



A-Z of issues in renewable energy projects

In this series of articles, Burgess Salmon's Energy team provides an "A-Z" of key legal and practical issues in renewable energy projects. This first edition covers "A to D" and sets out a number of issues that our construction and power teams regularly encounter.

Advance Works Agreements

The potential benefits of advance works agreements ("AWA") and the early involvement of a contractor and/or consultant design team are clear. Not least, an AWA can provide the project with a flying start and assist in keeping to critical budget and programme parameters.

In the context of renewables projects, AWAs are often used to optimise the chances of time critical milestones being met and to keep accreditation for financial incentives (such as ROCs) on track. Increasingly, therefore, AWAs are utilised by employers to engage contractors or consultants (often for significant elements of work) at a very early stage of the project and while the principal contract is negotiated in parallel.

The time pressures faced on projects utilising complex engineering solutions can be further exacerbated by a number of other factors including the significant time needed for a funder's due diligence process to be carried out (this can be particularly lengthy for project finance). This can often create a Mexican stand-off, where the funder's due diligence team will want to examine early design work and proposals but with the contractor unwilling to commit money and time to develop its design without any comfort that the project will progress to the next stage. AWAs can often assist as a way forward in these circumstances.

Despite the critical importance of the matters addressed in (and the work carried out by the contractor in connection with) AWAs, these agreements are often not given the time and consideration that they deserve. Key risks associated with early engagement between the parties will need to be considered and addressed, including:

- the expectations of the parties will need to be carefully communicated and managed from the outset of the project. From the employer's perspective, he will need to ensure that the contractor/consultant fully understands that the form of the AWA (and any concessions made in connection with the advance works) will not impact on the

final form of contract to be entered into between the parties at commercial/financial close. AWAs are a short term solution and should not be viewed as a precedent for the contractor's entire obligations (particularly if the project is being debt financed);

- the employer will need to ensure that the contractor/consultant is appropriately incentivised to negotiate and finalise the principal contract once the AWA has been entered into. AWAs are often viewed as a window of opportunity to disengage from contract negotiations so that commercial pressure is exerted on the employer to extend the AWA on numerous occasions throughout the life (or a significant portion) of the project. This simply will not be acceptable to funders of any significant capacity on renewables projects. A failure to move from an AWA to a full form of contract will jeopardise a funder's appetite for the project in question. Employers should insist that the principal contract is entered into as soon as possible and will apply retrospectively to govern and dictate the contractor's activities carried out pursuant to the AWA;



- the impact of any advance works (particularly design), needs to be carefully considered in the context of the project and any interface with other contractors. Whilst the desire will be to keep the AWA very short, appropriate controls will need to be included to ensure that any reliance by future/other contractors/consultants in respect of the advance works is appropriately addressed;
- where one or more contractors are competing for a project, it is not unusual for an employer to approach one of the contractors to carry out early design (but with no promise that the contractor in question will be selected to enter into the principal contract). In these circumstances, the contractor may be reluctant to agree to a term in the AWA

which enables the transfer of rights in the early design to the successful contractor (even where the contractor is paid pursuant to the AWA). Again, clear communication and management of the parties' expectations will be essential in these circumstances.

Whilst none of this is magic, these issues are often overlooked and parties can enter into an AWA without considering the strategic importance of this process and the impact that it may have on the project (and its prospects of success). A well-managed project can address these risks so as to ensure that maximum benefit is derived from an early engagement procurement strategy.

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Bonds (Project Funding)

Given the increasing lack of availability of traditional debt finance, there has been a lot of talk recently about innovative ways of funding projects. One such scheme is the European Commission's Project Bond 2020 Initiative which is currently in its pilot phase. Its aim is to kick-start financing from institutional investors (such as pension funds) which have traditionally been reluctant to invest in the construction phase of infrastructure delivery. This is achieved by increasing the credit rating of the project company (such as a PPP) by backing it with a loan or guarantee from the EIB. With an increased credit rating the project company is able to issue more credible bonds to investors making it more likely that it will be able to attract finance.

By the end of June 2013, the EIB Board of Directors had approved nine transport and energy projects in six different

Member States, including motorway and offshore wind projects in the UK. The pilot is due to end in line with the end of the current multi-annual financial framework 2007-2013. Additional funding for the initiative under the "Connecting Europe Facility" in the 2014-20 period would allow a further development of the initiative depending on budgetary allocations.

Whilst this sounds helpful, it is worth bearing in mind that:

- the focus will be on certain limited trans-European energy and transport projects
- a project must be likely to reach financial close during the pilot (from now until the end of 2016)
- because of the costs and complexity of such a financing route, it is generally envisaged that such schemes will only apply to large PPP transactions.

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Contracts for Difference

Feed-in Tariffs with Contracts for Difference (“CfDs”) are a key part of the Government’s electricity market reform (“EMR”), announced as part of the Energy White Paper in July 2011¹. The Energy Bill is central to the Government’s energy policy and its stated aims of keeping the lights on, keeping energy bills affordable and decarbonising energy generation.

CfDs will replace the Renewables Obligation (“RO”) as the main financial subsidy for development of renewable projects not supported under the small scale feed-in tariff regime which will continue to support small-scale (< 5MW) renewable generation. It is also intended to also incentivise new nuclear and carbon capture and storage (CCS) projects. CfDs will be long-term (15 years in the case of renewable technologies) contracts allocated to eligible generators and funded by contributions from licensed electricity suppliers. A new Government owned company will act as the single CfD counterparty.

Pricing

The fundamental basis of the CfD model is the provision of a pre-identified “strike price” to the generator for all eligible electricity generation (inclusive of financial subsidy). This strike price will operate against a reference wholesale market price – if this reference price is lower than the strike price the CfD counterparty will pay to the generator the difference between the two prices, whereas if the reference price is higher than the strike price the generator will have to pay to the CfD counterparty the difference. This means that, provided the generator is paid close to the reference price by its offtaker, it should receive a predictable and stable revenue stream for its energy.

Draft strike prices have been announced for key technologies².



Renewable Technology	Draft Strike Prices (£/MWh) (2012 prices) ³				
	2014/ 15	2015/ 16	2016/ 17	2017/ 18	2018/ 19
Advanced Conversion Technologies (with or without CHP)	155	155	150	140	135
Anaerobic Digestion (with or without CHP)	145	145	145	140	135
Biomass Conversion	105	105	105	105	105
Dedicated Biomass (with CHP)	120	120	120	120	120
Energy from Waste (with CHP)	90	90	90	90	90
Geothermal (with or without CHP)	125	120	120	120	120
Hydro	95	95	95	95	95
Landfill Gas	65	65	65	65	65
Offshore Wind	155	155	150	140	135
Onshore Wind	100	100	100	95	95
Sewage Gas	85	85	85	85	85
Large Solar Photo-Voltaic	125	125	120	115	110
Tidal Stream	305	305	305	305	305
Wave	305	305	305	305	305

The draft Delivery Plan confirms that these prices are intended to be (at least until 31 March 2017, when the RO will close to new applicants) comparable to the support levels available under the RO (taking into account differences such as contract length and inflation indexation arrangements) adjusted to account for the increased certainty generators have from not bearing wholesale price risk which the Government expects to be reflected in lower costs of capital. From April 2017, strike prices are set by reference to the constraints of the Levy Control Framework and expectations of future technology costs. The intention is that the new regime will deliver savings to consumers of around £5 billion to 2030, relative to the current regime. The published strike prices are now being consulted upon and will be finalised and published in the first five-yearly EMR Delivery Plan due in December 2013.

A common misconception is that the strike price is the guaranteed revenue a generator will receive; this is not the case. Since the CfD payment relates to the difference (positive or negative) between the market based reference price and the strike price, the generator takes the risk of not being able to find a route to market for its power at the reference price. Even if a generator enters into a power purchase agreement linked to a wholesale market price which is the same as or similar to the reference price, generators are typically paid around 10% less than the wholesale price to take account of so called “balancing risk” and cover other offtaker costs.

Eligibility for CfDs

Developers wishing to apply for CfDs will have to satisfy National Grid, the appointed “System Operator”, as to the following:

- **Eligibility** - the proposed project is from an eligible technology and is not in receipt of support from or applying for support from another low carbon electricity generation support scheme.
- **Achievement of a specified stage in the development process** – projects are required to have planning permission or development consent. Projects will also be required to have accepted a Grid Connection Offer.
- **Incorporation** – a generator will need to provide evidence that it is validly incorporated under the laws of the jurisdiction in which it is incorporated.
- **Supply Chain** – each project above 300 MW capacity must have a valid supply chain plan, setting out how the project will support the development of a wider, diverse, robust supply chain and support innovation and the development of skills. Further detail on this requirement will be published by DECC, including the criteria against which the supply chain plan will be assessed.

Additional evidence may be required for some technology classes, for example biomass conversions do not require significant levels of planning permission and often do not require a grid connection agreement, therefore biomass conversions will be required to provide a letter or letters of intent from feedstock providers sufficient to support 100% of the nameplate capacity of the plant.

Allocation

Initially, CfDs will be allocated on a first come, first served basis. The System Operator will run the application system and determine an applicant's eligibility. When satisfied, it will instruct the CfD counterparty to enter into a CfD on prescribed parameters. DECC expects this process to take approximately 60 working days.

Once a "significant" proportion of the Government's CfD budget has been allocated in a delivery year (which is currently proposed to be 50% of the budget for each delivery year), six-monthly technology-specific allocation rounds are proposed to be adopted. Such rounds will allocate CfDs on the basis of objective criteria (to be confirmed) if there is more demand than available resource. As part of their application, developers will be able to provide sealed bids containing the strike price they would be willing to accept for the project if an allocation constraint is triggered. Projects that do not provide a sealed bid will be treated as having bid at the published strike price. Bids will be accepted in price order, with the projects with the lowest strike prices being awarded CfDs first. The process

will operate on a "pay-as-clear" basis for each technology/technology group.

The majority of renewable energy technologies will be funded from one central budget (referred to as the "general pot"). However, the Government has reserved the right to choose to define a limited number of minimum or maximum levels of deployment or spend for some technologies or groups of technologies.

Target Commissioning Window

DECC will set Target Commissioning Windows for each technology type. The developer is able to nominate the start date of the Target Commissioning Window, so long as the project's Target Commissioning Date falls within that window. These dates will be included in the CfD. The developer will need to build and commission the facility within the Target Commissioning Window. Where a project fails to start generating before the expiry of the Target Commissioning Window, the payment term will start from the last day of that window. This means that the duration of the generator's CfD will reduce by an amount commensurate with the length of delay to commissioning of the facility. In addition, there will be included in each CfD a Longstop Date. Failure to commission by the Longstop Date will result in the CfD being terminated. DECC will again set a Longstop Date for each technology type. Suggested Target Commissioning Window and Longstop Date periods have been included in DECC's latest consultation on EMR⁴.

Amending Contract Capacity

A generator will only be able to claim CfD support for its contracted capacity. Generators will have to apply for additional CfDs to cover any additional capacity. DECC has confirmed however that developers may reduce capacity to a certain limited degree below their original proposal without penalty. Developers will be able to exercise this flexibility part before and part after construction. Further reductions over and above that allowed for in this "free" allocation will be possible, but at a cost to the developer through a reduction to the strike price in proportion to the extent of the under-delivery and subject to a maximum reduction, anything over which will lead to termination of the CfD.

DECC has now published its draft form of CfD as well as details of the allocation methodology for renewable technologies, as précised above. The consultation period has closed and final contract terms and allocation process methodology are expected to be published in December 2013.

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Direct Power Purchase Agreements

Traditionally electricity generated by renewable power projects has been sold directly to licensed suppliers who then trade the power on the wholesale market or supply it direct to their customers.

Although electricity supply, transmission and distribution activities are heavily regulated, for a number of years private wire arrangements and on-site generation has allowed smaller generators to supply local customers directly, on a licence exempt basis. While this may be a suitable arrangement in certain circumstances, unless there is constant demand for the generating plant's output, the generator will require grid access anyway so that surplus power can be exported to grid and revenue generated.

Direct power purchase agreements ("Direct PPAs") can bring electricity consumers and generators together irrespective of location, generating capacity and supply requirement. From our experience, there are now two contractual structures prevalent in the Direct PPA market and these are summarised overleaf.

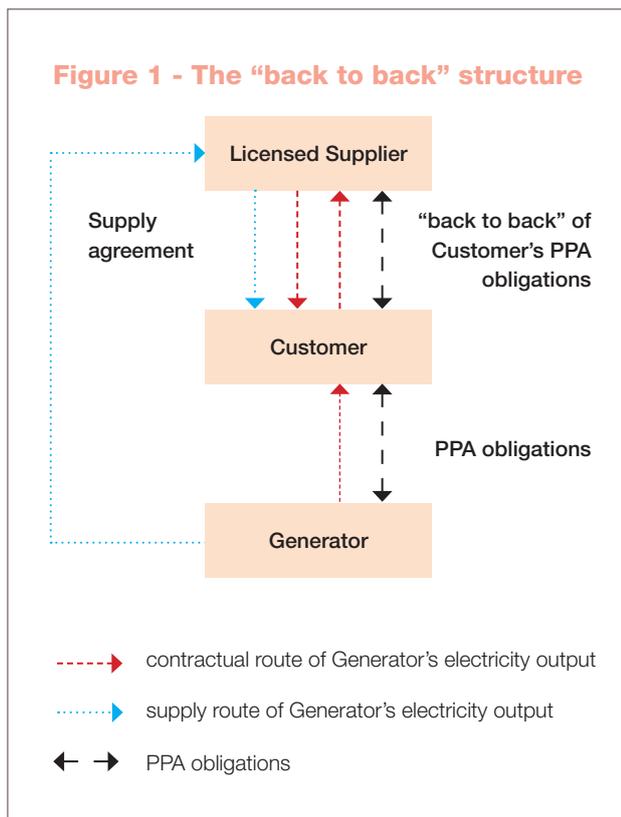


Figure 1 shows the "Back to Back" structure, in which the customer contracts to buy the electricity (and some or all of the associated benefits) from the generator and then on-sell to its own licensed supplier. The licensed supplier would then notionally supply the customer with the corresponding volume of electricity.

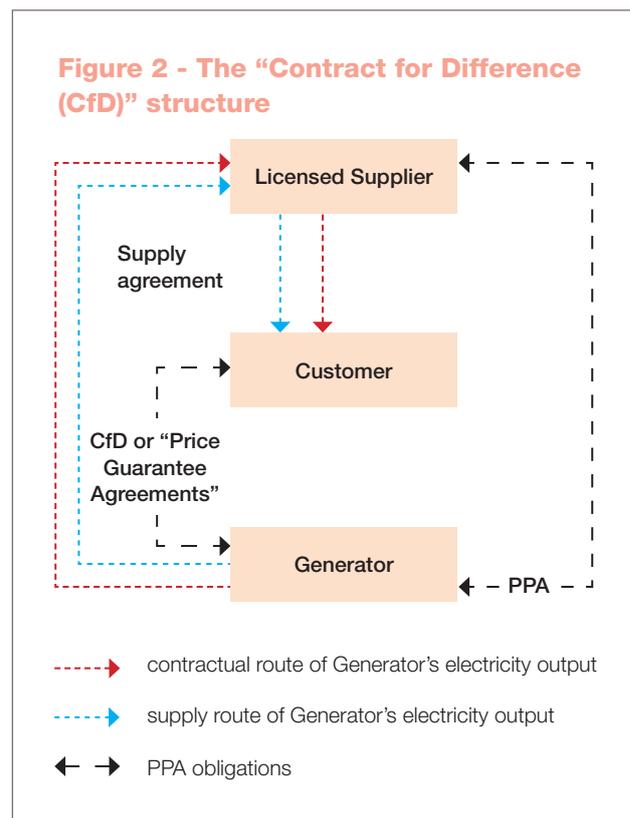


Figure 2 shows the CfD approach. In this model the generator contracts directly with the customer's licensed supplier under a power purchase agreement ("PPA"). A separate "contract for difference" agreement (the CfD (not to be confused with the FIT CfD proposed by the Government as part of Electricity Market Reform)) between the generator and the customer provides a "price guarantee" mechanism to counteract market price driven fluctuations in revenues under the PPA.

One advantage of this approach is that the customer will not have to be involved in general PPA negotiations (the arrangements under the CfD can piggy back on the PPA between the generator and the licensed supplier).

Key commercial considerations and benefits

Before proceeding with a Direct PPA structure, the customer and generator should consider, amongst others, the following high-level issues:

- As the generator is not supplying the customer directly, whichever structure is chosen, the customer will need an electricity supply agreement with a licensed supplier that is compatible with a Direct PPA structure, allowing the on-selling and crediting arrangements described above. This is known as "sleeving".
- Who will take the risk of imbalance costs.



- How the renewable and embedded benefits from the electricity generated (ROCs, LECs, REGOs etc) will be treated. If a back to back structure is used, the LECs and REGOs (plus ROCs (if relevant), unless they are sold separately) will need to pass up the chain from generator to customer to licensed supplier. While LECs and REGOs are primarily only of use/value to a licensed supplier, the customer may take a keen interest in the value of the LEC being sold and what the corresponding “green premium” is that the licensed supplier is charging under the supply agreement.

There are many advantages of the Direct PPA structure to customers, generators and licensed suppliers, including:

- the generator may be able to obtain a significantly higher fixed price for its power than has traditionally been available – this can have a profoundly positive impact on “worst case” revenue modelling;
- the licensed supplier takes the supply risk - the customer’s lights will not go out if the generator suffers an outage;
- generators and customers have a significantly wider market available to them for the sale and purchase of electricity;
- enabling the customer to spread its exposure to pricing fluctuations by agreeing a fixed or floating price mechanism with the generator and sleeve volumes of energy into its supply agreement at the price established with the generator under the Direct PPA. This can complement the pricing arrangements under its general electricity supply agreement and be used by the customer as part of its energy price hedging strategy;
- enabling the customer to demonstrate a commitment to traceable renewable energy from a specific generating facility; and
- allowing licensed suppliers to deliver innovative energy products to customers which help secure commercial supply agreements and have the added benefit of assisting the licensed supplier manage the risk of procuring green power for customers.

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¹ “Planning Our Electric Future: a White Paper for secure, affordable and low-carbon electricity”, DECC, July 2011

² Source: DECC: Electricity Market Reform: Delivering UK Investment, 27 June 2013 and DECC: Consultation on the draft Electricity Market Reform Delivery Plan, 17 July 2013

³ The strike price will be indexed annually by reference to the Consumer Price Index.

⁴ <https://www.gov.uk/government/publications/electricity-market-reform-contracts-for-difference>

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