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The UK's post-ROC regime for renewables emerges

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The UK governments energy market reform white paper, published in July, set out changes to the electricity market that are likely to favour renewable power, and was followed with new renewable obligation certificate banding proposals in October. The main features of the white paper are new feed in tariffs with contracts for differences (FiT CfD), an emissions performance standard for coal-fired power plants and a capacity mechanism for standby power. The reforms would accompany a new carbon price floor mechanism.

The FiT CfD will replace renewables obligation certificates (ROCs) from 2014 and is crucial for sponsors and lenders revenue expectations on future deals. The principle behind the new incentive is that a low carbon generator would be set a strike price and if the market price falls below this level, the generator would be reimbursed, while a higher reference price would have to partially paid back by the producer. After the FiT CfD is implemented in 2014 developers will have a one-off choice between the ROC and FiT CfD until 31 March 2017, when ROCs will be closed to new projects, and the ROC level will stay at the rate that day for grandfathered projects.

The relatively mature onshore wind sector has been quiet while sponsors wait for more detail about the reforms, says one banker. The lack of clarity has led to a difficulty in attracting long-term offtake offers from supply companies, he says. Further detail on the scheme should flow through to renewed activity in the sector, he adds. How the electricity reference price will be established for each technology type is unclear, and the government is expected to flesh out detail on the new mechanisms in the coming months or early next year.

The changes made in October to the banding of ROCs for each generation type have a more immediate effect. The ROC banding review is key to the UKs objective of generating 15% of its electricity from renewable sources by 2020, as it covers the 2013 to 2017 period. The proposals increase incentives for new technologies such as wave and tidal power, and reduce rates for onshore wind and solar photovoltaic. The lower prospects for cost reductions in offshore wind means they continue to receive strong support, and new proposals on biomass, including specific rules for conversions and enhanced co-firing, may lessen the likelihood that large-scale dedicated biomass plants will be developed.

Biomass breaks out

Earlier this year, Helius Energy closed on its £60.5 million ($95 million) CoRDe whisky waste-fired biomass plant in Scotland and several larger deals are looking to close financing. Lloyds and RBS were the lead arrangers of the £42.4 million in debt for Helius plant, while Rabo Project Equity acquired 44.7% of the plants equity. Helius Energy is also developing a 100MW plant in Bristol, England, and Eco2 and its equity provider BNP Paribas Clean Energy Fund are expected to close soon on their 38MW Sleaford straw-fired plant in Lincolnshire.

Debt for the Sleaford plant is expected to consist of £120 million of 12-year debt from RBS, NIBC, Siemens Financial Services (SFS) and UniCredit. Close for Sleaford would provide a useful reference deal, and together with the con-firmation of grandfathered ROC rates in the new banding, should increase sponsor confidence. But the new ROC proposals also feature separate levels of support for biomass conversions and enhanced biomass co-firing.

Drax operates a 4,000MW six-unit coal-fired project, but has plans to develop 900MW biomass units and co-fires with biomass at its existing units. Under the new proposals, it is unlikely to shift its co-firing proportion drastically. Whilst the proposed level of 1 ROC per MWh for enhanced co-firing will enable us to increase our co-firing, we would need a moderate uplift in ROC support to maximise our potential for [biomass generation], Drax said in an interim statement on 15 November.

Drax is developing its 100% biomass plants Siemens Project Ventures, and has chose sites for two new units, each of capacity 290MW. But the proposed level of 1.5 ROCs per MWh makes the investment case for our planned dedicated biomass developments highly challenging, Drax said. Helius Energy said the rate for dedicated biomass projects under the proposed ROC banding effectively maintains the existing levels for those projects already under construction or approaching financial close.

There remain significant challenges to closing a biomass project, with one major issue being the fuel supply contract. Even for the small- to medium-sized projects it has been difficult for fuel supply contract lengths to match optimal debt tenors, and the creditworthiness of the fuel supply companies is often low.

One banker takes the example of wood waste, aggregated by a disposal company and used as a fuel for smaller biomass deals. Youre dealing with relatively small companies in a relatively difficult to predict business with a raw material which can go from having no value to a lot of value in a very short time, he says. Taking a view on that kind of industry over 15 years is tough, he adds. On the agriculture side, farmers may choose to change crop planting patterns according to market prices. Sleaford is situated in an area of eastern England known for wheat production with straw as a byproduct, and Eco2 expects the vast majority of fuel to travel less than 30 miles to the plant.

Another banker says that optionality is key to finding comfort with the supply arrangements when using lower-rated suppliers such as farmers. Its perhaps a more bespoke approach to use a variety of contracts of different tenors and different volumes, he says. The project finance market is yet to really be tested by larger projects looking to source their feedstock from abroad, which brings about supply chain risk and sustainability concerns. For example, Scotland is looking to limit large-scale dedicated biomass generation because of such concerns.

Onshore ROCs out

The sluggish flow of UK onshore wind deals may pick up in 2012 as projects look to take advantage of current ROC rates before they fall by 10% from 2013 to 0.9 ROC per MWh under the new proposals. Many of the onshore wind deals have been financed through the EIB intermediated lending scheme, for which RBS, Lloyds and BNP Paribas are lenders. The scheme, which provides competitive long-term debt for greenfield projects, has made it difficult for banks outside the trio to compete in the space.

Government-backed lenders elsewhere from elsewhere in Europe, however, may inject some competition into the market. In August, German developer Energiekontor closed on the 24.6MW Hyndburn onshore windfarm in Lancashire, northern England. It was the first time a UK deal benefited from the KfW renewable support regime, which provides funding from the state development arm of KfW. The KfW funding provides liquidity at a time when Eurozone banks are under pressure from the sovereign debt crisis, and debt pricing is trending upwards.

KfW provides funds in a similar fashion to the EIB scheme but stipulates that projects have a minimum 25% German shareholding and the funding is made available to banks which themselves have a German presence. The banks then lend it on to the project, taking on project risk. The pool of eligible banks is much larger than the trio of intermediaries that the EIB uses. Importantly, KfW is to increase from the start of next year the amount it lends through the scheme from Eu10 million per project to Eu25 million, with the aim of promoting onshore wind power.

Nord/LB structured and arranged the £39.6 million non-recourse project debt financing for Hyndburn, and the all in funding cost of the KfW tranche was roughly 75bp below commercial funding rates, which at that time were around 250-280bp over Libor for UK onshore. Nord/LB had to swap KfWs Euro-denominated funding into sterling, which should provide a model for forex hedging as more projects come to market next year.

Developers will need to get a firm grasp, and quickly, on revenues under the FiT CfD option for the 2014-2017 window, compared to the use of the ROC rates until they expire in 2017. This modelling will lengthen negotiations, as the market takes on board the legislation changes in full detail. One banker questions the appetite of small wind power developers in dealing with the complications surrounding the FiT CfD. The question is what kinds of risks are embedded in this contract. And what is the administrative burden in managing those contracts?.

Offshore wind opens up

Offshore fared better than many expected in the ROC banding proposals. The UKs department of energy and climate change maintained the current 2 ROCs per MWh support until 2015 and proposes to reduce this to 1.9 for newly accredited projects during 2015/2016, and 1.8 for plants online in 2016/2017. The ROC rates will also be grandfathered for their operational lifetime. The proposals should be of particular comfort to developers of projects in Round 2 of the UKs offshore programme, but may also be relevant for projects in Round 3, which complete early phases before 2017.

Discounting the effects of any surge in commodity prices, it is expected that the costs of building offshore wind farms in UK waters will fall, at least on a like for like basis. But many projects are now having to manage the costs associated with building in more remote waters, which could put upward pressure on costs. The scarcity of installation vessels has become a material risk factor in cost analysis, but a lot of new vessels are being built by specialist companies as well as on a more speculative basis and installation processes are becoming more organised, says Allan Baker, global head of power at SG. One example is the staging of sections of the project such as monopoles close to the installation site to reduce shipping times. You can get a lot more done in one season... it becomes much more of a conveyor belt sort of approach, he says.

There is a limited pool of around a dozen banks comfortable with UK offshore projects. While there should be sufficient liquidity to close on the latest projects, like the £1 billion Lincs offshore project, liquidity will be severely tested for the larger projects coming to market in Round 3. Pension funds are looking seriously at offshore, though their involvement has been almost entirely limited to post-completion equity funding.

The 240MW Lincs projects developers are Centrica, Dong and Siemens, and although it is still scheduled to close in 2011, it has suffered delays to the installation of two transmission cables. Three of the banks in the 10-strong lending club on the project, BNP Paribas, Santander and Unicredit, are under pressure from funding cost issues due to the Eurozone crisis.

The other headline UK offshore deal in the market is more of a refinancing the £170 million acquisition by Marubeni of 49.9% of Dong Energys 172MW Gunfleet Sands 1 and 2 offshore wind farms. Marubeni completed the acquisition November 1, funding the purchase with a bridge loan until it can close a full project financing. The acquisition has a debt requirement of £150 million. Six banks have been issued a term sheet for the financing including SG, the structuring bank, Dexia, RBS, SMBC, Mizuho and BTMU.

The deal features a ROC swap between Marubeni and Dong, whereby Marubeni will receive more ROCs in the early years in exchange for providing Dong more ROCs in the later years providing it with higher cashflows when operational conditions are more certain. The financing also benefits from a minimum wind guarantee provided by Dong. Over the next 2 or 3 years, the unincorporated joint ventures the structures which allow for minority shareholders to finance their portion of the asset on a project finance basis are probably going to be where the market goes, says SGs Baker. ■