EXPLANATORY MEMORANDUM TO

THE POWER PURCHASE AGREEMENT SCHEME (AMENDMENT) REGULATIONS 2015

2015 No. 1412

1. This explanatory memorandum has been prepared by the Department of Energy and Climate Change and is laid before Parliament by Command of Her Majesty.

2. Purpose of the instrument

2.1 This instrument amends the Power Purchase Agreement Scheme Regulations 2014 (S.I 2014/2511) ("the Principal Regulations") by making a number of minor and technical amendments and clarifying the original policy intent.

3. Matters of special interest to the Joint Committee on Statutory Instruments

3.1 None.

4. Legislative Context

4.1 The Energy Act 2013 ("the Act") makes provision for Electricity Market Reform (EMR), which enables the Secretary of State to implement measures to reform the electricity market to encourage low-carbon electricity generation and ensure security of supply.

4.2 The Principal Regulations support the Contract for Difference (CFD) by implementing the Offtaker of Last Resort (OLR) scheme. The OLR scheme provides eligible renewable generators with a guaranteed 'backstop' route to market for their power: a backstop power purchase agreement (BPPA). This instrument amends the Principal Regulations by making a number of minor and technical amendments to those Regulations and clarifies the original policy intent.

4.3 This instrument is made under the powers in section 51(1) to (5) of the Act.

5. Territorial Extent and Application

5.1 This instrument extends to Great Britain.

6. European Convention on Human Rights

6.1 As the instrument is subject to negative resolution procedure and does not amend primary legislation, no statement is required.

7. Policy background

7.1 The OLR supports the CFD, a key part of the EMR programme, which is intended to incentivise investment in low-carbon electricity generation, while improving affordability for consumers, and maintaining energy security.

7.2 Without EMR, the market is unlikely to deliver much needed energy sector investment at the scale or pace required. Nor is the market likely to deliver the diverse generation mix needed to meet our carbon reduction and renewables targets or ensure security of supply. EMR has been designed as a set of transitional arrangements which work with the market and address market failures to ensure that low carbon electricity generation is an attractive investment opportunity.

7.3 CFDs will support investment in low carbon generation by providing long-term revenue stabilisation to low-carbon plant, allowing investment to come forward at a lower cost of capital and therefore at a lower cost to consumers. CFDs should remove some of the key constraints that have caused the deterioration in PPA terms, as they will remove the need for offtakers to provide a 'floor price' on power (which impact the balance sheets of offtakers) or take price risk on Renewables Obligation Certificates. This should make PPAs simpler and less costly to provide.

7.4 However, financiers are still likely to require generators to have long-term PPAs with credit-worthy offtakers in order to remove risks associated with long-term route-to-market costs and mitigate the transitional uncertainty of switching to CFDs. If this issue were not addressed it could remain difficult for independent renewable generators ("IRGs") to raise finance to develop projects while also limiting competition amongst PPA providers.

7.5 We have developed the OLR mechanism to support independent renewable CFD-holding generators get their power to the market by guaranteeing access to a 'backstop' PPA if they are unable to find an offtaker in the market on acceptable terms. Thus, the OLR will help IRGs play a full role in the market under CFDs.

7.6 Under the OLR, eligible generators will have the right to a 'backstop' PPA on specified terms with an offtaker. The offtaker will be required to purchase the generator's power, but will receive a competitively set fee to compensate for the costs of managing this output. The price offtakers pay to generators for the electricity generated under these PPAs is set at a significant discount to the generator's CFD Market Reference Price, and expected to be on worse terms when compared to those available in the open-market. This is to ensure that the OLR is a genuine 'last resort', only to be used if an open-market PPA cannot be obtained.

7.7 We expect that CFD generators should be able to find PPAs on better terms outside of the OLR arrangement. However, the OLR caps the downside risk for financers by guaranteeing access to the market at a specified discount to the market reference price. This allows investors and lenders to understand the 'worst case' price that the generator will receive for its power, and provide debt-finance accordingly.

7.8 By providing investors and lenders with more certainty over route-to-market and PPA risks, we expect them to accept a wider range of possible offtakers and shorter term contracting strategies which will increase competition and innovation in the PPA market. This should reduce the cost of providing a PPA and thus potentially reduce costs to consumers.

7.9 The Principal Regulations set out:

- Requirements on and timings within which Ofgem must act to administrate the scheme;

- Information requirements for generators when applying for entry into the scheme;
- Criteria for Ofgem to determine and verify generator eligibility;
- Determining which licensed suppliers are to offer to enter into a BPPA;
- The OLR auction rules and timings;
- Provisions for the modification of timelines in exceptional circumstances;
- Levelisation and mutualisation provisions; and
- Review and management of the PPA scheme, including requirements on Ofgem to maintain records and to provide information on the scheme to inform annual reporting.

7.10 The Principal Regulations set out a levelisation process which includes mutualisation of unpaid amounts. Licensed suppliers are required to make payments to or receive payments from Ofgem for the purpose of ensuring that the costs of participating in the PPA scheme are proportionate to the market shares which the licensed suppliers have in the electricity supply market in Great Britain.

7.11 The Principal Regulations also set out requirements on Ofgem to undertake enforcement action in cases where there is a breach of a supplier licence and to review and report on the OLR scheme.

7.12 We have made a number of minor and technical amendments to the Principal Regulations to ensure they reflect the original policy intent which include correcting typographical errors.

7.13 One further amendment to the Principal Regulations is to enable Ofgem to disregard any bid from a supplier if that bid is made before new or updated generator information is circulated by Ofgem. The Principal Regulations already provide for new or updated information to be circulated by Ofgem in the event that errors are identified. This amendment allows suppliers to bid again on the basis of this new or updated information. This is in keeping with the policy intent and has been agreed with Ofgem.

8. Consultation outcome

8.1 The policy set out in this instrument was subject to two consultations. The first consultation was published in February 2014 and lasted for 6 weeks. The consultation document, *Supporting independent renewable investment: Offtaker of Last Resort*[1] sought views on the key design features of the OLR. We received thirty-five responses from a wide variety of sources including generators, vertically integrated utilities, suppliers, consumer groups, industry bodies and trade associations. The consultation demonstrated there was widespread support for the mechanism, with the majority of responses agreeing that the introduction of the OLR would be beneficial. Following stakeholder responses, we placed statutory deadlines upon Ofgem's requirements to determine eligibility, and established that licenced suppliers that wish to act as an OLR must provide minimum credit requirements to do so.

---

[1] https://www.gov.uk/government/consultations/supporting-independent-renewable-investment-offtaker-of-last-resort

8.2 The second consultation was published in June 2014 and ran for 4 weeks. The consultation document, *Implementing the Offtaker of Last Resort*[2] requested views on the implementation of the OLR and detailed the processes and timing for generators to be allocated a BPPA and for the administration of the scheme by Ofgem. We received twenty-two responses from stakeholders representing the energy industry interests and responses were widely in support of the implementation proposals. There was broad support for the policy on the implementation of the OLR but some stakeholders did express concerns about baseload generators being given the option to terminate the BPPA after 6 months due to the way that offtakers trade baseload power season ahead. Following stakeholder feedback, the following changes were made:

- baseload generators are now required to remain in the contract for a year;
- generators are now required to provide a declaration that they are not subject to legal action relating to financial crime; and
- levelisation will only take place when there is a sum to be levelised.

8.3 A more detailed analysis of the consultation responses and the post-consultation outcomes can be found in the government responses to the consultations[3].

9. Guidance

9.1 The Government Responses to the consultations have been published and set out the views of stakeholders in response to the previously proposed policy positions, and an explanation of the final policy decisions taken.

10. Impact

10.1 The OLR scheme is available for CFD-holding renewable generators. This instrument applies to generators who have opted to enter into the CFD and require a BPPA under the OLR scheme. Developers and generators are not obligated to participate in the OLR and would only do so when they cannot access an open market PPA.

10.2 Licensed suppliers with a share of the GB electricity market above 6% are mandated to bid into the OLR auction. This obligation is placed on suppliers through modifications to electricity supply licence conditions, which require mandatory suppliers and allow voluntary suppliers to bid into an OLR auction. As such, the OLR has limited impact on business, charities or voluntary bodies.

10.3 The impact on the public sector is the cost borne by Ofgem of delivering their OLR functions.

10.4 An Impact Assessment was published alongside the Explanatory Memorandum to the Principal Regulations on the OPSI website.

11. Regulating small business

11.1 The legislation applies to renewable electricity generators who have obtained a CFD and is intended to have a positive effect on small businesses. The OLR aims to address issues in

[2] https://www.gov.uk/government/consultations/implementing-the-offtaker-of-last-resort
[3] https://www.gov.uk/government/consultations/implementing-the-offtaker-of-last-resort

the PPA market that affect small and medium sized generators. The OLR also aims to increase competition in the supply market by encouraging small and medium sized suppliers to participate by placing OLR bids.

11.2 By ensuring a route-to-market for the generator's output, the OLR has the potential to make lenders more comfortable accepting alternative routes-to-market for independent renewable generator projects, such as shorter-term contracting strategies. This should reduce the cost of investment in renewable electricity, boosting competition amongst both generators and offtakers, and lowering costs to consumers.

12. Monitoring & review

12.1 The Principal Regulations make provision for an annual review by the Secretary of State of the criteria for selecting mandatory licensed suppliers and the operation of the PPA scheme. There will be no review of the criteria for selecting mandatory licensed suppliers in respect of the OLR Year which ends on 31 March 2016. Information provided by Ofgem in their annual report will inform the annual review.

13. Contact

13.1 Tim Warham at the Department of Energy and Climate Change. Tel: 07760 990635 or email: Tim.Warham@decc.gsi.gov.uk can answer any queries regarding the instrument.