the chosen FIT model will not impede the rate at which new investment is made (or increase the associated cost) through creating a perception that the support provided by the chosen model is less robust than the support which the ROC regime has provided in recent years. Our own experience, which we think would be shared by most of our renewable developer clients, is that the ROC regime has come to be viewed as a settled and stable support mechanism which, after the initial familiarisation process when ROCs were first introduced, is widely understood by all stakeholders and critically by developers and their financiers.
- 8.2 Provided that support is set at the right level, a Fixed FIT, is the most "financeable" of the options. It would attract institutional investors looking for low risk, predictable income streams who are put off by both short and long term wholesale price risk. We are assuming that there is a pool of investors (presumably pension funds and debt capital markets) who will respond to these investments rather than other more traditional investments. However, as explained in paragraph 7.5, we have doubts that the Fixed FIT is a viable option.
- 8.3 A FIT with CfD, again subject to the right level of support and the above comments on the wholesale electricity price for certain forms of low carbon generation (with steady operating loads like nuclear) may attract investment. For other forms of generation, including most renewables, there will not be the necessary certainty to attract project finance or attract certain other classes of capital. The investment available for those forms of generation is likely to be lower than available under the RO.

- 8.4 We think however, that any advantages which may be claimed for a FIT with CfD or a Fixed FIT are outweighed by the attendant disadvantages given through the course of our responses above.
- 8.5 This leaves the Premium FIT model. Although a Premium FIT does not protect the generator against some key risks – e.g. price risk, imbalance risk and the consequences of the market becoming illiquid, our assessment is that a Premium FIT model is the most conceptually sound of all the FIT models. The Premium FIT has the advantage that its main characteristic resembles the support which is provided by the ROC regime: a reward for the generator over and above the price which it can realise in the wholesale market for the sale of electricity. Consistent with practice in the market today under the ROC regime, a Premium FIT model will not (nor would a FIT with CfD model) obviate the need for a generator, and specifically one using project finance, to contract his output long term under a PPA to hedge the price and imbalance risks referred to above.
- 8.6 We believe that a statutory incentive on the part of licensed suppliers to source electricity from low carbon generation is required. We have gained the impression over the last 3 months (from talking to many of our clients and contacts in the energy sector about the potential impact of the EMR proposals) that the lack of a statutory incentive is undermining confidence in the Premium FIT model. We think that the reason for this is twofold, namely:-
- (a) developers have become familiar with the dynamics of the RO regime over the years and, particularly in the case of independent generators who need to access external debt and equity markets to finance new investment, have come to draw comfort from the incentive which the buy-out mechanism gives to suppliers to contract for renewable source generation; and
 - (b) the absence of a supplier obligation in the proposals outlined in the Consultation Document is creating a concern that suppliers will lack the incentive which they currently have to enter into PPAs on reasonable financial and other commercial terms which hedge developers against market risks and give them the opportunity to earn a reasonable return on their investment.
- 8.7 If a decision were taken to adopt a Premium FIT model and to develop the proposals in the Consultation Document in a way which gives developers some reassurance on the supplier incentive issue discussed above, we think that Government has a number of options available to it for imposing such incentive.
- 8.8 One option might be to design a form of levy along the lines of the fossil fuel levy which was introduced by section 33 of the Electricity Act 1989. It obliged licensed suppliers to make a payment of fossil fuel levy on electricity, which they supplied at a level designed to recover the additional costs associated with generation capacity. This was contracted under the non-fossil fuel obligation, which the Secretary of State introduced through the exercise of the order making power conferred by section 32 of the Electricity Act 1989. It would be possible to design a levy having similar characteristics requiring licensed suppliers to fund

the cost of Premium FITs in proportion to the quantity of electricity which they respectively source from low carbon generation.

- 8.9 Another potential option would be to consider whether a variant of the incentive under the ROC regime (i.e. the buy-out price mechanism) could be developed to work alongside a Premium FIT model.
- 8.10 Irrespective of how the detail of the supplier incentive would look, we think that the overriding objective would be to produce an outcome which ensures that licensed suppliers bear the cost of the Premium FIT according to the proportion of the electricity which they source from low carbon generation. The higher the proportion, the lower the cost burden.
- 9 What impact do you think the different models of FITs will have on different types of generators (e.g. vertically integrated utilities, existing independent gas, wind or biomass generators and new entrant generators)? How would the different models impact on contract negotiations/relationships with electricity suppliers?**
- 9.1 We think that many of the issues arising under this heading have already been covered in the responses above.
- 9.2 For all models (other than Fixed FIT where we assume a central Government backed body would be the purchaser) the absence of the quasi-compulsion provided by the RO will cause difficulties for independent generators, as well as their investors and funders, in securing appropriate deals with electricity suppliers.
- 9.3 A Fixed FIT model negates exposure to pricing and balancing risks. A generator will not therefore have concerns about market liquidity under a Fixed FIT model. However, as explained elsewhere in this response, we do not believe that the Fixed FIT model is viable.
- 9.4 A FIT with CfD model will favour those forms of generation where short term price volatility can be borne. Others, including most renewables, will find this difficult except where the generator is part of a wider group that can manage this risk through wider energy trading positions.
- 9.5 While capable of protecting a generator against long term price risk, a FIT with CfD leaves many other risks with the generator. We believe that the FIT with CfD model proposed in the Consultation Document will be viewed as a complex instrument and, if it were to be redesigned to address or provide a hedge against these other risks, the perception of complexity would increase. We believe that a FIT with CfD is not a viable way forward because of these and other issues discussed elsewhere in our response.

9.6 Overall, we are left with the strong impression that a Premium FIT model is much more likely to provide a viable way forward than either of the other models, caveated by the views we have expressed about the existing regime.

10 **How important do you think greater liquidity in the wholesale market is to the effective operation of the FIT with CfD model? What reference price or index should be used?**

10.1 The importance of this cannot be over-emphasised. The issue is critical to attracting capital to invest under this model. In our view this issue needs to be brought within the scope of the current consultation.

10.2 We have already expressed the view that a FIT with CfD model is unlikely to attract the levels of investment which are needed to achieve the decarbonisation targets which the Government has set for the electricity industry. We do not therefore explore this question in detail, save to observe that (if a CfD with FIT model were to be adopted) the liquidity and reference price aspects would be of paramount importance. In particular, generators using wind or other intermittent generation sources would want reassurance that the protection conferred by the FIT with CfD is not eroded by a reference price which is not a realistic representation of the price at which the generator can sell into the market.

11 **Should the FIT be paid on availability or output?**

11.1 The challenges of designing a system which is capable of verifying whether or not a generating unit (which is not in production) is available will be enormous. The associated monitoring and reporting requirements would also be cumbersome and costly. Both models are potentially viable depending on the detail of the implementation of the selected FIT. Availability payments would help in managing some of the risks addressed above but would need to be considered in light of other aspects of the EMR (including capacity payments).

Emissions Performance Standards

12 **Do you agree with the Government's assessment of the impact of an emission performance standard on the decarbonisation of the electricity sector and on security of supply risk?**

12.1 Given the technical nature of this issue, we have concentrated our efforts in responding to other questions in this Consultation Document.

13 **Which option do you consider most appropriate for the level of the EPS? What considerations should the Government take into account in designing derogations for projects forming part of the UK or EU demonstration programme?**

13.1 See above.

14 **Do you agree that the EPS should be aimed at new plant, and 'grandfathered' at the point of consent? How should the Government determine the economic life of a power station for the purposes of grandfathering?**

14.1 See above.

15 **Do you agree that the EPS should be extended to cover existing plant in the event they undergo significant life extensions or upgrades? How could the Government implement such an approach in practice?**

15.1 See above.

16 **Do you agree with the proposed review of the EPS, incorporated into the progress reports required under the Energy Act 2010?**

16.1 See above.

17 **How should biomass be treated for the purposes of meeting the EPS? What additional considerations should the Government take into account?**

17.1 See above.

18 **Do you agree the principle of exceptions to the EPS in the event of long-term or short-term energy shortfalls?**

18.1 See above.

Options for Market Efficiency and Security of Supply

19 **Do you agree with our assessment of the pros and cons of introducing a capacity mechanism?**

19.1 In the main, we agree with the assessment set out in the Consultation Document.

19.2 We would, however, wish to highlight the following:

- there is a lack of clarity as to the principal objectives of the "mischief" that the capacity mechanism is intended to cure: is it the capacity on the system, the flexibility of the capacity on the system to respond and/or the development of a "reserve"?

- we believe that the risk of unintended consequences is greater than highlighted in the document; and
- the consequences of the introduction of a capacity mechanism on wholesale electricity price need to be thought through and modelled.

20 Do you agree with the Government's preferred policy of introducing a capacity mechanism in addition to the improvements to the current market?

- 20.1 Yes. This is desirable to achieve security of supply objectives. It is important, however, that greater focus is given to whether or not the principal objective should be increasing the amount of installed capacity (protecting against the risk of existing base load coming off the system), increasing the amount of flexible plant on the system or increasing the amount of operating reserve available to the system.

21 What do you think the impacts of introducing a targeted capacity mechanism will be on prices in the wholesale electricity market?

- 21.1 The ultimate impact can only be assessed when the extent of the mechanism and the support it provides is known. The extent of the targeting will also have an impact. We believe it is likely that any significant capacity mechanism (targeted or not) will be likely to depress wholesale energy prices.

22 Do you agree with Government's preference for the design of a capacity mechanism:

- a central body holding the responsibility;
- volume based, not price based; and
- a targeted mechanism, rather than market-wide.

- 22.1 We agree that a central body is a necessary element. Interface between that body and the System Operator will need to be carefully considered. It will also be important that the body has clear principles to work to. In order to deliver long-term investment in plant that will meet the capacity objectives, the body should be able to deliver long-term certainty.

- 22.2 A volume based system is more in keeping with the overall objectives than a price based system.

- 22.3 There are pros and cons to a targeted mechanism. A targeted mechanism may lend itself more readily to a contractually based system which could overcome concerns the market may have as to the degree of political risk associated with other mechanisms. On the other hand a market based approach may be more likely to result in a more efficient meeting of the objectives, with the market correcting itself as matters continue. That said, an approach which allowed the market as a whole to respond to specific criteria (but remained technology neutral) should be possible.

22.4 We believe it is important that any approach adopted avoids an auction mechanic. Experience has shown that such mechanics, while appearing to be cost efficient, often fail to deliver the required results. Analysis of the relative failure of the NFFO / SRO mechanic is a good example of this.

23 **What do you think the impact of introducing a capacity mechanism would be on incentives to invest in demand-side response, storage, interconnection and energy efficiency? Will the preferred package of options allow these technologies to play more of a role?**

23.1 We express no view on this for the time being. Greater clarity on the capacity objectives is required.

24 **Which of the two models of targeted capacity mechanism would you prefer to see implemented:**

- Last-resort dispatch; or
- Economic dispatch.

24.1 We express no view on this for the time being. Greater clarity on the capacity objectives is required.

25 **Do you think there should be a locational element to capacity pricing?**

25.1 We express no view on this for the time being. Greater clarity on the capacity objectives is required.

Analysis of Packages

26 **Do you agree with the Government's preferred package of options (carbon price support, feed-in tariff (CfD or premium), emission performance standard, peak capacity tender)? Why?**

26.1 For the reasons set out elsewhere in this response, we do not agree with the Government's preferred package of options which incorporates the FIT with CfD.

27 **What are your views on the alternative package that Government has described?**

27.1 For the reasons set out elsewhere in this response, we believe that developers and financiers will find the Government's alternative package to be a much more attractive option.

28 **Will the proposed package of options have wider impacts on the electricity system that have not been identified in this document, for example on electricity networks?**

28.1 See comments above.

29 **How do you see the different elements of the preferred package interacting? Are these interactions different for other packages?**

29.1 See comments above.

Implementation Issues

30 **What do you think are the main implementation risks for the Government's preferred package? Are these risks different for the other packages being considered?**

30.1 The main implementation risks we see in the Government's preferred package include: (1) the risk of stalling finance availability for projects; and (2) the inclusion of a FIT with CfD.

30.2 **Financing** - It is perhaps in this area where the uncertainty caused by the proposed phased introduction of the reforms, combined with the fact that the reforms are being proposed in the first place, appears to be leading to a stalling in the availability of finance for projects.

30.3 Given the usual uncertainty regarding timeframes for the commissioning of projects (with attendant risks related to prolongation of the consenting and/or construction phases) we think it is unlikely that many offshore wind projects will be able to adopt the RO and they will therefore be forced to adopt the new regime. Some onshore wind projects may seek to proceed under the vintaged RO arrangements.

30.4 As a general point, however, we think more is required to provide certainty as to the operation of the transitional arrangements, particularly where projects run the risk of delay in commissioning.

30.5 Separately, the mere fact that this fairly fundamental change of the support mechanisms for Electricity Generation is proposed, leads to uncertainty and a degree of nervousness in the financial community. Given the international competition for capital, it is important to move through this reform quickly to provide certainty to the markets.

30.6 **CfD** - For the reasons set out elsewhere in this response, we believe the FIT with CfD will be too complex and will further deter investment in the UK market.

30.7 From feedback we have attained from clients, we believe that new investment under a FIT with CfD would be slower to materialise than would be the case if a Premium FIT model

were adopted. In particular, investment in renewable generation would be especially impeded through the introduction of a FIT with CfD as structured in the Consultation Document.

- 30.8 We believe there would be fewer implementation risks in the Government's alternative package which includes the Premium FIT. The Premium FIT would only require to be modestly reformed from the RO system which is currently in place and which the market is already comfortable with. The simplicity and familiarity of a Premium FIT approach will be most attractive for stakeholders, developers and financiers and will cause the least amount of disturbance for generators in securing a viable PPA.
- 30.9 Great care will need to be exercised to ensure that the FIT model in the chosen package will not impede the rate at which new investment is made.
- 31 **Do you have views on the role that auctions or tenders can play in setting the price for a feed-in tariff, compared to administratively determined support levels?**
- **Can auctions or tenders deliver competitive market prices that appropriately reflect the risks and uncertainties of new or emerging technologies?**
 - **Should auctions, tenders or the administrative approach to setting levels be technology neutral or technology specific?**
 - **How should the different costs of each technology be reflected? Should there be a single contract for difference on the electricity price for all low-carbon and a series of technology different premiums on top?**
 - **Are there other models government should consider?**
 - **Should prices be set for individual projects or for technologies**
 - **Do you think there is sufficient competition amongst potential developers / sites to run effective auctions?**
 - **Could an auction contribute to preventing the feed-in tariff policy from incentivising an unsustainable level of deployment of any one particular technology? Are there other ways to mitigate against this risk?**
- 31.1 We have significant concerns regarding the use of auctions to set sustainable support for levels of low carbon technology.
- 31.2 The auction used under the Non-Fossil Fuel Obligation system did not instil much confidence in the market. Bidders under the NFFO were faced with the many uncertainties associated with developing a new technology, including the uncertainty of costs. The NFFO bidders pitched low in an attempt to secure a contract. Many were ultimately not able to deliver the project due to failure to secure planning permission or because they had a contract that was not viable. There is little confidence that auctions will realistically reflect true costs of a project.
- 31.3 The use of auctions will be especially concerning to developers of emerging technologies (such as wave and tidal) who face increasing uncertainty, especially with regards to costs and funding. As was the case for onshore wind under the NFFO auctions, there was a

pressure to reduce costs before the technology had been fully developed purely to compete in the auctions. This resulted in the under-bidding of projects that could not be delivered.

31.4 Auctions would provide a huge amount of uncertainty for developers. Very few developers will be willing to commit the substantial amount of work and development capital that is required to submit a bid without a guarantee of securing a contract. Small developers will especially be deterred from entering the market due to the added costs of and work required to take a project forward to the auctioning stage, without the security of being awarded a contract.

31.5 Our preference is to continue using an approach similar to that used to set banding levels for the RO. Setting support levels needs to be done in a manner that is transparent and subject to review and scrutiny of the industry.

32 What changes do you think would be necessary to the institutional arrangements in the electricity sector to support these market reforms?

32.1 Firstly, as stated earlier, we believe the Government's objectives in respect of the FIT could be met by making adjustments to the scope of the existing RO, thus incurring few institutional changes to the current market.

32.2 Secondly, we believe that an important aspect of the current system that must remain is a statutory incentive to supply a minimum amount of low carbon electricity. Removing such an obligation would undermine the entire PPA market. The current ROC regime provides significant reassurance to wind and other renewable developers that electricity suppliers will be incentivised to enter into long term PPAs.

32.3 If suppliers are not obligated to purchase low carbon electricity, generators will take on a high risk of selling to the market and PPAs will be more difficult to secure. PPAs will become much less competitive and those that are secured will be negotiated at discount prices or for shorter terms.

32.4 Financing will also be more difficult to attain as investors prefer the certainty of long term PPAs. The more risk that is transferred, the more costs of capital for the generator, making it more expensive for the consumer.

32.5 As indicated in our response above, we believe that a similar incentive should be built into the new FIT support mechanism.

33 Do you have view on how market distortion and any other unintended consequences of a FIT or a targeted capacity mechanism can be minimised?

- 33.1 No further comments.
- 34 **Do you agree with the Government's assessment of the risks of delays to planned investments while the preferred package is implemented?**
- 34.1 There is a great risk of delay to planned investments through the implementation of the proposed packages under the EMR. The use of auctions will cause further delay as developers, especially those of emerging technologies - will be reluctant to take projects forward without the confidence they need that their development will be successful.
- 34.2 Round Three offshore wind development projects may also experience significant delay. Offshore wind developers have already agreed timetables with the Crown Estate to take developments forward, with penalties imposed for non-compliance. This agreement was made on the presumption that support would be available through the RO. The developers have already invested a great deal of time and money into their projects and any delay could cause leases to be withdrawn from these projects if timescales are not complied with.
- 35 **Do you agree with the principles underpinning the transition of the Renewables Obligation into the new arrangements? Are there other strategies which you think could be used to avoid delays to planned investments?**
- 35.1 See below.
- 36 **We propose that accreditation under the RO would remain open until 31 March 2017. The Government's ambition to introduce the new feed-in tariff for low carbon in 2013/14 (subject to Parliamentary time). Which of these options do you favour:**
- All new renewable electricity capacity accrediting before 1 April 2017 accredits under the RO;
 - All new renewable electricity capacity accrediting after the introduction of the low-carbon support mechanism but before 1 April 2017 should have a choice between accrediting under the RO or the new mechanism.
- 36.1 Every effort must be made to avoid as much hiatus in the market as possible. Developers need to feel confident that support will be available well in advance of project deployment in order to make the best investment decisions.
- 36.2 Developers should have a choice between accrediting under the RO or the new mechanism in order to gain some familiarity with the new system before the RO comes to an end. This will help developers choose the option that will provide them with the most revenue certainty and allow them to make crucial investment decisions in advance.
- 36.3 In addition, there needs to be some flexibility for project delay (for example, through risks associated with construction, development, consenting or technology). To avoid a hiatus in

the market, developers need to be able take investment decisions forward without the risk of losing support if their project is delayed beyond the vintaging date for reasons beyond their control. Developers should have the option to be able to change their minds prior to the vintaging date, according to their project programme. The vintaging timeline could also be flexible enough to accommodate those projects that may only miss accreditation by a very short period of time.

- 36.4 For example, currently the schedules for Round Three could potentially result in accreditation onto a revenue support scheme occurring close to 2017. This would put developers into a position where they could potentially be too late to take advantage of the RO but not have enough time to factor the new regime into their programme.

We believe further clarity on issues affecting the RO, particularly in relation to questions 37 and 38, is required for us to provide a more informed response.

The comments we have set out in this response relate to issues we consider to be of significance to various stakeholders in the electricity market. We strongly feel that the Government's proposed package requires a great deal of work to instil the clarity and certainty the electricity market requires.

Yours Faithfully

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