The voice of the energy industry

Call for Input: Connections Reform – Financial Instrument Proposal – Energy UK response

22 November 2024

Energy UK is the trade association for the energy industry with over 100 members - from established FTSE 100 companies through to new, growing suppliers, generators and service providers across energy, transport, heat and technology. Our members deliver nearly 80% of the UK's power generation and over 95% of the energy supply for 28 million UK homes as well as businesses.

The sector invests £13bn annually and delivers nearly £30bn in gross value - on top of the nearly £100bn in economic activity through its supply chain and interaction with other sectors. The energy industry is key to delivering growth and plans to invest £100bn over the course of this decade in new energy sources. The energy sector supports 700,000 jobs in every corner of the country.

Energy UK plays a key role in ensuring we attract and retain a diverse workforce. In addition to our Young Energy Professionals Forum, which has over 2,000 members representing over 350 organisations, we are a founding member of TIDE, an industry-wide taskforce to tackle Inclusion and Diversity across energy.

Energy UK does not agree with the currently proposed version of the financial instrument. If introduced, the instrument would need to be heavily modified to ensure Great Britain (GB) remains a competitive place to invest in clean energy. The instrument should take effect two years after achieving Gate 2, provisions must be made to ensure securities can be recouped by developers if they fall out of the queue through no fault of their own, a 'ratchet mechanism' should be considered to limit burdensome securities for developers, and exemptions must be made for small community projects, NHS decarbonisation projects and first-of-a-kind projects essential to the Clean Power 2030 (CP30) plan.

If the financial instrument is not pursued, the focus must be on ensuring the connection milestones and Gate 2 mechanism are fit for purpose to ensure serious projects, aligned to the Government's clean power plans are advanced.

If you would like to discuss this response in further detail with Energy UK and its members, we would welcome further engagement.

Tobias Burke,
Policy Manager
tobias.burke@energy-uk.org.uk

Consultation Response

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.

Energy UK does not support the initial proposal of a financial instrument.

Energy UK supports the principle of a financial instrument that effectively dissuades 'zombie' projects from progressing through the queue without disproportionately undermining the investment case for generation and storage projects or competition in the wider electricity market. An appropriate alternative approach would be to ensure effective implementation and use of the connection queue management milestones and the Gate 2 process.

Energy UK recognises the need for effective measures to reduce the size of the connections queue. If the NESO does not pursue a financial instrument, the focus should be on ensuring the queue management milestones and Gate 2 criteria are fit for purpose. The newly emerged proposals for Gate 2, to more actively encourage the pursuit of planning permission, and ordering the Gate 2 queue based on the progression of planning permission are welcome steps in this direction.

Pursuing a modified financial instrument (option ii)

Significant changes to the current proposal would be needed for Energy UK to support the implementation of any financial measure.

Delivering an appropriate price signal

If introduced, the £/MW figure would need to be reconsidered. The analysis by Baringa that informed the proposed £20k/MW commitment appears to be based on a flawed understanding of project development economics, specifically the role of project risk. When developers estimate the projected costs of project development, they often price in the potential that the project may fail for a myriad of reasons including a failure to obtain planning permission or unrelated financial troubles which cause delays to investment. The impact of the financial instrument on risk factors does not appear to have been considered in Baringa's modelling.

Baringa's assumptions when determining the 'hurdle rate', and thus the maximum size of the financial instrument, may also insufficiently consider project development costs, land rights and planning permission costs, and the myriad of unforeseen costs entailed in project development. Developers often do not know the exact location of the connection point early in the project, making the hurdle rate difficult to estimate from one project to another.

When calculating the minimum size of the financial instrument, the probability of being a 're-seller' is based purely on anecdotal evidence. While we appreciate the difficulty of obtaining sufficiently robust data on the probability of an actor being a 'zombie' project, the importance of this policy area demands greater robustness than a reliance on anecdotal information.

There are many more, often smaller, projects connecting to the distribution level where a financial instrument as proposed would be inappropriate. It appears, based on details gathered to date on the state of the queue at distribution, that queue blockages at the distribution level are less of an issue than at the transmission level. This is reinforced when one considers that, according to the NESO's draft data impact assessment from connections reform, key technologies in the distribution queue are undersupplied compared to the CP30 distribution pathways, with the exemption of energy storage and fossil fuel generation. A financial instrument may therefore not be appropriate for all technologies in the distribution queue.

International Comparisons

Firstly, while the original proposal presented to the Transmission Charging Methodology Forum (TCMF) compared the financial instrument to similar policies used in Ireland and Spain, we believe this comparison to be mischaracterised. As the proposal stands, many projects in GB would need to place financial securities many years in advance of receiving a connection and being able to draw down their security. This would be a major, long-term financial commitment, especially for projects with long lead times. In the two countries cited as examples, the financial security demanded of developers occurs much closer to the time of project connection, normally 2 years following planning consent.

In Ireland, the focus to ensure legitimate project progression is through securing land rights as only projects that have received full planning consent may progress. The financial commitment in Ireland is more 'performative' than what is proposed in this consultation. In Spain, careful consideration is given to ensuring that developers can recoup their financial commitment should they fall out of the connection queue due to factors outside of their control, such as if their planning permission is not approved. There appears to be little consideration of this in the current NESO proposal. There may be instances where a project gets a Letter of Authority, is assessed as strategically necessary, passes Gate 2 and posts a financial security but then does not receive planning consent. It is uncertain if that project would be liable for full recovery of the security in this case, and if they cannot, if the intention is to punish serious projects in the queue over factors they cannot control.

Legal Implications

Should a financial instrument be considered, legal implications of the proposal must also be assessed. For example, the current CUSC charging methodology mandates that charges, including connection charges, are as cost-reflective as reasonably

possible for the activities undertaken by the licensee. NESO must consider the implications of a financial instrument for the cost-reflective mandate of connection charges and thus assess the risk of legal challenge.

Not implementing a financial instrument, instead focusing on milestones and Gate 2 (option iii)

In the interest of encouraging investment in the GB electricity system and ensuring the market continues to be competitive, it may not be appropriate to introduce a financial instrument to the connections queue. It may be sufficient to focus on ensuring that the only projects that reach Gate 2 and progress, are those that meet their queue management milestones, obtain land rights and are classified as strategically necessary for CP30 and later the SSEP. Scarcity rents paid to landowners to meet Gate 2 are unrecoverable, notably for those projects genuinely seeking connections but not deemed strategically 'needed'.

The information gathered to date on the readiness of projects to proceed in the queue and the likely dropout rates present an imperfect dataset and methodology for estimating how many projects in the queue could meet Gate 2.

A financial instrument may fail to dissuade speculative applications, as these may not be based on premeditated economic interest but merely a lack of an initial barrier to application, and a lack of available information before applications are submitted. Speculative applications may continue simply due to ignorance of the existence of the financial instrument. If the financial instrument is intended to apply to those projects which have already obtained land rights and are considered strategically needed, it may do little to dissuade projects from staying in the queue until this stage.

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

If applied poorly, the financial instrument could seriously undermine the investment case for clean power projects in GB. There remain concerns that the proposed form of a financial instrument would put downward pressure on all projects, undermining the Government's CP30 plan and wider objectives in system stability, cost-effectiveness for consumers, and decarbonisation. In one instance, a developer has already paused £100m of investment directly as a result of this financial instrument proposal.

In an internationally competitive sector, the NESO must consider in full the likely impacts on investment into the UK of any measures.

Without a project-by-project consideration of the implications of a financial instrument, it is impossible to know which technologies and business models will be most impacted.

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.

Energy UK agrees that the financial instrument should, if implemented, apply to parties subject to the User Commitment obligations only, and thus should not apply to directly connected demand or DNOs.

This would not reflect the purpose of the proposed instrument.

There is a strong case for small community projects and projects dedicated to decarbonising NHS hospitals to be exempt from the measure due to their knock-on local and societal benefits, and the lack of access to capital in that sector.

Innovative projects that are fist-of-a-kind technologies and essential to CP30 should also be exempt from a financial instrument. The routes to market for these technologies are still highly dependent on policy and regulatory developments and as such, the risk impact of the proposed financial instrument is much greater.

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

As stated in response to Q1, more detailed consideration of the approaches taken in Spain and Ireland should be delivered before committing to any approach.

The existing fixed security profile for projects obligated for all generators under CUSC Section 15 could form the basis for a financial instrument through modification. All adherents to Section 15 User Commitment obligations must post securities with their relevant transmission operator for attributable and wider works relating to their connection. The securities ramp up every year as the connection date draws closer, though this remains around 42-45% of attributable and wider connection costs in the final three years prior to connection.

If NESO does introduce a financial instrument it must explore increasing the ramp-up or 'ratchet mechanisms' of security requirements as the connection date approaches, in line with the queue management milestones. Perhaps an appropriate point would be two years after obtaining planning permission (Milestone 2). From there, the security ramps up in value, declining only after the project has passed Milestone 6 (construction plan agreement). Should this be seen as insufficient in cutting projects from the queue after implementation, NESO can retain the right to modify the sharpness or final quantity of security requirements across connection contracts.

Q5: Do you see any risks[1] to the profitability or financial viability of your projects arising from the introduction of the financial instrument? If so,

[1] For example, the period in which the financial commitment is required, the value of the financial commitment required during that period, or the conditions around the liability.

- **Please explain what those risks are, their cause and whether they are technology dependent;**

The timing of the financial instrument does pose a risk to developers. If, upon reaching Gate 2, a project is given a firm connection date many years from the offer, that developer would need to maintain the security from obtaining a Letter of Authority (LoA) through to construction planning until project commitment. This would be a huge financial commitment and not comparable to financial instruments used internationally, where the instrument is used around 2 years following planning consent and much closer to the point of project commitment.

Small community energy projects and NHS hospital decarbonisation projects are particularly at risk, given their level of access to capital. Other vulnerable groups include first-of-a-kind technologies essential to CP30.

- **If possible, please provide a ranking of those risks in the order of their likely magnitude; and**

The time between the financial commitment and actual connection is the most significant risk given its potential to undermine competition for international investment if implemented in its current form.

There are potential implications for consumer bills in a less competitive market. Beyond this, there are implications for customer decarbonisation pathways as businesses, housing providers, and public services look to connect low-carbon technologies on-site. These projects are expected to play a significant role in system balancing at least cost, but will not be able to participate in system balancing if they are not enabled to connect.

Energy UK strongly supports the rollout of community energy projects, and the potential knock-on impact of the financial instrument on community decarbonisation is high but, in the context of wider carbon targets, ranks lower than international investment.

There remains a risk to innovative, first-of-a-kind projects that could prove essential to CP30 or longer-term system operation and Net Zero. Any approach must consider the potential impacts for innovation.

- **Outline any mitigations for those risks that should be considered.**

Any financial instrument should be applied later in the connection process and, as mentioned earlier in this response, an appropriate point might be 2 years following planning consent. As planning consent is now expected to play a larger role in the progression to Gate 2 and the ordering of the Gate 2 projects, this change to the timeline to align with that process would be more appropriate.

Some Energy UK members have suggested a *de minimis* level at which the financial instrument applies. There needs to be a threshold so local decarbonisation projects in the 1-7.5 MW range are not unfairly caught. This would be crucial for community

energy projects or NHS decarbonisation projects, which tend to have less access to capital. This could be addressed by raising the threshold at which the Transmission Impact Assessment (TIA) kicks in, something currently being explored as part of the Connections Action Plan (CAP).

Other exemptions to the financial instrument should be considered for first-of-a-kind technologies deemed essential to CP30 and dependent on regulatory or policy developments.

Other members suggest a ramp-up or 'ratchet system' whereby developers are not exposed to the financial instrument until some years after Gate 2 has been achieved, with the amount of time dependent on technology type, nature of the project and the existing contract arrangements (especially with respect to existing securities). The security can ramp up in value as the project date approaches, declining only after the project has passed Milestone 6 (construction plan agreement). Should this be seen as insufficient in cutting projects from the queue after implementation, NESO can retain the right to modify the sharpness or final quantity of security requirements across connection contracts. This would bring the regime closer to similar mechanisms used in other countries.

Another measure would be for NESO to consider a cap on the financial instrument. In this case, projects would be liable for the £/MW rate or the total capped amount. This is essential to avoid excessive liabilities for large projects and the cap could be tailored to suit certain technology types.

Questions regarding developers' approaches to financing the instrument

Q6: Please let us know how much you typically spend on DEVEX,[2] 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?

N/A

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)?

N/A

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?

The industry remains concerned about raising millions of pounds in investment which would remain as a security, potentially for years prior to connection. Under current

[2] For the sake of clarity, we define DEVEX as all expenditure undertaken prior to the start of construction.

proposals, that money may also be at risk as securities could still be lost if the project fails due to factors outside the developers' control, such as a refusal of planning permission.

Questions regarding parameters that we have included in our modelling

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)?

N/A

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?

N/A

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?

It is not possible for Energy UK to estimate or analyse the likely dropout rate at any stage of the queue. This analysis should be delivered by the NESO before proceeding. The NESO must also embed monitoring and benchmarking to understand how changes under connections reform will impact the pace of connection and the number of projects leaving the queue. The level of uncertainty in the process to date means we are reaching an investment hiatus for some technologies. Without further clarity, this will impact the UK investment case and the number of projects actively moving forward in the queue without even being implemented.

Upcoming reforms to the national planning regime could reduce this figure. However, these reforms may be slow coming and the poor application of a financial instrument prior to securing planning permission could increase the dropout rate from the Gate 2 queue.

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?**

N/A

- **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?**

  N/A