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**Offtaker of Last Resort Advisory Group Discussion Paper 3.2:   
CONDITIONS OF ACCESS**

### Overview

**Headlines:**

* The OLR is designed to provide a ‘last resort’ route to market for generators whose PPA has expired or been terminated due to offtaker default, and who are unable to find a new route-to-market on better terms than the backstop PPA.
* However, generators may also wish to obtain a backstop PPA in other circumstances, e.g:

○ Their PPA has been terminated because the *generator* defaulted on its obligations;

○ They have *agreed* with an offtaker to terminate a long-term PPA and enter the OLR, with the offtaker compensating the generator for the difference between the backstop PPA and their original PPA;

○ To cover a short period between one PPA expiring and negotiating a new one.

* Our emerging view is that:

○ There should **not** be any restrictions on the circumstances under which generators can access a backstop PPA, to ensure the mechanism is bankable and minimise the need for potentially subjective assessments by Ofgem of generator eligibility;

○ To protect against the ‘moral hazard’ of providing a safety net to defaulting generators, backstop offtakers should be able to terminate a backstop PPA if the generator behaves in a way that would lead to an open market PPA being terminated, and the generator should not be eligible for further Backstop PPAs;

○ To manage the risk that the OLR is used as a commercial short-term backstop and to incentivise offtakers to manage the power efficiently, Generators should be required to commit to Backstop PPAs for minimum period (e.g. 6 months);

○ We would seek to manage other risks of unintended consequences by setting the backstop discount at a level that discouraged such behaviours.

**Key Questions:**

* Do you agree that Backstop PPAs should be available to generators regardless of whether they default on their open market PPA?
* Do you agree that if a generator behaves within a Backstop PPA in a manner that would see an open-market PPA terminated, the offtaker should have the right to terminate the backstop PPA and the generator would lose entitlement to future backstop PPAs?
* Do you agree that we should not look to restrict the ability for offtakers to ‘buy out’ generators from long-term PPAs?
* Do you agree that generators should be required to commit to a Backstop PPA for a minimum period of time?

# Introduction

This paper considers whether there should be any restrictions on the circumstances under which generators can access backstop PPAs, and any requirements for committing to and remaining in a backstop PPA once one has been awarded.

# 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** | * Minimise uncertainty for generators (and lenders) as to the circumstances in which the backstop protection will be available. |
| **Minimise system costs** | * Minimise risk that the backstop provides protection for poorly performing generators. * Minimise the risk that the OLR is used by generators that don’t actually need it. |
| **Impact on suppliers** | * Ensure suppliers and other backstop offtakers have sufficient certainty as to how long the generator will be in the scheme to allow them to minimise impact on business * Ensure suppliers are given sufficient notice of generators requiring a backstop |
| **Potential for market distortions** | * Retain appropriate incentives for generators to seek to continue to contract in the PPA market so that the backstop arrangements are a genuine last resort |
| **Practicality and cost of implementation and administration** | * Minimise administrative burden in relation to the monitoring of generators entry and exit from the scheme. |
| **Legal risk and potential compliance cost** | * Avoid the need for discretion on part of scheme administrator as to the circumstances when a generator is able to access the OLR. |

# Accessing the OLR

The OLR is designed to provide a ‘last resort’ route to market for generators on specified terms, effectively capping their long-term route-to-market costs and thereby allowing generators to use shorter-term PPAs and a wider variety of PPA counterparties, beyond the established players.

We anticipate the main reasons why a generator would request a backstop PPA would be if their previous PPA has expired or been terminated due to offtaker default, and they are unable to find a new route-to-market on better terms than the backstop PPA. These are the principal circumstances that the OLR has been designed to provide protection for.

There are, however, scenarios in which generators might seek to access a Backstop PPA where their PPA had not expired, or where the market route-to-market discounts do not exceed those offered via the OLR. We discuss these below.

### Generators defaulting on an open-market PPA

One scenario in which generators may seek a backstop PPA is if their original PPA was terminated as a consequence of the generator defaulting on its obligations. In such a situation, even if route-to-market costs are less than the backstop discount, the generator may be unable to attain a PPA on such terms because offtakers are unwilling to contract with a generator that has previously been shown to be unreliable.

There is a potential moral hazard in allowing a generator to enter a backstop PPA in such circumstances, as it could reduce the incentives on the generator to meet its obligations in its original PPA. Further, there is a risk that such a generator may continue to fail to meet their obligations under the backstop PPA given their previous history of poor performance. However, a counter-argument is that as long as the discount in backstop PPAs is significantly larger than the discount in open-market PPAs, generators will face strong economic incentives not to default on their PPAs, and the existence of the OLR does remove these incentives (although it mitigates the extent of potential losses).

We consider two options to address this potential moral hazard:

1. **OLR protection is not available to generators whose open market PPAs are terminated due to generator default**

One solution would be for scheme rules to prevent generators that have had an open market PPA terminated from accessing the OLR. However, we believe that there are a number of difficulties with this approach, including:

* The extent to which Ofgem (or any other competent authority) would be in a position to determine whether a breach of the original PPA that led to termination had indeed occurred, and establishing fault. This could put any administrator in a difficult position where breach was dependent on circumstance or commercial / legal interpretation.
* It may be a disproportionate response to an issue that is unlikely to occur and may not be due to fault by the generator (e.g. prolonged force majeure might lead to termination of a generator’s PPA, but it may not be appropriate to penalise generators for this by not offering them OLR protection after the force majeure has been lifted).
* It might introduce unbankable risks for generators.

1. Do you agree that **the OLR** **should be available** to generators regardless of whether they default on their open market PPA?
2. **Eligibility for the OLR removed for generators whose backstop PPAs are terminated as a result of generator default**

An alternative would allow all generators access to the OLR, but to revoke or suspend eligibility for further backstop PPAs from generators that have a backstop PPA terminated by an offtaker as a result of generator default.

This approach has several advantages:

* There is no need for Ofgem to assess the reasons why a generator’s open market PPA was terminated
* It incentivises generators to co-operate with offtakers under the backstop PPA
* It mitigates the moral hazard of supporting poorly performing generators throughout their CfD

However, there are potential issues:

* Is there a risk of an offtaker ‘frustrating’ a backstop PPA with the result that the generator loses future OLR protection?
* Whether it will be possible to assess ‘persistent breach’ where a generator has a series of back-to-back one-year PPAs with different offtakers.

1. Do you agree that if a generator behaves within a Backstop PPA in a manner that would see an open-market PPA terminated, the offtaker should have the right to terminate the backstop PPA and the generator would lose entitlement to future backstop PPAs?

(a) How often are PPAs terminated in the market?

(b) Could offtakers ‘frustrate’ backstop PPAs and find an excuse for terminating them?

### Offtakers terminating long-term PPAs

The OLR could create an incentive for offtakers to ‘buy out’ generators from a long-term PPA once RTM costs exceed the backstop discount. In doing so offtakers would be able to socialise their losses by letting the generator enter the backstop, whilst making the generator good for the difference between the LTPPA price and the backstop price. Generators might also look to share in some of the avoided losses from the Offtaker. In this way, long term PPA providers may be able to liquidate losses below the backstop in exactly the same way as a generator on a short term PPA strategy can.

Mutual termination would represent a change in the marketplace and could mean that generators access a Backstop PPA before the term of their existing open-market PPA expires. The question therefore arises as to whether this is something that it would be desirable to prevent through the design of the OLR (for example, requiring generators to lodge details of previous PPA contracts with Ofgem). This is explored in more detail in the Baringa supporting paper. Our conclusion is that **there are no strong arguments** for preventing offtakers from socialising losses beneath the backstop, because this would only create a bias towards shorter term contracting strategies, distorting the market and reducing flexibility for generators.

1. Do you agree that we should not look to restrict the ability for offtakers to ‘buy out’ generators from long-term PPAs?

### Seeking a Backstop PPA despite lower discounts in the open market

Whilst the OLR is designed to provide a ‘last resort’ route to market, it is not intended to provide support if better alternatives are available in the open market. We would not expect any generator to seek a Backstop PPA if better alternatives existed; to do so would reflect questionable commercial instincts (and ultimately cheaper power for consumers) or indicate a fundamental difference in the risk-reward ratio of a Backstop PPA when compared to an equivalent PPA in the open market.

However, it is possible that Generators might want access a Backstop PPA for a short period despite better terms being available in the open market, for example, when negotiating a new open-market PPA. Here, allowing access to a Backstop PPA could allow generators to negotiate more forcefully in the knowledge that they had a backup contract if necessary that could be used to fill any gap. We believe that this does not reflect the objective of the OLR: a Backstop PPA should exist to provide support if route-to-market costs exceed the backstop discount, and not to strengthen the negotiating hand of generators or reduce their desire to enter open-market PPAs in a timely manner.

Furthermore, there is a cost associated with generators frequently entering backstop PPAs for a very short period of time – both in terms of administrative costs of allocation to Ofgem / suppliers, and reduced incentives on suppliers to forecast and actively trade the power generated (which would ultimately lead to higher costs to consumers).

As such, we propose that Generators that seek a Backstop PPA should be committed to remaining within the agreement for a minimum period of time – for example, by including a minimum six month break-clause within backstop PPAs (with a minimum notice period for leaving). The consequences of the generator leaving the backstop PPA early could be losing eligibility for future backstop PPAs, and / or loss of any collateral posted by the generator under backstop PPAs.

The addendum below sets out the steps here.

1. Do you agree that we should require generators to commit to a Backstop PPA for a minimum period of time, in order to prevent the OLR being used as a stop-gap?

(a) Is six months an appropriate period, in terms of allowing generators to get back to the open market as quickly as possible, whilst also minimising costs of the scheme?

(b) What penalties would be appropriate for generators who leave backstop PPAs early?

# Addendum - Accessing the OLR – Strawman

We propose that eligible generators seeking a Backstop PPA would go through the following stages:

* 1. Expressing interest
  2. Committing to and entering a Backstop PPA
  3. Exiting a Backstop PPA and the OLR, or
  4. If wishing to continue within the OLR, repeating the process before expiry of their initial backstop PPA.

1. ***Initial interest***

We propose that Generators should be required to notify Ofgem of their potential need for a Backstop PPA a minimum period before they require it. To lodge their interest, the project in question must (a) meet the criteria for an eligible project (e.g. technology, CfD status), and (b) meet any other access criteria (e.g. have lodged financial and RTM information with Ofgem, if required).

The notification period needs to be sufficient to enable Ofgem to set in motion any processes necessary to allocate a generator to a backstop offtaker. For example, this might include notifying Elexon that a new additional BMU is required (for embedded generators) and allowing time for the process to be completed.

1. ***Commitment***

A generator that has notified Ofgem of a potential need for a Backstop PPA should be free to revoke that notification at no cost until a minimum period before the contract is due to be allocated (for example, a week). Beyond this point, a generator must commit to entering into a backstop PPA. Penalties for failing to do so could match those for exiting a backstop PPA before the minimum period – e.g. loss of eligibility for future backstop PPAs, or calling any collateral requirement.

1. ***Exit***

Once a generator has been allocated a Backstop PPA they will be required to retain the contract for a minimum period of time. **We propose that a Backstop PPA have both a minimum tenor of and break-clause at six months**. At this point a generator could either exit, or continue with the contract through to the next allocation date.

1. ***Continuation***

We propose that the default position would be for generators to exit the OLR at the end of their Backstop PPA unless they notify Ofgem a minimum period of time prior to expiry that they would like a further contract.