

matthew.coyne@decc.gsi.gov.uk

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Response to DECC call for evidence: PPAs for independent generators

Community Energy Scotland is Scotland's only national charity dedicated to supporting communities to develop renewable energy projects. To date we have supported over 1400 projects across Scotland with project development and design. As such we have a detailed knowledge of the issues surrounding the development of renewable energy projects by independent generators.

Highlands and Islands Enterprise (HIE) is the Scottish Government's agency responsible for economic and community development across the North and West of Scotland and the islands. HIE along with its local partners: the democratically elected local authorities covering the North and West of Scotland and the islands: Shetland Islands Council, Orkney Islands Council, Comhairle nan Eilean Siar, Highland Council and Argyll & Bute Council make representations to key participants on behalf of industry to ensure that the right conditions exist to facilitate investment in renewable energy projects, particularly for independent generators. We are working closely with Scottish Government in relation to a wide range of regulatory issues and are supporting its efforts to challenge barriers currently blocking renewables development across Scotland.

We welcome the opportunity to respond to this call for evidence and hope you find the comments below useful.

Identifying the problem

In framing the problem, we feel it is important to understand precisely the motivations on Big 6 Suppliers for signing contracts under the Renewables Obligation (RO). Under the RO, PPAs have been available to independent and non-Vertically Integrated Utility (VIU) players. The key drivers for the VIU Big 6 Suppliers for doing this are:

- An Obligation on them to purchase Renewable Obligation Certificates (ROCs)
- Financial rewards through the recycle benefit for Suppliers that source renewable electricity

In the earlier years of the RO, it was independent generators that were quicker off the mark in realising projects. They had been operating under the previous NFFO regime and so had the ability to gear up to and understand the benefits of the RO quickly.

However the incumbent utilities (Big 6) have to various degrees caught up, and there has been some consolidation in the market. New independent developers have also entered the market, but many seek to sell on ownership of a consented project. VIUs will prefer to utilise their own portfolio first, and this is undoubtedly behind some of the drop in PPA offerings to independent players evidenced in the Scottish Renewables response.

EMR won't change this trend for consolidation (and perhaps vertical integration of new European utilities in the GB market), but it is accelerating it. That is because the problems for independent players are compounded by EMR.

Suppliers are struggling to offer any future terms at the moment, because of the uncertainty which remains in EMR. Generators are not being given even indicative contract structures or generic terms. Generators planning to commission after the RO closes for business are thus in an information vacuum at the moment. Only projects close to commissioning are likely to get any meaningful engagement from suppliers.

Community projects

Community-owned projects are a sub-set of independently-owned renewable energy projects. They differ from privately-owned projects principally in where revenues flow – namely directly back to the community. They usually rely wholly on the value of the project to raise finance, and the value of the project is encapsulated in the PPA.

Community developers tend to have less in-house specialist expertise and financial leverage than commercial developers. Community Energy Scotland and the community focused support from the Scottish Government help to compensate for this. However as community projects are often at the smaller end of the market they can lack negotiating power with larger companies and the utilities, which means they are very sensitive to regulatory changes. Key principles of the current regulatory environment include:

- Grid companies obligated to provide a grid connection
- Suppliers obliged to purchase renewable energy

Communities also learn-by-doing and have, over the years, accumulated some hard-won knowledge in the current market. Altering the PPA market will erode the value of this knowledge, and as such communities might expect to be hit hardest by these changes. They will need to raise finance on the strength of one electricity-only PPA, for a fraction of the project's overall value and probably be shorter in length than existing RO contracts, as well as a mutualised CFD with no obligation. This is an untested combination with which financiers are unfamiliar and – we understand – sceptical.

To illustrate this point, we thought it would be useful to summarise and draw comparison between the current uncertainty under EMR and the experience of smaller independent generators under the FIT below.

Experience of the Feed In Tariff- market uncertainty and cost of capital

The recent experience of the Feed in Tariff provides a clear correlation between market uncertainty related to Government policy, and the cost of capital. This has a disproportionate impact on developers of independent generation that are dependent on third party finance.

Based on our own experience of projects seeking third party finance, after the announcement of the FIT review and the unexpected cut to <50kW solar PV, over the following six months the pattern of commercial lending rates for project finance moved from approximately 2.5% to 3.5% over Libor.

Even though the unexpected cut was focused on PV, the demonstration of Government willingness to intervene in this way created a contagion of uncertainty that affected lending to all technologies, and for several months the deal flow for third party finance was effectively paralysed as projects were unable to reach financial close until further clarity on FIT levels was eventually provided.

This pattern of 'spiky' investment increases deployment costs as the installer and hardware markets become tight, creates administrative log jams with accreditation processes, and is harder for the network operators to accommodate on the electricity system. This pattern is perfectly plotted by the registration data for PV FiT installations between Nov 2011 and April 2012.

What this experience shows is that independent generators, who are not vertically integrated and have a more limited project portfolio, are more vulnerable to political uncertainty. For this reason we are concerned that the Draft Energy Bill as currently proposed will have a disproportionate impact on the ability of independent generators to secure finance for their projects, owing to a number of factors:

- The Contracts for Difference (CfD) mechanism as currently proposed is overly complex and likely to be 'unbankable'
- It is subject to significant political risk under the HM Treasury's 'Levy Control Framework' which may unpredictably affect the level of support
- It will create contractual risk due to the lack of UK Government underwriting of contracts
- It will create financial risk as the proposed contract period for renewables is only 15 years
- Due to the inclusion of nuclear generators within CfD, there is a high risk of European State Aid issues

In particular as the CfD is focused on 'low carbon' rather than renewable electricity, we are concerned that after the end of the Renewables Obligation the market for renewable electricity contracts ('Power Purchase Agreements') will be limited, and this will make it very difficult for small scale generators to access finance.

The above evidence strongly suggests at the very least a need for transitional arrangements similar to those in place for nuclear, where Government provides some assurances on price.

Requirement for a stable support mechanism that independent renewable generators can access

A diverse portfolio of renewable energy technologies, at a range of scales of deployment and under heterogeneous ownership is key to both security of supply and public engagement in the low carbon agenda.

In order to bring the right investment mix forward, third party finance must be accessible and affordable, by creating market certainty in the long term value of generated electricity. The key requirements for achieving this are a premium for renewable electricity, and ensuring that there is in principle a known 'floor' for the market price.

Under the FIT these functions are separated out (as a guaranteed premium and a minimum export value) and under the RO they are largely combined (through a quota obligation). For either mechanism to be credible, they have to be locked in to a long term commitment to pre-defined targets, underwritten by a ringfenced budget.

Initial feedback from bank lenders who specialise in the independent generation sector is that the Draft Energy Bill is a potential threat to smaller electricity suppliers and generators, and a lower risk approach would be to extend current support mechanisms. As clarity and certainty are key to investor confidence and cost of finance, "For smaller generators, continuation of the FIT would be the easiest solution".

In line with the recommendations of the Energy and Climate Change Committee our preference would also be for DECC to provide an alternative to CfD for small scale generators by extending the current Feed in Tariff scheme beyond the 5MW capacity cap.

By providing a fixed premium for renewable generators, and a minimum price for electricity exports (i.e. a buyer of last resort), this could provide a bankable alternative to CfD if the level of support remains stable over time.

The appropriate level of the new cap would depend on agreeing a long term budget and degression mechanism with DECC and the Treasury for this support.

A clear commitment to provide confidence to small scale developers is required to bring new investment forward. However we also note that appropriate reform of the supply market could be complementary to this, and reduce the need for DECC to act as the buyer of last resort in practice.

Reference price

The reference price is likely to be unattainable for intermittent generators. It is based on day-ahead prices. Because intermittent generation is not very predictable at the day-ahead stage, it is very unlikely to be able to successfully trade in day-ahead markets. Players with a large portfolio may, in time, be able to aggregate and trade a fraction of intermittent generation at day-ahead stage, but the average price for intermittent generation is unlikely to be related to day-ahead prices. As EMR is predicated on the assumption that renewable generators can achieve this price, this presents major price risk.

Suppliers trading predictable energy in day-ahead markets will be setting day-ahead prices used to set the reference price, whilst also being financially exposed to the reference price through EMR. Perhaps this interaction needs more thought.

Aggregators or independent suppliers

DECC's call for evidence places much faith in the emergence of "aggregators" despite the fact that they have been hoped for, but not emerged, for nearly a decade. Even if aggregators do appear, they will serve to add value that Suppliers would otherwise (and might prefer to) have done themselves.

In essence they would need to act like independent suppliers to offer a long-term route to market. Relying on short-term trading is a completely new model that – even if viable if market liquidity improves dramatically – would likely need to be proven over the long-term for financiers to be comfortable.

However, the key for most generators under EMR is likely to be the emergence of more independent, non-VIU, Suppliers. The DECC call for evidence focuses on the value added by suppliers in trading energy, but most generators biggest worry under EMR is the availability of offtake per se for their electricity. In the absence of an Obligation or any financial incentive to validate CfDs with electricity, independent generators worry the Big 6 will either not sign contracts or offer poor terms, and in any event prefer to contract their own generation. New independent suppliers would also need to be large enough to contract for large, independently-owned, offshore wind projects, something that existing small suppliers cannot currently do.

Opening up the supply market- Encouraging 'vertical integration' at a local level through collaboration between generators, suppliers and consumers

New technologies have created alternatives to the large scale grid balancing mechanism, but the barriers to small scale suppliers created by licensing requirements and the Balancing and Settlement Code are preventing new companies from offering innovative solutions to customers. The 'License Lite' proposals which were, in 2009, at the forefront of examining some of the barriers to small electricity supply companies were mentioned explicitly in the EMR White Paper:

"5.19 For some small distributed generation there may be opportunities to supply directly to consumers, but they may be deterred by the costs and complexity of acting as an energy supplier. Ofgem published its final proposals for a 'Licence Lite' regime in February 2009⁸². This will allow small electricity generators to become licensed suppliers under a regime which is proportionate to their size and impact, while protecting consumers' rights to switch energy supplier. The Government is closely monitoring progress made by the industry in using these proposals to gain better access to the market."

We note that the License Lite 'proposals' remain as such and have not been legislated, despite the fact that there has been no progress that we are aware of in terms of licensed suppliers offering the services required for the License Lite proposals to function. As such we will be formally requesting an update from DECC on the current status of the License Lite proposals.

Furthermore the failure to mention the concept anywhere in the Draft Energy Bill represents a missed opportunity to encourage genuine reform of the electricity supply market and allow a range of new market entrants. A diverse and competitive supply market, offering products suitable for all scales of generation, is a key route to ensuring that generators can realise the full value of their electricity output, hence stimulating investment and reducing the need for public support.

We hope you find the comments made in this response useful. If you require clarification or any further information on any of the points raised, please don't hesitate to contact us.

Yours sincerely



Senior Development Manager
Energy Policy & Strategic Projects
Highlands and Islands Enterprise



Senior Development Officer
Policy & Innovation
Community Energy Scotland

In partnership with:
Shetland Islands Council
Orkney Islands Council
Comhairle nan Eilean Siar
Highland Council
Argyll & Bute Council



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