

### **RENEWABLE HEAT INCENTIVE ANNOUNCEMENT INJECTS SOME CERTAINTY INTO A MARKET IN TRANSITION**

The Department of Energy and Climate Change (DECC) has finally published its long awaited Renewable Heat Incentive (RHI) policy document, bringing clarity on key aspects of the scheme and the timescales for the introduction of support for both commercial and domestic renewable heating schemes.

The policy confirms that the scheme will be introduced shortly after regulations are published in the summer. The first phase will apply to the industrial, business and public sectors, with a Renewable Heat Premium Payment available for householders. Households will also operate under a tariff regime from October 2012. Installations which were installed on or after 15 July 2009 will be eligible to join the scheme, receiving tariff payments from the date of introduction of the scheme.

Payments under the RHI will only be made to the owner of the plant used, or intended to be used, for the renewable generation of heat. This is despite calls from some stakeholders to enable payments to be assigned to assist in reducing credit risk with lenders, and contrasts with the Feed-in Tariff (FiT) regime where such assignment is possible. DECC states that it does not believe that doing so would fully reduce risk to lenders, and that it does not wish to further delay the introduction of the scheme. An installation may be one or a number of units of the same technology connected to a common heating system, with the capacity of multiple units installed within a 12 month period being considered as combined for the purposes of support. Different technologies on the same site will be treated as individual installations.

In order to be eligible for payments, the heat generated must be useable and useful heat, and used for space, water or process heating. In describing “useful” heat, the policy document does not provide an exhaustive list – rather sets out broad principles of what it wants to support:

- the utilisation of useful heat;
- the heat must be supplied to meet an economically justifiable heating requirement, such as a heat load that would otherwise be met by an alternative form of heating, such as a gas boiler;
- the heat load should be an existing or new heating requirement, and not created artificially, simply to claim the RHI; and
- acceptable uses of heat are space, water and process heating, where the heat is used in fully enclosed structures.

The exception to this approach is biomethane injection, where it is simply injected into the gas grid. The policy also confirms that heat used for cooling will be eligible, as long as it is not generated by heat pumps.

The levels of support for biomass and biomethane injection have been broadly welcomed, but concerns have been raised over the limitation of support for biogas CHP to schemes under 200kWth in capacity. The low rate of return for solar thermal has also been raised as an issue, as has the fact that only energy from waste using either municipal solid waste as a fuel, or using a fuel derived from municipal solid waste, will be eligible for support, leaving fuels from commercial and industrial wastes out in the cold.

However, there is no doubt that the announcement brings some certainty to one aspect of the market, against what is currently an otherwise very uncertain policy background for renewables in general.

The Electricity Market Reform process rumbles on, with consultees raising concern over the length of time that it may take to finalise key details of the Government's preferred Contract for Difference form of FiT regime. The proposal to remove the supplier obligation has also raised eyebrows with concerns that it may impact on smaller generators, exposing them to offtake risk, and potentially removing a key driver for investment in renewable energy projects. Questions have also been raised over the potential use of auctions to determine support levels or required capacity.

However, in terms of renewable heat it is likely to be even more difficult to raise finance, given the infancy of the market and the dearth of existing heat infrastructure in the UK. Against a backdrop of relatively slow house building, the industrial heat market may seem more attractive for developers, but lenders may regard this with some trepidation where proposals are reliant on only a single large commercial user of heat, which could be seen as more risky than supplying a domestic district heating scheme.

## **A NEW TRANSPARENT AND FORMULISED APPROACH TO COMMUNITY BENEFIT PAYMENTS**

Community benefit payments, or goodwill payments, have long been a controversial feature on the periphery of onshore wind planning applications. However, in recent months both the Scottish Government and RenewableUK have been developing different proposals in an attempt to formulise the approach taken to payments by renewables developers.

RenewableUK have developed a protocol which is a voluntary scheme that will apply to participating members' planning applications, submitted on or after 16 May 2011, in respect of onshore wind farms of 5 MW and above. Those participating in the protocol will have to submit a "statement of community benefit" with their planning application. This will set out the developer's commitment to provide benefits – which will be no less than a prescriptive amount of £1,000 per MW installed capacity. A separate statement will also identify the benefiting community. Developers are to commit to early and transparent community consultation (in line with the local authority or the Major Infrastructure Planning Unit's minimum statutory requirements), and to annual payments for the duration of the commercial operation of the wind farm. The income generated by the protocol will go directly back to local communities.

The Scottish Government proposals, contained in its consultation paper "Securing the Benefits of Scotland's Next Energy Revolution", have only recently closed to public consultation. The proposals are still very much in their infancy but are very different to the terms of the RenewableUK protocol.

The Scottish Government proposals would apply across the entire renewables sector – on and off shore – as it is considered that local communities hosting offshore development are likely to encounter the same issues when it comes to securing and maximising the levels of community benefit. In addition, a portion of renewables generated income would be passed to a national "Future Generations Fund", modelled on Norway's oil fund, not just for the local community. It is the intention that the Fund would then be invested in key areas, such as Scotland's renewables skills base, to foster a successful renewables and low carbon revolution. Rather than prescribe a fixed payment, it is proposed that a "Register of Community Benefits" would fully empower communities to individually negotiate benefits with developers. The Scottish Government considers that this open and transparent register would help local communities better understand the levels and types of community benefit they could realistically achieve, as well as ensuring consistency and equity across communities.

However, similarly to the RenewableUK protocol, it is suggested that a statement of community benefit could be an accompanying document to a planning application. Currently, any form of goodwill payment is outside the planning system, as they cannot directly influence or be taken into account by a planning authority in making its decision on a planning application. There are legal and policy reasons for this: they do not in any way relate to the impact of a development; they are not necessary in planning terms; nor are they necessarily related in scale and kind to the development.

Whilst there are calls for community benefit payments to be openly considered as part of the planning process, to do so would require legislative and planning policy change. Otherwise, the planning system will again be faced with the disrepute that haunted planning agreements in the early nineties, with accusations of planning permissions being bought and sold – which resulted in a number of legislative and policy reforms being instituted.

It is understood that no planning authority in England has a proposed policy on how it would respond if a goodwill payment is offered in connection with a wind farm development. However, many councils in Scotland, such as Argyll & Bute, Highland and Dumfries & Galloway, have had governance frameworks for community benefits for a number of years. Although community benefits payments are not mandatory, these frameworks are recognised by developers and welcomed as guidelines towards “good practice”. What is clearly required, throughout the UK, is a stable and consistent framework which is not overly prescriptive but allows renewables developers and communities to continue to tailor the community benefits arrangements on a case by case basis, and, of course, avoid chaos and disrepute being brought into the planning system.

## **A NEW CONSENTING PLANNING REGIME FOR HYDRO DEVELOPMENT IN SCOTLAND**

Scotland has 85% of the UK’s hydro electric resource, much of it developed in a post war “gold rush”. However, until relatively recently it has been perceived to be a neglected technology in the renewable energy mix, losing out to its more lucrative, modern and what many environmentalists consider to be better alternative generating forms.

An update on the 2008 Hydro Resources Study estimated that there could be 1.2 GW of financially viable new hydro capacity in Scotland across 7,043 schemes. Coupled with contributing towards renewables targets and the job opportunities they present, the Scottish Government has considered what obstacles hinder the development of small-scale and micro-scale hydro schemes. As a result, a new consenting planning process for hydro schemes is about to be introduced in Scotland, to bring it into line with the process already operating in England and Wales.

Currently, the consents planning threshold in the Electricity Act 1989 (Scotland) Order 1990 for onshore hydropower is 1 MW, with the result that those applications over 1 MW are decided by the Scottish Ministers. However, from 1 June 2011, the 1990 Order will be revoked and applications to build hydro-schemes with 50 MW installed capacity or below will be determined by planning authorities. Planning authorities already consider hydro applications, sometimes at committee, before responding to the Scottish Ministers. However, rather than making a recommendation to the Scottish Ministers, councils will now make those decisions locally.

The Scottish Government considers that this should result in more efficient decision making by cutting out an unnecessary level of bureaucracy. This is a move that will be welcomed by hydro developers, who have campaigned hard for the threshold limit to be raised for a number of years, in order to place hydro on an equal footing with decisions for wind farms.

Applicants for hydro schemes below the 50 MW threshold will have a new option of being able to apply for planning permission in principle (PPP), in addition to detailed planning permission. PPP can exclude much of the detail of a proposal and allow the principle of development to be established without having to spend needless amounts of money on detailed proposals. However, the additional legislative consenting requirements under the Controlled Activities Regulations and the need for an Environmental Impact Assessment will remain unchanged, and sufficient information to meet those obligations will still need to be obtained and submitted.

Depending on the scale of development, applications for hydro schemes will be classed as either local or major development and this will have a number of implications in the processing of the application. Planning applications for the construction of a hydro station with a generating capacity which exceeds 20 MW will be considered to be major development. Major applications are subject to enhanced scrutiny measures, such as mandatory pre-application consultation. There is also a requirement for design and access statements to accompany an application – which means that landscape siting and design considerations will become no less important. From receipt of an application, planning authorities will have four months to reach a determination. Rights of appeal against non determination of applications or against their refusal will be to the Scottish Ministers – an appeal right which does not currently exist under the Section 36 process and a move that ought to be welcomed.

Local development, i.e. 20 MW or less, will not be subject to the statutory pre-application consultation requirements, but a design statement will be required in certain circumstances. Planning authorities will have two months to determine the application but depending on the scale of the planning authority's scheme of delegation, the right to challenge a local development decision might be to the Council's local review body rather than the Scottish Ministers. This will potentially reduce appeal rights to the Scottish Ministers, which hydro schemes under 1 MW currently enjoy.

Allowing planning authorities to determine all hydro applications of 50 MW or less should decrease duplication and inefficiencies in the current s36 consultation process. Given that many issues surrounding a hydro project are of a local nature, it may actually be more appropriate for the planning authority to determine them. The key to any successful hydro application will remain in engaging with the planning authority at the outset of the development planning process, as well as securing the support from local communities and other stakeholders such as SEPA.

The hydro sector contributes to nearly 10% of Scotland's energy generation and there is policy ambition to increase this and turn Scotland into a hydro nation. The Feed-in Tariff (FiT) regime across the UK also makes small scale hydro power a lucrative investment. There are also indications that some planning authorities are actively supporting hydro development over other forms of renewable generation. It is clear that hydro developers have a positive contribution to make to Scotland's renewable targets and the new consenting planning regime may indeed also help to fuel another hydro "gold rush".

## **COLLABORATIVE PRACTICES**

The progress towards a low carbon economy holds huge potential for those involved in the renewables industry. New skills are evolving amidst new technologies, which are helping to create the tools and equipment needed to fully benefit from the UK's ample renewable energy resources. Unfortunately however, one of the principal obstacles to further developing the sector is lenders' aversion to risk and their reluctance to invest in what are seen as nascent technologies, such as wave and tidal.

In order to circumvent the funding challenge, the industry is seeing a trend towards working collaboratively – larger companies with strong balance sheets are partnering with smaller

companies that are developing new technologies. Joint venturing in this way has many benefits including: increased resources, access to a larger skills and talent base, reduced commercial risk with liabilities being shared amongst the parties, and broader routes to market.

Careful consideration should be given to the most appropriate vehicle to use. The most common options are to set up a purely contractual alliance/partnering arrangement, or to use a company or a limited liability partnership established for the sole purpose of operating the joint venture (JV). Whilst all of these involve parties coming together in business, there are important differences, which reflect varying degrees of integration of the interests of the parties.

### **Contractual Alliances**

The contractual arrangement is in many ways the most straightforward as it does not involve establishing a new vehicle or the transfer of any property or assets to it by the parties. This enables the parties to pool their resources and assets whilst still remaining independent of each other from a legal, tax and accounting perspective. However, as the nature of their relationship and their respective rights and obligations in relation to the JV are solely based in contract, the terms of the JV agreement/alliance agreement are of fundamental importance and require very careful and detailed consideration. This type of arrangement is very common in the oil and gas industry where developers enter into joint operating agreements to explore and extract oil/gas but is less common in other sectors.

Amongst other things, care must be taken to ensure that the JV agreement is drafted correctly to avoid any unwanted legal consequences, for example the parties would usually wish to avoid a partnership inadvertently being created, as partnerships could give rise to joint and several liability for the parties, a notion which would cut across them remaining separate entities.

### **Company**

A limited company can be set up for a specific project allowing the venturing parties to become shareholders to benefit from the limitation of liability afforded by a private company structure. As a separate legal entity the company will be able to contract and hold property. The SPV structure is relatively formal, requiring shares and detailed provisions regarding share capital structure, share transfers etc to be implemented to govern the relationship between the shareholders (which are usually covered in articles of association in addition to the provisions set out in the Companies Act 2006). Under the SPV route, the sharing of profits (and liability for costs and losses) is determined by reference to shareholding/capital interests.

The company will be subject to the usual regulatory, reporting and accounting requirements under the Companies Act 2006 and related legislation.

### **Limited Liability Partnership (LLP)**

In many respects similar to a private company, a Limited Liability Partnership (LLP) is a corporate body with a separate legal personality. It can contract and hold property, and the members have limited liability in respect of losses and liabilities of the business.

An LLP combines the organisational flexibility and tax status of an unincorporated partnership with limited liability for its members. However, it must comply with a range of annual reporting requirements, similar to those of private companies.

The LLP is a more flexible vehicle in many ways, as there is no share capital and the structuring of the members' capital and profit sharing arrangements is a matter of contract to be set out in the LLP Agreement (not dissimilar to a shareholders agreement).

## **Which structure is for you?**

The structure used will to a great degree be dictated by the individual circumstances, and whether or not the LLP tax regime or the corporation tax regime is more beneficial is something that requires to be looked at on a case by case basis. This may be less important if the two parties working together are companies as opposed to individuals, but there are still instances when even contracting companies can benefit from careful structuring.

If one or more of the parties are individuals, there may be tax advantages in using an LLP given its tax transparency where essentially profits and gains in the LLP are treated as profits and gains of the members themselves. Under a company structure the company is taxed on profits or gains under the corporation tax regime at either 21% or 28% (depending upon the level of the company's profits). Any dividends declared out of distributable profits are then subject to higher rate (but not basic rate) income tax in the shareholder's hands, thus giving rise to an effective double tax charge for shareholders who are individuals.

In addition, due to the tax transparency of an LLP, if one of the joint venture partners is placing property into the LLP and if structured correctly, an LLP can afford savings in respect of stamp duty land tax. Depending on the value of the property, this can prove significant.

Whilst the fundamental success or failure of a business enterprise is unlikely to turn on the vehicle employed, taking time to consider the most appropriate structure will certainly help to provide a framework that will facilitate rather than hinder the progress of the enterprise and minimise the risk of unintended consequences for the parties.

## **GRID INJECTION OF BIOMETHANE READY TO TAKE OFF?**

The Government's clear proposals to increase anaerobic digestion (AD) projects in the UK include plans to significantly increase the injection of biomethane from AD of biomass wastes and sewage sludge into the gas grid, as the most efficient way of using the heat generated from combusting the gas. The Renewable Heat Incentive (RHI) policy document has confirmed support levels for biomethane injection, but there are likely to be a number of other issues to be overcome before the Government sees the number of projects that it would like coming forward.

Currently, injection of gas into the grid in the UK largely means injecting large quantities of North Sea gas into the grid from a number of large terminals. The scale of these operations is significantly larger than the more distributed operations that will be necessary to deliver the injection of biomethane from AD processes into the grid, and as such a level of reconsideration, and ultimately deregulation, is likely to be necessary in order to reduce costs before such projects are truly commercially attractive.

The Gas (Exemptions) Order 2011 has just created a new category of exemption from the requirement for a gas transporters licence under the Gas Act for distributed gas injection, including injection of biomethane. This is necessary to cater for pipework owned by a producer of biomethane, which would otherwise require a gas transporter's licence to operate. This also raises a wider issue, namely that of ownership of equipment, including connections and grid injection equipment, as between the network operator and the producer of the biomethane. Another issue is that of payment for reinforcement of the network connection, with the current regime being based on "deep charging", whereby the party wishing to connect pays for any necessary reinforcement.

Yet another issue is the potential to alter the grid gas specification to cater for increased injection of biomethane. A derogation is currently required from the Health and Safety Executive where the oxygen content of the biomethane is over 2% – a requirement which seems unsustainable if such a concentration is commonplace for biomethane.

The successful injection project at Didcot has captured the industry's attention, and with some clarity creeping into the frame in the form of the RHI, it is crucial that the last pieces of the jigsaw are put in place. Grid injection of biomethane has the benefit of largely making use of existing infrastructure, in contrast to other ways of delivering renewable heat. However, the significant capital costs associated with the installation of gas measuring and monitoring equipment essentially designed to accommodate large scale North Sea gas injection will have to come down if we are going to see any real numbers of these types of project.

Both industry and Government will have to work together to understand the real barriers to grid injection projects, and to identify areas where deregulation may be appropriate. However, the introduction of the RHI has the potential to kick start a significant increase in grid injection projects, provided the momentum is kept up by the Department of Climate Change and Energy (DECC) in reviewing the regulatory requirements applicable to such schemes, and seeking to remove unnecessary burdens on producers of biomethane – whether financial or regulatory.

### **ANAEROBIC DIGESTION (AD) PROJECTS: MAKING THEM BANKABLE**

The Government has made it clear that it considers that anaerobic digestion (AD) can play a major part in the UK's drive towards a low carbon economy. However, despite huge interest in the sector from developers, landowners and funders, it is clear that uptake has been much lower than anticipated.

The unwillingness (or indeed inability) of banks to back renewable energy projects was once again highlighted by UK company Add Energy, which was forced to change its business model after its customers failed to secure finance.

Add Energy has developed a unique anaerobic digestion system aimed at farms, which enables animal or food waste to be used to generate up to 1 MW of electricity. It is estimated that under the current Feed-in-Tariff (FiTs) regime, farmers using the Add Energy system could earn around £100,000 p.a. from the electricity they generate. However, Add Energy, having received interest amounting to £18 million in potential orders had its efforts thwarted as banks refused to grant the necessary finance to its customers to allow them to buy into the technology.

Add Energy's new business model no longer focuses on looking for farmers to invest in the technology themselves, but instead seeks private investors interested in facilitating a lease of the technology (and equipment) to farmers to enable them to install the system on their land.

The Government has indicated its backing of AD, stating "We are working to facilitate a much greater uptake of anaerobic digestion by local authorities, businesses and farming. Our objective is to stimulate the growth of the technology by addressing barriers, and providing financial assistance and market support."

However, even with the Government's apparent backing, AD projects have not had the uptake that had been hoped, with particular disappointment being expressed over the lack of farm based AD plants taking advantage of the FiTs regime. As such, the Government is looking into the lack of growth in the AD sector and in particular, a review of the lack of FiTs for farm based AD plants has been sanctioned under the current FiTs review.

The Government noted as it announced the early FiTs review that there are currently only two AD plants accredited under the FiTs regime, showing that it is difficult for many AD projects to get off the ground. Many commentators have put this lack of uptake down to a lack of funding.

Funding, whether from banks or private investors, is hard to come by in the current climate, so what can you do to help ensure your AD project can obtain funding?

### **Waste supply agreement**

An AD system is of no value if there is no waste to be digested in it, and the security of supply of the waste feedstock is a key diligence point for any prospective funder of an AD project. To demonstrate the security of supply you will need a well drafted waste supply agreement. There are a host of issues that the agreement should cover but some of the key commercial matters from a funder's perspective include:

- what minimum quantities of waste are guaranteed, with associated penalties should these amounts not be met?;
- what type of waste do you require and to what specification?;
- if securing a supply contract prospectively, prior to the facility being constructed, how is pricing going to be dealt with amidst uncertainty over future prices, particularly for biomass wastes?;
- how do you future-proof your contract – what impact will incoming changes in waste and environmental legislation have? How will you adjust the price structure over time? Will it be linked to RPI/changes in landfill tax or other incentives?;
- how will risks be apportioned between you and your waste supplier and what limitations of liability are appropriate?; and
- what length of time are you contracted for and in what circumstances can the agreement be terminated by the supplier?

These aspects only scratch the surface of the matters which require to be covered in a waste supply agreement. Other issues that are likely to arise include due diligence on the waste supplier's ability to continue to meet their obligations under the contract, and the issue of quality of the waste feedstock being secured. This is particularly the case against a background of uncertainty over future waste feedstock composition, as increased source segregation and recycling change the make-up of residual waste, particularly from municipal sources.

Although you can never completely eliminate commercial risks in a waste supply agreement, if drafted properly it can ensure that you have the contractual certainty of a steady stream of waste or, should the waste supplier default, there are appropriate penalties imposed to compensate you. Either way, the waste supply agreement is a key aspect of any funder's due diligence in the context of an AD project.

### **Choice of equipment**

If you are intending to install equipment developed by another company, you should ensure that you undertake an in-depth analysis of the proven performance of the equipment in respect of your proposed waste streams. Third party evidence/testing results may be required.

Funders will want to ensure that the equipment supply contract contains appropriate specifications and performance criteria as well as ensuring that the equipment meets applicable regulatory requirements.

### **Technology**

Alternatively, if you are using your own technology, you should ensure that your intellectual property rights in the technology are adequately protected – a patented system will be preferable to a funder.

## **Planning and Permitting**

Finally, before you approach any funder, you should ensure that you have done your due diligence on planning and permitting in the context of your chosen site, and that you have a clear strategy in place for obtaining planning consent and all relevant permits. This is crucial to show the deliverability of your project, promoting the success of your scheme in the eye of the funder. If you are not the owner of the land on which the AD plant is to be developed then it goes without saying that a watertight land agreement should go hand in hand with the rest of your planning and permitting arrangements.

Experience has shown that difficulty in obtaining funding is one of the key barriers being faced in the context of AD, and you can make a significant difference to your funding prospects if you have addressed the issues highlighted above.

*The matters covered in this ebulletin are intended as a general overview and discussion of the subjects dealt with. They are not intended, and should not be used, as a substitute for taking legal advice in any specific situation. Semple Fraser LLP will accept no responsibility for any actions taken or not taken on the basis of this publication.*

**FOR FURTHER INFORMATION PLEASE CONTACT: BILL FOWLER**