Eggborough
Power Ltd

16 August 2012

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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

Eggborough Power Limited (EPL) is an independent generator which owns and operates Eggborough Power Station, a 2,000 MW coal fired power station situated in the Aire Valley in North Yorkshire. Eggborough Power Station was previously owned and operated by British Energy (and latterly EDF) to provide flexible and reliable mid merit support to the "baseload" nuclear portfolio. EPL is now owned by substantial private shareholders and is operating as an essentially merchant power plant in the wholesale market.

While EPL currently co-fires biomass with coal, earning Renewable Obligation Certificates (ROCs), looking to the future the plant could potentially be converted to 100% biomass if the investment climate is right. This would allow us to produce up to 2000MW of renewable power for the UK, extending the life of the plant and helping to provide secure supplies of electricity for future generations. To undertake such a plant conversion will require significant funding and we therefore have a substantial interest in securing longer term contracts for the renewable power EPL could produce in the future.

EPL's answers to your questions are set out below.
We believe that PPA availability will encourage new entrants, will help to ensure a thriving independent generation sector and will promote competition. We would be happy to discuss the points raised in more detail if that would be of help.

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.

EPL is an independent power producer with significant experience in PPAs over the last 3 years. In Q1 2010 EPL was carved out from the EDF fleet. At that time we approached 16 major industry players including generators, banks and proprietary traders. At that stage none of them were willing to enter into a PPA with Eggborough and so we have been forced to manage our commodity risk on a merchant basis. We also have recent experience in negotiating PPAs. Through a market wide tender we have been looking for a longer term PPA to help underwrite the investment required in the plant to facilitate our conversion to Biomass. During that process we approached 13 market participants including utilities banks and proprietary traders, **only one counterparty** expressed any

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interest in a PPA but this was at a level commensurate with off-shore wind whereby the subsidy of 2 ROCs per MWh meant that the maximum floor price the offtaker was willing to guarantee was £30/MWh. We understand that £30/MWh is now the industry standard for a renewable energy floor price. With Biomass prices at around £8/GJ, the £30/MWh floor presents an unacceptable level of risk to finance providers. The lack of a liquid forward market, is leading investors to insist upon longer term PPAs with guarantees on minimum pricing levels.
Our most recent experience has served to highlight the issues around market liquidity that EPL along with other smaller, independent, players have been raising for some years. These are concerns many parties have raised with Ofgem and we have been hoping that their work on liquidity in the prompt and forward markets will seek to address this. This is not simply about needing liquid markets as way to sell output in the short term, but the lack of liquidity can also make it difficult to sell power forward in a manner that would make underwriting investment efficient.

The lack of liquidity has a number of impacts on players such as ourselves:

- Our choice of counter-party is limited. Smaller players may wish to buy power from EPL, but they may not be able to utilise our full output and face commercial risk that they cannot easily buy or sell power to achieve the shape they need.
- While generators can index sales, the lack of a robust price index leaves smaller parties concerned that they are indexing against a price that the dominant players (the Big 6) may have undue influence over. The integrated players act on both sides of the market, which is very thinly traded and open to significant price movements. Some traded products may not trade for days and then can suddenly trade with prices moving sharply. Even if the larger parties do not intend to move prices, the lack of liquidity makes any larger trades alter the market price disproportionately when compared to a liquid market.
- The lack of counter-parties allows those parties to exert market power. EPL has found that the Big 6 suppliers, if they chose to offer terms, all offer extremely similar terms, notably the discount applied to the price they will pay for ROCs. This limits EPL's commercial options.
- Lack of liquidity also makes it difficult for buyers and sellers to correctly price forward sales. In EPL's experience this results in suppliers wanting to cap and collar forward prices leaving us no choice but to accept such structures. Investors can reasonably be concerned that such structures may result in them surrendering future value whilst placing a collar in the contract suggests that large utilities believe that prices could collapse, which whilst unlikely, by virtue of being proposed by the utility, raises investors' concerns.

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?

The price offered for the purchase of ROCs has reduced. This seems to be a slowly evolving response by suppliers, with ROC values noticeably reducing in the last 3-4 years. It could be taken as evidence that market power is being exerted, possibly in light of the additional scrutiny being placed by Ofgem and Government on end consumer prices. While Ofgem's Retail Market Review work has focussed on the difference between wholesale power prices and retail prices, they do not appear to have looked at the other elements of the final price in any detail. It may be possible that suppliers are trying to capture value from ROC margins, rather than power prices.

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?

EPL is a single site company so we do not have experience of other EU markets. However we would note that the existence of feed in tariffs in other markets does ensure that the full benefit of support to "green" generators goes to the generator, rather than being shared with suppliers as is the case in the GB market. We also note that other markets have significantly greater levels of liquidity giving sellers and buyers a more robust indication of the forward price of power.

On green support, EPL have found that suppliers (the big 6) all offer to buy ROCs, but at a standard 10% discount from the market price. This leads independent generators to require more ROCs than they would need if the support went directly to them. The GB RO arrangements therefore allow suppliers as well as generators to benefit from the support, which we do not believe was ever the intention of the mechanism.

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 purchasing power of the vertically integrated companies has a negative impact on our ability to compete. We have found that some of them are unwilling to engage with us even at the opening stage of our discussions.

On top of the issues surrounding liquidity, small and medium sized companies often do not have the credit facilities open to them to do a longer term deal with large utilities. The central trading arrangements also have significant credit requirements, as do the monopoly network providers, tying up the limited credit open to some parties and limiting their ability to extend credit lines in bi-lateral trading. This means that parties can often only afford to sign deals that are annual, with longer term contracts being too expensive, with the additional costs making them uncompetitive in the wider market.

The wider policy background has also been a major issue, notably the long wait for a decision on the RO banding for renewable generation. While the recent decision is broadly welcomed, the fact it has been accompanied by further consultations on issues such as the limit to the amount of co-fired or converted biomass ROCs a supplier can use to meet its own obligation means it has not created a stable investment background. Further uncertainty makes investment decisions very challenging.

For biomass generation there is further uncertainty over the sustainability criteria for biomass. Generators have welcomed the commitment to try and set the criteria to 2020, but again this is subject to further consultation. To create longer term, sustainable, reliable fuel supply chains there is a real need to offer generators the ability to create long term purchase agreements for fuel, so fuel suppliers will invest in their businesses as well as generators investing. Changes in the sustainability criteria are difficult for generators to manage unless they diversify into fuel supplies themselves. Biomass producers, often based outside the EU are wary of taking on regulatory risks that they do not understand and cannot effectively manage either. This creates regulatory risk uplift in the fuel prices, which feed through into power prices.

At the present time all parties are having problems valuing contracts into the future as there is no forward curve for the parties to price against. However, one area we believe the Government could help with is the ROC values. Given the buy-out price is known each year, the Government could require suppliers offer prices that are not less than the buy-out price. This would ensure that renewable generators could lock in the renewable value of projects even if they cannot lock-in the power value.

Liquidity is hindered by Government policy that creates 'known unknowns' such as the carbon support price. While EPL is convinced that HMT, by stating a trajectory price for carbon, did not design the new tax to stifle longer term trading it has certainly added to perceived regulatory risk. EU ETS has the benefit of being a risk that sellers and buyers can hedge. EPL understands the Government's frustration with the low price of EUAs, but working to reduce the supply, and thus raise the price, of EUAs would have a less detrimental impact on market liquidity. Taxes simply cannot be hedged in the trade market and thus create a risk companies cannot efficiently manage.

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?

At the current time it is difficult for parties to judge what the overall impact will be, but we do not believe that the EMR package as currently outlined will have any significant impact on bi-lateral trading for existing parties, notably PPAs. What will be far more relevant is if Ofgem can bring real liquidity to the market, which EPL, along with other players very much hopes that they can. We can say however that the uncertainty around the EMR package has created another challenge to the financing of our conversion since potential offtakers are insisting on putting Change in Law provisions into PPAs which transfer all risk to the generator.

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

EPL has focussed very much on price, but are aware that for some parties a personal relationship can be very important. For our business there is very little to choose between the largest suppliers, with similar credit rating, commercial terms, etc.

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?

Yes, EPL has seen falling returns as a result of the heavily discounted prices being offered for ROCs making financing impossible. At the present time we do not believe that there is anything in the EMR package that will address this issue in the short term, though a move to administered prices will help in the medium term.

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?

Of the specific options raised EPL's comments would be:

Market led initiatives

Generally EPL believes in market solutions and we have noted already that liquidity is a key driver in terms of achieving a better investment environment for existing companies and potential new entrants. While having a code of conduct may be useful, we do not believe that the Government or Ofgem can, or should, force parties to trade.

It would take time and effort to negotiate any "codes of conduct" and enforcement could be difficult and time consuming. It would therefore offer little by way of timely help. A code may also limit the ability of suppliers to develop new PPA terms or being creative in addressing market changes as they arise. If a code is needed that suggests that there is an underlying market failure that is best addressed at source.

Competition Measures

To truly address competition the Government, or regulatory authorities, would have to require the break-up of the integrated, dominant companies. At the present time we do not believe that there is an appetite for such a move. The next best option will be for Ofgem to require that the companies separate their supply and generation businesses, acting as independent companies for the purpose of trading wholesale power. Such a licence requirement would at least substantially improve the levels of liquidity in the market as integrated players would have to move 100% of their power sales into the wholesale market, avoiding "internal" trading. This is also a regulatory change that could be achieved in a timely manner, with a new licence condition and then subsequent audits, and at very low cost. The potential benefits of effective competition would be far greater than any other changes that the Government could make.

Cash-out is an issue that both Ofgem and Government often cite as a barrier to competition. While it is true that the costs of imbalance can hit smaller parties disproportionately, it is a very complicated calculation and EPL do not believe it is in itself as great a barrier to market entry and competition as suggested. To alter cash-out will also take much industry time and effort and we are not sure what the "right" answer would look like. EPL would therefore suggest that at least for now the market is left as is. All parties are of course able to propose changes to the Balancing and Settlement Code cash-out rules and we note none have done so in recent years, making this look like a low priority for parties.

Aggregators already exist in the market and we see no particular reason to "support" them and no practical means to do so. It is unclear what the barrier to aggregators is, except the costs of using them. There have been aggregators since NETA went live in 2001 and there are parties who find them a useful risk management option. However, more effective competition in the wholesale market would provide a more robust, longer term solution to issues surrounding competition.

Regulatory Measures

Regulatory measures could be more useful and some could be implemented in a timely manner. EPL believes that forcing suppliers to offer PPAs would enhance investment opportunities, there are policies, as outlined in this response, that are worthy of further consideration:

- Regulation of the minimum price suppliers must pay for ROCs, or a central ROC purchase price;
- Timely action from Ofgem to resolve liquidity;
- Consideration of tax breaks for investment in green generation;
- Credit support for smaller scale infrastructure investment, or additional bank lending to vital sectors; and
- A review of Government, and associated EU policy that may hinder longer term trading.

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

Any changes to specific sectors or market rules risks creating a further distortion in the market, and will therefore create winners and losers. The best way to achieve a robust, competitive market that operates to the benefit of customers is make sure that it functions as close to a "real" market as possible, recognising the role that central monopolies play in delivering energy. Some specific issues surrounding the policies raised are:

- Codes of conduct may only be applicable to some parties and may stop companies developing better products into the future. There is much to be said for tailoring deals between parties, hence the existence of "origination" teams who look to structure specific deals for their company.
- Ofgem's mandatory auction idea risks creating an auction that only the Big 6 can, or wish, to participate in. This could worsen, not improve the position of smaller parties. There is also a risk that Ofgem requires the auction of products that do not meet the smaller suppliers' needs. Overall there could be more volume in the market, but only trading between 6 parties.
- Requirements to offer PPAs also risk suppliers not offering generators the terms that they need to invest in the new plant.
- Cash-out changes could increase volatility, or treat different parties in an inequitable way. Reducing incentives to balance may increase balancing costs to customers, which is again not helpful.

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

To further encourage investment, the Government should consider wider support mechanisms such as: capital allowances; reduced freight charges for renewable rail cargoes and reduced business rates. Investment decisions can be helped by such support mechanisms and sends long term signals about the Government's commitment to build a greener economy. While some preferential tax arrangements already exist for some power investments, notably CHP, given the scale of investments required across the sector additional, targeted support should be considered.

The Government has created a support for major infrastructure projects, but the structure of the mechanism will not obviously help companies such as EPL invest. In the power sector the support seems only likely to help companies such as National Grid who are most likely to be able to raise finance for themselves, with their rates of return underwritten by regulated prices. The Treasury needs to consider how it supports smaller, private companies providing vital infrastructure to the UK. While not investing in billion pound cables, underwritten by customers, companies like EPL can potentially provide enough green power for circa 2,000,000 homes if given the right investment signals.

Our company also provides around 500 jobs and further investment would create up to 1,000 additional jobs while the plant up grade occurs. On top of the direct employment, EPL is responsible for in excess of 1,000 indirect jobs, which at the current time are all vital to the local economy. Shipping our fuel supply chain, loading and stocking at ports and moving by rail, is also supporting jobs and investment in some key infrastructure that EPL and other power stations use. As such the power station and its continued operation make a significant contribution to UK plc.

The processes surrounding accreditation of power projects for "green" benefits could also be improved. For example, the accreditation process for ROCs is not subject to any form of guidance. This makes it difficult for investors to be comfortable that they will start to receive green benefits when their projects go live or at some later date. While Ofgem tries to be helpful, understanding the triggers for "commissioning" and "accreditation" can be difficult for lenders to fully understand.

Summary

In terms of our views on the high level options outlined in Section 6 of the call for evidence, we fully support the "Market-led initiatives" of establishing PPA contract models consistent with the regime and developing codes of practice for pricing transparency and market participation. These are areas that the industry should be continuously working on and updating but it is critical that DECC assertively facilitates these discussions and drives solutions.
Competition measures are key to maintaining a healthy UK energy industry. We strongly support boosting UK power market liquidity for up to 3 years in base-load, peak and block trading. In our view more direct action is needed here. We fully appreciate that Ofgem have been leading the study in this area but now a coordinated follow up with DECC, whereby serious measures are introduced to force power into the market rather than it being used to self supply for example, are needed. We also need improved systems and controls around data transparency e.g. in terms of all quantities and instruments being traded, so that evidence can be gathered, measured and analysed to ensure that no participant is consciously or unconsciously stifling the wholesale power market.
Direct regulation to force larger participants to offer PPAs is problematic in terms of potential market distortions however; we are very concerned that the large utilities do not have the need to drive change with market-led or competition measures, so we would not rule out participating in constructing regulatory solutions as a last resort. In conclusion we would urge DECC and Ofgem to be bolder in pushing through market-led and competition measures even if this means that some of the larger participants are inconvenienced.
EPL hopes that these comments are helpful, but is happy to discuss any of the points raised in more detail.

Yours sincerely

Commercial Director
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