RBS
The Royal Bank of Scotland

Electricity Market Reform – RBS Group response

Executive Summary

RBS recognises the aspirations of Government in undertaking a review of the legislation currently underpinning the UK renewables sector and we welcome the reinforcement of Government's commitment to the UK's carbon reduction targets. We also concur that it is essential for security of supply and for minimising costs to consumers that the UK have a varied portfolio of energy generation and that performance efficiency be enhanced across the generation fleet.

While we have sought to comment on each element of the proposed reforms it is our understanding that Government's preferred approach is a package comprising carbon price support, capacity payment mechanism, emissions performance standard and a Feed-in Tariff with Contracts for Difference. We have therefore concentrated our response on the merits and challenges of a CfD FIT instrument and how that might work in practice.

RBS role in the market

RBS anticipates playing a major role in financing the renewables build out program over the forthcoming decade. As with our peer banks, our involvement will be in two core ways: financing utilities and other equity investors on a corporate basis; and financing individual assets, or portfolios of assets, on a limited recourse project finance basis. For the latter, we rely on the revenues an asset generates to repay our debt, and therefore carry out detailed due diligence on the economic robustness of these assets, including the regulatory regime that applies and their technological characteristics.

Project finance debt will be structured and sized in a way that results in a high probability of repayment, with the level of debt raised against a project being dependent on that project's overall costs incurred and the projected revenue stream and its potential volatility – the higher the volatility the less debt that will be made available.

So it is the role of RBS and our peer banks to support our clients in the financing and investment decisions they make, be this on a corporate basis or a project-by-project basis. In this way we look to equity to make initial investment decisions with the role of the Project Finance banks then being to develop a debt financing package reflective of the certainty of project cashflows given the legislative regime.

While we are encouraged by the intention behind a UK electricity market reform we think there are areas of the proposed packages that would require further development in order to provide us with the transparency we would look for and to determine the extent to which they are fit for purpose in attracting the estimated £200bn of investment required into the sector.

Analysis of the proposed reforms

Carbon Price Support (CPS)

In determining the appropriate carbon price support mechanism we recognise that it is important that Government ensures that the CPS does not result in UK carbon prices being materially higher than those in mainland Europe. From a senior debt project financing perspective, for the carbon price to be bankable it is fundamental that that price signal be predictable and transparent over a sustained period of time. Variability, be it in pricing or tenor, may damage bankability.

Capacity Payment mechanism (CPM)

We share Government's view that as inflexible low-carbon generation increases, a CPM would ensure security of supply through incentivising the construction of flexible reserve plants and demand reduction measures. We understand Government's caution around possible unintended consequences if a market-wide capacity mechanism were to be introduced. We also recognise that a targeted capacity mechanism represents a smaller intervention in the market. That said, in the absence of further detail about how a central-tendering process for generation fleet would work in practice it is our view that a market-wide CPM represents the most attractive scenario to investment capital, de-risking the process and thereby reducing the cost of investment capital and, ultimately, the cost to the consumer.

Emissions Performance Standard (EPS)

We welcome the Emissions Performance Standard on new plant as contemplated by Government, as it recognises the important role that thermal generation plant continues to play the generation mix while also addressing the issue of the unabated construction and operation of new coal-fired power stations being inconsistent with climate change goals. Measures such as an EPS will be key in attracting first phase investment to Carbon Capture and Storage (CCS) technology, in order to build the track record required for senior debt to play a role in financing CCS in the future.

Feed-in Tariff (FIT) to replace the Renewables Obligation (RO)

The RO has played an important part in establishing the UK as an attractive market for investment in renewable energy technologies, and its proposed curtailment is likely to prompt a degree of instability and will need to be managed extremely carefully in order not to undermine confidence in the UK renewables market as a whole. While the UK has extremely attractive wind resources compared with other EU countries, investment capital is mobile and it is fundamental to ensure that sensitivities around potential policy risk and the transition from one regime to another are addressed robustly in order to maintain investor appetite and confidence.

While a Premium FIT is likely to be a popular alternative to the existing RO mechanism we recognise that it may not appear to be fundamentally different to the current system and to that extent is unlikely to be the optimum model for realising the necessary levels of investment in intermittent generation such as offshore wind. We are also sensitive to Government's desire to minimise cost increases for consumers, albeit it is our view that this risk could be mitigated through a Premium FIT with different strike prices for different technologies and the ability to revisit these prices as technologies mature.

We understand that Government's preferred FIT model is one with a Contract for Difference (CfD) in order to allow for generators to return money to consumers if electricity prices are greater than a certain level in the market. While Banks are familiar with the mechanics of CfDs and so will be able to structure a debt financing package around a revenue stream of this nature, it is our view that greater detail is required in a number of areas in order to give comfort over how a FIT with CfD mechanism would work in practice.

First among these is the nature of the reference price (the "average wholesale electricity price") and the ability of an intermittent generator to achieve this price. The difference between the index price against which a contract is settled and the price at which electricity from an intermittent generator can be sold introduces a significant degree of uncertainty into the predictability of an asset's revenue stream which is likely to impact upon the level of senior debt available for a project and the terms on which it is offered.

We note that the Dutch FIT with CfD mechanism is cited as an example of such a system at work, and that the APX Energy Exchange is a suitably large and liquid market, and one which is adjusted to take account of balancing charges for intermittent generation. Such a market dynamic is fundamental for the success of a FIT with CfD model and we would be interested to hear further details on the nature of the anticipated market in the UK and the manner in which a reference price is expected to be established.

We would also welcome further clarity on the manner in which purchasers will be incentivised to purchase renewable electricity. Under the proposed reforms there would appear to be no obligation on any party to purchase electricity, and in our view this is likely to result in greater off-take and balancing risk, particularly for intermittent generation as this increases as a proportion of UK generation, and more conservative debt sizing assumptions accordingly. There is also the question of how an auction process is intended to work absent an obligation, how it is anticipated that utilities and developers will interact given that they are bidding in the same auction and the likely impact of this on wholesale electricity prices.

From a senior debt perspective it will also be important to understand the nature of the counterparty to any CfD contract and to be comfortable with that counterparty's credit standing in order to be able to leverage and price that element of a project's revenue stream appropriately.

Transition arrangements and Grandfathering of the RO

In anticipating a change in the renewables regime it is imperative that existing investment decisions are not adversely impacted and that investors in the market today have the clarity and confidence to continue to make such decisions. The consequence of an unclear or disjointed transition process is likely to be an investment hiatus; something the sector must avoid at all costs if our climate change targets are to be achieved. To that end Government's focus on transition arrangements and Grandfathering of the RO is extremely welcome and we take comfort from the measures set out in the consultation document.

In determining the optimum methodology for a Grandfathered RO it is critical for investor confidence to seek to maintain the value of the ROC going forward in order to preserve the economics of investment and financing decisions made to date under the RO. Calculating the Obligation will be extremely important in this and it is our view that a fixed ROC system is likely to cause multiple implementation issues, including an impact on current PPAs, and would need to be considered fully by Government in order to understand the potential impact on public finances. We therefore consider a headroom only approach to be the most practical alternative to a continuation of using both calculations.

Conclusion

Of critical importance in designing and then implementing Electricity Market Reform is continued investment in the sector and the avoidance of any development hiatus. RBS is highly motivated to lend to the UK renewables sector and our role is to follow initial financing by equity investors with senior debt financing packages reflective of the certainty of project cashflows given the legislative regime.

Market liquidity is a prereqresuite for many of Government's proposed measures to be successful and to this end we look forward to the additional level of detail to come around this proposed market and the "average wholesale electricity price" that the financing community will require in order to invest in the development of a generation fleet that is by definition a price taker.

Ultimately we agree with Government's stated policy objectives of security of supply, decarbonisation and affordability, and we take great comfort from the commitment to Grandfather the existing RO arrangements. Contracts for difference are understood by the bank market and are likely to be financeable in the context of a low carbon generator, provided a sufficiently deep and liquid market exists.