**This paper is for discussion and does not represent government policy or policy intent**

# Offtaker of Last Resort Advisory Group Discussion Paper 3.1: Timing of Access

# Overview

**Headlines:**

* We are progressing with the OLR policy design as quickly as possible; the intention is for the OLR secondary legislation to come into force around the time the first CfDs are allocated in autumn 2014. We aim to publish the draft secondary legislation in advance of the first CfDs being awarded, and propose that any generators signing CfDs before legislation comes into force would be entitled to the OLR on the terms set out within those regulations.
* Additional time may be required after secondary legislation comes into force for Ofgem to put in place systems to administer the OLR. However, this should not impact on generators since they are unlikely to commission for several months (at least) after signing a CfD.
* We are considering whether there should be a period after an eligible project’s CfD commences before it can access a Backstop PPA. Arguments in favour of such a delayto accessing Backstop PPAs include:

○ Imbalance and route to market costs are much more predictable in the near-term, so there is less need to provide protection against unforeseen costs during this period.

○ The short-term PPA market is more liquid, so it should be easier for generators to get PPAs at reasonable discounts during this period.

○ Lenders may require generators to have PPAs with a minimum initial tenor in order for them to release funds. They have suggested that access to the OLR during the term of this PPA would have little impact on their lending decision.

* Arguments in favour of allowing generators to access Backstop PPAs *immediately* (from the point at which the project’s CfD commences) include:

○ The risk that generators will actually access the OLR from day one is likely to be low, for the reasons given above, so there is little downside in offering it

○ Immediate access to Backstop PPAs could give generators greater flexibility over their contracting strategies, potentially leading to more efficient outcomes, whereas restricting access could see contracting strategies dictated by lenders to a greater extent.

**Key Questions:**

Q1: Given construction lead-times, what would be the impact on generators if Backstop PPAs cannot be accessed for a period of time after the allocation of CfDs commences?

Q2: Assuming that the backstop discount is set significantly below discounts in the open market, do the group agree that it is unlikely that a generator would want or need to access the OLR during the early years of output?

Q3: Does the group believe that there are any significant risks to generators, offtakers or consumers of allowing generators to access Backstop PPAs from the point at which their CfD starts?

Q4: Does the group think there are potential benefits from allowing generators access to Backstop PPAs from the point at which their CfD starts?

# Introduction

This paper sets out the likely timetable for OLR implementation, acknowledging that the systems required to allocate Backstop PPAs might not be up and running by the time the first CfDs are signed. Since route to market costs are more predictable in the near term, and the discount available through the OLR is likely to be least attractive during early years of generation, the paper also considers whether there should be a period after an eligible project’s CfD commences before it can access a Backstop PPA.

# Assessment Criteria

The design of the review procedure should align with the criteria set out in Table 1 below.

**Table 1: Assessment criteria**

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| --- | --- |
| **Criteria** | **Description** |
| **Availability of financeable routes to market for independents** | * The timing of access should afford generators sufficient flexibility in the route-to-market choice. |
| **Minimise system costs** | * Ensure sufficient incentives are kept on generators to put in place appropriate contracting arrangements on a commercial basis |
| **Impact on suppliers** | - |
| **Potential for market distortions** | * Should not “crowd-out” commercial PPA market and encourage both new entry and competition wherever possible |
| **Practicality and cost of implementation and administration** | * Needs to be feasible for Ofgem and suppliers to implement within time scale |
| **Legal risk and potential compliance cost** | - |

# Timing of Access to Backstop PPAs

The point at which generators are able to access Backstop PPAs will depend on both the time it takes to implement the OLR and any decision on the appropriateness of a delay to access from the point of the CfD commencing. This section discusses each of these in turn.

## Implementing the OLR

We are progressing with the OLR policy design as quickly as possible and envisage consulting on the policy early next year. We currently aim to publish the Government’s response to the consultation, including draft secondary legislation and proposed terms of Backstop PPAs, by Q2 2014. This timetable should allow for OLR secondary legislation to come into force around the time the first CfDs are allocated in autumn 2014, depending on the result of consultation and the Parliamentary process. Any generators signing CfDs before secondary legislation comes into force would be eligible for the OLR on the terms set out within that legislation. We believe that this should provide generators and lenders with confidence over the detailed OLR provisions at the point at which the CfD is open to applicants.

Additional time may be required once the secondary legislation comes into force for Ofgem and offtakers to put in place the systems to allocate Backstop PPAs to generators and implement the levelisation process. However, this should not impact on generators since they will not need a backstop PPA before commissioning, likely to be several months (at least) after signing their CfD.

Q1: Given construction lead-times, what would be the impact on generators if Backstop PPAs cannot be accessed for a period of time after the allocation of CfDs commences?

## Delay to access

Where otherwise lenders would require long term PPAs, the OLR may enable generators to use shorter-term contracting approaches with a wider range of offtakers by effectively capping downside losses and guaranteeing offtake. Regulations and licence conditions will set out the terms of the OLR generators will be eligible for at the point of CfD signing (with the provisions grandfathered from that point). However, there is a question over whether generators should be able to access the Backstop PPA immediately[[1]](#footnote-1) (subject to the practicality of implementation, above), or a given period of time after their CfD commences.

**We question whether a generator requires access to a Backstop PPA in the early years**, given that:

1. Imbalance and route to market costs are much more predictable in the near-term, so there is less need to provide protection for lenders against extreme downside scenarios during this period.
2. Liquidity of shorter-term PPAs (1-3years) is currently robust, and should improve further under the CfD, so it should be easier for generators to get short-term PPAs at reasonable discounts.
3. Lenders may require generators to have PPAs with a minimum initial tenor in order for them to release funds. As such, access to the OLR during the term of this PPA would have little impact on their willingness to lend.
4. The nature of the Backstop PPA (most likely[[2]](#footnote-2) a constant discount (fixed priced or percentage) across the life of the CfD) coupled with the profile of RTM risks (which are expected to increase over time) means that generators are least likely to need access to a Backstop PPA in the early years.
5. The discount within Backstop PPAs is likely to be such that generators cannot obtain their desired leverage by relying on backstop PPAs revenues alone (i.e. they will need to demonstrate contracted revenues above the backstop in order to get their target gearing).

There should therefore be both a strong incentive for generators to contract their output for the initial period of their CfD (at a much smaller discount to the reference price than they would secure in a Backstop PPA) and greater availability of offtakers willing to provide those PPAs. It would seem highly unlikely that a generator would need support from the OLR provisions during this initial phase. Preventing access at this point would help ensure the OLR remained a last resort, and could help encourage lenders to fully engage with and understand the risks and rewards on offer through the CfD.

Q2: Assuming that the backstop discount is set significantly below discounts in the open market, do the group agree that it is unlikely that a generator would want or need to access the OLR during the early years of output?

However, it is **not clear** **whether there are significant risks if generators *are* able to access Backstop PPAs** from the point of at which their CfD commences[[3]](#footnote-3):

1. Given the arguments above, it is highly unlikely that generators would seek Backstop PPAs in the early years of generation.
2. We do not believe that the OLR will distort the open PPA market[[4]](#footnote-4), and as such, allowing early access should not impact on the open market for PPAs.

Q3: Does the group believe there are any significant risks to generators, offtakers or consumers of allowing generators to access backstop PPAs from the point at which their CfD starts?

Furthermore **there might be some advantages to allowing immediate/early access** for generators to Backstop PPAs:

1. If access is delayed, lenders may require generators to contract with offtakers for any period of output over which they were not able to obtain a Backstop PPA, in order to secure revenues. The length of a delay could in turn dictate the length of initial PPAs generators require, which could differ from what would be the case if backstop PPAs were available from the start of generators’ CfDs. Allowing generators access to a Backstop PPA immediately may therefore provide greater flexibility to developers and generators over their contracting strategies, reflecting the level of exposure that they are willing to accept above the backstop discount. The longer the period of delay before generators have access to the OLR, the fewer the number of credit-worthy offtakers in a position to offer such PPAs.
2. Furthermore, a generator might be able to secure investment at FID on the OLR alone without having to contract for power (at a cost) pre-construction, with the intention of refinancing post-construction once a PPA is in place. This would allow a PPA for power to be signed much closer to commissioning, potentially on better terms. Such an approach would limit the amount of debt that a project could obtain when compared against an alternative where power was contracted pre-FID at smaller discount than provided by the backstop, although some developers might be able to equity-finance the project initially and refinance nearer commissioning when they had a PPA in place.
3. Access to Backstop PPAs would underwrite the PPAs attained by generators during this initial phase, which may allow generators to use less well-established counterparties as the Backstop would provide protection in the unlikely event of offtaker default.

Q4: Does the group think there are potential benefits from allowing generators access to Backstop PPAs from the point at which their CfD starts?

1. From the point at which the project’s CfD starts. [↑](#footnote-ref-1)
2. The issue of the structure of the backstop discount will be discussed in the Pricing paper. An alternative approach would be one in which the discount is profiled to increase over time. [↑](#footnote-ref-2)
3. Under a ‘no-delay’ approach, generators would be able to apply for a Backstop PPA from the point at which their CfD contract starts. [↑](#footnote-ref-3)
4. See Baringa supporting paper 1A [↑](#footnote-ref-4)