Matt Coyne
Department of Energy & Climate Change,
4th Floor Area C,
3 Whitehall Place,
London, SW1A 2AW

16 August 2012

Dear Matt,

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

The REA welcomes the opportunity to respond to the Call for Evidence on barriers to securing long-term contracts for independent renewable generation investment. Independent generators have a valuable contribution to meeting the legally binding renewable and carbon targets. It is vital that now and in the transition taking place under Electricity Market Reform (EMR) independent generators are able to sell their power on reasonable terms. Government should be seeking to reduce the barriers to independent generators and ensure they do not face a situation where there is not an adequate route to market.

The REA represents a wide variety of organisations across the renewable energy sector, including generators, project developers, fuel and power suppliers, investors, equipment producers and service providers. Members range in size from major multinationals to sole traders. There are over 600 corporate members of the REA, making it the largest renewable energy trade association in the UK. This response is also endorsed by the Solar Trade Association, which is affiliated to the REA.

The REA's main objective is to secure the best legislative and regulatory framework for expanding renewable energy production in the UK. The Association undertakes policy development and provides input to government departments, agencies, regulators and NGOs.

Specific questions in the consultation

Identifying the problem – current situation

There is no industry wide consensus on this issue and our response reflects the different views held in our membership. This clearly demonstrates the need for this call for evidence and for DECC to carefully consider and assess the information that it receives.

Independent generators and developers have raised concerns regarding the availability and terms of PPAs. Some generators are only being offered PPA's on terms that are acceptable to their financiers from Statkraft, and the reason why in 2011 and 2012 they accounted for the majority of the market. Other organisations are offering PPA's but these are at large discounts or in some cases they will not commit to take all the ROCs, for many generators these terms will make the PPA not bankable and with no finance, there will be no generation project. Generators are concerned that providers prefer their own projects to stand alone projects, and only taking a proportion of the ROCs to make sure they have enough capacity for their own projects. They have also raised the issue of the ability for generators and customers to enter into contracts directly with each other without a utility acting as a "middle man". Many customers have credit ratings as good as utilities. A few independent supplies have been traded but more should be done to make this less challenging. The general view from the generators is there are very few PPA providers in the market place offering financeable terms and that they

The supplier perspective in contrast is that the PPA market is competitive and provides a challenging environment in terms of maintaining margins. They are not aware of evidence to suggest that independent renewable generators are currently struggling for a route to market, or have to take excessive discounts on the power offered.

The REA is not in a position to share its own evidence on this issue as it does not directly participate in the market. We have encouraged our members to respond individually to the call for evidence setting out their experiences with the Power Purchase Agreement (PPA) market over the past three years, and the detailed information requested in Annex A. We hope that the evidence DECC receives will enable it to make an accurate assessment of the current market situation.

Impact of the EMR

The industry is also divided on the impact the introduction the EMR will have on PPAs. We envisage that PPAs will always be available and the actual issue is whether they will be commercially viable and the PPA terms bankable.

Independent developers are very concerned that the move from the RO to CfD is likely to undermine their ability to secure PPAs. Developers fear PPA terms will deteriorate further without a competitive PPA market; and this could result in them being unable to secure a PPA at the reference price. Their view is that the uncertainty over Electricity Market Reform and other market activity has had a role in off-takers unwillingness to commit to long term positions. This could continue to undermine the ability of an independent generator to secure a PPA (variable or fixed price) as suppliers will no longer be under an obligation to source renewable electricity under EMR.

Commercial incentives may still exist for suppliers and independent aggregators to continue to offer PPAs under the EMR, but how effective these incentives will be is uncertain from an independent generator perspective. It could take time for this market to develop which leaves independent generators concerned they will be without a viable or accessible route to market and an efficient pricing mechanism in the short term or longer term as well. They are also concerned that it will be particularly hard for small projects to get PPAs; isolated projects under 1MW might not be of interest to supply companies. Developers who can put together a portfolio of smaller projects or have a sizeable 10MW plus project might be more attractive.

The vertically integrated utilities (VIU) have a different view and their understanding is that a move to CFDs will have benefits for intermittent renewable developers. Their perspective is that the CfDs will remove and reduce a number of existing market risks for intermittent renewables, providing long term price certainty using a day ahead index and removing the need to contract with a supplier to realise ROC value.

They do expect the price offered under a PPA to change in future, as more wind power is commissioned, the intermittent and less predictable nature may affect the terms that are offered to renewable generators. As the level of intermittent generation on the system increases, wholesale electricity market prices will become more variable, and a higher penetration of intermittent generation capacity is also likely to increase imbalance risks and associated costs. However, they feel the CFD will insulate wind generators from lower wholesale electricity prices as the reference price for intermittent generation will be the hourly day-ahead market price. This provides risk protection and the EMR will make the market more competitive by removing the need for floor prices in PPAs.

The key issue for the design of the CfD is to ensure that the strike price for renewable projects takes full account of all the applicable risks and their costs, regardless of the route to market. The independent generators would not necessary totally disagree with the position that discounting will eventually be paid for by the reference level for the CfD being set higher. But fear this is unlikely to be immediate, and there is uncertainty as to whether and how the CfD will take this into account. It is only likely to be reflected when the government find the system is not working, which could be too late for some projects and the damage to investor confidence is already done.

The independent generators are concerned also that the CfD could leave them having to sign longer term PPA's as opposed to the shorter 6 month contracts some have been using under the RO. The CfD is two-way, either topping up to the strike price when the wholesale market price is below, but it could go negative during the life of the project (and term of the debt). Generators anticipate that the income is therefore much more dependent on the electricity contract. This could mean it is important that the PPA 'tracks' the CfD reference price in some way, to give confidence to the lender that its payments will be met. If they view that there is any possibility that the suppliers will not offer suitable contracts or be subject to a heavily discount then the lenders will want to have the security of a long term contract in place at financial close.

The ROC has been a fixed amount and in some cases half the energy value (depending on banding), so this makes a significant contribution towards underpinning the loan/interest payments. It has taken time but lenders are now fairly comfortable with the concept of a fixed contribution from ROCs plus an assumed, and usually cautious, level of income from the PPA. That leaves the generator free to enter the electricity market on either a short or longer term basis in order to optimise their income and take advantage of trends. It is too early to say what approach lenders will take, however, the fact that the support regime is changing is leading independent generators to expect lenders take a cautious approach in the early years and insist on a long term PPA.

Some of the VIUs, again in contrast, do not think that EMR will have any effects on the length of PPAs required by developers. Their perspective is that the main impact is that it will remove the need for a floor price in PPAs, which is a key risk for offtakers. They expect this will mean PPAs will become 'simpler' products that can be offered by a broader range of market participants, and the EMR will make the market more competitive. Other VIUs however do believe that the introduction of CfDs will result in developers requiring longer term PPAs and are looking at ways of developing power purchase products that can provide them with the duration they require.

Options to achieve the Government's objective

The call for evidence sets out a number of options, which are not mutually exclusive, and a number they should be pursuing regardless of the EMR.

Competition measures

Improvements in the transparency and efficient operation of the wholesale market should be pursued regardless of the EMR. Government should ensure every effort is taken to improve liquidity in power trading.

Supporting the roles of aggregators in the market is desirable as new entrants should provide more competition into the market. However it should be recognised that aggregators have historically struggled to expand in the market and there are a number of market design issues that make it difficult.

Market Liquidity

The latest update of Ofgem's review[1] into liquidity has reported that although there has been some improvement there has not been significant change. Most respondents to the consultation considered that action is required to improve liquidity in the GB power market, and as a result Ofgem will come forward in the autumn with proposals for the mandatory action. It is clear, firstly there is an issue with market liquidity, and secondly this is unlikely to be resolved by the time the first CfD's are signed. The government cannot solely rely on these proposals to support the independent PPA market.

Market-led initiatives

Assistance with the standardisation of PPAs in future will reduce transactions costs for investors. This could have benefits regardless of the EMR proposals. The NFPA already provides a contract that most generators tend to generally find acceptable. In itself this does not provide a solution for independent generators, as even standard terms are frequently renegotiated and need to have effective competition between PPA providers to be effective.

By defining standard contracts that require all suppliers to state in percentage terms the discount they are offering on the reference price, whilst other PPA contract terms are identical; and data on this can be gathered. This creates an additional benefit that the contracts could be useful to inform future CfD's. This will then:

- Provide evidence of the health of the PPA market in a general sense

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[1] Retail Market Review: GB wholesale market liquidity update

http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=281&refer=MARKETS/RETMKTS/RMR

- Enable DECC to adjust strike prices for different technologies to reflect the discount

How this is done will need to be considered, to take into account any confidential information, whether it is provided on a voluntary basis, and whether the data is aggregated.

The various different views just regarding the current PPA market indicates that agreeing on the problem and how to address it might be difficult, and a long process.

Generators could use a route to market similar to the NFPA auction of short term PPA's that exists today. As long as there was a sufficient scale of contracts to attract suppliers this should present an efficient way to obtain a reasonable amount of power from a number of different generators. The major concern with this model is whether a generator would be able to obtain finance for the plant on the basis of the CfD FiT alone. Independent generators expect many investors will require a generator to have a long-term PPA.

Regulatory Measures

It is clear that there are considerable risks perceived in the PPA market at the moment, and that perception of these risks varies according to the group that is being consulted. Given that these risks are generally considered highest by the independent generator groups DECC might want to consider a precautionary regulatory intervention, which can then be lifted as market confidence becomes established.

We think a mandatory buyer of last resort really should be the last resort, and should only be implemented in the absence of an economic incentive to contract elsewhere due to excessive discounts in PPAs. It has been suggested that government could just indicate if the market for PPAs falls beneath some sort of minimum level they will intervene. This is not supported by the independent generators as projects will be vulnerable to PPA terms and taking powers could take years to implement, and by then it might be too late.

The VIUs do not see any case for a "buyer of last resort" as they believe that the CfD may increase off-taker participation. Also, as the problem is not that PPAs are not available to independent generators but more the terms and discounts, which they believe the "buyer of last resort" model will not solve, they are not supportive of this option.

Some independent generators would like a supplier obligation for low carbon electricity held as a reserve option. Others do not favour this option due the difficulty of enforcing a requirement to offer commercial terms, particularly as this is what VIUs are claiming they do already. The VIUs do not see much merit in imposing an obligation on large suppliers and believe this type of approach is likely to result in market distortions and potentially result in higher costs to customers.

A number of the independent generators would prefer to have the option to contract with a body under the EMR arrangements to which they would sell their output. The contracting body would then sell the power to electricity suppliers, exactly as NFPA currently does with the statutory NFFO contracts today. This model would require a funding mechanism to finance any loss on its portfolio and also retain any surplus. The benefits of this proposal are that the generator would be able to finance their plant, realising the full CfD contract price, and power from these generators would still be sold into the market.

Overall

Industry agrees that it is vital independent generators have a route to market. However, it is difficult to reach an industry wide consensus on the scale of the issue now, and the best way forward under the EMR.

There are a number of uncertainties about the eventual impact of EMR and the length of time required to resolve the issue of liquidity in the market. A mandatory regulation solution might not be appropriate at this point in time but independent generators are observing a deterioration of the PPA market and believe there is a substantial risk they could face even more unfavourable terms in the future. They are calling for a government incentive or regulatory measure, even if this is used for transitional period to ensure they have a route to market.

This is in contrast to the vertically integrated utilities that feel strongly there is not an issue with PPA's currently and expect the CfD to bring improvements, if the strike price is set correctly and reflects the costs and risks of renewable generation,

Government will clearly need to carefully consider the next steps, informed by the evidence it receives from all those involved in the market.

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