



Renewables Obligation: a summary of the Grandfathering Consultation

June 2010

Introduction

The Department of Energy and Climate Change (DECC) recently published a consultation regarding the grandfathering policy of support for dedicated biomass, anaerobic digestion ("AD") and energy from waste ("EfW") under the Renewables Obligation (the "Consultation"), a full copy of which can be viewed at:

<http://www.decc.gov.uk/en/content/cms/consultations/grandfathering/grandfathering.aspx>

This note summarises the key proposals of the Consultation, which sought responses by 28 May 2010.

What is Grandfathering?

One of the aims of the Renewables Obligation ("RO") is to allow generators to finance the fixed costs of their developments over the lifetime of the project's eligibility for RO support. The theory of grandfathering is that the level of RO support which a generator receives is fixed ("grandfathered") during the RO eligibility period and will not reduce in any subsequent banding review. This guarantee of income provides an element of certainty and security to the generator, which helps to secure third party debt and equity investment in the project.

The RO does not, however, currently grandfather the level of support provided to biomass, AD or EfW generators. Thus, the number of Renewable Obligation Certificates (ROCs) which a generator of this type may receive during its period of RO eligibility is liable to vary.

In respect of biomass, the Government's initial reason for this policy was due to a significant proportion of a biomass generator's costs being comprised of ongoing fuel costs (as opposed to upfront fixed capex), which are liable to vary over time. The Government therefore concluded that grandfathering of RO biomass support was inappropriate as it risked:

- (i) over-compensating generators if the level of RO support became too high as fuel costs decreased, or vice versa; and
- (ii) market distortion if generators entering the market at different times received a different level of RO support, which created disparity between the price that each generator was able to pay for the same fuel stock.

After extensive lobbying, however, the Government now recognises that the absence of grandfathering for biomass

generators has created a large degree of investor uncertainty, which has resulted in high discount rates on future ROC levels being applied to hedge against the risk of decreasing RO support. This, in turn, has made it very difficult for biomass generators to secure external funding, which has depressed the development of the biomass sector. The Consultation therefore considers a number of options to address this issue and the viability of extending grandfathering to AD and EfW technologies.

Key Aspects of the Grandfathering Proposals

Chapter 4 of the Consultation outlines the governments proposals in relation to the grandfathering of dedicated biomass, AD and EfW, as summarised below.

Dedicated Biomass

The preferred option – the Government has looked at a number of options and has proposed that the proportion of RO support that is deemed attributable to fixed non-fuel costs will be grandfathered, leaving the remaining RO support attributable to the variable fuel costs as "free floating", meaning it is subject to change at future banding reviews (i.e. every 5 years). The Government's reasons behind this approach are twofold:

- (i) firstly, it protects existing generators from having support reduced due to a reduction in upfront capital costs which new market entrants may benefit from (i.e. due to an advance in technology); and
- (ii) secondly, if biomass fuel prices should rise or fall, it retains flexibility for the RO to respond by increasing or reducing support for both new and existing generators (subject to a policy intention not to reduce support below a minimum level for existing generators).

The Consultation recognises that this two-pronged approach requires the splitting of non-fuel costs and fuel costs and suggests two possible methods of achieving this:

1. taking the levelised capital, operational and maintenance costs, net of electricity revenues to estimate the level of ROCs required to support biomass non-fuel costs; or
2. determining the contribution of non-fuel costs to total costs, and applying these contributions proportionally to the ROC band.

Burgess Salmon LLP, Narrow Quay House, Narrow Quay, Bristol BS1 4AH
Tel: +44 (0) 117 939 2000 Fax: +44 (0) 117 902 4400
Chancery Exchange, 10 Furnival Street, London EC4A 1AB
Tel: +44 (0) 20 7685 1200 Fax: +44 (0) 20 7685 1266
www.burgess-salmon.com



The Government does not express an opinion regarding which method it prefers and, instead, is seeking responses from interested parties.

The alternative options – the Consultation also considers three alternative options with respect to grandfathering of biomass RO support.

Alternative option 1 - the first is to grandfather biomass generators at accreditation – both with respect to upfront capex and ongoing fuel costs. This approach is in line with other RO technologies and, arguably, does offer generators a greater degree of certainty. Notwithstanding this, the Government does not favour its extension to biomass generators due to the risk of over- or under-compensation on fuel price variation and the generation of market distortion (as outlined above).

Alternative option 2 - the second alternative is to grandfather biomass generators at current levels and “band up” if the level of RO support is increased for new entrants, thus minimising the potential for market distortion. No “banding down” would be permitted, thus insulating investors against any downside risk. Despite these advantages, the Government concluded that this option was not suitable as it offered the end-consumer poor value for money due to the risk of over-compensation if fuel prices fell in the future and the level of RO support for accredited generators could not be adjusted accordingly. Furthermore, any reduction in RO support for new entrants would expose them to an inability to compete for fuel against existing biomass generators.

Alternative option 3 - the third alternative is to leave the current policy unchanged, at least until any banding changes in 2013. The Government realised, however, that this risked a hiatus in biomass deployment as funders continued to discount the value of ROC revenue due to the uncertainty of future support.

Anaerobic Digestion

It is recognised that AD has a different fuel supply risk to that of dedicated biomass. Indeed, AD plants tend to be smaller in scale and rely on locally sourced feedstock which is obtained at little or even negative cost. These elements make AD generators less sensitive to differing support levels for future entrants to the market as they are less likely to be competing for the same fuel. Therefore, as support for all technologies is maintained for the length of the tariff under the FIT scheme, the recommendation is to grandfather AD plants at the current ROC level of 2 ROCs per MWh, thus ensuring parity across the different schemes.

Standard Energy from Waste/Energy from Waste with Combined Heat and Power

It is noted that EfW and EfW with Combined Heat and Power (“CHP”) plants are more likely to secure long term fuel contracts under PFI deals with local authorities. These contractual arrangements make it costly for the generator or the local authority to terminate early, therefore ensuring a degree of certainty in relation to the costs/income of both parties. Consequently, the Consultation

proposes grandfathering RO support for EfW generators at the current ROC level of 1 ROC per MWh.

In relation to EfW with CHP, grandfathering of the _ ROC uplift for dedicated biomass projects was considered to support the additional capital costs associated with this type of build. However, to ensure that grandfathering policy compliments the Renewables Heat Incentive (RHI) (due to be launched in 2011), it has been decided that further consultation is required in this area.

Industry Response

The introduction of ROC grandfathering for AD and EfW technologies has been largely welcomed by industry participants. However, many commentators feel that this policy should also be extended to include gasification and pyrolysis – two technologies that currently compete with EfW plants for fuel and, therefore, warrant the same level of consideration. Furthermore, the Consultation suggests that bioliquids should not be grandfathered as DECC remains sceptical as to whether relying on bioliquids for electricity generation is advisable given that they may offer greater value as a fuel source within the transport sector. Industry commentators reject this standpoint and believe that discriminating against bioliquids is unfair and adds an unnecessary degree of complexity to the RO policy, thus further undermining investor confidence.

With respect to the Government’s proposals regarding biomass, industry has responded and one of the main submissions has been from members of the Renewable Energy Association (REA). REA favour the second alternative option outlined above as scepticism remains regarding the ability to correlate ROC entitlement to actual capex or biomass prices. Specifically, members are concerned about (i) the lack of any established market to provide a fuel reference point when assessing the level of RO support for the variable fuel element of a biomass project; (ii) the proposed 5-year time interval between banding reviews for the variable fuel element – REA members believe this period is too long to effectively track fuel prices, which fluctuate on a shorter term basis; and (iii) the significant time which lenders may need to gain confidence in the proposed arrangements, particularly with respect to the variable fuel support, meaning that investment in biomass projects will remain stagnated and/or be offered on the basis that the variable element will be significantly or entirely discounted, which would materially hinder a plants ability to secure adequate debt financing.

Conclusion

The Government’s proposal to extend RO grandfathering to biomass, AD and EfW generators will help to appease concerns regarding the current disparity of support when compared to other RO technologies. However, it is yet to be seen whether the Government’s proposed approach with respect to splitting the grandfathering of biomass support will act to provide an adequate level of revenue certainty to investors and, thus, reignite participation in this sector.

Burges Salmon's Renewable Energy Team

Burges Salmon has one of the most respected Renewable Energy teams in the UK and was recognised for its work in the area in 2009 when it was awarded "Energy and Infrastructure Team of the Year" at The Lawyer Awards 2009. The team advise on all types of technology including anaerobic digestion, solar, geothermal, wind, biomass and hydro. Our work has included structuring and documenting small community projects, public authority projects, direct on site generation and advising on a new generation of direct power purchase arrangements which are becoming increasingly popular.

If you would like further information, please contact:



Ross Fairley
Partner

+44(0)117 902 6351

ross.fairley@burges-salmon.com



Rosie Lord
Solicitor

+44(0)117 307 6848

rosie.lord@burges-salmon.com