

Energy UK Response to BEIS consultation: Contracts for Difference – changes to Supply Chain Plans and the CfD contract

28th January 2021

About Energy UK

Energy UK is the trade association for the energy industry with over 100 members spanning every aspect of the energy sector – from established FTSE 100 companies, right through to new, growing suppliers and generators, which now make up over half of our membership.

We represent the diverse nature of the UK's energy industry with our members delivering over 80% of both the UK's power generation and energy supply for the 28 million UK homes as well as businesses.

The energy industry invests £13bn annually, delivers £31bn in gross value added on top of the £95bn in economic activity through its supply chain and interaction with other sectors, and supports 738,000 jobs in every corner of the country.

Introduction

Energy UK welcomes the opportunity to respond to the BEIS consultation on Contracts for Difference (CfD) – changes to Supply Chain Plans (SCPs) and the CfD contract. We share the government's ambition to strengthen the UK based renewables supply chain and the intention to align the SCP process to the government priorities in the Industrial Strategy. Energy UK believes that a robust and enduring SCP process, with a strengthened compliance process, is an important factor in supporting the expansion of UK-based renewables supply chains and increasing the domestic content of UK projects.

Whilst we share the government's aims for the UK supply chain, and welcome aspects of the proposal, such as alignment with The Offshore Wind Sector Deal and closer monitoring assessment, we disagree with the approach to compliance proposed by government in the consultation. We believe that the proposed penalty (CfD contract termination) is disproportionate to any potential non-delivery of SCP commitments, is a blunt method of assessment, and may introduce an unintended barrier to deploying the government target of 40GW of offshore wind by 2030. We commend government on setting such an ambitious 2030 target and are committed to working with government to reasonably remove all barriers to deployment to facilitate achievement of this ambition. We are further concerned by the proposal to introduce the sanction at the post-construction phase of the project and the significant additional risk this places on investors at the point of Final Investment Decision (FID).

We support an alternative approach to strengthening the SCP compliance process, which we believe better satisfies the public policy goals of promoting the UK supply chain, minimising project delivery risk and cost to consumers, ease of implementation, and appropriate allocation of roles and responsibilities. We suggest that the timing of the sanction is brought forward to the Milestone Delivery Date (MDD) and that an interim, non-binary assessment/compliance stage is introduced at this earlier stage, involving the potential for voluntary payments into an existing industry supply chain fund (Offshore Wind Growth Partnership – OWGP). We also suggest that any new SCP process implemented is backed by clear and upfront criteria by government, with ongoing monitoring and guidance, and an independent appeals process. We believe this alternative approach, combined with other complimentary policies, can stimulate investment towards a globally competitive UK renewables supply chain.

Should you have any questions regarding this consultation response then please do not hesitate to get in touch via the details below.

Philip McNally

Policy Manager, Power

Energy UK

020 7024 7633

philip.mcnally@energy-uk.org.uk

Response to Questions

Supply Chain Plans

Energy UK shares the government's ambition to strengthen the UK based renewables supply chain. We recognise that this will be key to realising the economic benefits from consumer investment in low-carbon electricity generation and delivery of net-zero emissions by 2050. We note the important role that CfD SCPs play in the expansion of domestic supply chains, however, we disagree particularly with the compliance-related proposals in the consultation and have therefore chosen not to respond to the individual questions in this section. Below, we outline our concerns with the proposed approach, and note alternative options to strengthen the SCP compliance process.

The role of SCPs in increasing domestic content in the UK offshore wind supply chain

Energy UK supports the government's ambition to increase the UK content of offshore wind supply chains¹, however, we caution against relying solely on the SCP process to achieve the stated targets. There are a number of other factors that, together, have an important role to play in the growth of domestic supply chains including strategic interventions (i.e. strengthening capacity at UK ports) and the availability of licensed sites in appropriate locations for manufacturing facilities. These will help ensure that the UK is globally competitive for the production and assembly of offshore wind components going forwards, which in turn will ensure that suppliers have export opportunities, unconstrained by a UK cost premium, and certainty of demand over a reasonable time horizon. The SCP process is a key element of increasing UK content, however, without ongoing efforts to introduce complimentary factors to incentivise Tier 1 companies and others to build capacity, the SCP process alone may lead to higher prices for consumers without stimulating crucial investment in manufacturing capacity.

Energy UK welcomed the announcement by government to create a £160m fund for upgrading ports and infrastructure. This type of capital support for the UK offshore wind supply chain is key to ensuring sufficient UK manufacturing capacity. However, further ongoing funding will be required in addition to efforts from industry to support the growth of the UK supply chain in line with the expansion of UK renewables capacity.

Timing of the proposed changes

Energy UK is concerned about the timing of the proposed changes in the context of CfD Allocation Round (AR) 4. The culmination of this consultation process, and any associated confirmation of a new SCP process, is still several months away and risks introducing significant change to the process with just months before AR4 is due to take place in late-2021. Energy UK is particularly keen to see BEIS maintain the current AR4 timeline, especially given the knock-on consequences that a delay may have on achieving the government's own 2030 offshore wind and climate targets. We therefore suggest that BEIS considers an interim solution for AR4. This will both allow the auction to run on time, and provide

¹ The 300MW threshold capacity above which SCPs are required effectively limits their relevance to offshore wind projects and, therefore, our response to this section will be focused on this technology.

additional time to develop a more robust and enduring SCP process that will deliver on the dual aims of stimulating investment in low-carbon infrastructure, as well as the associated supply chains.

BEIS Proposal

We recognise that strengthening the SCP compliance process is a necessary part of improving the policy framework to support the expansion of the UK renewables supply chain. However we disagree with the proposal to introduce an Operational Condition Precedent (OCP) whereby failure to produce a Supply Chain Implementation Report to the LCCC ahead of commissioning would give rise to a CfD contract termination right for the LCCC. The four key concerns Energy UK has with the proposal include:

1. **The timing of the proposal on the CfD project development timeline.** Introducing a catastrophic risk at the post construction stage of a project imposes significant risk on the investor at the point of FID. Energy UK believes this could result in a significant increase in the cost of capital, and therefore an increase in the CfD strike price.
2. **The scale of the proposed penalty.** Energy UK believes that the proposed penalty (CfD contract termination) is disproportionate to any potential non-delivery of SCP commitments and introduces a new barrier to deploying the government target of 40GW offshore wind by 2030.
3. **The pass/fail assessment.** We believe that a binary pass/fail assessment is too blunt and does not allow for recognition of partial compliance with the SCP or the associated scaling of an appropriate penalty. We are also concerned by the lack of an independent appeals process.
4. **Subjectivity in assessment.** Where a developer falls short on an element of the SCP, the BEIS decision on whether failure was in or out of the developer's control is mostly subjective. Introducing subjectivity to the process increases the level of regulatory risk, which must be accounted for by investors at FID, likely raising the cost of capital.

Alternative approaches to strengthening the SCP compliance process

Energy UK believes a number of amendments can be made to the BEIS proposal to better achieve the goal of increasing SCP compliance.

1. **Bring forward SCP compliance assessment.** As noted above, Energy UK is concerned by the proposal to introduce a potentially catastrophic risk at the post construction phase of a CfD project. We therefore propose that the SCP compliance assessment is brought forward, for example to the MDD stage. Bringing forward the assessment to MDD stage would align with FID therefore enabling a decision on FID without the uncertainty around whether the OCP would be achieved.

We accept that assessment at this earlier stage would not provide BEIS with absolute certainty that all aspects of the SCP will be fulfilled. However, Tier 1 contracts are issued at MDD stage and are a key aspect of incentivising investment in UK supply chain capacity. Furthermore, bringing forward the assessment to MDD would mean that assessment would take place ahead of the AR5 process. This is key in informing developer AR5 SCP decisions and ensures that any financial contributions made by non-compliance in AR4 can be distributed to the supply chain ahead of AR5.

2. **Provide clear criteria and guidance for how SCPs will be assessed.** To avoid the regulatory uncertainty that is introduced by a subjective, non-transparent compliance assessment, Energy UK proposes that BEIS introduces clear and upfront criteria for how SCPs are scored at assessment, and clear guidance on the setting of SCP commitments. The introduction of a quantitative scoring mechanism would improve transparency for the SCP assessment and remove the subjective perception of the process, thereby reducing regulatory uncertainty and remove the potential for risk premiums to be incorporated into bids.
3. **Introduce an independent appeals process.** As mentioned above, Energy UK is concerned by the proposal to introduce punitive measures without the simultaneous introduction of an independent appeals process. Since their introduction in 2014 the CfD scheme has had the

principle of an independent appeals process. Energy UK believes that maintaining the principle of allowing developers to be able to appeal the assessment of the SCP is key to maintaining investor confidence that decisions will not be made arbitrarily. We suggest that the appeals process should follow the precedent set in other EMR schemes, whereby the first level would be to submit a formal request to BEIS to reconsider its decision followed by an appeal to an independent body, likely to be Ofgem given its role as an appeals adjudicator in other EMR disputes.

4. **Enable non-compliant developers to make financial contributions to a supply chain fund.**

As a replacement for the disproportionate, finite penalty of contract termination, Energy UK suggests the introduction of an additional interim, non-binary assessment / compliance stage at the earlier MDD stage. This would involve the potential for voluntary payments to be paid into an existing industry supply chain fund (OWGP). This would provide a 'double-win' incentive for the industry, thereby incentivising i) delivery of SCP commitments in the first place, and only if that fails, ii) payment into an existing fund that promotes the UK supply chain for offshore wind (OWGP). We propose that the size of the contribution is capped to retain the attractiveness of the mechanism to project finance, in a similar manner to Capacity Market liabilities. Having said that, the size of the contribution should be sufficiently high to avoid creating the perverse incentive whereby developers buy out of their commitments and pursue lower cost international supply chains.

Energy UK and its members are keen to work with BEIS on the detailed design of an appropriate SCP assessment framework to achieve the goal of increasing SCP compliance whilst minimising project delivery risk and cost to consumers. As mentioned above, we note there is limited time to implement changes to the SCP process in a fair manner ahead of AR4. We also note that it is crucial that AR4 stays on track for late-2021. We, therefore, suggest that BEIS considers alternative interim solutions for AR4 whilst concurrently working on the detailed design of a robust, enduring SCP compliance process for future allocation rounds.

Energy UK recognises that the floating offshore wind (FOW) sector is in a nascent stage which may create challenges with the level of local content that can be achieved in early projects. We recommend that government work closely with early FOW projects to determine a reasonable level of local content in their SCPs. Ultimately, we believe the UK FOW supply chain ambition should be of a similar level to that stated in the Offshore Wind Sector Deal and that any 'lessons learnt' from fixed offshore wind supply chain development should be taken account of in relation to FOW at this early stage.

Phasing of Floating Offshore Wind

1. The government welcomes views on the proposal not to extend phasing to floating offshore wind.

Industry welcomes the new government ambition for 1GW installed FOW capacity by 2030 and Energy UK expects FOW deployment to ramp up significantly throughout the 2030s, due to the larger availability of deeper water sites throughout GB. However, the global FOW market is currently in a nascent stage with an expected cumulative installed capacity at the end of 2020 of 125MW.² Two-thirds of this capacity is located in UK waters, however, with other countries recognising the potential of this technology, it is crucial that government moves quickly to establish the UK as a global-leader and ensure that the associated economic benefits are realised. We urge government to ensure that FOW policy formation facilitates commercial scale deployment as soon as possible to ensure that the UK captures a strong share of this burgeoning market.

² https://prod-drupal-files.storage.googleapis.com/documents/resource/public/FWJIP_Phase_2_Summary_Report_0.pdf

Energy UK disagrees with the government view that floating offshore wind (FOW) generators are not subject to the same weather risks during installation as fixed offshore wind, and we therefore do not agree with the proposal not to extend phasing to FOW. Despite some benefits from the assembly of FOW turbines in port, deployment will still be subject to weather risk as it will not be possible to tow turbines out to site for installation during periods of adverse weather. Furthermore, OFTO construction, inter-array cable layout and commissioning all require stable weather conditions.

We therefore believe that phasing, which has played a key role in the deployment of large fixed offshore wind sites, will play a similarly important role in the efficient deployment of FOW. We believe that the FOW sector will move quickly to the deployment of larger projects and thus do not see the benefit of adapting the regulations to facilitate smaller projects only.

In light of this, we do see the potential benefits of introducing a threshold below which phasing will not apply. We believe that 300MW would be a suitable level for such a threshold. Such a threshold would allow larger projects to better manage risk as seen in the deployment of fixed offshore projects.

Floating Offshore Wind

2. The government welcomes views on its proposed drafting treatment of Floating Offshore Wind within the CfD Agreement and Standard Terms.

Energy UK agrees with the proposed drafting treatment of FOW within the CfD Agreement and Standard Terms.

3. The government welcomes views on the proposal to set the Longstop Period for floating offshore wind at 12 months.

Energy UK disagrees with the proposal to set the Longstop Period for FOW at 12 months. This follows on from our explanation above that we do not agree with the government view that construction risk for FOW projects is significantly lower than for fixed offshore wind projects. We believe that FOW should be treated in the same manner as fixed offshore wind unless there is clear evidence otherwise.

4. The government welcomes views on the proposal to set the Required Installed Capacity of floating offshore wind at 95% of the Installed Capacity Estimate.

Energy UK disagrees with the proposal to set the Required Installed Capacity (RIC) of floating offshore wind at 95% of the Installed Capacity Estimate (ICE). This follows on from our explanation above that we do not agree with the government view that construction risk for FOW projects is significantly lower than for fixed offshore wind projects. We believe that FOW should be treated in the same manner as fixed offshore wind unless there is clear evidence otherwise and therefore the RIC for FOW should be set at 85% of the ICE.

5. The government welcomes views on the proposal that floating offshore wind should be included in the definition of Eligible Low Capacity Facility in common with all other forms of wind technology.

Energy UK agrees with the proposal that FOW should be included in the definition of Eligible Low Capacity Facility. However, as stated above, we do not agree with the proposal to set the RIC at 95% of the ICE and therefore believe that, for FOW, the effect of the Eligible Low Capacity Facility should

be that a project's RIC will be deemed to be the lower of either 85% of the ICE or the ICE less the size of one of the project's turbines.

6. The government welcomes views on the proposed new Operational Condition Precedent requiring generators to demonstrate that their project satisfies the legal requirements of floating offshore wind CfD unit and the associated evidence requirements.

Energy UK agrees with the proposal to introduce a new OCP requiring generators to demonstrate that their project satisfies the legal requirements of a FOW CfD unit.

Negative Pricing

7. The government welcomes views on the proposed drafting changes to implement the amendment to the negative pricing rule for intermittent generators in the CfD contract.

Energy UK supports the intent of the extension of the negative pricing rule. However, there is a linked but separate question of which party ultimately takes on the risks arising from negative pricing. Negative pricing is becoming an increasingly significant risk for all generators. The level of negative pricing in future years depends heavily on the composition of the future generation mix, which is driven by government policy. As that composition is not possible to predict in detail, it is correspondingly hard to predict the significance of negative pricing.

Given this context, one possible impact of the extension of the negative pricing rule is that it will affect the perception of investors of the level of revenue risk for projects supported by the CfD. Investment will be key to the delivery of the Government's Net Zero targets, and investors will conclude that CfD revenue risk has increased due to this rule change, so this will increase debt financing costs and reduce project investment gearing ratios. That in turn will lead to increased project costs and increased strike prices under the CfD. It is important to note that this risk of a change in investor perception is potentially independent of the actual change in risk from the rule change.

It may be less costly overall if some or all of the risk is taken by consumers, who are the ultimate counter-party in the CfD. In recognition of this, other support schemes for renewable generators across Europe have incorporated a degree of compensation for negative pricing, through arrangements that do not distort the market price formation, for example, by compensating generators if the total number of negative price hours in a year exceeds a pre-set threshold.

Energy UK believes that government should look to implement an annual cap on the number of negatively priced settlement periods for which a generator would not receive payments. We believe such an approach would still allow for the correct market signal to be sent to generators, whilst also providing investors with an instrument for accurate risk measurement, therefore reducing the likelihood of investors overpricing the risk from the rule change.

Coal-to-biomass Conversions

8. The government welcomes views on the proposed drafting changes to the CfD contract to give effect to the government's decision to exclude new biomass conversions from future CfD allocation rounds.

Energy UK agrees with the proposal to exclude new biomass conversions from future CfD allocation rounds.

Milestone Delivery Date

9. The government welcomes views on the proposed drafting change to extend the Milestone Delivery Date in the CfD contract to 18 months.

Energy UK agrees with the proposal to extend the Milestone Delivery Date in the CfD contract to 18 months.

Minor and Technical Contract Changes

10. The government welcomes views on these proposed minor and technical changes to the CfD contract.

Energy UK agrees with the proposed minor and technical changes to the CfD contract.