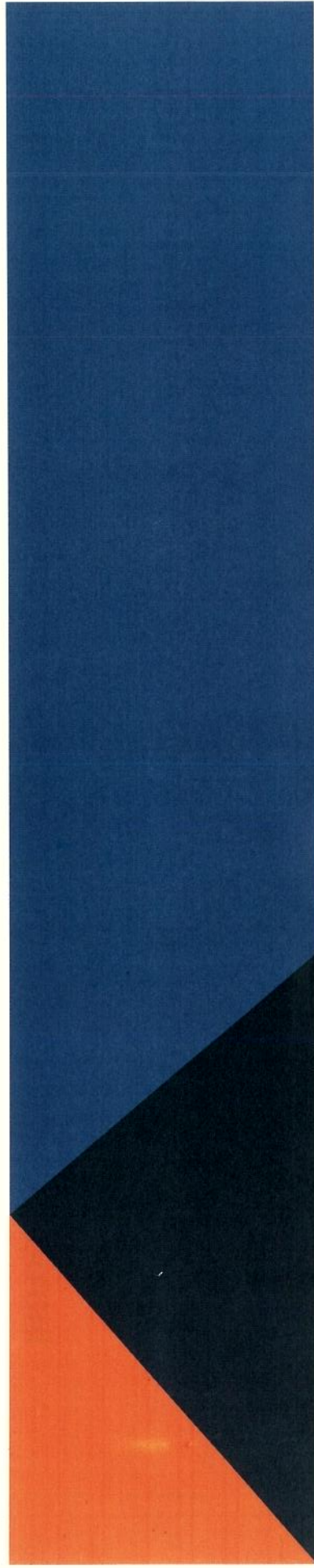


***IPFA response to DECC's call for evidence on the role of gas
in the electricity market (June 2012)***



CONTENTS

- Introduction
- The future role of gas
- Financing and investment
- The gas market
- Unconventional gas

INTRODUCTION

- The International Project Finance Association (IPFA) welcomes the opportunity to respond to DECC's *call for evidence on the role of gas in the electricity market* (the "Call for Evidence").
- The IPFA is the largest and the only international, independent, not-for-profit association dedicated to promoting and representing the interests of private companies and public sector organisations in project finance throughout the world.
- This response has been prepared taking into account the views of IPFA stakeholders including: RBS, BNP Paribas, BG, Ernst & Young, Gas Strategies, Freshfields Bruckhaus Deringer, Linklaters and Herbert Smith. However, unless stated otherwise, this response represents the initial views of the IPFA and not of individual stakeholders.
- Whilst acknowledging the validity of the questions set out at paragraph 6 of the Call for Evidence, given the specialism of the IPFA, this response is primarily focused on considering the implications of the EMR proposals for the financeability of gas-fired generation in the United Kingdom, and in particular the provision of long-term finance for "greenfield" power generation projects on a stand-alone basis (where lenders have historically played a critical role providing funding).
- The IPFA would welcome the opportunity to discuss these issues in more detail in conjunction with Government and other industry participants.

THE FUTURE ROLE OF GAS (1)

Government policy

- The IPFA considers that gas-fired generation will continue to remain the primary source of flexible generation capacity in the UK over the short to medium term (and possibly to 2050 and beyond).
- This has been brought into sharp focus by the pace of development of new nuclear and offshore wind projects and the intermittent nature of most renewable generation technologies.
- Although we do not consider that the UK is likely to suffer a shortfall in the level of gas-fired generation in the immediate future, there is a risk that the capacity margin may drop below 10% as early as 2016 – investment decisions will need to be made soon if this is to be avoided. We suggest that Government does not formulate policy on the assumption that investment and finance will continue to flow into gas-fired generation projects as required to fill a capacity gap.
- Government needs to state unequivocally in its future policy initiatives that gas will continue to perform a key role in the UK's energy mix and formulate a coherent energy policy with this in mind.
- Unless there is a clear legislative framework that enables development of new gas-fired power generation, there is a risk that both the significant amount of capacity already consented to and future projects might not be financeable (or buildable). The proposed EMR legislation emphasises the need for clarity on the long-term rewards for gas-fired generation.

THE FUTURE ROLE OF GAS (2)

Gas Strategy

- We welcome the announcement that Government is to formulate and publish a defined Gas Strategy this autumn, and suggest that Government continues to engage actively with gas industry stakeholders throughout the development process to ensure that the final policy outcome is realistic and workable, achieves broad “buy-in”, and does not jeopardise the availability of financing for new CCGT plants.
- We are particularly pleased to note that the aggressive, critical rhetoric aimed towards gas-fired generation recently emanating from Government appears to have been superseded by a more realistic outlook, taking into account the key driver of “affordability” and security of supply, as well as emissions reductions.
- “Affordability” of supply is an area where gas-fired generation has a clear advantage over renewables and new nuclear on account of the proven nature of the technology, the lower capital costs per MW, and the shorter construction period relative to many other technologies. This makes gas-fired generation particularly attractive to financiers, provided other factors do not provide obstacles to funding.
- Whilst acknowledging the progressive change in Government thinking shown by publication of the Call for Evidence and proposed Gas Strategy, we are concerned that the insufficient level of detail in DECC’s proposals to date means a realistic assessment of possible impacts on the gas sector is currently extremely difficult.

FINANCING AND INVESTMENT (1)

Historical financing of the gas-fired generation market

- Following privatisation of the electricity generation sector, the so called “dash for gas” resulted in significant expansion in the level of gas-fired generation in the UK, a large proportion of which was developed on the back of long-term project finance from lenders.
- Initially, such projects were financed on the basis of long-term CfDs; subsequently, financing was on a “merchant” basis where lenders were exposed to market price risk.
- The abolition of the electricity “pool” and introduction of NETA resulted in a dramatic fall in wholesale prices and the insolvency of a number of bank financed projects.
- In light of this history, subsequent financing of gas-fired plants has been on the basis that lenders are not exposed to market risk on either gas or electricity, with these risks being passed through to tollers with long-term contractual rights to the power generation from such projects.
- The appetite of long-term creditworthy potential tollers is therefore key to any project financing of new gas-fired power generation.
- We note that Government is shortly to release a further Call for Evidence on the impact of EMR on independent generation and PPAs. The interaction of the capacity mechanism and a “PPA / Flexible Gas Supply Agreement” structure would also be an area which could be usefully explored.

FINANCING AND INVESTMENT (2)

Future developments in financing of the gas-fired generation market

- In assessing credit, lenders will consider not only the credit rating of the toller but also the risk to the toller based on the future prospects of gas and electricity markets over the period of the tolling arrangement.
- The EMR proposals introduce a substantial element of uncertainty into the future development of these markets.
- We understand that the Capacity Market mechanism has been proposed to mitigate in part these risks. However, the capacity mechanism is closely linked to and will have to evolve in line with the level of investment in newer, low carbon forms of energy – investment is highly uncertain and may not be forthcoming given operational challenges, relatively high costs and low stable returns.
- From a financing viewpoint, unless the mechanism provides long-term certainty of revenue and risk allocation that meets the stringent requirements of lenders, it is highly unlikely that the Capacity Market mechanism will enable project financing. Consequently, only the larger utilities (able to fund on balance sheet) would be able to develop such projects with consequential effects on the liquidity of the market.
- Further, lenders recognise that the role of gas generation will be likely to change over the life of a project and revenues will therefore be generated through the provision of flexible generation supported by contracts which recognise the value of this operating regime to the grid operator.
- Government will also need to convincingly demonstrate that the same issues which flowed from the legacy of “dash for gas” and NETA will not rear their heads again if lenders are to be reassured (and investors/financiers may therefore be unwilling to commit to large scale investment without expanded protection directly from Government).

FINANCING AND INVESTMENT (3)

Capacity Market

- Government's current proposals for the Capacity Market will need to be clarified and developed in far greater level of detail before financiers will be able to evaluate the prospects for lending on the basis of such a mechanism.
- The working assumption is that tolling agreements will be less common under the reformed electricity market – if this is the case, will Government be willing to provide some form of “backstop” to the gas price risk in order to stimulate investment?
- Government appears to want maximum flexibility in the Capacity Market, as opposed to developing a STOR-plus mechanism (which would have an associated need for high market prices before availability requirement is triggered).
- We urge Government to close any gap in thinking between policy desires and practical reality – to attract investment and financing for a twenty year project requires up-front certainty, which is difficult to reconcile with a flexible mechanism.
- Given the lack of clarity in the proposals, the revised timetable for design choice now seemingly being mid-2013, and doubts as to whether the Capacity Mechanism is to be implemented at all, Government runs the risk of an investment hiatus in gas-fired plant which may have significant implications for future capacity availability.

FINANCING AND INVESTMENT (4)

EMR proposals and risk allocation

- The EMR proposals raise questions around Government's proposed risk allocation strategy, in particular the need to ensure that it is appropriately balanced between project participants (including financiers).
- Many believe that the EMR proposals and the consequential change in market structure have introduced real political risk to the UK energy market which was not the case previously.
- We would urge Government to give serious consideration to:
 - scope of the change in law provisions – a key driver to the level of investment attracted, and the appetite of lenders to provide funds; and
 - allocation of risk for changes in fuel inputs – who will bear the risk of sourcing gas feedstock under a capacity market mechanism? Should the capacity mechanism for securing flexible power generation capacity be linked to a mechanism for securing flexibility in gas supply? Will Government be prepared to “backstop”?
- In face of such risks, especially relating to capital intensive projects (such as gas), investors/ financiers may be unwilling to commit to investment without expanded protection directly from Government.
- This is also of particular relevance given increased investor uncertainty fuelled by recent actions of European governments in the electricity sector (including retrospective cuts to Spanish solar FiTs, German nuclear generation phase-out, and Government's proposed reductions in the support provided by UK solar FiTs).

FINANCING AND INVESTMENT (5)

Additional points of Government clarification

- It would be helpful for Government to provide additional transparency on several key areas which have not been fully addressed in the EMR announcements to date:
 - Does Government retain confidence that the predicted level of renewable and nuclear generation deployment will materialise in the timeframe envisaged? If there is a shortfall, how does Government intend to incentivise developers to ensure that sufficient baseload back-up generation (including gas-fired) is in place?
 - Will gas-fired plant continue to provide baseload generation for the UK energy market or does Government envisage it playing a purely “peaker” role? How will the role for less flexible fully written down existing plant differ from (i) newer existing plant and (ii) plant yet to come online?
 - When will Government be able to provide further detail on the mechanism which will cap the FiT CfDs being offered to eligible low carbon generators? The level at which this is set will have a material effect on investor confidence in the gas generation sector.
- We also query whether, in light of increased Government interventionism through the EMR proposals, there will continue to be a “true” electricity market in the UK or whether a structure akin to “command-and-control” will emerge. Whilst not necessarily an intrinsic problem, this will affect the way in which investors and financiers consider the viability of projects to be developed and operated under the new market.

FINANCING AND INVESTMENT (6)

Modelling exercises and market structure

- Concerns have also been raised around the outputs from the various modelling exercises carried out by Government to date for the EMR proposals, particularly whether these have been fully thought through and tested with the gas market in mind.
- We suggest that this is another area where Government could productively engage with gas industry stakeholders.
- We consider that gas will continue to play a key role in the UK electricity generation mix and it appears that there is still an appetite to lend to gas-fired generation projects among financiers (many of whom have previously financed such projects in the UK).
- However, Government should bear in mind that investment decisions in the energy sector are increasingly made outside the UK and on no other basis than providing investors with a certain and economically sustainable return in comparison with other investment opportunities.
- Therefore Government must provide developers and financiers with sufficient certainty that a robust market structure, backed by well considered policy, will be put in place for gas-fired generation (rather than the focus being purely on low-carbon technologies).
- A theoretically attractive, but practically unworkable, mechanism will not be of use to Government, investors, financiers or consumers.

FINANCING AND INVESTMENT (7)

Implications of Basel III regulations

- We note that regulatory reforms following the financial crisis, particularly Basel III and the Solvency II Directive, are creating issues for banks and insurance companies (and potentially pension funds).
- The requirements of these new regulations will make long-term lending, such as project finance, more expensive and less attractive to financiers.
- Under Basel III, a short-term liquidity buffer, known as the liquidity coverage ratio, will include liquid forms of debt such as government bonds and top-notch corporate paper, but not project finance loans, seen as among the most illiquid.
- A second ratio, the net stable funding ratio, makes the provision of long-term debt such as project finance more expensive for banks by requiring them to match their liabilities with their assets in terms of funding. Though designed to support and strengthen the global financing community, this might negatively impact the banking community as costs spiral, possibly pricing debt, particularly long-term loans, out of the market.
- Further, Basel III will also have cost implications for derivatives. Project finance often uses derivative instruments in order to cross subsidise loan returns. As a result of Basel III, project finance returns will reduce.

FINANCING AND INVESTMENT (8)

Implications of Basel III regulations

- Commercial banks are moving towards shorter-term project financings with balloon final repayments (such as soft or hard mini-perms), with bank debt possibly being limited to the construction phase.
- Refinancing risk may be mitigated by cash sweeps and margin step-ups towards the end of a mini-perm. In addition, sponsors may be required to bear some or all of the refinancing risk by accepting direct recourse by banks.
- However, without certainty in revenue projections beyond the forecast refinancing date, lenders cannot make assumptions enabling them to evaluate whether such refinancing risks are acceptable.
- Although Basel III is to be implemented between 2013 and 2018, the impact on project finance may be felt before the rules kick in as banks compete to show investors they are well positioned for the new capital requirements.

THE GAS MARKET (1)

Government policy and the gas market

- Whilst Government policy is yet to have been clarified, it appears that gas-fired generation is intended to be operated on a “peaker” as opposed to “baseload” basis in order to fill any capacity gaps.
- We envisage that this will have an important impact on the demand for gas, with increasing volatility in prices likely as a result of increased purchases direct from the market (as long term gas sales agreements will not be as attractive for “peaker” plants).
- There is a risk that if project sponsors are dependent on revenue from the market, then without a capacity element, “peaker” plants might not operate for sufficiently long periods to justify investment.
- The increasing amount of interconnection between the UK and continental European gas markets has already led to an increasingly homogenised gas price (with UK prices being driven towards the traditionally higher European oil-indexed long term contract price).
- Further consideration of the impact of the proposed EMR reforms on the liquidity of the UK gas market should therefore form a part of Government’s Gas Strategy, especially with respect to securing flexible and affordable day to day gas supply. Governments should also consider arguments for hourly gas trading to coincide with trading in the power markets.

THE GAS MARKET (2)

Future of the gas market

- Our initial view is that existing gas supply infrastructure will probably be sufficient to address the majority of the anticipated changes to the nature of the gas market without significant additional investment being required in the short term.
- However, we suggest that Government gives further thought to the requirement for, and the means of, stimulating the development and implementation of any specific technologies, such as fast-acting storage, which may be required to provide the required level of immediate response to projects operating in a more liquid gas market and governed by Capacity Market agreements.
- Gas demand will increase at times of low yield from renewable, but less reliable, forms of energy (such as wind). This will further exacerbate the need for flexible storage capacity.
- Whilst the EMR proposals have been focused almost exclusively on the power side of the equation, Government needs to evaluate the benefits of imposing similar structures on the gas supply market.
- Given the possible impact on gas market liquidity highlighted above, one approach that we suggest is discussed with gas market participants is for equivalent "capacity market" principles to be applied to the upstream gas supply infrastructure which would primarily be supplying gas-fired plants operating under the Capacity Mechanism.

UNCONVENTIONAL GAS

- Given the current status of developments, it is not possible to put forward a realistic analysis of the impact of unconventional gas on the gas or power markets in the UK (and it will not be possible to do so by the time that the Gas Strategy is published later this year).
- A variety of key issues, including the environmental impact, a full assessment of the levels of extractable reserves, and likely timescales until economically viable production, remain unresolved. However, we acknowledge the on-going support which Government has been providing to industry to ensure that efficient progress can be made.
- Whilst proven success elsewhere in Europe may operate as an impetus to development of unconventional gas movement in the UK, the recent downgrade of the size of the shale gas deposits in Poland sounds an additional note of caution.
- Taking into account the uncertainties highlighted above, we would urge Government not to factor potential unconventional gas development in the UK when setting its immediate policy objectives.
- For so long as lenders' economic and risk allocation parameters are satisfied for the project in question, it is not of material importance to financing being made available whether gas is sourced from unconventional or conventional resources.

If you require any further information on the contents of this response,
please feel free to contact:

, email: tel. +44

Or

, email: tel. +44



