ReedSmith

Grandfathering the Renewable Obligation: How the ROC market will continue following the switch to the Feed in Tariff system in 2017

17 August 2012

Authors: Richard A. Ceeney , Stefan Schmitz , Nicholas Rock

Despite regular reassurances from the UK Government that the RO system will be “grandfathered” in such a way as to keep the system operational and effective beyond 2017, the proposed closing of the RO scheme to new entrants and its replacement by the new FiT CfD[1] has caused unease amongst potential investors, who are concerned as to the value and stability of the RO system following the switch. This unease is not unreasonable: the value of ROC derives not from the ROCs themselves, but from the way that the RO system creates a demand and thus a market for the ROCs. How will that demand be maintained once large-scale renewable energy projects do not exclusively fall within the RO pool, and once generators can meet renewable energy targets through FiT CfD projects? Will existing projects maintain their value following the 2017 switch, and for the duration of what is often (for large-scale wind and solar projects) an anticipated project lifetime of at least 20 years? This alert explains how recent UK Government policy statements answer these questions.

Once the RO scheme has been closed to new entrants, it would need to adapt in order to remain viable and effective and to provide equivalent benefits, by making sure that there is still demand for ROCs and that money is paid into the redistribution[2] fund.

The current RO system sets the size of the Obligation as the higher of:

(1) a fixed target of a certain number of ROCs per MWh; or

(2) the anticipated renewable energy generation plus a 10% "headroom" to ensure that demand exceeds anticipated supply.

However, in 2017 the fixed target calculation would lose its relevance (or, at least, it would become wholly artificial) as a result of the existence of the two parallel regimes (the RO scheme and the FiT CfD) operating simultaneously – because the RO would itself no longer represent the entirety (and, in time, even the majority) of the UK’s renewable generation.

The UK Government has provided details on the proposed changes to the RO system following the 2017 switch. In doing so, they have divided the transition process into two stages – the period between 2017 and 2027, and the period beyond 2027.

The rationale for changing the principle in 2027 is an effort to leave the RO system as unchanged as possible for as long as possible. Until 2027, it is anticipated that there will be sufficient RO projects in existence for a viable and worthwhile marketplace for ROCs to exist;

however, by 2027, it is anticipated that a number of projects covered by the RO system would have dropped out of the system (having reached the end of their mechanical life) and would be significantly outnumbered by the renewable energy generation capacity of the FiT CfD sector; at that point, it appears that the UK Government has concluded that it would not be worthwhile to continue to sustain a market for ROCs.

For the intervening period, between 2017 and 2027, the UK Government plans simply to adapt the current RO system, by removing the fixed target calculation and instead using solely the second limb, of anticipated generation plus 10% headroom. That switch would ensure that demand for ROCs continues, with utilities continuing to maintain a share of their generation from renewable energy sources and continuing to pay penalties, which would then be redistributed, in the event that they miss their targets. As the 10% headroom will ensure that there will always be a gap and that demand for ROCs will always be higher than supply, ROCs should keep their value.

This would continue until 2027, at which point the plan is for the projects covered by the RO system to be transferred to a new, Premium Feed in Tariff system (distinct from the FiT CfD) in which it will fix the price of the ROCs for the remaining 10 years of the RO (i.e., until 2037) at its long-term value. The Government would buy the ROCs directly from the generators. This will reduce volatility in the final years of the mechanism. The long-term value of a ROC would be the buyout price plus 10% headroom as at 2027, and index-linked thereafter. This is intended to produce an equivalent benefit to the value generated by the ROCs.

This Premium Feed in Tariff would replace the ROCs, or the ROC element in a PPA, but (unlike Feed in Tariff systems in other countries, such as the EEG in Germany) would not constitute the whole payment under, or effectively replace, the PPA itself (hence the term "Premium"). The PPAs would still provide for income from the sale of electricity, augmented by the Premium FiT.

These plans are not set in stone. That said, the UK Government has consistently and repeatedly set out its commitment to "grandfathering" existing projects (so that the value of the RO system to existing projects is retained, even if incentives reduce for subsequent projects). This is a logical and necessary step, not least given the reliance that the UK Government places upon the energy market to provide the investment that the UK needs in order to meet demand; a failure to hold firm on pre-existing promises would significantly threaten credibility and therefore investment.

The specifics of the mechanisms may change (and the government is quite vague on these at the moment). However, based upon the information and policy produced by the UK Government to date, investors should have confidence that there should be no dramatic cut in incentive for existing RO projects.

---

[1] From 2014, large renewable energy projects achieving completion will be able to choose between receiving Renewable Obligation Certificates (ROCs) or the new Feed in Tariff Contract for Difference (FiT CfD), and in 2017 the choice will be removed completely, with the Renewable Obligation (RO) system closing to new entrants. FiT CfD accreditation will not be available for

projects completed before the FiT CfD becomes available: it will not be possible to switch an existing RO project to the FiT CfD system when it opens. Therefore, for projects accredited to the RO system, it will be the RO system that applies throughout the project's lifetime.

[2] The fund into which all penalties are paid and which is re-distributed among the ROC holders

About Reed Smith

Reed Smith is a global relationship law firm with more than 1,600 lawyers in 23 offices throughout the United States, Europe, Asia and the Middle East.

This Client Alert was compiled up to and including July 2012.