Reform of the power sector

The implications for allocating capital

BIEE Conference: Financing the Energy Transition
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Reputation built on Results

Introduction to Baringa

- Baringa Partners LLP is a market-leading consulting company with a **focus on energy, commodities and financial services**

- Founded in the UK in 2000 – Baringa Partners has a market turnover of **approximately £60m, with 300 professionals.** Our **German branch office** was opened in 2011 to increase support of our clients in central and eastern Europe

- Baringa Partners has a strong track record working with numerous companies in the international commodities trading markets – our capabilities and experiences extend across Oil, Gas, Power, Coal, Carbon and Soft Commodities; our clients comprise **Oil Majors, Utilities, Investment Banks, Exchanges and Investment Funds**

- Through the recent **merger with Redpoint Energy** Baringa Partners has expanded its strategic advisory capabilities to serve **strategic projects and transformation projects at the interface between business and technology challenges** in the energy wholesale and retail domains.

Policy detail

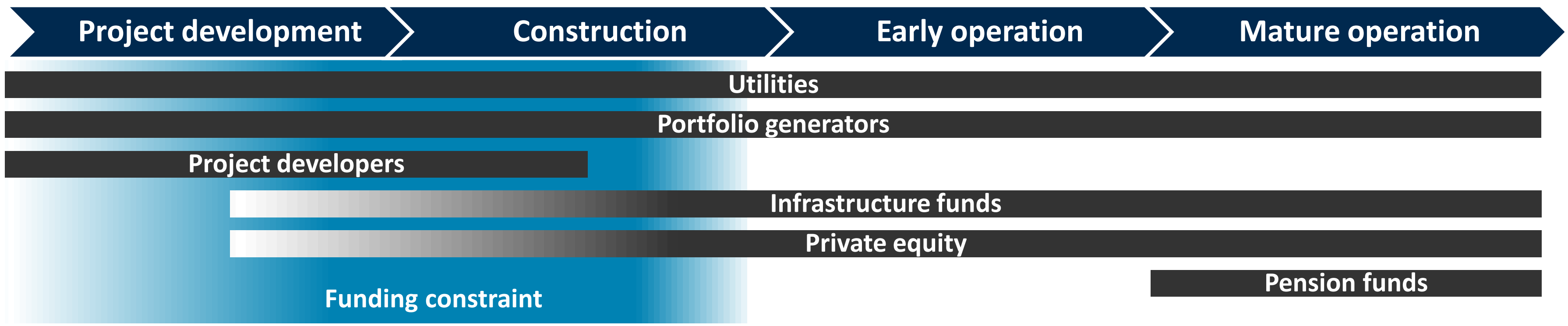
Increasing clarity on policy will lead to portfolios being rebalanced by existing investors and, potentially, to the arrival of new investors

Recent policy developments		Requirements of new investors	
CPS rates	▶ Confirmation of 2015/6 CPS rates in Spring 2013 increased confidence in pathway to 30 £/tCO_2 in 2020	**Understanding the market**	▶ Many new investors have little prior experience of GB or other liberalised markets
CfDs	▶ Draft strike prices published in June 2013 ▶ Further documentation – inc. draft contract – published in August 2013	**Learning from GB**	▶ Part of the rationale for investing is often to learn from GB experience as home markets are liberalised
Capacity Mechanism	▶ Latest CM straw man and detailed design docs published in June 2013 ▶ Indication of key parameters e.g. CONE	**Transparency on risk / reward balance**	▶ New investors more likely to make significant investments in GB as policy uncertainty falls
Electricity Balancing SCR	▶ Draft policy decision published in July 2013 indicating a move to marginal cash-out prices	**Structuring to transfer residual risks**	▶ Initially looking to limit risk to equity returns ▶ Deals are being structured to accommodate this

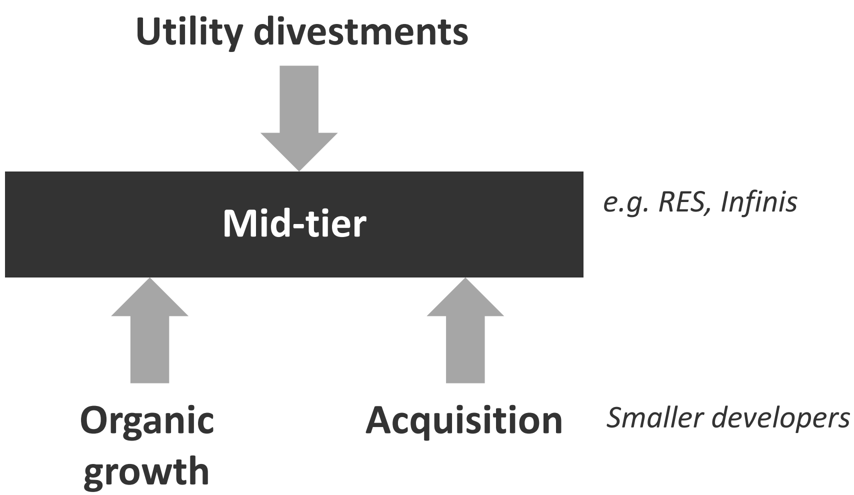
The emerging ‘mid-tier’

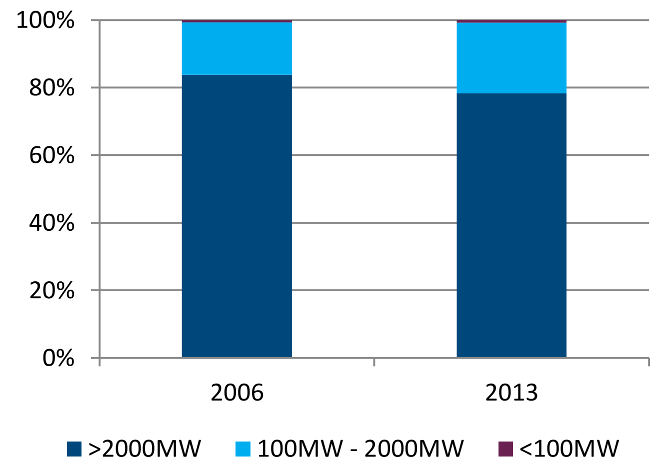
At the same time, new ‘mid-tier’ players are emerging, benefiting from the opportunity posed by the need for new investment

Equity funding is increasingly being sourced from a more diverse pool of investors



Recycling of capital, combined with the constraints on utilities, leads to growth opportunities for mid-tier players





Source: DUKES, Baringa analysis

Response of the VIUs

The large VIUs are more likely to dispose of assets, rather than to acquire assets

There are many factors constraining the capital allocation decisions of Europe's large utilities…

Market fundamentals

- Increasing renewables generation suppressing power prices
- High gas prices relative to coal, leading to low spark spreads

Adverse policy decisions in home markets

- Phasing out of nuclear in Germany
- Uncertainty over, or cuts to, renewables funding, sometime retrospectively

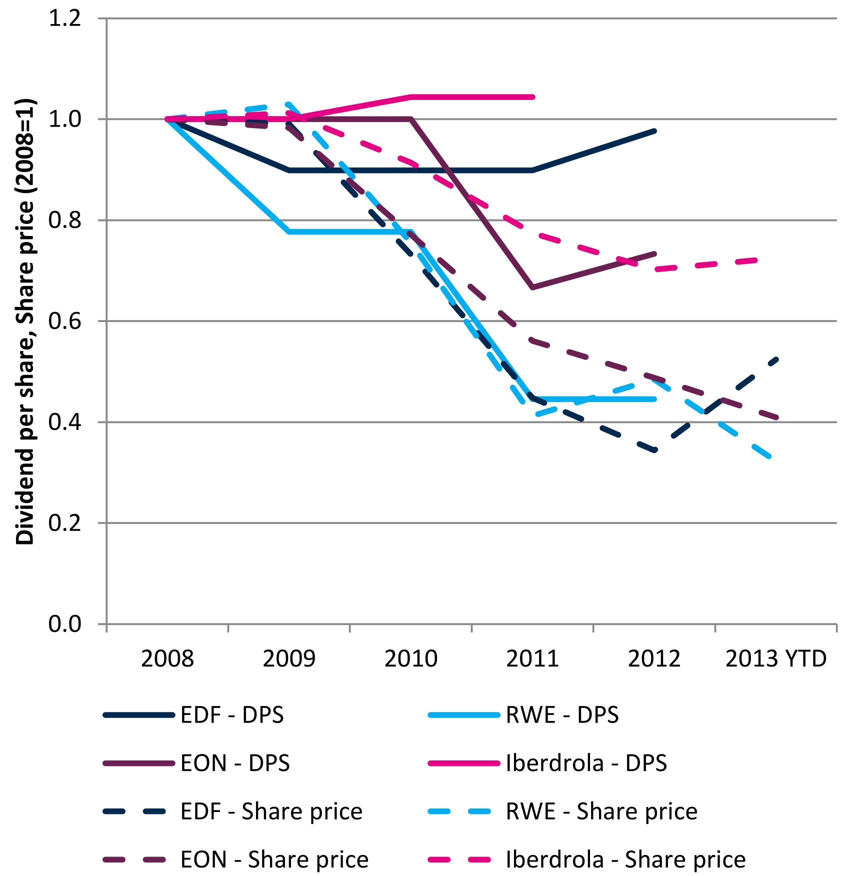
High debt servicing costs

- High gearing levels resulting from acquisitions made in a more favourable environment

Sale of non-core assets

- Sale of non-core assets to reduce debt burden and preserve credit ratings
- Sales and re-focusing likely to continue

…leading to poor performance of shares and little opportunity to raise new equity



Source: FT.com, Baringa analysis

Available capital

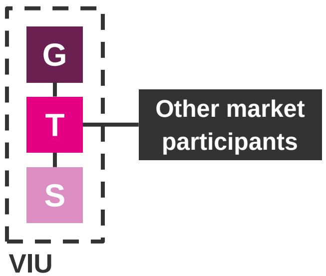
As transparency improves over the allocation of risk through policy and regulation, the role of each type of capital will become clearer

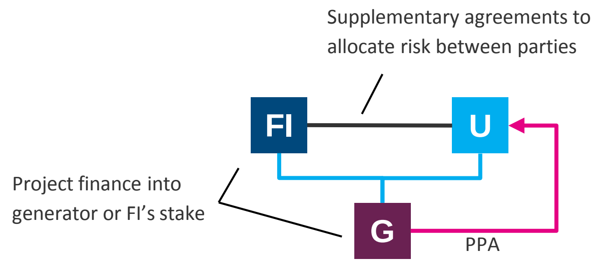
Funding source	Current share in GB	Trend	Current role	Future role
UK VIUs	●	↓	▶ Role through full project life cycle ▶ Often sole equity provider, with investment held on B/S	▶ Increasingly not sole investor ▶ Decline in share as a result of B/S constraints
European utilities	◐	↔	▶ Role through life cycle, but in particular through to construction	▶ Divestment requirements likely to limit growth in GB role
Non-European utilities and conglomerates	○	↑	▶ N/A	▶ Initially interested in regulated and/or low risk cash flows ▶ May be a candidate to take on additional risk as they gain confidence / experience
Private equity Sovereign wealth	◐	↔	▶ 3-5 year holding period ▶ Typically, but not exclusively, focused on operational assets	▶ PE holding periods increasing
Infrastructure funds International trading houses	◐	↑	▶ Focus on operational assets with tried and tested regulation and technologies	▶ Some willingness to take on additional risk ▶ e.g. already evident in onshore wind construction risk
Other financial investors	◐	↑	▶ Pension funds already invest e.g. where LT contracts are in place	▶ Initially limited to assets with good operating track record

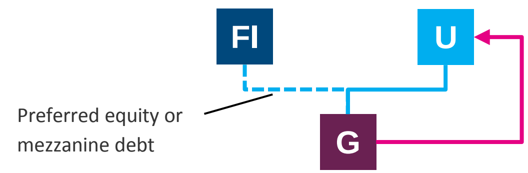
Evolutionary deal structures

Better optimised allocation of capital to match the allocation of risk and reward will continue to lead to more complex deal structures

Until recently VIUs drove the deals agenda	Increasingly innovative risk-sharing structures are being deployed	This could even lead to new tiers of capital







- VIUs essentially managing bulk of the market risk
- Other investors present but largely dependent on LT contracts (e.g. PPAs) that pass risk to the VIUs

- New investors take an equity stake, but heavily protected from e.g. market / technology / yield risk
- Risks taken on by utility, e.g. through PPA, OMA, SHA

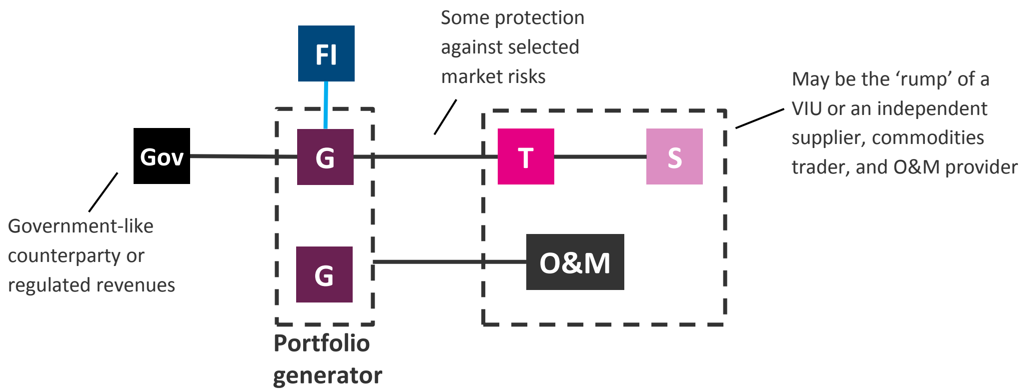
- Financial investors become increasingly familiar and confident with risks
- Heavily tailored contracting structures fall away, but investor still requires a 'preferred' stake

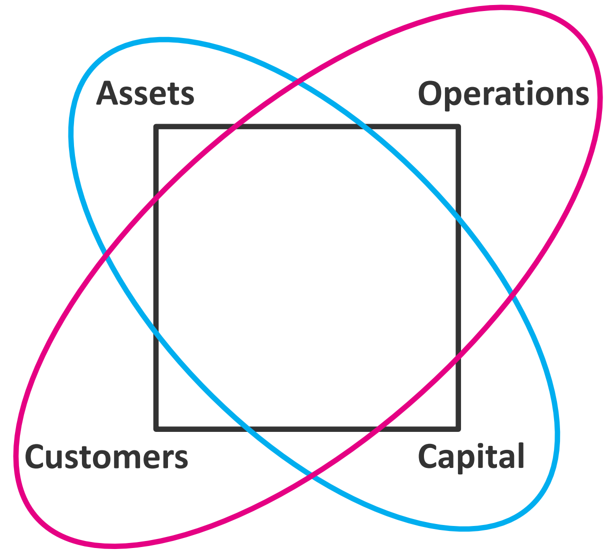
Key

- G Generator
- T Commodities trader
- S Supplier
- U Utility
- FI Financial investor
- Contracts or transfer pricing
- Ownership
- Energy flows

Revolutionary deal structures

Over time an optimal allocation of capital might lead to a fundamental change in the role of the utility





Increasingly regulated revenues could lead to a larger role for portfolio generators

- Much of the risk taken by VIUs will be transferred to consumers (e.g. through CfD, backstop)
- New investors may be able to get comfortable with the residual risk such that they can build portfolios with no utility investor
- Less risk is being transferred to the PPA counterparty, and the downside in the event of default is reduced, leading to a wider range of potential offtakers

This could lead to a change in the focus of a VIU

- Utilities have taken on a wide range of activities
- More efficient risk allocation might lead to other/new market participants raising capital to finance power generation assets
- Utilities might then excel in managing operational risk and customers

Setting deal criteria

All investors need to be clear on their strategic ambitions in a changing market

- New entrant investors need to…
  - Understand the residual risk in the market
  - Be clear on their appetite for taking on that risk
  - Set deal selection criteria accordingly
- Incumbent VIUs need to…
  - Revisit their business case for being vertically integrated
  - If this remains valid – determine how best to defend their generation market share
  - If not – determine what is ‘core’: what should I excel at?
  - Understand the implications for their shareholders

Thank you

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