**Off-taker of Last Resort Advisory Group – Fourth Meeting**

**Wednesday 20th November 2013 14:00 – 16:00**

**Minutes and actions**

**Attendees:**

**DECC attendees:**

Tim Warham (chair)

Alex Weir

Darryl Croft

Matt Coyne

Adam Harper

Helena Crow

Michelle Toussaint-Bourne

**Advisory Group attendees:**

David Handley, RES

Phil Broom, GDF Suez

Keith Patterson, Brodies

Christian Pegrum, Eon

Martin Bell, Ofgem

Charlie Garrood, PwC

Maria Paz Garcia Alajarin, EDP Renewables

Andrew MacLellan, Energos (by phone)

Ravi Baga, EDF

Stuart Noble, Scottish Power

Edward Crosthwaite Eyre, Baringa

Chris P. Collins, Baringa

**Apologies:**

Dima Rifai, Paradigm Change Capital Partners LLP

Konstantin Suplatov, PwC

Ben Cosh, Green Company

Nick Gardiner, BNP Paribas

Robert Owens, Smartest Energy

Simon Proctor, Good Energy

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|  | **Pricing** | | **Paper 4: Pricing** | | | **Alex Weir** |  |
| After introductions, Alex Weir (AW) presented paper 4 on the proposal for pricing the discount for the off-taker of last resort mechanism. The Group discussed the questions set out in the presentation.  **Q1. Do you agree that discounts should be set on a £/MWh basis?**  The following points were raised:   * Some people were concerned that if set on a £/MWh basis, generators’ incentives to balance efficiently would be negatively impacted. However, others argued that generators balancing incentives are not affected by the nature of the discount, and instead are determined by the contractual provisions in the PPA. * The group agreed that a £/MWh discount is more risky for offtakers on a long-term basis, as imbalance risk is generally correlated with wholesale prices. Under competitive allocation, companies may price in the risk but it was questioned whether in a regulatory allocation process, levelisation would sufficiently protect suppliers. * Additionally, in the short term, companies may be able to deal with the risk but if the discount was fixed for a long period of time, it becomes harder for offtakers to value it. * Some members of the group argued that a £/MWh discount increases the likelihood of the OLR being used compared with a % discount in the event of higher wholesale prices over the long term. * The group raised the point that if the reference price fell, a £/MWh discount could lead to generators having to pay money back to offtakers. AW explained that when combined with a CfD top-up, a £/MWh discount would give generators a constant revenue stream (unless market prices became negative) regardless of the wholesale price. * The group pointed out that a market with a lot of renewable energy generation (e.g. wind), could have peak periods of high generation where prices dropped but imbalance costs increased. However, the group thought this was only likely to be for short periods. * The group questioned whether the objective was to provide revenue certainty, or to make projects financeable by providing a guaranteed, bankable route to market. AW explained that to provide a bankable route to market, it may be necessary to provide a guaranteed minimum revenue stream, which would require a £/MWh discount. DECC are exploring with lenders the question of whether a % discount would be bankable. * The group questioned how much risk DECC is trying to remove from generators and if all risk was being stripped out of the market. AW pointed out that risk was not being stripped out rather, it would be floored. This approach would cap risk, especially downside risk, at a low level through the discount, effectively providing generators with a floor price for their power, in a similar way to PPAs under the RO.   **Q2. Do you agree that discounts should be fixed for CfD term?**   * The majority of generators in the group considered that the backstop discount should be fixed (in real terms) over time. The key risk for generators is long-term route to market / imbalance cost, so there is no need to have a smaller discount in the near term. * The majority of suppliers in the group argued that the discount should increase over time to reflect expected route-to-market costs. They argued that the objective should be to keep the probability of accessing the OLR constant over time, which requires taking account of the expected trajectory in route-to-market costs. * The group pointed out that lenders would model projects using the backstop PPA for the income. AW pointed out that this could be done whether the discount was flat or varied. However, the group debated whether some investors would take early stage risk, refinance at a later stage and then sell onto an infrastructure fund. In this instance, the infrastructure fund might be concerned if there is an indication of a reduction of revenue in the latter stages. However, it was pointed out that the revenues in early and later stages were not comparable as the terms were not the same because at the front end revenues would be bankable through a PPA with a credit-worthy counterparty - the concern would be over revenue at the back end. * The group pointed out that limited competition may increase the risk of generators needing to access the OLR in the near term, e.g. resulting from fewer players in the market, greater likelihood of new entrant counterparties going bankrupt, and the possibility of generators contracting with smaller counterparties. However, it was noted that this risk should improve over time but that there may be an increased risk to the consumer in the early stages therefore a fixed discount may be preferable.   **Q3. Do you agree that discounts should be indexed to CPI?**   * The group agreed that if the discount was set at a £/MWh basis then it should be indexed to CPI.   **Q4. Do you agree with our general modelling approach?**   1. **Do you agree with the range of discounts?** 2. **Do you agree with the range of scenarios?**   On the proposed criteria for the modelling, the discussion saw the following points raised:   * The group pointed out that the 1.25 DSCR was an aggressive assumption and the market is currently working with a 1.45 DSCR. However AW pointed out that some lenders have said they would price with a downside risk scenario of 1.1 DSCR and that lenders would look at projections of PPA discounts that would be a continuation of the base case. The downside stress test would be against OLR revenues for the whole term. European examples such as France should be able to show comparable DSCR. * The group questioned whether projects would be able to get started without a 5 year PPA. AW pointed out that this case was looking at what would happen with a 5 year PPA. Lenders have indicated that they cannot envisage financing a project without a PPA. * The group made suggestions for future modelling runs:   + Modelling should include a scenario that allows for initial equity financing with refinancing after construction to bring debt into the project.   + Scenario 3 may not provide as much information as scenarios 1 and 2 and it may be better to look at variances within the sensitivities of these scenarios, i.e. what sort or debt can you get into the project, what are the debt scenarios, what is the DSCR and how will it change.   + Run a scenario based on expected open market PPA revenue for the life of the project, and test whether downside revenues (e.g. P90 output, OLR only) meet a 1.1 DSCR coverage.   + Additional test backstop discounts of £15/MWh and £35/MWh * The group asked about the level of open market PPA discounts that were factored into modelling – whether the 5% discount assumption used for setting the strike price for offshore wind or the 15% discount used in the OLR modelling was correct. AW explained that the strike price assumptions are based on an RO-X methodology, not a bottom-up analysis of likely discounts in the market. The key question for strike price setting is whether there is any reason to change the RO assumptions as a result of the move to the CfD. * AW summarised the suggestions that DECC should:   + Model some rolling 1 year PPA scenarios;   + Look at debt sizing under a stress test – e.g. P90 output, 1.1x DSCR, OLR revenues only; and   + Adjust the assumption for base case DSCR.   **Q5. Do you agree with the general principles for selecting a discount?**  The group discussed the criteria for selecting a Backstop PPA, raising the following points:   * The group pointed out that it would not be helpful if the OLR price polluted the market price. There needs to be clarity between the OLR as a safety net for generators wishing to access the market which is also in the interest of consumers. * AW explained the IRR table referred to different scenarios set out in the paper, emphasising that the key issue is the differences between the scenarios rather than the absolute results. The reference case where the OLR has not impact was compared with the three sections comparing the different backstop discounts. This shows that the equity IRR is higher in the scenario with a £20/MWh backstop discount compared with the 15 year PPA. This is because the gearing has decreased but the expected increase in market revenues have made up for the reduced gearing. * DECC would welcome feedback on OLRAG members’ own modelling – for example, how PPA providers are pricing these risks, how costs change over time and how equity providers make their investment decisions. This will feed into our own modelling and policy development. * Additional contributions were invited from the group providing insight into individual company modelling. In particular, responses in writing would be welcomed on the following questions which time did not allow to be covered in this session:   Q6. Do you agree with our assessment of the different approaches?  Q7. Which approach do you think strikes the best overall balance?   * AW explained that this is early modelling, but it suggests that discounts in this region may work for generators. * The group commented that as the market becomes more familiar with CfDs, confidence in the mechanism should increase. Therefore, the market should not be alarmed at for example 60% gearing ratios in the early days as these should improve over time. | | | | | | | |
| **2.** | | **Forward Look** | |  |  | | |
| Thanks were communicated to the group for their continued support and contributions to the process so far. The possibility of a wrap up meeting was put to the group. **The next OLRAG meeting will be on the 27th November and will cover Cost Assessment and Levelisation.** | | | | | | | |