Developing onshore wind under ROCs versus CfDs

Introduction
On 27 June, Electricity Market Reform “EMR” draft strike prices for Contracts for Difference (“CfDs”) were announced by Department of Energy and Climate Change (“DECC”).

Jones Lang LaSalle’s Renewable Energy Capital team has undertaken research for Infinergy to compare value and returns under CfDs and ROCs. This paper shares some commentary from that analysis.

Key features of CfDs:
• Onshore wind draft strike prices set at £100/MWh for projects commissioned up to April 2017, subsequently £95/MWh
• 15 year term for CfDs as opposed to 20 years under ROCs
• Inflating with CPI from 2012
• Final strike prices to be released in December 2013
• From 2014 new projects will have the choice to register under ROCs or CfDs
• Government will be the contracting counterparty

What risks and rewards do investors face under CfDs?
EMR fixes the price per unit paid to renewable power generators for 15 years. The government achieves this through a “Contract for Difference” which pays/receives the difference between market price and a pre agreed strike price. The contracting counterparty is wholly owned by the UK government.

Revenue volatility under CfDs is therefore lower than under ROCs, reducing risk to the investor. However investors also forfeit power price upsides.

Fifteen year CfDs expose investors to both a greater period of uncertain revenue and an increased “right to evacuate” risk at the end of project life, where ROCs provided government support for 20 years alongside optional PPA price protection for up to 15 years.

Due to lower revenue volatility in the first 15 years, greater gearing is expected under CfDs, however the tenor of debt facilities may be shorter than under the ROC regime, due to a shorter period of government support.

How can a project owner make a comparison between accrediting under ROCs and CfDs?
Comparisons between accrediting under ROCs versus CfDs need to be made on a project specific basis, as the outcome is dependent upon project specific factors including the date of commissioning, appetite for debt and PPA strategy. Comparison would be made by calculating the NPV of the project under both ROCs and CfDs and depends on investors’ perception of risk.

The impact of CfDs on project finance
One of the government’s aims is to enable increased gearing under CfDs compared to ROCs. This is supported by the 2010 Redpoint report: ‘Electricity Market Reform: Analysis of Policy Options’, which assumes gearing under CfDs of 85%, opposed to 70% under ROCs. However this relies on the final CfD structure giving banks the comfort they require. Our analysis assumes the same gearing assumptions.
The PPA market
It is not yet clear how the PPA market will respond to CfDs. Unknowns include the tenor, imbalance and discounts from market price.

We have assumed the generator will receive 92% of the strike price under CfDs, and 90% of gross revenue under ROCs.

Case study: Infinergy appointed JLL to perform CfD vs ROCs analysis on the 39MW Tom Nan Clach onshore wind site

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<th>Figure 2: Tom Nan Clach</th>
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**Analysis**

**Unlevered**
- Investors require returns for un-built sites in the region of 11% - 12% under ROCs
- CfDs drive greater certainty enabling investors to accept a lower IRR
- A reduction in IRR of c.1.5% is required to achieve equivalent value to ROCs

**Levered**
- Investors require returns for un-built sites in the region of 13% - 15% under ROCs
- The CfD revenue stream enables higher gearing (we have assumed 85% as opposed to 70% under ROCs)
- A 1-2% reduction in equity IRR under CfDs is required to drive an equivalent value to ROCs

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<th>Figure 3: NPV assuming CfDs attract 1-1.5% lower blended cost of capital than ROCs</th>
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**Conclusions**
It is widely anticipated that CfDs will drive a lower cost of capital, due to reduced revenue volatility. The key question is “how much lower?” In our experience fixed revenue markets can access an approximate 0.5-1.5% lower cost of capital. However the biggest win here could be for levered equity, which depends on banks’ appetites and resolving CfD structuring concerns.

Required returns under CfDs will not finally emerge until uncertainties around the mechanics, including the structure of PPAs, are resolved. Only then can investment decisions be made and a true value comparison with the RO become possible.

Renewable Energy infrastructure is an asset class well suited to a large pool of institutional capital and CfDs should expedite the flow of capital, for example from pension funds and insurance, who have been slow to the market thus far.

**The Team**
Jones Lang LaSalle is the world’s leading real estate investment management firm. Jones Lang LaSalle’s Renewable Energy Capital team provides commercial and financial advice to both developers and investors in the Renewable Energy sector.

Jones Lang LaSalle is unique in combining corporate finance expertise and dedicated renewables planning capabilities to offer clients bespoke advice from project inception to completion.

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