**The material in this paper is work in progress and is not a statement of government policy or policy intent**

**OFF-TAKER OF LAST RESORT ADVISORY GROUP PAPER 4   
BARINGA SUPPORTING PAPER A**

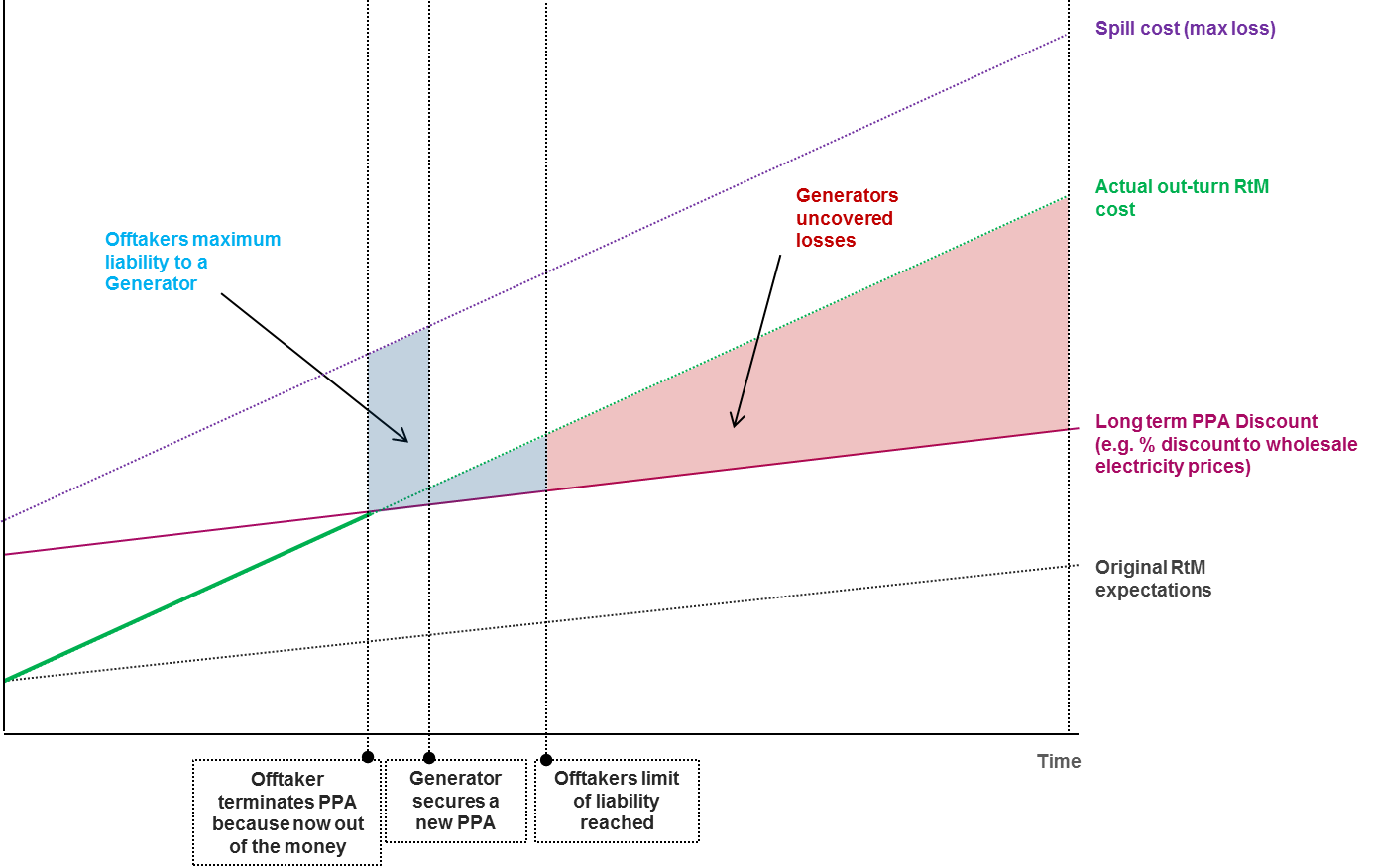
**Introduction**

1. The sixth paper submitted to the OLR advisory group considers conditions of access for eligible generators looking to enter the OLR mechanism.
2. One potential implication of the OLR is that by providing a floor on route-to-market (“**RtM**”) risk for generators, offtakers could be incentivised to terminate long term PPAs in extreme imbalance and liquidity scenarios and socialise losses below the backstop in the market.
3. In this regard, this paper considers the following two questions:
   1. **Question 1** - Does the OLR strengthen the incentives for PPA providers to *unilaterally* terminate long term contracts (relative to the counterfactual where it does not exist)?
   2. **Question 2** - Will the existence of the OLR incentivise PPA providers to buy generators out of long term PPAs to allow socialisation of losses above the backstop?
4. In relation to each question, we consider whether mitigating action should be taken within the design of the OLR to prevent or discourage offtakers using the OLR to socialise losses.

**Question 1 – Incentives on offtakers to unilaterally walk away from long term PPAs**

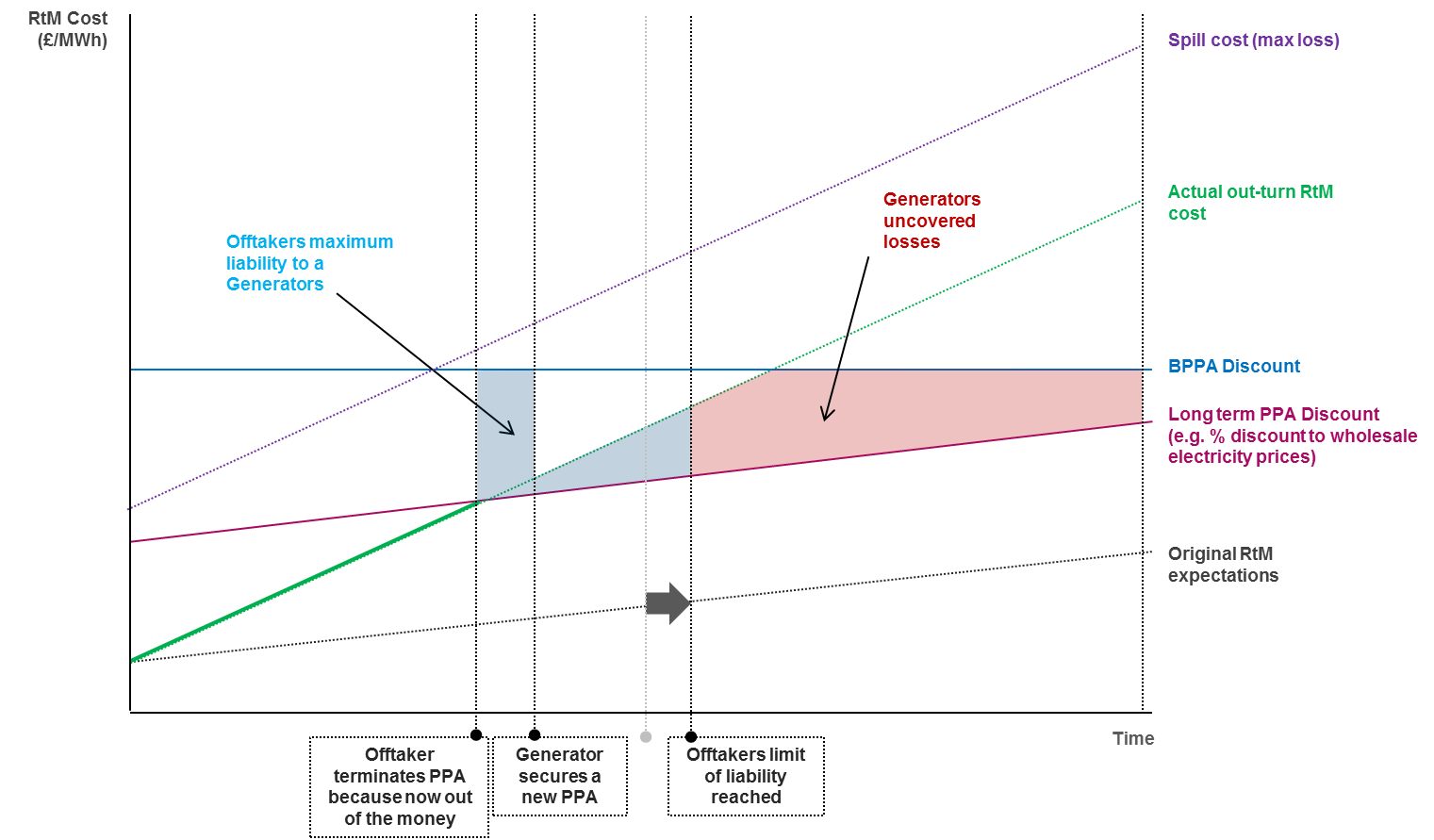
1. The OLR does not change the incentives on offtakers to unilaterally walk away from long term PPAs relative to the counterfactual where it was not available.
2. This is because the maximum liability of an offtaker under a long term PPA is generally not the full marked-to-market exposure (i.e. the difference between the price a generator would have been paid under a long term contract and the price that the generator is able to contract for in the open market (or under the OLR) following an offtaker default).
3. Instead, for most long term PPAs, the offtaker’s liability is capped at an amount that is only likely to cover the generator’s re-tendering costs plus its trading losses for a specified period after the termination (e.g. 6 months). This dynamic is shown diagrammatically for a non OLR world in Figure [1] below.

**Figure [1]: Offtakers maximum liability in the event of no OLR**



1. As such, under a scenario where the OLR is in place and an offtaker walks away from an out of the money contract, the only effect is to increase the period over which the generator is covered by the termination compensation. As far as the offtaker is concerned, its losses are the same under both as its maximum liability is fixed. It is just the generator whose position is mitigated by the down side protection of the OLR. This is shown in Figure [2] below.

**Figure [2]: Offtakers maximum liability where the OLR is in place**

****

1. A key point to note here is that the principal incentive on an offtaker to honour long term PPAs in a world with or without the OLR is not likely to be the termination liabilities (which are capped), but rather the reputational / strategic implications of doing so and the consequential impact on its ability to continue to write long term financeable contracts in the GB market.[[1]](#footnote-1)

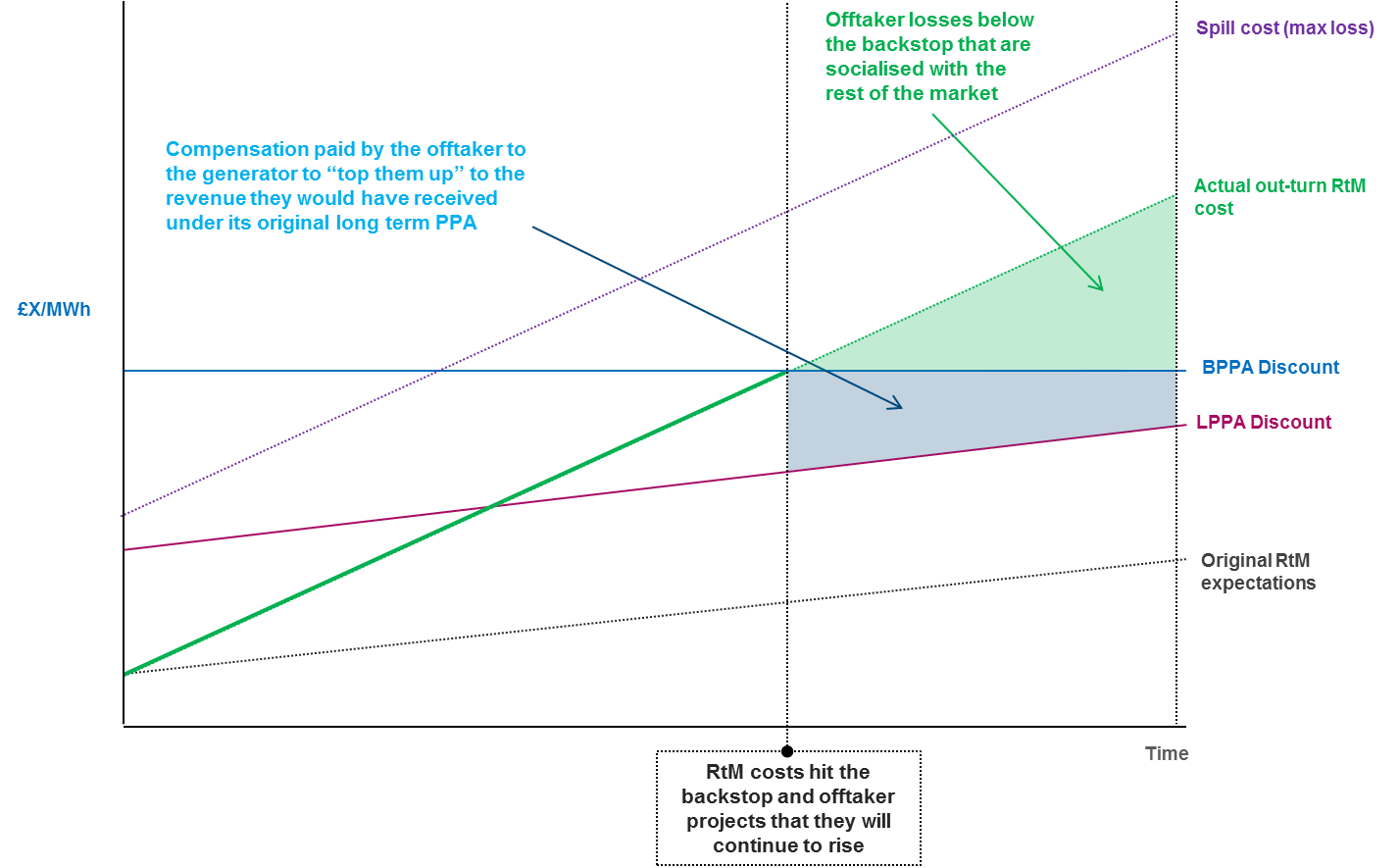
*Need for mitigating action in the design of the OLR*

1. On the basis that this is a risk that generators are exposed to regardless of the OLR, we do not think it is necessary to include any protections within the design of the OLR to make it more difficult for offtakers to unilaterally walk away from contracts and leave losses above the backstop to be socialised in the market.
2. Indeed, it would be very difficult to develop any workable and practical protection within the OLR that could have this effect. The only option might be to target losses under a backstop PPA back on the relevant defaulting offtaker through the levelisation process. However:
   1. Firstly, this would assumes that all long term offtakers are likely to be suppliers subject to levelisation payments which cannot be guaranteed; and
   2. Secondly, it is unlikely to materially help a generator who is still exposed to any loss between the pricing in its original PPA and the backstop.

**Question 2 – Incentives on offtakers to “buy-out” a generator from its rights under a long term PPA**

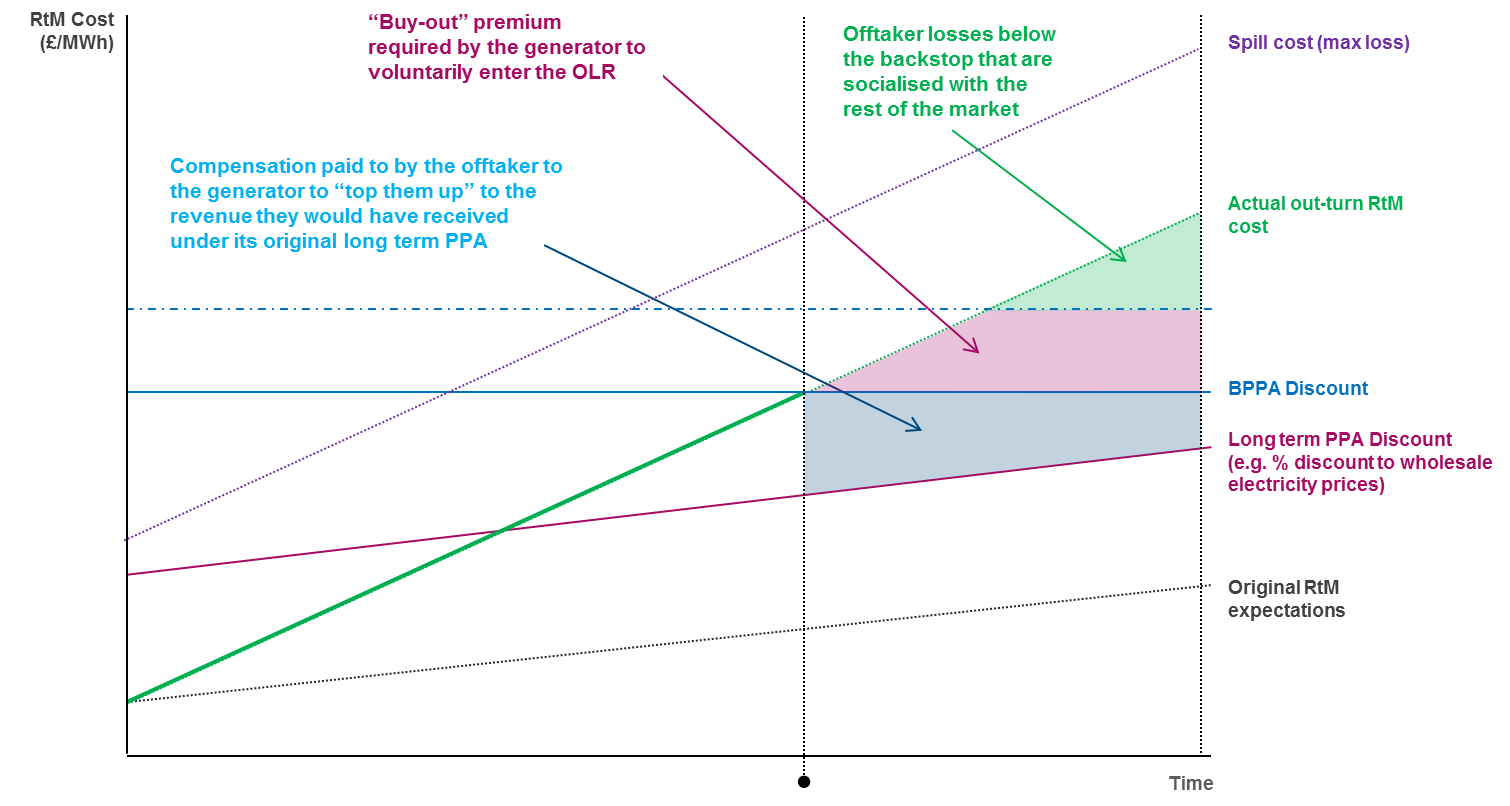
1. While the OLR does not accentuate the propensity of offtakers to unilaterally walk away from contracts, where long term RtM costs are projected to rise above the level in a generator’s backstop PPA there is an incentive on providers of out-of-the-money long-term PPAs to encourage generators to *voluntarily* enter the OLR and allow the offtaker to socialise its losses below that level in the market.
2. This is because a generator should theoretically be indifferent to entering the OLR if the offtaker makes up the difference between what the generator would have been paid under the original long term PPA and what it will receive in under its backstop PPA. This dynamic is represented diagrammatically in Figure [**3**] below.

**Figure [3]: Offtakers incentives to “buy-out” generators from long term PPAs.**

****

1. In reality, however, a generator will be reluctant to leave the relative safety of their long-term PPA without receiving an additional incentive over and above the minimum compensation required to leave it indifferent to being in the OLR (i.e. the blue box in Figure [3] above).
2. At a minimum, a generator would require a buy-out premium that reflects any additional costs of voluntarily entering the OLR and the risk associated with relying on two separate contracts for its revenue (i.e. the backstop PPA and the compensation agreement).
3. However, a generator may in fact be able to negotiate a larger buy-out premium as it will know that, for every pound of forecast loss that the offtaker can socialise in the market, that offtaker will make a gain relative to the counterfactual where it is required to honour its original contractual obligations[[2]](#footnote-2).
4. As such, generators will most likely look to take a share of the offtaker’s avoided losses even if that exceeds the amount needed to compensate the actual cost and risks of entering the OLR (as shown in in Figure [3] below).

**Figure [3]: Offtaker incentives in relation to the buy out premium**



1. Indeed, on the basis that an offtaker will be in a fairly week negotiating position if it is trying to buy a generator out of a long term PPA at the time it actually is facing a loss, it is likely to push for pre-agreed buy-out provisions that are hardwired into the long term PPA from day one.
2. One might imagine that offtakers may offer a combination of the following:
   1. a pre-agreed “buy-out premium” to incentivise the generator to voluntarily enter the backstop; and
   2. a reduction in the discount under the PPA to reflect the reduced RtM risk for the offtaker.
3. There is likely to be an inverse relationship between these two benefits; as the larger the buy-out premium demanded by a generator, the greater RtM risk the offtaker will be required to price in its long term PPA offer. This is because an offtaker will only exercise any buy-out right where its projected post-backstop losses under the long term PPA are greater than the additional cost of buying-out the generator. Obviously, if a generator demands a large buy-out premium, projected RtM costs would need to be greater than where the generator requires no premium at all.
4. If, as is likely in the early days of the OLR and CfDs, generators (and in particular their lenders) take a conservative view of the acceptability of buy-out provisions and either ask for significant premiums or do not accept them at all, offtakers will most probably end up pricing the full extent of the imbalance risk (and exclude any possibility of socialising losses below a generator’s backstop price in the market).
5. As such, there is a risk that pricing under long term PPA may not differ significantly between an OLR and non-OLR world (excluding any impact of additional competition in the PPA market, driven by lenders accepting a greater variety of entities as bankable offtakers). Moreover, generators under long term PPAs will be less likely to enter the OLR in the event of higher RtM costs. The extent to which thus manifests will very much rest on the extent to which lenders and generators are prepared to accept buy-out provisions and voluntarily enter the OLR in return for a lower discount upfront.

*Need for mitigating action in the design of the OLR`*

1. Having established that generators may allow offtakers access to the OLR to socialise losses in return for lower discounts, the next question is whether this is something that should be discouraged or prevented within the design of the OLR (for example, by making entry into the OLR conditional upon a generator proving that either its original PPA has expired or its original offtaker is insolvent).
2. Our view is that offtakers buying generators out of long term PPAs in the event of higher than expected RtM cost should be viewed as a logical outcome of the policy mechanism. If generators who opt for short term PPA strategies can socialise their losses below the level of the backstop, why then should long term PPA providers not be able to do the same?
3. Not allowing offtakers and generators to agree buy-out provisions will only mean that offtakers will price the full extent of the imbalance downside in long term PPA offers, creating a natural bias amongst generators to opt for a shorter term contracting strategy where they can take advantage of the downside protection of the OLR. [[3]](#footnote-3)
4. There are, however, two potential issues that are worth noting in this regard:
   1. Firstly, while the economically rational argument may be to allow offtakers to buy generators out of long term PPAs in the manner described above, there is the obvious “perception” issue of offtakers terminating long term PPAs, liquidating their losses and then offering backstop PPAs and making a margin on that contract. This could be accentuated by the fact that smaller suppliers would be less likely to play a significant role in the long term PPA market but could end up funding losses socialised by larger suppliers. However, this could equally be mitigated through a clear communication upfront as to why DECC have chosen not to restrict this behaviour.
   2. Secondly, there is theoretical risk that consumers could end up effectively funding imbalance cost (and risk) twice in the event that:
      1. the introduction of the OLR does not actually succeed in driving greater flexibility in contracting strategy, meaning that long term PPAs with the existing set of ‘bankable’ counterparties are still required to finance projects; and
      2. lenders to those projects that do reach financial close do not accept buy out provisions in long term PPAs.
   3. Under this scenario, projects (and therefore consumers) would receive no benefit from the existence of the OLR upfront, as offtakers would quite reasonably price the whole downside without comfort that they can buy out the generator at a given price (indeed they may even price additional rents if the market remains uncompetitive). As such, strike prices would be reflective of the market’s expectation of full RtM exposure that ignores any potential impact of the OLR.
   4. However, consumers could end up funding losses under the backstop level when a generator agrees to allow its offtaker to buy it out of the long term contract in the event that RtM cost expectations change for the worse.
   5. However, while this is a theoretical risk, we think it is unlikely. Moreover, we do not view this as a reason to design structural protections into the OLR to prevent offtaker buying out generators, as to do so would be effectively acknowledging that there is a significant risk that the OLR could fail as a policy mechanism. If that is the case, there are likely to be more material questions about the structure and shape of the OLR mechanism as a whole.

1. Indeed, as we understand it, it is precisely this analysis that drives lenders’ natural preference for what is termed “institutional offtake” when looking for bankable PPAs – i.e. market participants that, not only have a strong balance sheet, investment grade credit rating and the expertise and experience to carry out the obligations, but also a strategic interest in the GB market (with either a large consumer base or a large generation portfolio) that would make it difficult for them to walk away from long term liabilities. [↑](#footnote-ref-1)
2. Note: this assumes that the offtaker would not have otherwise terminated the original PPA and incurred the termination penalties. Otherwise, the offtaker would only be prepared to compensate the generator up to the level of termination payments owed under the original PPA. [↑](#footnote-ref-2)
3. We note that the materiality of the impact of the OLR on discounts in long term PPAs will obviously depend on the level of the discount and the manner in which that is factored into offtakers pricing methodologies. [↑](#footnote-ref-3)