REA Response to NESO Call for Input: Financial Instrument Proposal

The Association for Renewable Energy and Clean Technology (the REA) is a not-for-profit trade association, representing British renewable energy producers and clean technology and promoting the use of renewable energy in the UK. It has around 500 corporate members, and a further 5,000 through our subsidiaries, making it the largest renewable energy trade association in the UK. More information available at www.r-e-a.net.

Pertinent to this consultation are REA member forums dedicated to solar PV, energy storage (including long duration energy storage), energy from waste, biomass power, anaerobic digestion, deep Geothermal and electric vehicle charging infrastructure all relevant to achieving Clean Power 2030 and requiring grid connections

Q1: Please indicate whether you are either i) broadly supportive of our initial proposal for a financial instrument; ii) supportive of a financial instrument in principle but believe that our initial proposal requires further changes; or iii) believe that a financial instrument in any form is the wrong solution. Please explain.

REA are aligned with option 2.

The REA recognise that a financial instrument could have a beneficial effect on the connections queue but only if appropriately designed and proportionate to the existing development expenditure. As such, we believe the suggested level of £20,0000/MW for a Capacity Commitment Fee to be too high.

In calculating this proposed value, REA members indicate NESO has likely focused on larger scale developers in the queue and taken averages across all applications, irrespective of differences between technology classes and typical developer profiles. As such, we believe the proposal are likely to have a disproportional effect on smaller developers and their financiers.

The proposed £20,000/MWh figure appears to be based on calculation using a probability of connecting existing projects at between 60 -70%, set out in a Baringa study. With the full volume of applications in the queue, vs what NESO suggest is required and physically able to connect, this percentage seems to be higher than previous estimations and is, as a result, inflating the calculated level of securities required on an NPV basis. Previous statements by NESO have suggested probability to be nearer 30 – 40 % [1], which would suggest a figure of between £2-5,000/ MW being a more appropriate level. Given the substantial difference this would make to the level of risk developers are being required to take on, we believe there to be a strong case for considering a lower level of securities while still achieving the aim of removing unrealistic applications from the queue.

The proposals also do not appear to account for the level of investment that is already required to get to Gate 2. Given this measure is intended to be applied to existing applications, many projects approaching Gate 2 will already be heavily invested, especially in securing planning rights. The retrospective nature of these proposals puts these commitments at risk. This may well achieve a reduction in the queue, but at a serious cost of damaging investor sentiment in the UK and undermining broader efforts to get to clean power 2030.

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The level of security cost is also expected to make it unlikely for projects to consider more expensive or risky, but potentially more beneficial, projects. This includes co-located storage projects that could deliver much needed flexibility to the system. If developing a generation asset requires securities of £20,0000/MW, this is likely to impact possibilities for also funding additional opportunities or appetite for adding any additional technology risk to projects. The increase in risk profile for the development of the generation technology makes project delivery more difficult.

Finally, we note that much of these proposals seem to be focused on disincentivising 'resellers' within the queue. We support the fact that applicants should not be able to sit on connection agreements and then 'trade them in' having made no progress on development. The proposed reforms around Gate 1 and Gate 2 requirements go some way to addressing this issue. However, NESO should be aware that this does not represent all reseller situations. Where progress is made on contracted land for projects to be sold onto renewable developers, they are providing value to the connection which sees project advance. Members raise a number of examples where this approach has been successful in either seeing those able to specialise in securing land rights the ability to then pass projects onto those better placed to actually deliver generation projects. Where such arrangements help to move projects forward, they should be supported.

As stated, a financial instrument could well be beneficial, but members indicate the following design refinements should be considered:

i. If having a capacity commitment fee, reducing the required fee to about £3k/MW, which would be a more accurate reflection of lower probability of connections. This would still create an upfront commitment, but not one that would undermine the investor market. We note a level of £3K/MW would be largely consistent with the level that credible developers already are required to post as securities to fix their securities under existing grid offers. If NESO determines that securities at Gate 2 are required we would recommended this level is not increased but the timing accelerated such that it is due on acceptance of a Gate 2 offer.
ii. Consider a financial instrument that is better aligned to individual technology classes. The relative DEVEX costs are significantly different between technologies. The proposed capacity commitment fee should reflect this.
iii. Place a greater emphasis on evidnce-based milestones within the queue. Advancing the wider proposals around Gate 2, as proposed will help this. Requiring clear land contracting from Gate 2 will restrict resellers from being able to 'trade in' connections. The expected impact of this should be considered and see reduced reliance on the capacity commitment fee, lowering he proposed amount.
iv. Consider an escalating, annual commitment fee once the project has been granted planning permission that puts the incentive on advancing projects. This, therefore, creates an incentive to build rather than looking to resale, while not creating an unnecessary high barrier and risk profile to join the queue.

[1] https://www.neso.energy/news/eso-leads-way-major-initiative-accelerate-connections-electricity-transmission-grid

Q2: What consequences do you anticipate from introducing a financial instrument in the form that we have proposed? Please explain your response.

REA members have indicated the high proposed commitment fee will see viable projects no longer able to continue with the risk being too high. Such developers suggest they could lose significant levels of DEVEX that is already committed, as a result. This is especially true for smaller developers, which state they are likely to exit the market, reducing competition and the pipeline of opportunities for larger parties going forward.

The presences of these proposals are also already having an impact with some members reporting that they are delaying development activities (such as surveys and planning) due to the potential uncertainty and financial risks.

The proposals are also considered retrospective in nature, which will undermine investor confidence across the UK renewable sector.

Below in question 5, we provide a case study of where significant investment has already been made and where these new requirements could undermine such projects. This could drive investment to other markets and place achieving Clean Power 2030 at risk.

Q3: Do you agree that only parties that are currently subject to User Commitment obligations should be subject to the new requirement? Are there any additional parties that it should be applicable to? Or should there be any exclusions? Please explain.

If a financial instrument is introduced, then it should only apply to those currently subject to User Commitment Obligations but should not exceed those agreed levels. As express in question 1, we believe the required security needs to be appropriate to the size of the developer and technology class. This does not equate to an exclusion, but ensuring required commitments are proportionate.

Q4: Please detail any existing financial security requirements you believe should be considered in the development of a financial instrument modification.

The proposed capacity commitment fee raises are estimated in many cases to raise the committed development risk by 2 – 4 times depending on project size, noting that security must be put up in advance and would likely be lost if the project does not proceed.

Such additional commitments include:

- Existing connection securities and User Commitments
- Planning Permissions
- DCO examinations

Mitigating the impact of the Connection Commitment Fee, when considered alongside these additional costs, could be done through a structure that recognises that early-stage projects are unable to put up significant volumes of securities. A requirement that, therefore, starts low and increases over time, aligned with the grid milestones would help to ensure that projects are being encouraged to progress and that securities remain proportional as projects develop.

It is also important to consider how these reforms will interact with the wider connection reform proposals. Proposals to increase requirements for achieving Gate 2 are welcome but do themselves come with requirements for increased committed investment, which is added to the

securities being proposed here. The impact of these reforms should be properly assessed and delivered first, before setting the level of the Capacity Commitment Fee.

Q5: Do you see any risks to the profitability or financial viability of your projects arising from the introduction of the financial instrument? If so,

• Please explain what those risks are, their cause and whether they are technology dependent;
• If possible, please provide a ranking of those risks in the order of their likely magnitude; and
• Outline any mitigations for those risks that should be considered.

A few members have indicated that the development risk that will be placed on them as a result of these proposals could create too higher a risk for their projects to continue. Below we provide an individual case studies. This has been anonymised for commercial sensitives:

Case Study

- Our project in [X] has been developed over the past 3 years – it has taken this long to source the 1,500ha of land required.
- We have already secured the connection with c. £3m of securities. These are non-refundable if we do not deliver the project.
- Our grid offer is for 2031.
- NG has recently asked us to agree a milestone to submit planning by November 2027. We will agree to this - it is fully consistent with the required timeline to develop the project.
- To get to planning submission we estimate will require a further £4m, with an additional £3m during DCO examination.
- This means that we are at risk to a binary planning decision for £3m + £4m + £4m = £10m.
- NG's proposal (based on some rough Baringa analysis) is that we will need to put up a further £16m (£19m less existing £3m) of non-refundable securities in March, so our planning decision risk increases from £10m to £26m.
- Our investor will not support this level of risk exposure.
- We have already had feedback from the Head of Development from a large international utility that is heavily involved in UK energy that is taking the same view. Whilst they have more balance sheet this increases their risk position and, even if successful, reduces returns (because they have tied up £[20]m for 5 years).
- One of the key benefits of the UK as a jurisdiction is investor certainty – this continued moving of the goalposts is killing any investor certainty and will lead to investors seeking alternative opportunities. In addition to implanting new construction milestones which have to be achieved, which we agree with, NG is now trying to retrospectively increase investor risk.

Questions regarding developers' approaches to financing the instrument

The following questions will help us understand the financial impact that the instrument may have on developers:

Q6: Please let us know how much you typically spend on DEVEX, identifying this by technology? Can you also let us know how much of a premium you would expect to pay on top of this if you were acquiring a Ready to Build (RTB) asset?

Members will need to reply directly to this with estimates of existing DEVEX, however NESO should be aware that a range of a DEVEX range of £5 – 15 million is not uncommon depending on the technology and size of project. Members will need to reply directly to this with estimates of existing DEVEX, however NESO should be aware that a DEVEX range of £5 – 15 million is not uncommon depending on the technology and size of project. The value of RTB assets depends on multiple factors including location, natural resource, PPA offtake opportunities, capital costs and market sentiment. NESO should not be seeking to regulate a well functioning market – it should regulate the grid offers it has made by requiring developers to evidence their projects are progressing such that they meet the Gate 2 and future requirements.

Q7: Please explain how you fund your DEVEX? As part of this, can you also comment on the point at which you would expect to secure debt finance (if at all)?

We do not commonly see developers utilise debt finance to fund DEVEX given the inherently risky nature of developing projects. However, we believe that NESO's proposals would increase this risk and increase the overall cost of a project, with a corresponding increase in the cost to consumers. Equally this could see the exit of small and medium-sized developers who do not have the balance sheet to fund the level of securities proposed.

Q8: Do you expect that you would be able to raise finance to cover the cost of the financial instrument? If so, what sort of finance would this be and what sort of cost do you expect that it may have?

If the instrument is introduced as proposed then Developers will need to raise additional equity capital, reducing the return for investors and development teams. If the instrument is refundable if planning is refused (as is typically the case in other countries) members may be able to raise debt finance to cover the costs of the proposals but this will require them to rely more heavily on higher risk and higher-cost debt, again raising the cost of capital for projects. While others suggest that that the risk now being placed on the developer, would mean they would be unwilling to finance in this manner and would likely leave the market. As such, the proposal could impact the competitiveness of the UK market.

Questions regarding parameters that we have included in our modelling

The below question will help us sense-check the assumptions used in our analysis:

Q9: What is the typical cost of capital (real, project-level, pre-tax) that you use to perform an "all-in" financial assessment of a project (i.e. from development through to end of operation)? How much higher would the cost of capital be for just the development stage (which we define as covering all costs and activities prior to the start of construction)?

Q10: Do you agree that a 0.5% outperformance on cost of capital (project level) is a reasonable lower-end outperformance that developers would target? If not, what would it be?

Q11: What proportion of all projects that make it to Gate 2 do you expect to fail – i.e. to drop out of the queue? Do you expect the drop-out rate to differ materially by technology, and if so, how?

As demonstrated above, projects approaching Gate 2 are already heavily invested. This, by their nature, means they are most likely to proceed, however if the level of committed funding required to get to gate 2 increases significantly, we can expect less to manage to achieve this milestone. While this maybe desirable from a queue management perspective, this should not come at the cost of losing smaller developers and damaging investor sentiment. We note that NESO has historically stated that it anticipates only 30-40% of projects with grid offers will achieve connection.

Q12: The speculative project archetype is a developer that incurs the absolute minimum amount of costs needed to secure a connection agreement. Do you have a view on:

- *the proportion of speculative projects that get to Gate 2 that are likely to result in successful project development and how this compares to the proportion for non-speculative projects?*
- *the typical resale value (ideally by technology type and on a per MW basis) that such a speculative project may be able to command from selling the connection agreement?*

Our understanding of the Baringa analysis is that it captures both speculative developers (where only a grid offer was secured) but also developers who have developed a project to a certain stage, starting with ensuring that the appropriate land required for the project is contracted. NESO, through its published Gate 2 proposals, has now effectively ensured that pure speculative developers can no longer participate in the market – to achieve Gate 2 a developer has to evidence grid and land, which is a higher bar than a pure grid offer speculative developer. If such a developer is not able to progress the project, either due to lack of planning experience or funding, we do not see any issue with that party selling the project to a more appropriate party who is in a better position to take the project forward. This approach will maximise the opportunity to achieve CP30 and meet the UK's net zero commitments

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