

Matt Coyne
Department of Energy & Climate Change
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16th August 2012

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

Dear Matt,

Introduction

SmartestEnergy welcomes the opportunity to respond to the call for evidence on barriers to securing long-term contracts for independent renewable generation investment. SmartestEnergy was launched in 2001 to take advantage of opportunities from deregulation of the UK energy market. Our founding aim was to provide a route to market for small embedded generation projects. We have grown to become the UK's largest purchaser of electricity from the independent generation sector, supporting 200 customers ranging from community investment schemes to blue-chip companies.

SmartestEnergy does not currently own generation assets. However, we are answering this call for evidence in partnership with a division of our parent company, Marubeni: the Overseas Power Project Department III. This division deals with the development and investment of power projects (using various technologies) through various types of partnerships on a project-by-project basis. This response therefore reflects a perspective from both the shorter-term PPA market and the view of a longer-term investor.

Overview

By way of introduction we would like to highlight that the context is important when discussing the PPA market. The document refers to "higher discounts applied to PPAs in GB compared to other European markets." If this is true it is important to understand the reasons for this. It may be a function of the costs of balancing; the GB system is more diverse and islanded than those on the continent. There may be a case for simplifying the cash out mechanism but due consideration needs to be given to the unique nature of the GB system.

It would be prejudicial and inappropriate to absolve any class of generation from the costs of balancing. All participants should be exposed to balancing costs as this is part of getting power to market. This feature is a fundamental aspect of NETA and changing it we feel would be detrimental to the effective functioning of the market. We are firmly of the view that any form of subsidy should be placed around the basic market mechanisms and not as a part of them so that the full costs of the subsidy are transparent.

An issue that is currently under observation is liquidity. We would like to point out that liquidity in the wholesale market is not such a problem for the time horizon on which short-term PPAs are hedged. However, greater granularity of products is required in years 2, 3 and 4.

We note that the Renewables Obligation helped to ensure that renewable electricity had a market. We would like to point out that although the proposed FiT CfDs arrangements do not include a requirement for suppliers to buy low carbon electricity they do provide a price guarantee, negating the need for long-term PPAs to enable loans to be accessed.

We do not accept the argument that the Big Six will pull out of the PPA market on the basis that they no longer require ROCs. Where there are commercial opportunities for providing a service and demand for low carbon electricity from consumers, competition will flourish. Only those very large generators would be able to justify becoming a supplier to sell direct to the market so new PPA providers should enter the market for those generators who are not large enough to justify entry costs.

As EMR introduces a new support mechanism in the form of FiT CfDs it raises new challenges. We would like to highlight here that we are proposing a CfD Services Agent model as it would provide an optional service to assist those smaller generators to which CfD payment flows, handling contracts, and collateral requirements are an additional burden.

A benefit to EMR arrangements is that they should make it easier for developers to enter into short-term PPAs in the knowledge that they have a guaranteed fixed income for the duration of the CfD. A long-term floor is therefore not required, and Marubeni: the Overseas Power Project Department III sees the guaranteed fixed income provided as more attractive than a floor. By allowing generators to enter into a succession of shorter PPA contracts there is greater contracting flexibility and hence it improves competition.

There is no need for standard PPAs. In general PPAs have fairly standard terms across the industry already. It would be inappropriate to mandate particular commercial terms in a standard PPA because this would remove competition as there would be less differentiation; it could create a potential barrier to entry and may deter existing providers.

Finally, any hiatus is caused by uncertainty over other matters not the PPA markets. We observe that changes in the incentive regimes and the fear of political commitments being retracted (or rumours of change) create much uncertainty and increase risk for investors who may find plans are stalled until the context becomes stable once more. The current EMR situation would seem to indicate that any government needs to be mindful of the fact that offers of support can themselves become barriers to growth as investors hang on to seek more and more concessions.

The remainder of this response

Our answers to individual questions follow in the order from the Call for Evidence document; SmartestEnergy has answered the questions in Annex A for PPA Providers but unfortunately Marubeni: the Overseas Power Project Department III cannot provide answers to those directed at Independent Renewable Developers as they have not yet been involved in the early stage of development to which the questions refer:

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.

We have answered these questions in the section of questions headed Annex A For PPA Providers.

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 noted in the document, one other non-Big Six player has been successful in the long-term PPA market over the last 2 years. This is some evidence of the market attracting new players. We believe the Big Six are still active. Further evidence we see of competition in the PPA market is in the number of quotes for PPA contracts that we have offered but not won. There are also players impacting on the PPA marketplace who are not suppliers or aggregators –namely I&C customers looking for 'linked supply' type arrangements.

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?

Marubeni: the Overseas Power Project Department III explains that they see in other international markets that PPAs for renewable power projects are backed by a long-term FIT (not CfD style) with the support from the government, with longer-term PPAs as a result.

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

The main hurdles to overcome are collateral requirements and system development/market interface. However, these issues are the same in the retail market. It is in the nature of things that some companies are prepared to take on these costs to offer an aggregation service to smaller players.

There is also the current Cash-Out review which, although not exactly a barrier to participation, is an uncertainty and it makes pricing any PPA business more difficult than it would be otherwise. The lack of certainty about exactly how EMR will change the generation fleet is also a factor that must be feeding through into PPA providers thinking about exactly what the output from different types of plant will be worth over the medium to long term. This is likely to be impacting on imbalance charging/risk premiums.

With regards to generators participating in the GB market, the upcoming FiT CfD arrangements may present a burden to smaller sized generators as they would have to manage CfD payment flows, handle contracts, and collateral requirements. This could be mitigated by a CfD Services Agent model whereby the Agent can handle the demands on behalf of those generators who require the service.

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, see answer under question e in the annex. The FiT CfD and the potential for a capacity mechanism are the main drivers.

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

Marubeni: the Overseas Power Project Department III identifies the ability to execute trades and the financial credibility during the PPA term as the major determining factors.

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?

Though Marubeni: the Overseas Power Project Department III has been involved in a limited number of deals and are not ready to specifically comment on a change of investment returns, they think the more stable revenue will make the investors more comfortable on the revenue risk.

If the EMR package provides stable revenue for a long term, it should be a driver to change investment returns to a lower side.

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?

Market-led initiatives – we do not believe that any particular market-led initiatives are required as greater competition in the PPA market will develop as a matter of course.

Competition measures – Improving liquidity – we are of the view that the best way to improve liquidity is to create a Self-Supply Restriction on the Big Six, possibly in conjunction with Mandatory Market Making. We are opposed to Ofgem's seemingly preferred option of Mandatory Auctions as we believe this will not improve liquidity but transfer it to a monthly hiatus. Continuous trading opportunities are key to any market.

Cash-out reform – we support the current review and single cash-out may be the way forward, but it is important to be mindful of the physical characteristics of the GB system and maintaining an incentive to balance.

Measures to support independent aggregators – we are not seeking any special treatment here. We accept that we are in a competitive market. In some ways it is misleading to talk about aggregators; the Big Six and several other players such as GDF, Good Energy etc. are also aggregators.

Regulatory measures – an obligation on the Big Six to offer PPA terms would be anti-competitive for the independent aggregators. Similarly, an off-taker of last resort and standard PPA terms would be inappropriate as this would distort or remove competition.

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

We believe that all of the options described in the document would lead to a market which is more consolidated around the Big Six and this cannot be good for competition (see previous answer for more detail).

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

We believe it would be a mistake to intervene in the market at this stage. As previously stated, the nature of the CfD FiT arrangements themselves will lead to greater flexibility in the way in which PPAs are contracted precisely because of the guaranteed price the CfD gives.

Annex A 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 significant increase in the number of requests/approaches (particularly from PV, AD and on-shore wind in Scotland) for both PPAs and advice at early stages of scheme developments. This increase in volume occurred around 3 months before the April 2010 changes to the FiT tariffs and has remained high.

- 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?

As a result of the increased volume of requests we needed to treble the size of our sales team and introduce a higher cut-off threshold of 500kW of capacity (previously set at 100kW). Floor pricing within a long-term PPA is something we have difficulties accommodating although we continue to discuss these arrangements with developers, and pre-EMR had hoped to be able to develop a floor price structure using financial hedging arrangements. Liquidity in the market is clearly not sufficient to support back-to-back transactions (in terms of long-term tenure). However, the strike price under the FiT CfD proposals solves this problem for generators as the proposals allow for a long-term price, but shorter-term PPAs. There is also an on-going issue that currently many PPAs do not represent market tradable quantities of power but the introduction of FiT CfDs do not alleviate this problem (see answer to question e for more detail).

- 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?

Our terms have remained broadly similar but we do offer bespoke arrangements for Project Finance PPAs. Examples of when we have differed from usual PPA contracts include being the first company to guarantee FiT accredited sites the export tariff or a higher price when the wholesale market was favourable. Also, when generators are financed by a non-recourse finance arrangement we are flexible in meeting their requirements, such as providing letters of parent company guarantee and accepting some non-standard risks associated with PPAs, occasionally taking some long-term price risks (e.g. fixing prices for 5 years where sufficient liquidity does not exist).

We appear to have experienced an increase in the frequency with which potential PPA customers are open to the possibility of pricing against a market reference price of some kind. As a result we have increased the power pricing flexibility within our PPA contract arrangements. Our ability to offer PPA arrangements has not materially changed though – only the demand for them.

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

We have been able to win more PPAs, seeing faster growth since 2010. There still remains a number of quotes every month which we offer but do not win. This is further evidence of competition in the PPA market.

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

We note that the current proposals will require generators to handle an extra payment flow as well as another contract and collateral. This may be a burden on smaller generators and as such we see there being a couple of options to mitigate this barrier. Under current proposals we could offer to be the counterparty: signing the FiT CfD on behalf of the generator and dealing with all payment flows and collateral requirements. However, if SmartestEnergy were ever to default, then the generators who were using us as a counterparty would have lost their FiT CfD payments and a route to market. A "PPA Provider of Last Resort" (whereby other suppliers are obliged to offer a PPA at a fair discount if the original PPA provider defaults) would provide a guaranteed route to market to enable developers to choose smaller PPA providers without concern for being able to sell their power in future if the PPA provider defaults. However, under the situation just described using a PPA Provider of Last Resort, the generator would regain their route to market but would have lost their CfD contract. The addition of a CfD Services Agent in the FiT CfD structure would be beneficial as it would carry all the benefits, such as reducing collateral and reconciliation issues for generators, but negate the issue of reliance on the supplier/PPA provider to sign the FiT CfD. Under this model, in the case of default, the generator could transfer their business to another supplier/PPA provider (PPA Provider of Last Resort) and also CfD payments would revert back to them as is standard. On a side note, if both PPA and CfD payments flowed through the CfD Services Agent, this may also lead to improved PPA terms and products.

Though we would not be obliged to contract for low carbon electricity, the RO scheme was not the main driver of our activities. Consequently, we believe there will be very little change to the nature of our PPAs. Of course there will eventually be no RO payment, but all other charges, including balancing will remain (though at what level is unknown due to the current review and different trading requirements associated with EMR).

We haven't been given any clear impression yet as to what customers will want in their PPA arrangements in the light of the CfD. We would expect a PPA with the price linked to the relevant CfD reference point to be the 'vanilla' choice for a generator who wants to earn the defined FiT price level, and this would be our basic offering. However, the level of demand for products that provide the generator with other pricing mechanisms is not clear. For example, will they seek the ability to fix a PPA price – with the intent of timing/beating the spot market and therefore earning more than the defined FiT price level?

We note the proposal to calculate the price by averaging each day's season product during the year ahead. Whilst we appreciate that the motivation behind this may be to make it easier for owners of large plant to sell their power it strikes us that this may make it hugely difficult for smaller baseload plant types who will effectively be unable to find a party who is prepared to sell them a PPA on the basis that it is untradeable. Anyone selling this power will have to hedge the volume on the seasons, but because these products are not daily, whereas the hedging activity will have to be daily, the volume commitment to be hedged will have to be divided by the number of days in the year i.e. it will be a tiny amount which is not tradable. For example, let us take the case of a bio

station of 10MW and let us assume that there are 200 trading days in the year, this means that 0.05 MW would need to be hedged each day. Realistic minimum volumes for trading the season products are 10MW, possibly 5MW. We would put forward that the proposals for intermittent i.e. day ahead index are extended to baseload plant. This should not be too much of an issue for nuclear; the volumes currently trading at the day ahead stage are 10GW.

Should you wish to discuss any aspect of these issues further, please do not hesitate to contact me.

Yours sincerely,

Deputy VP Commercial – Head of Regulation
SmartestEnergy Limited.

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