REA Response
Introducing Fixed Price Certificates into Renewables Obligation schemes: Call for Evidence

The Association for Renewable Energy & Clean Technologies (REA) is pleased to submit this response. The REA represents industry stakeholders from across the sector and includes dedicated member forums focused on solar, energy storage, green gas & hydrogen, biomass power, and energy from waste (including advanced conversion technologies). Our members include generators, project developers, heat suppliers, investors, equipment producers and service providers. Members range in size from major multinationals to sole traders. There are over 500 corporate members of the REA, making it the largest renewable energy trade association in the UK.

Given the range of our members, the REA would welcome the opportunity to arrange an industry roundtable with DESNZ to further discuss these proposals.

Summary of Response:

- The REA recognises that the introduction of FPC's may, in the future, be required to ensure the price security of the RO. However, suggests that the Call for Evidence does not present sufficient data to suggest that this significant disruption to the scheme is needed in 2027. Instead, the Government should not look to introduce FPC's until the 2030's – if at all - once more participants are exiting the scheme.
- We reiterate the importance of ensuring the price set for the FPCs is equivalent to the value of ROCs. This means putting the value at the relevant buyout price when FPCs are introduced, plus 10%.
- Not including the 10% headroom, as proposed, would damage generator revenue and devalue existing assets. This is also counter to previous statements of intent from the Government. As such, failure to do so would be considered a retrospective change.
- The REA, as a principle, believe the model of FPCs should be kept simple. As such we currently favour Model 1 in the consultation, however, call for a more detailed impact assessment to better understand the impact on suppliers and generators if trading arrangements are to be lost.
- We also recommend the use of retrospective data to collect supplier obligations and suggest that both functions of the administrator and central counterparty should be kept within the same entity.
- The REA are opposed to indexing FPCs to CPI instead of RPI (as under the current scheme). We note this will happen automatically across the economy from 2030. To make this change before this date would penalise low-carbon generators and undermine existing business models. It, therefore, should be avoided.

Q1. What are the benefits and drawbacks associated with Model 1?

The REA believes that model 1 provides a more straightforward and predictable model for the introduction of Fixed Price Certificates (FPCs). We, however, note that a fuller impact assessment is really required to determine the impact of losing trading arrangements for both suppliers and generators. We suggest that DESNZ complete this fuller impact assessment as part of the Government response to this call for evidence.

We agree with the identified benefits within the consultation, namely that it could:

- increase revenue certainty for generators as RO contracts start to come to an end in 2027 and generators exit the scheme.
- create long-term administrative savings for suppliers.

- potentially reduced costs for consumers as third-party traders' fees would be eliminated.

The loss of the benefits of trading is seen as a drawback, and the new model will need to be reflected in contractual arrangements between suppliers and generators. The impact of this needs to be carefully considered. Overall, we suspect the impact the loss of trading arrangements to be manageable, as long as the price set for FPCs is equivalent to the revenue generators expect from current ROC sales. Critically this needs to include the ROC recycle value that is passed to generators from suppliers through the current PPA arrangement. Critically, the loss of trading arrangements must not lead to a loss of revenue for generators.

Q2. On balance, which option for frequency of payment and settlements do you think strikes the best balance of benefits for all market participants and why?

The REA are supportive that the Government intends generators to continue to receive monthly payments in all proposed arrangements.

In general, we believe it appropriate that the frequency of payment requested from suppliers strikes a sensible balance between administrative burden and the use of retrospective data to avoid the need for reconciliation of payments to generators or further requests for payment from suppliers. The use of advanced data, that then needs reconciling, could lead to additional costs for both generators and suppliers, which could have cash flow implications. As such, we currently suggest that either option 2a or 2b is likely preferable, however believe this needs to be properly modelled with suppliers to understand broader impacts than spelled out in the consultation.

Q3. For your preferred option, which measures are most important to minimise the risks associated with this option?

No REA Response Intended

Q4. What would the impact of each option be on scheme administration, including costs?

No REA Response Intended

Q5. What broad impact would Model 1 have over the sector? We welcome evidence specifically on cost of capital, risk premiums, and administrative costs to relevant market participants.

Broadly the impact of Model 1 would be to greatly simplify the renewable obligation scheme, effectively turning the market-based mechanism into a support payment from the counterparty to the generator, funded through suppliers. However, it should be noted that the current traded arrangements work well for both suppliers and generators, with there being little call to make the change to FPC's until really needed to secure the scheme. As such, current arrangements should be maintained for as long as possible.

For generators, the important factor will be how the value of FPCs is set. The cost of capital and risk premium could be significantly increased if the FPCs do not include the 10% headroom revenue provided to generators through the ROC recycle value. Any potential loss of value, caused by the loss of this headroom, will be seen as a retrospective change to the scheme. This is especially true given previous government and Ofgem guidance making clear that the value of FPCs would be "fixed at the 2027 buy-out price, plus 10%" (see answer to question 21). Given this has always been stated as the case and built into current business models, any change from this intention will devalue existing assets, increase the cost of capital and undermine investor confidence. This must be avoided.

Q6. What are the benefits and drawbacks associated with Model 2?

It is not clear from the consultation what value there is to be had for enabling trading arrangements when the price of the certificate is going to be set by the administrator. While keeping trading arrangements available might suit existing contractual arrangements, the lack of any additional value for an FPC will mean those contract arrangements will likely be changed or become redundant. As such model 2 seems to complicate the introduction of the FPCs unnecessarily, with little additional benefit to the market.

However, as stated in Question 1, we note that a fuller impact assessment is really required to determine the impact each model will have on both suppliers and generators. We suggest that DESNZ complete this fuller impact assessment as part of the Government response to this call for evidence.

It is recognised that some options for model 2, could mean the creation of a headroom, that could itself be passed back to generators as a form of FPC recycler value. However, it would be simpler to achieve just by including the 10% headroom value in the price of the FPCs in model 1 without creating a costly and administratively difficult scheme.

Q7. On balance, which option for frequency of payments and settlements do you think strikes the best balance of benefits for all market participants, and why?

As stated in Q2, the REA is supportive that the Government intends generators to continue to receive monthly payments in all proposed arrangements.

We also reiterate, that where appropriate, retrospective data is used to ensure accurate payments for generators and requests from suppliers, without the potentially disruptive and possibly expensive need for reconciliation. As such we believe option 5 to be preferable to option 6. We recognise this would require the development of a bridging reserve, but suggest that the overall cost of this reserve could be minimised if settled quarterly rather than annually. Again, we believe models should be appropriately tested with suppliers first before a final decision is made to ensure the administrative balance of the scheme is appropriate.

Q8. For your preferred option, which measures are most important to minimise the risks associated with this option?

No REA Response Intended

Q9. What would the impact of each option be on scheme administration, including costs?

No REA Response Intended

Q10. What broad impact would Model 2 have over the sector? We welcome evidence specifically on cost of capital, risk premiums, and administrative costs to relevant market participants.

Overall, we believe Model 2 could add complexity to the introduction of fixed-price certificates, without clear evidence of additional gain. This is likely to increase administrative costs for both suppliers and generators which will no longer be worthwhile as the market-based advantages and benefits of the renewable obligation will no longer be in place with FPCs.

Q11. Of the two models presented in this document, which would you favour, and why?

Overall, the REA currently favours Model 1 as the simplest way of introducing FPCs. However, note that we would really want to see a full impact assessment to fully understand their impacts.

Q12. What are the respective benefits and drawbacks of having advanced payment by suppliers and reconciliation? On balance, do you consider that the benefits outweigh the drawbacks?

From a generator's perspective, we are keen that the introduction of FPCs be kept simple and transparent. The use of advanced data seems to add complication to the scheme when retrospective data can be used without the later need for reconciliation. The consultation is not clear on the benefits that using advanced data provides and, unless there is a strong demand and reason for its use from suppliers, we would not favour the use of advanced data.

If advanced data is used, it must be fully transparent about how reconciliation would work and over what periods. It would be concerning and disruptive if generators were later asked to repay an amount that had previously been paid out to them for their generation.

Q13. What are the benefits and risks of adding headroom to the supplier obligation to manage any potential discrepancy between the forecasted supplier obligation and actual generator receipts?

No REA Response Intended

Q14. How should the surplus headroom be redistributed, and why?

Surplus headroom should be redistributed to suppliers with the expectation that such a benefit may also be recycled to generators through PPA arrangements. However, we stress that this should not be considered a replacement for the current ROC recycle value that results from the current 10% headroom, funded by buy-out and late payments. This 10% headroom should be built directly into the price of the FPC.

Q15. What benefits and drawbacks would a reserve fund have as compared to a headroom?

No REA Response Intended

Q16. Besides headroom and a reserve fund, are there other options for dealing with the risk of misalignment under advanced settlement options?

No REA Response Intended

Q17. What risks might this option present for suppliers, consumers, or the central counterparty?

No REA Response Intended

Q18. What information regarding the introduction of the new schedule will suppliers require and by when to set consumer tariffs and manage PPA arrangements appropriately?

No REA Response Intended

Q19. What are the potential benefits and drawbacks of centralising both functions of administrator and central counterparty into the same entity?

The REA are supportive of seeing both the administrator and central counterparty combined within the same entity. There seems to be little chance of a conflict of interest between the two roles and believe having one body, rather than two, would add simplicity to the scheme. This is no different to the role Ofgem already play in the RO, both setting the obligation and ensuring suppliers meet their obligation. A new division of tasks, therefore, seems unnecessary.

Q20. What factors should be taken into account when setting the price of FPCs?

The most important factor is to ensure that generation projects on the RO are not subject to reduced revenue due to the introduction of Fixed Price Certificates. It is critical that the Government honour and maintain previous clear statements that they and the regulator have made in regard to setting the price of the FPC (see question 21). These commitments have been used by asset owners to design their business models and underpin investment decisions. Any move to not implement previous commitments will be seen as a retrospective change to the support scheme. This will devalue existing RO assets, drive up the cost of capital and damage investor confidence, at a time when the UK is trying to attract increased investment in new low-carbon deployment.

DESNZ should be aware of the damage already done to investor confidence over the last twelve months, due to several factors including the introduction of the Electricity Generator Levy, the attractiveness of other foreign markets (such as the Inflation Reduction Act in the US) and a failure of government to reflect increased inflation costs into the administrative strike prices of the last CfD allocation round. A move to devalue the RO, by removing 10% of the value from the scheme, would be seen as part of the wider difficulties investors and asset owners are already experiencing in the UK market. This must be avoided if the UK is to continue to attract the level of investment needed to realise the energy transition.

Q21. Should the price of FPCs be set at a level which excludes the ten per cent headroom built into the current scheme? Why and why not? As caveated above, please treat these questions as only applying to scenarios where the chosen FPC model does not involve the use of a new headroom designed to manage misalignment between the supplier obligation settlements levied and the payments issuing to generators.

No.

It is damaging for the Government to suggest going back on previous policy statements which made clear that, once Fixed ROCs were introduced, they would include the 10% headroom. This is clearly stated within the Renewable Obligation Guidance for Generators. Paragraph 1.14, page 8:

“From 1 April 2017, the obligation will be set annually until 31 March 2027. Then a fixed price certificate scheme will be introduced with the price of certificates fixed at the 2027 buy-out price, plus 10%. “ [1]

Similarly, this is also stated in the Technical Update, issued by the Government in 2011 at the point of Renewable Obligation Design, page 54, paragraph 213:

"Our intention is for the price of the Fixed ROC to be set at the long-term value of the ROC. In 2027, this will be the 2027 buyout price, plus 10 per cent. The Fixed ROC price would remain inflation-linked from 2027, in the same way that the buyout price is currently inflation-linked" [2]

These statements have been the basis of existing project design and business model planning. Those who have invested in the RO will be expecting ongoing revenue from the scheme that is reflective of buy-out price plus 10%, until the end of their contractual arrangements. Failure to deliver this will result in a retrospective change that will damage generation asset values, undermine investor confidence and could lead to legal challenges.

While we recognise the duty of the government to consider the cost of the scheme, the government also must honour previous commitments that sit as the basis of investment decisions. Failure to do so will drive up the cost of capital, which will make the energy transition more expensive overall for consumers. This should be avoided.

[1] https://www.ofgem.gov.uk/sites/default/files/docs/2019/04/ro_generator_guidance_apr19.pdf
[2] https://assets.publishing.service.gov.uk/media/5a79b691e5274a684690b920/3884-planning-electric-future-technical-update.pdf

Q22. Should the price of FPCs be indexed to the CPI instead of the RPI (as under the current scheme)?

No.

Again, this would be a targeted and retrospective policy change that will reduce nominal revenues received under the RO. Most generators will not have the ability available to them to easily amend existing contracts to reduce costs in the same way. Equally, those investors who have financed projects through RPI-linked debt tranches will have modelled their business case against RPI-linked subsidy revenues that could now be subject to change.

Industry recognises that the Government have already announced an economy-wide change that will mean RPI-linked contracts will match CPI in 2030. This will deliver cost reductions across a wide number of schemes across the economy. As this is an indiscriminatory change, it will be easier to manage, in addition to there being sufficient time for contracts to make the transition. A move to CPI within FPCs in advance of 2030 will be a lot more disruptive to renewable low-carbon investments.

Again such a move is counter to the previous intentions stated by the Government, creating a damaging investment environment.

Q23. What would be the implications for generators of a shift to CPI? How much of an impact would this have on the viability of continuous operation of RO plants?

Some indicative calculations from members suggest that an early move to CPI, before 2030, could reduce asset valuations by up to 2%, resulting from a 1-2% decrease in revenue from ROCs. However, more detailed modelling is required.

It is important to note that this is on top of decreased valuations that have already been caused by the introduction of the Electricity Generator Levy, increased operational costs due to inflation and possible further devaluation caused by the potential loss of the 10% headroom in the FPC. While RO plants may continue operation, it will put off further investment in such assets. Reducing the possibility of repowering existing projects, leading to a loss of renewable generation capacity at a time when the Government are aiming to get to a net zero power system by 2035. The government should be looking to ensure existing generation is maintained, not lost, as the RO comes to an end.

Q24. What are the benefits and drawbacks associated with Option 1 and Option 2 of this section? Which option would you favour?

Moves to change how inflation is treated in the RO misunderstand the nature of inflation in the economy and how it will impact business models. As such we do not support either option 1 or 2.

The government must recognise that inflation itself compounds and that the current model for the RO is the basis on which revenue calculations have been done, and in some cases seen assets sold. Changes to how inflation is treated within the RO would again undermine business models and should be avoided.

The point of the RO is that the price risk sits with the generator and their investors. This means that when prices are low, as they were during the lockdown, the generator accepts lower revenues. Conversely, when prices are high, they can get the benefit of those prices. This also recognises that along with inflation compounding year on year, so does the purchasing power of the investor to deal with increased operation and maintenance costs and the cost-of-service providers.

Specifically regarding option 2, which links the RO to the price of electricity prices, we note these risks penalising existing assets that have higher operational costs, such as those technologies with feedstocks. The government should not be looking to make changes to a scheme that could unfairly disadvantage specific scheme participants.

The Government have already introduced the Electricity Generator Levy to address extraordinary revenues within the sector. It would be inappropriate to change the RO's treatment of inflation to also try and address this. This will effectively penalise low-carbon RO projects twice. This will undermine the Government's investments and policy intentions in seeing the deployment of low-carbon generation.

Q25. Do you agree with the proposal to introduce the new FPC model in 2027?

Given the disruption to the sector the introduction of Fixed Price Certificates could cause, and the fact that the Government rightly recognises that price volatility in the RO will not happen until significant numbers of projects start to come to the end of their contracts, expected in the 2030s, we do not believe it appropriate to see FPCs introduced in 2027. This call for evidence does not produce enough data to suggest the need to see FPCs delivered immediately, and risks disrupting the market and increasing supplier administrative costs, before really being necessary. As such, we suggest that the government should not consider the introduction of FPCs until later in the 2030s, maintaining existing RO trading arrangements for both suppliers and generators in the short to medium-term.

Q26. What length of time would constitute a reasonable period of notice for market participants and other parties (e.g. administrator, counterparty) to prepare for the transition to the new model?

As long as government is clear on the design of FPCs and that it will not reduce revenues for generators, then a period of two to three years will be sufficient.

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