Welsh Power

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Confidential

Mr Matt Coyne
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Dear Mr Coyne

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

Welsh Power Group (WPG) is a privately owned energy company with a strong track-record in development, in both conventional and renewable energy.

In January 2009 the company received planning consent for the construction of a 49.9MW biomass plant at Newport Docks, Wales, through its wholly-owned subsidiary Nevis Power Limited. Late last year WPG sold a 50% stake in the project to a subsidiary of Santander Bank to secure the financing of the plant.

As well as renewable energy, WPG submitted an application to develop Wyre Power, an 850MW CCGT (combined-cycle gas turbine) power plant near Fleetwood, Lancashire in August 2009. We also own and operate an OCGT, Leven Power, on a STOR contract to NGC as well as Rhymney Power, a new build STOR project.

Formerly, WPG owned and operated Uskmouth Power until its sale in 2009 to SSE. It developed and built Severn Power, a new 850MW CCGT plant in South Wales, which it subsequently sold to DONG Energy. WPG also started its own retail business, Haven Power, in 2007, but this has subsequently been bought by Drax.

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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.***

WPG has been negotiating a PPA for Nevis Power, but this has been the first time we have been to the market with this type of project in recent years. New projects such as Nevis require PPAs to raise project finance debt for construction. This may not be necessary in a market with a robust forward curve, where investors could be comfortable that they could sell their power and hedge risks in the market. A major concern currently for independent renewable developers is a lack of real depth in the power market. The consequences of the existing conditions translate into serious financing and liquidity issues for independent developers of all generation assets. However, while Ofgem has been promising changes to the market to improve liquidity, at the current time investors cannot manage risk in the wholesale market, nor value projects, and are becoming reliable on PPAs. This is not a very satisfactory state of affairs with the PPAs only really being offered by the "big 6" widely acknowledged as being dominant market players.

Independent developers seeking PPAs discover that at any one time only 2-3 of the big 6 are willing to offer any terms. It is commonplace for these companies to exploit their market position by typically taking between 10-15% of all revenues for offering to provide a route to market, but take none of the risk. In these situations, the independent generator receives the current market price for their product, minus the commission paid to the PPA provider. PPA providers often offer unattractive discounting terms, such as low floor and ceiling prices, or significantly discounted prices to remove the ceiling. The limited difference in the offerings from the big 6 have confirmed our view that they not only have market power, but are able to use it, with no incentive to actively compete with one another. This situation does not represent a well-functioning, competitive market.

The changes that would make the greatest difference in the market would be:

- Ensure that the value of ROCs accrues to the generators, as the RO was designed to do. At the present time RO value is eroded by the purchasing supplier refusing to pay the full ROC value. This means that some of the support customers are meant to be giving to renewable generators is in fact going to the suppliers;
- Improve the liquidity in the market, preferably by breaking up the big 6, so that there is a robust liquid market in which parties can manage their risks.

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?***

WPG has not been active in the market since it sold Uskmouth Power. However, we note since 2009 we have noticed that the value offered by suppliers for ROCs has fallen. WPG used to sell ROCs from Uskmouth as it was co-firing biomass. At the time we achieved near 100% of the value of the ROCs, but today the suppliers offer only in the region of 90% of the value, which over the course of a project's lifetime is a £ms of lost revenue.

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?***

WPG does not operate in other markets so do not feel able to answer this question. However, we would note that feed-in-tariffs for renewable energy in many other member states would ensure that the full value of support goes to the generator. In the GB market, while EMR proposed FITs, the RO mechanism disadvantages renewable generators here compared to other states. This may encourage investment away from the UK at a time when new plants are desperately needed.

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 level of change and uncertainty in the market is freezing investment. WPG waited months to hear the results of the RO banding only for the policy to refer to new consultations on issues such as supplier limits on biomass ROCs. Such ongoing uncertainty will again stall the progression of these developments. There is nothing that developers can do to get investors comfortable with investment if the rules of the market keep changing.

On top of the RO banding, which has created untold problems for plants trying to achieve financial close, there are also: EMR proposals to introduce a capacity mechanism and alter the support for renewables; Ofgem's liquidity work; Ofgem's review of cash-out; and numerous other changes such as to charging. Overall this gives investors concerns that the market background is always altering. While WPG appreciates that some of this work may be beneficial, it is not clear why work on liquidity takes so long, if a cash-out review is currently necessary.

One of the market's bigger problems, often ignored by DECC and Ofgem, is credit. The market rules require that a vast amount of credit is lodged with monopolies and the central trading arrangements. With financing for business extremely difficult to secure this is a hindrance to the amount of working capital that parties have available. Credit requirements are impacting liquidity and they do impact the parties that can 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?***

For WPG, who is expecting to complete investment under the RO, the EMR proposals have some indirect consequences. It will be to our benefit when the RO starts to see administered prices paid to renewable generators. However, for the time being the greatest impact is the uncertainty it is creating for investors.

There are some wider changes, for example to the embedded benefits regime, which will impact our business far sooner than EMR will. Those changes need Ofgem to consider how the market benefits awarded to smaller plants can be protected.

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

For WPG our focus has been on price, but we are aware that for some parties a personal relationship can be very important. In reality we have found that there has been very little to choose between the offers we have seen. The suppliers appear to treat the generators in a similar manner to the end customers, offering very little differentiation.

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?***

WPG believes that in a liquid and competitive market we should have reasonably expected to get more value from ROCs, better terms and more counter-parties to choose from. In reality there is little that is offered in EMR that would resolve any of these issues. What may be more important is the work of Ofgem on liquidity; but only if they can deliver timely change.

For generators coming forward under the FIT CfD regime they may find that life is easier. Depending on the final design, they may not have to actively sell their power, as the support should be based on metered output and not on a requirement to contract with a third party, but the final design remains subject to further design and consultation. However, if the Government proceeds with the model where each generator must find a counterparty the new mechanism may be of little help renewable generators. The FIT CfD model is concerning for independent generators, as lending institutions will still require PPAs and there is a serious risk that the big 6 will charge more for their PPA services, due to the complexity of the mechanism. Independents would have no other choice but to accept this, as there are no alternatives.

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?***

WPG would make the following comments on the specific options outlined:

Market led initiatives

WPG believes in markets. They offer the best way to achieve an economically efficient outcome, but also to deliver solutions to problems that investors are comfortable to finance. We can see limited merits in a code of conduct, assuming it can be done with minimal resource and in a timely manner, but we would support the Government trying to force parties into trading with one another.

A code of conduct looks like a solution to the lack of competition, which should be there to drive forward innovative contracting development. We would therefore prefer to see work focus on competition than codes of conduct.

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Competition Measures
WPG would like to see decisive action to make the market competitive. Such measures could include:

- A break up of the dominant players;
- Licence requirements that stop integrated players "trading" between supplier and generation;
- Obligations on the big 6 to always offer terms to third parties to buy or sell power.

Ofgem stops its cash-out review as it will help nothing, and only creates greater uncertainty. Ofgem says that cash-out is a barrier to competition and market entry, but we do not believe this is true. While imbalance charges could be reduced, there is no "right" answer and Ofgem concentrates its resources on achieving effective competition. Any BSC party with a problem on cash-out can raise a BSC modification, the fact they have not done so suggests this is not the issue that Ofgem believes.

WPG is not sure what measures DECC has in mind that would support or promote aggregators. Since NETA go live there have been such parties in the market and they do not obviously face any worse barriers to market entry than other players. The reason that parties do not always want to use the aggregators is an issue of price more than anything else.

Regulatory Measures
In the short term there may be some additional regulatory measures that the Government could examine for improving the terms of PPAs offered to companies such as WPG:

- The price that suppliers have to pay generators for ROCs could be regulated to make sure that 100% of the benefit of ROCs goes to the generators.
- Ofgem should take forward their liquidity regulations in a timely manner. While we favour break-up of the generators, if Ofgem thinks it can achieve liquidity with compulsory auctions it should get on with it.
- Tax breaks for investment in green generation could help get more marginal investment moving while the policy framework settles down.
- The Government has announced that there is credit support of infrastructure investment. This support should be offered to smaller scale infrastructure investment, or additional bank lending to the energy sector should be encouraged, notably by Government owned banks.
- WPG considers the introduction of a credit-worthy central body responsible for offering a standard-form PPA, at a reasonable rate, to smaller (sub-50MW) power station operators, to be a possible option. The new body would then sell electricity and ROCs in the market. We recognise that this represents further Government intervention, however, given the other quite extensive interventionist actions already taken (for example the Carbon Price Floor), it is not a significant one. The big 6 would still be able to offer their own PPA terms, but owing to the base standard offered by the new body, would be unable to exploit their dominant position.

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

WPG recognises that any regulations or additional obligations can distort the market. However, given the state of the market, WPG believes that there is a case for trying to kick-start more competition.

On the policies outlined we believe that:

- Codes of conduct will have little direct effect, but could remove incentives on suppliers to innovate with contract terms. The policy also risks the suppliers offering worse terms if they feel they are forced to do business with parties they would not normally trade with.
- Ofgem's mandatory auction may well force parties to offer for sale energy that only the big 6 can buy or sell, not meeting the needs of the smaller parties. The types of products, costs of the auctions, credit, etc. will all be vital in making sure that the auctions improve and not worsen the position of smaller players.
- Cash-out changes look like they may end up treating different parties in an unduly discriminatory manner, for example giving preferential treatment to wind. Unless parties can compete on a level playing field the market will become increasingly distorted and prices to customers will ultimately rise.

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

Given the problems that exist in the wider market (liquidity, uncertainty, credit shortage, etc.) WPG would like to see the Government look at wider policies as a route to help investors. In particular we would like to see the Government look at:

- increased capital allowances for renewable generation;
- reductions in business rates;
- use of credit support terms for independent investors in smaller projects;
- reduced credit requirements from the monopolies for connection and use of system charges; and
- reducing the barriers to market entry by making the rules for accrediting green energy easier, so investors have more confidence that their plans will achieve the support due to it.

WPG would be happy to discuss any of the issues raised in this response if that would be of further help.

Yours sincerely

[redacted]

Chairman