

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

OFFTAKER OF LAST RESORT ADVISORY GROUP DISCUSSION PAPER 2: IDENTITY OF THE BACKSTOP OFFTAKERS

Introduction

This paper is concerned with who will provide Backstop PPAs including:

1. Success criteria – what goals do we need to satisfy to measure the success of the scheme? In this paper, the three main goals are:
 - (a) Bankability
 - (b) Cost & incentives
 - (c) Distortions & Impact
2. A review of the legislation – what options are within the remit of legislation?
3. Mandatory obligation & voluntary entitlement – what is the best way to get offtakers into the scheme?
4. Calibrating the Mandatory threshold for offtakers – what is the cut-off point for determining a mandatory offtaker? What metrics can we use to measure this?
5. Criteria for voluntary offtakers – what are the minimum criteria that offtakers will be expected to fulfil?

1. Appraisal Criteria

1.1 Three key criteria need to be considered when deciding who should be the Backstop Offtakers under the OLR mechanism

1.2 **Bankability** – Capital providers need to be confident that the payment covenant under the Backstop PPA is robust. In the context of offtaker identity, this would include “Narrow” credit risk – meaning, the likelihood of default under the Backstop PPA by the Backstop Offtaker and the impact that this will have on the project prior to re-allocation to a new Backstop Offtaker. We have assumed that the credit rating of the entity itself becomes less important (a) the shorter the period of time it takes to transfer to a new offtaker on default and (b) the greater the level of credit support the backstop offtaker is required to provide under the backstop PPA ¹.

1.3 **Cost to consumers** – To minimise the cost of the scheme, backstop offtakers need to be able to efficiently manage the imbalance and trading risks under backstop PPAs.

¹ We acknowledge that banks will also factor in the enforcement risk of actually being able to draw down on a Letter of Credit/guarantee. The form of credit support will therefore have bearing on the extent of this risk. This will be considered in a separate paper.

- 1.4 **Market distortions & impact on suppliers** – It is important that the offtaker of last resort scheme does not unduly distort the market. In the context of offtaker identity, this means not imposing significant barriers to entry or growth amongst smaller suppliers, and not excluding smaller suppliers from the ability to share in any opportunities arising out of the mechanism.

Question 1:

Would you agree that these are appropriate and achievable goals? Are there any criteria that should be considered in the context of offtaker identity?

2. Review of the Legislation

- 2.1 Clauses 44 to 48 of the Energy Bill (as currently drafted) provide that modifications to electricity supply licence conditions (including industry codes) will form the basis for the establishment of a 'power purchase agreement scheme' (which could be used to implement an offtaker of last resort (OLR) mechanism). Licence modifications may include provision as to the circumstances in which a licenced supplier is required or permitted to enter into a PPA under the scheme, including provision for determining which licenced supplier or suppliers may or must do so in any particular case.
- 2.2 Hence, under the current Bill provisions, only licenced suppliers can participate in the offtaker of last resort mechanism. This is due to the fact that Ofgem will be administering the scheme, and they do not have regulatory powers over unlicensed entities. Furthermore, by establishing the scheme in licence conditions, Ofgem can use their enforcement powers to, for example, ensure payments are made under levelisation, or that offtakers enter into a contract when required to do so (such as if they are the successful bidder in a competitive allocation process).
- 2.3 We are aware that restricting this scheme to licenced suppliers may limit competition in any competitive allocation process. However, many aggregators currently active in the market already hold supply licences, and it would be possible for other aggregators/banks to apply for a supply licence if they wish to participate in the scheme (electricity traders must already be parties to the BSC). It may also be possible for such entities to enter into an arrangement with a licensed supplier under which they could fulfil their obligations under the scheme (for example, by undertaking to trade the power and manage the imbalance of generators who enter into PPAs with the supplier).

Question 2:

Do you think that potential offtakers who do not possess a supply licence will have an interest in participating in the OLR scheme, in particular under competitive allocation?

Question 3:

How challenging would it be for aggregators/banks wishing to participate in the scheme but that do not have a supply licence to obtain one?

3. Mandatory Obligation & Voluntary Entitlement

3.1 The question of whether certain suppliers should be required to take on backstop PPAs and other suppliers should have the option to do so is affected in part by the allocation mechanism. We therefore consider the issue separately in the next sections for regulatory and competitive allocation.

Regulatory allocation

3.2 Under regulatory allocation, backstop PPAs would be imposed on suppliers by Ofgem. It is therefore clear that some suppliers must be **obliged** to enter into backstop PPAs when directed to do so by Ofgem (**Mandatory Backstop Offtakers**). We believe that it would be appropriate to place this obligation only on suppliers that have a customer base or market share over a certain threshold, to ensure that the suppliers have the technical and financial capacity to meet the obligations of being a Backstop Offtaker and are sufficiently credit-worthy to give confidence to lenders. Furthermore, requiring all suppliers to participate may create an unnecessary burden for smaller players and act as a barrier to new entrants. How the threshold should be determined is discussed further in section 4.

3.3 It is less clear whether there would be any benefit in allowing smaller suppliers to opt into the scheme as **Voluntary Backstop Offtakers** subject to meeting minimum requirements (discussed further in section 5). The advantage of doing so is that it would potentially create a wider pool of off-takers amongst whom Backstop PPAs could be allocated, thereby spreading out the burden. However, it seems unlikely that many such suppliers will opt to take part, since by doing so they would be subject to the risk associated with a regulatory cost assessment process (namely, that their costs under backstop PPAs may exceed the costs determined by Ofgem). Conversely, there may be little downside to allowing such suppliers to opt in, as long as the criteria are sufficient to give lenders confidence in the bankability of the mechanism.

Question 4:

Why would a non-mandated supplier volunteer to offer backstop PPAs under administrative allocation? Are there benefits/downsides to allowing this?

Competitive allocation

3.4 Under competitive allocation, in theory suppliers should be incentivised to participate because it helps minimise their exposure to levelisation costs whilst simultaneously enabling them to profit if awarded the Backstop PPA. Not participating would enable a competitor to win a tender at a high price, leading to higher levelisation payments for the non-participants (Box 1 illustrates the rationale for this).

3.5 However, there may not provide sufficient *certainty* to lenders that there will always be a backstop off-taker for a project if no suppliers are required to participate. It is hard to anticipate all possible market conditions that could arise over the lifetime of a CfD which could lead to off-takers being unwilling to bid in a competitive tender. We therefore believe that **even with**

competitive allocation, there will be a need to require some suppliers to bid for backstop PPAs to provide ensure the mechanism is bankable.

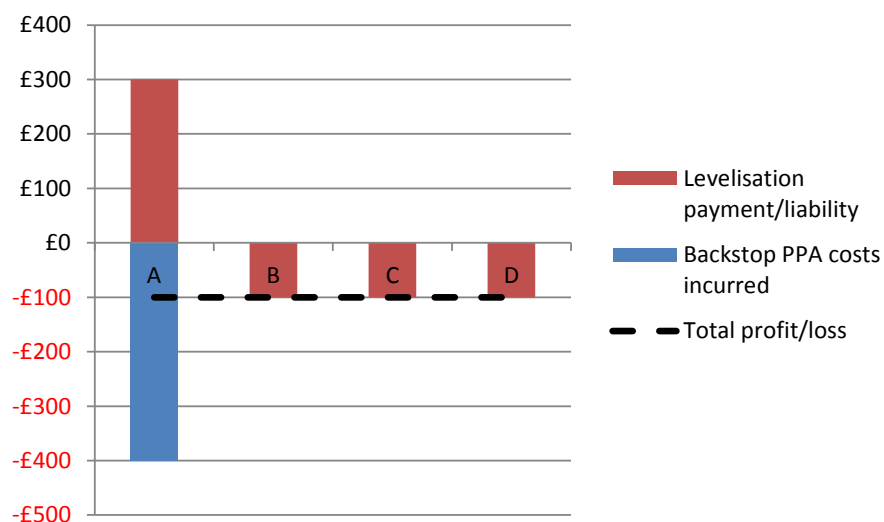
- 3.6 There are clear benefits from allowing non-mandated suppliers to participate in a competitive allocation process as voluntary backstop offtakers (subject to meeting minimum criteria), in terms of an increased level of competition (leading to more cost-reflective bids), and also enabling smaller suppliers to share in any benefits resulting from competitive allocation.

Question 5:

Do you agree that it is necessary to mandate offtaker participation under competitive allocation to ensure 'bankability' of the mechanism?

Box 1

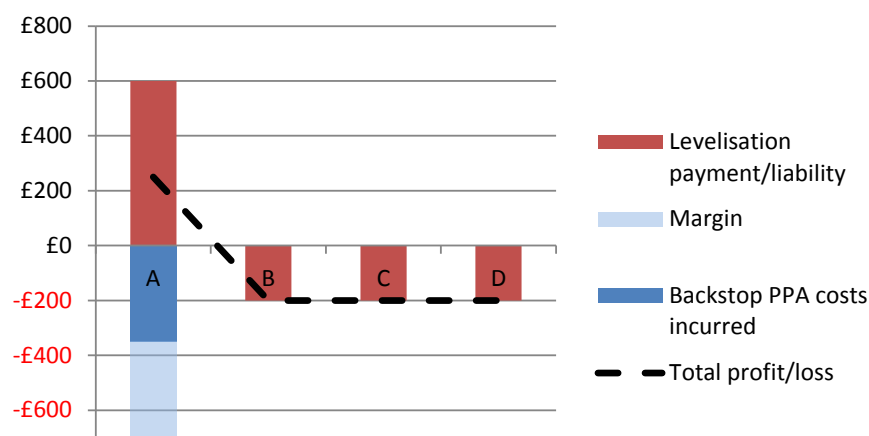
Under a competitive allocation, levelisation would be applied against the aggregate total of management fees paid to (or by) all Backstop Offtakers. Figure 1 illustrates the situation whereby supplier A is allocated the Backstop PPA at a total cost of £400. This cost is split between all four suppliers, giving each (including supplier A) a net loss of £100.



Any mark-up on the management cost of the winning bidder against the true cost will create profit for that supplier and incur costs for those within the levelisation process; the degree to which a supplier might choose to inflate their bid costs above the true costs will depend on the amount of competition.

In figure 2, the lack of competition allows supplier A to win the contract despite including a generous margin. The levelisation process requires each supplier to share the stated total cost (£800) giving a net payment to supplier A of £600. Yet, since the true costs were only £350, supplier A makes a £250 profit and is £450 better off relative to their competitors.

Suppliers should therefore be incentivised to participate as an offtaker under competitive allocation rather than risk a significant disadvantage relative to their competitors. However, this may depend on the materiality of the potential loss or benefit, and the costs of participating in the auction (e.g. assessing bids, auction fees, etc.), so participation may not be guaranteed.



4. Calibrating the Mandatory Threshold for Offtakers

- 4.1 Mandatory backstop offtakers must be able to be a bankable PPA counterparty to any generator that enters the scheme, including potentially in times of market stress (e.g. high imbalance costs), without undue impact on the company's ability to continue as a going concern. It is likely that only larger supply companies with a strong customer base are likely to be able to meet these requirements. From the perspective of cost to consumers, it would also be desirable if mandatory offtakers have the ability to offer an efficient route to market (i.e. forecasting, trading expertise etc.) for the generators eligible for backstop PPAs.
- 4.2 Our current assessment of the capabilities a mandatory offtaker would need to have in order to perform the function efficiently are as follows:
- (a) An ability to source the working capital required to deal with the cash flow mismatch arising from the lag between having to make payments to generators under the backstop PPA and receiving compensating payments from the levelisation mechanism.
 - (b) Trading expertise and infrastructure – the ability to trade the power in the CfD reference market. This may depend on the nature of the reference price in the backstop PPA – for example, greater capabilities are required to trade in the season ahead market (which is the proposed reference price market for baseload CfDs) than the day-ahead market (for intermittent CfDs). Note that an offtaker could outsource this function to a third party if it did not have the necessary in-house capability.
 - (c) Forecasting expertise - for intermittent generators, providing a backstop PPA efficiently will require wind / solar / tidal forecasting capability. Note that an offtaker could outsource this function to a third party if it did not have the necessary in-house capability.
 - (d) A sufficiently robust balance sheet to absorb any mismatch between the actual costs incurred under backstop PPAs and the levelisation payments received (e.g. the possibility that offtakers are not fully compensated for their costs).
- 4.3 We believe that market share – in terms of proportion of total electricity supplied – is likely to be a good proxy for these abilities, given that larger suppliers tend to have these capabilities, or will have the financial strength to sub-contract them.
- 4.4 To set the threshold, we propose to assess likely requirements based on generator eligibility (technology, size etc), then map suppliers according to their market share against the above capabilities.

Question 6:

Do you agree that the aforementioned capabilities are appropriate?

Question 7:

Do you agree that larger suppliers will generally have the above capabilities (or be able to procure them), and therefore that market share is an appropriate metric for setting the Mandatory threshold?

5. Criteria for voluntary offtakers

5.1 It will be important for bankability to ensure that suppliers can only opt into the scheme if they would be acceptable to lenders and have the technical capabilities. We believe this can be ensured with criteria along the following lines:

- (a) To opt into the scheme, voluntary offtakers may have to meet a minimum credit rating or provide a parent company guarantee from a company with a minimum rating.
- (b) The scheme rules could state that voluntary offtakers would not be allocated generators whose output was larger than x% of their total supply (although it is not clear how this would apply to aggregators with a small supply base).
- (c) Voluntary offtakers may be able to state on opting into the scheme what technologies and sizes of generators they will accept (i.e. they can ensure they only get allocated generators that they are capable of dealing with). Note that under competitive allocation this may not be necessary, as they could choose to bid only for suitable generators.

5.2 It is also important to consider whether we need any eligibility requirements for voluntary backstop providers if we include the following in the design:

- (a) Firstly, that in the event that entity goes insolvent, the plant will be re-allocated to a mandatory offtaker within a given period of time (who represents a large chunk of the total retail market); and
- (b) Secondly, the backstop PPA includes a requirement to post collateral for the period prior to re-allocation

Question 8:

Do you agree with the criteria for voluntary offtakers, in particular the possibility that they may not be allocated more than x% of their total supply?

Question 9:

Would it be necessary to place any eligibility requirements on voluntary offtakers, if we include insolvency and collateral requirements in the design?