International
ESBI Energy Innovation

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Dear Matt

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

ESBI welcomes the opportunity to provide views in response to DECC's call for evidence on the barriers that independent generation developers are experiencing in securing long-term offtake contracts for their power. Independent generation developers and operators will play a key role in the achievement of Government's energy policy objectives, in the delivery of renewable technologies and also the flexible conventional generation that will support them. It is important that these generators have a route to market that ensures appropriate returns over appropriate timescales. An effective market for Power Purchase Agreements (PPAs) is therefore critical to ensuring energy policy goals are met.

This response provides a brief overview of ESBI, followed by a summary of our views on the issues raised in the call for evidence.

ESB International

ESB International (ESBI) brings together our worldwide generation, engineering and related services businesses.

ESBI continues to grow our position in the UK wind market. Our operational and development portfolio will be around 165MW, comprising of: the 24MW West Durham Wind Farm in Northern England; the 20MW Hunters Hill; and 15MW Crockagarron projects in Northern Ireland. Additionally, we recently completed commissioning of England's largest onshore wind farm, at 66MW, at Fullabrook in Devon and we have recently started construction of our 38MW Mynydd y Betws Wind Farm in South Wales. We are also active in the ocean energy sector.

In addition to increasing our renewable portfolio, we have been a developer and operator of independent Combined Cycle Gas Turbine (CCGT) generation projects in the GB market for almost 20 years. We own, operate and trade Corby power station and developed the 850MW plant at Marchwood, which was commissioned late in 2009. We are also at an advanced stage with our latest 860MW development at Carrington which is intended to become operational early in 2015. Additionally, we own and operate the 406MW Coolkeeragh plant in Northern Ireland. We are also developing further large-scale CCGT projects at other locations across GB, including our 1500MW project at Knottingley in West Yorkshire.

With increases in physical interconnection, in particular the commissioning of the East-West interconnector later this year, coupled with the further development of the regional market, our operations in Ireland will become increasingly linked with the GB market.

Summary of views

Government's energy policy goals of delivering affordable, secure and low-carbon electricity cannot be delivered solely by the large, vertically integrated utility (VIU) companies. A material proportion of the very significant investment that is required to change the UK's generation mix to meet these challenges will be delivered by independent generators. This investment will comprise of a range of renewable and low-carbon generation technologies and new cleaner conventional generation capacity that will support a generation mix with large increases in the amount of those intermittent and inflexible low-carbon technologies. All these types of independent generation require an effective market for PPAs. We are therefore concerned that the call for evidence focuses too specifically on the availability of PPAs for renewable generation. We believe the issues for independent conventional generation mirror those experienced by renewable generators and should therefore be included within the scope of DECC's call for evidence.

For many independent generators, entering into a PPA is a critical step in achieving the delivery of new projects and effectively operating existing assets. For smaller generators, a PPA provides a route to market for their power, as well as an effective mechanism for transferring key risks to industry players that are better placed to manage them. In particular, a PPA enables smaller generators to transfer energy balancing risk and the associated costs to larger parties, such as the VIUs, that have the ability to better forecast intermittency and hedge across wider generation and supply portfolios. For larger independent generators, particular those building and operating conventional power stations, a PPA can provide a route to market in a market in which a fundamental lack of forward liquidity makes participation especially difficult.

The PPAs provided to independent generators must be with credit-worthy parties and on terms that satisfy the requirements of debt and equity providers. DECC is correct in its observation that, for a number of reasons (discussed below), the PPA market is less buoyant than has previously been seen. This has manifested itself in a reduction in the number of interested counterparties, a general deterioration in the availability of PPAs, and the terms contained within them. There has been no change in financiers' expectations (indeed, the current situation in the global financial markets means expectations have often raised) and this has therefore had an adverse impact on the availability of project finance for independent renewable and conventional generators. If this is to be reversed, then independents will need to see a real improvement in the availability of credible PPAs, or be provided with bankable alternative routes to market.

Factors impacting the availability of PPAs

There are a number of factors that we believe have contributed to the reduction in the availability of PPAs. In our experience, providers of PPAs have expressed a range of reasons for the reduction in the availability and terms of PPAs. In general, most of these relate to the significant amount of policy and regulatory uncertainty that has been introduced to the market in recent years. The main factors that we believe have impacted the PPA market are listed below:

Uncertainty on RO levels

Over the last 12-18 months there has been considerable uncertainty around the enduring level of support that the RO will provide from 2013. Government's delay in announcing the new banding levels greatly contributed to some of the uncertainty that has resulted in the current state of the PPA market. It has been difficult for developers and providers of PPAs to enter in to offtake agreements with the underlying uncertainty on returns that the RO banding review has caused.

Impact of Electricity Market Reform (EMR)

Government is of the view that the current electricity market will not deliver its energy policy goals. In response, it instigated the EMR process to fundamentally overhaul the market and support mechanisms for the various generation technologies participating in it. Whilst the introduction of the FiT CfD to replace the RO and the capacity market to support conventional generation are seen by some as positive steps to providing greater certainty in returns, the considerable "unknowns" arising from the lack of detail of the mechanisms and underlying value of support to be provided have been major factors in the worsening of the PPA market.

Lack of market liquidity

There is currently a fundamental lack of forward liquidity in the market. Whilst there have been some recent developments that have provided a stimulus for greater liquidity in the prompt markets, there remains no liquidity and therefore no robust market reference price further along the delivery curve. The lack of liquidity directly impacts the robustness of market indices used in PPAs and the availability of PPAs from smaller suppliers and independent aggregators. It should be noted that the lack of long-term liquidity is perhaps the most critical issue affecting the availability of PPAs for independent conventional generation.

Balancing and cash-out reform

One of the key risks that independent (particularly renewable) generators wish to transfer within a PPA relates to forecasting and the cost of balancing. Market participants with larger, or more diverse, portfolios or supply positions are better able to balance their energy. The costs associated with imbalance (ie cash-out) can be large and difficult to manage for smaller parties, especially those that are reliant on intermittent sources of fuel, such as wind or wave. Ofgem's recently announced Significant Code Review on reforming the current cash-out arrangements may lead to some improvements for smaller players but the uncertainty of the outcome and associated timeline for delivery will do little to improve the PPA market for the foreseeable future.

VIU delivery of low-carbon generation

Over recent years, the market has seen an increasing proportion of the large VIUs' renewable power requirements being sourced internally. This has particularly been the case as projects of significant scale, in particular onshore and offshore wind developments have been commissioned. Whilst this is not necessarily a symptom of market or policy failure, we would welcome moves to encourage the recognition of the value through diversity, competition and innovation that independent developers can bring to market through a more liquid market for PPAs.

Options for change

The following section discusses each of the various options for change that DECC provide in its call for evidence.

Market-led initiatives

In general, ESBI supports market-led initiatives to remedy perceived market failures as they are often less contentious and can therefore be introduced more efficiently than mandated measures. In the call for evidence and supporting stakeholder seminars, DECC has suggested a number of market-led initiatives that could be brought forward, including:

- Standard PPA terms for both RO and FiT CfD supported plant
- Voluntary code of practice on terms and market participation
- Self aggregation

We are of the view of that, of the above options, the creation of standard PPA terms could be the easiest and least cost to facilitate and could deliver relatively quick benefits for independent developers. Irrespective of any further measures that are mandated, we strongly believe the standardisation of terms should be encouraged. However, we would urge that any standardisation of terms must result in agreements that are credit-worthy and bankable. We are sceptical as to whether the option of a voluntary code would deliver any tangible results and if it could be monitored and governed effectively to ensure the intended benefits are realised. We strongly support the role that independent aggregators play, and could play in improving the PPA market, but we struggle to see how groups of independent generators could practically aggregate themselves in the market as it currently stands. In particular, contractual relationships would likely be prohibitively complicated for smaller parties to effectively manage. The arrangement would also still require a lead party amongst the aggregated generators to act as the main signatory to any agreement with a PPA provider.

Improving competition

We strongly support any measures that are brought forward under this heading. The main suggestions included in the call for evidence (improved liquidity, cash-out reform and better supporting independent aggregation) are sensible and should be progressed. We note Ofgem's recent announcements on cash-out reform and look forward to the results; however we are concerned that the suggested timetable will not deliver improvements in the timescales required by industry and the EMR process.

With regards to improving wholesale market liquidity, we strongly believe that improved liquidity will deliver efficient solutions to many of the issues currently seen in the market today, especially for independent players of all sizes, both on the supply and generation sides. Ofgem has recognised this and has been undertaking its own review and stimulus of liquidity for a number of years; however we have a number of concerns with the way the Ofgem process is progressing. We note that there has been some market-led improvement in levels of liquidity in the prompt markets but this has not been mirrored further along the delivery curve. We are disappointed that Ofgem has decided to continue to adopt a "wait and see" approach to allow the market further opportunity to bring forward measures to improve liquidity and are of the view that measures must now be mandated before the improvements required by industry and the PPA market are realised. We stand by the view that improvements in liquidity throughout the delivery curve will be the single most effective tool in encouraging independent aggregators to participate in the market.

<u>Regulatory measures</u>

Mandated regulatory measures should be seen as a last resort and only introduced in the event that other market-based initiatives do come forward or do not work. In general, mandated measures take a long time to develop and be introduced and often have unintended consequences. As such, we do not believe regulatory measures should be instigated hastily, before the market is able to address the issues that have been raised. Below are our comments on the suggestions provided in DECC's call for evidence.

Obligation to offer terms

Obliging suppliers to offer terms may be relatively easy to implement, requiring only minor changes to the supply licence, however we are of the view that it is likely to carry unforeseen consequences that would negate its intended benefits and introduce distortions that would run contrary to other measures, such as improving liquidity. In particular we are sceptical that "commercial terms" can easily be defined and measured against and whether these terms would differ from the reduced terms currently seen in the market. In addition, obligations around individual terms (such as length of agreement) will invariably mean that discounts to other terms are used to re-align the agreement to the benefit of the provider.

Off-taker of last resort

In principle, the provision of a "back-stop" in the form of an off-taker of last resort may be beneficial. However, there are a number of fundamental concerns that would likely mean this option would not work and indeed could distort the market. We are particularly concerned that establishing the off-taker of last resort could drive all liquidity in the PPA market to one point, effectively creating a pool-based market for PPAs and eroding choice for generators in the wider market. In addition, current levels of liquidity would make it difficult for the off-taker to sell the power which it had purchased under the arrangement. For an off-taker of last resort to deliver the intended results would require the body to be credit-worthy and the PPAs bankable. To facilitate this would require very significant amounts of credit, both from generators selling to the body and those suppliers which choose to purchase from it. We envisage this could make the arrangements prohibitively expensive for most generators that would seek to benefit from the off-taker of last resort.

Conclusions

We agree that there has been a reduction in the availability of PPAs and terms that are offered in them. However, we do not agree that the PPA market has completely stagnated although it has become more challenging. We welcome DECC's recognition of the difficulties that independent renewable generators have in securing off-take agreements, but we would urge that DECC also acknowledges that the issues faced by renewable generators are the same as those seen by conventional independent generators seeking off-take agreements and therefore the two should not be separated.

Where possible, we would prefer to see the barriers that independent generators are facing solved through market initiatives, in particular the improvement of liquidity throughout the wholesale market delivery curve. Of the suggestions raised in the call for evidence, some may bring benefits but the more fundamental changes suggested under the mandated proposals could lead to market distortions and unintended consequences that could actually worsen the issues that they seek to address. Whichever

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solution comes forward, we would urge that the financial and credit requirements are minimised to the extent that they can be, in order to further encourage the important role that smaller independent developers and operators play in the delivery of Government's energy policy goals.

Should you wish to discuss any of the views expressed in this response further, please do not hesitate to contact me.

Yours sincerely,

GB Regulation Manager

ESBI Investments

Email: [redacted]