KPMG

Long-duration storage and flexibility

Income Stabilisation Mechanism

Presentation of a potential design

Prepared by KPMG LLP for Drax Corporate Limited

CONFIDENTIAL

27 December 2021

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This Summary Report (the "Report") on proposals for an Income Stabilisation Mechanism for long-duration storage and flexibility has been prepared by KPMG LLP ("KPMG") in accordance with the specific terms of reference agreed between Drax Corporate Limited ("the Company") and KPMG and to address the scope of work outlined in Appendix 3.

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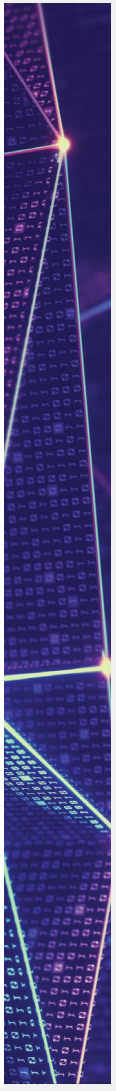
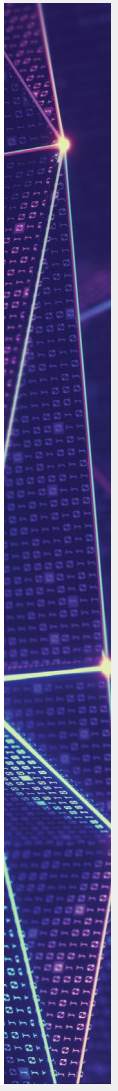


Key messages

- KPMG was retained by Drax Corporate PLC to investigate whether any market challenges existed that may limit the development of long-duration energy storage and, if those challenges existed what options may exist to address those challenges
- The GB energy transition to Net Zero by 2050 has the potential to result in the Electricity System Operator (ESO) having a greater requirement for flexible, long-duration[1] storage and dispatchable plant:
    - The level and profile of electricity demand is changing as result of increasing uptake of Electric Vehicles (EVs) and electric space heating;
    - Increased renewable generation, and its intermittency, has the potential to increase the ESO's requirement for dispatchable generation;
    - Flexible, long-duration storage has a role in managing these two trends.
- A limited number of market characteristics can present challenges to securing efficient finance for long-duration storage projects, specifically:
    - Revenue and cost uncertainty;
    - Long lead times for project development; and
    - High up front capital expenditure requirements.
- It is generally accepted that there are a number of options for market intervention to support flexibility and long-duration storage: including RAV models, contracts for Differences (CfDs), a modified form of the capacity mechanism, a cap and floor regime.
- An assessment of these available options using a set of selection criteria is presented on page 8. Based on this assessment while most approaches have some advantages, a cap and floor revenue support mechanism has the potential to be suitable for long-duration storage projects because:
    - It can address the market challenges described above without distorting the market;
    - It is an approach recognised by investors (and the regulator) given its application elsewhere in the sector (e.g. interconnectors); and
    - It would incentivise the asset to be operated in accordance with system need and maximum efficiency.
- A cap and floor mechanism will require a number of specific design features to reflect the nature of flexibility and long duration storage projects. Specifically:
    - Pass through the costs of charging/pumping;
    - Flexibility to reflect the different long-duration storage technologies; and
    - Ensuring revenue stabilisation does not reduce incentives to deliver market efficient outcomes.



1. We recognise that a formal definition of long-duration storage is yet to be formulated by BEIS and for the purposes of this analysis we regard long-duration storage as aligning with BEIS comment that "storage across days, weeks and months could greatly reduce the costs of reaching Net Zero" BEIS (2021) "*Facilitation the deployment of large-scale and long-duration electricity storage: call for evidence.*"

Net Zero is likely to require more flexible, long-duration storage

The level and profile of electricity demand is changing…

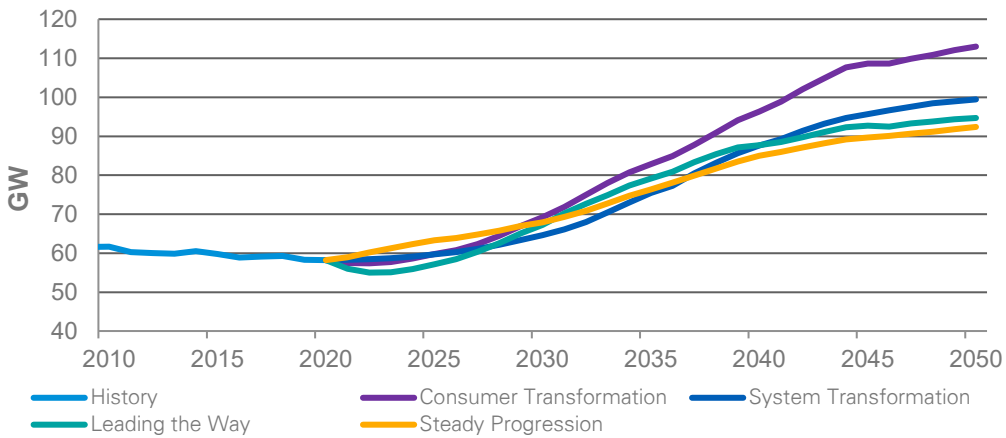
- Government's 10 Point Plan for a Green Industrial Revolution aims to accelerate deployment of Low Carbon Technologies (LCTs).
- The deployment of EVs and heat pumps in particular, is expected to accelerate over the coming decade and beyond and will impact peak demand.
- By 2050, peak demand is estimated (by the National Grid Energy System Operator - ESO) to be at least 30GW higher than current levels, and over 50GW higher in a world of high heat pump uptake·

… and the focus on renewable generation increases intermittency…

- Government is targeting 40GW of offshore wind capacity by 2030.
- Increasing wind capacity and reductions in capacity of other dispatchable plant has the effect of making less dispatchable generation available to the ESO (see right)
- Greater variability of demand on the transmission network will emerge, resulting from some renewables being connected to distribution, exacerbating the balancing challenge for the ESO.

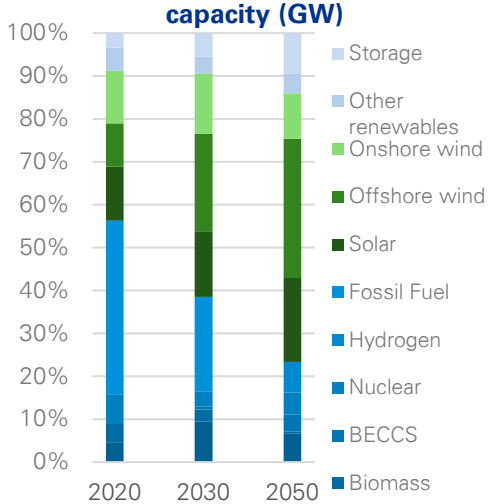
ESO balancing costs are already increasing to manage the situation: Year-to-date balancing costs in 2020-21 stand at £1.68bn; close to 30% higher than 2019-20 and over 40% higher than 2018-19.

Electricity System Peak Demand Scenarios



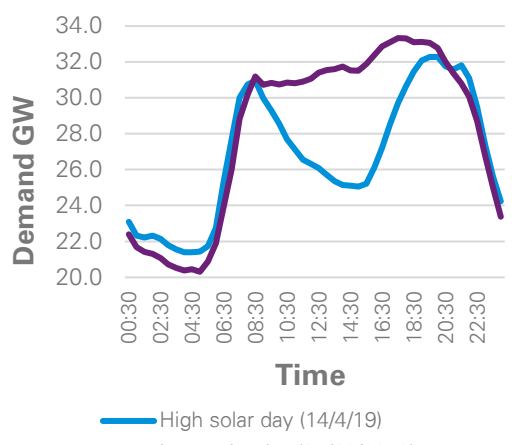
Source: National Grid ESO, Future Energy Scenarios 2021, Data workbook, FL.4

Installed electricity generation capacity (GW)



Source: KPMG analysis and National Grid ESO, Future Energy Scenarios 2021, Data workbook FL.13 and SV.22

Transmission System Demand – high-solar vs low-solar day



Source: National Grid ESO, Summer Outlook Data Workbook 2020, Figure 4 Embedded Solar

Net Zero potentially requires more flexible, long-duration storage

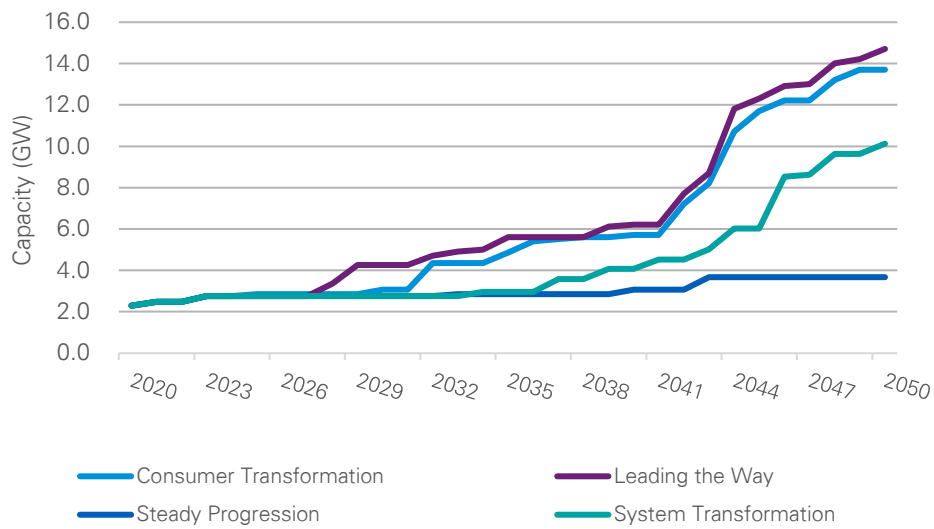
The ESO is already forecasting an increasing requirement for long-duration storage

- National Grid Future Energy Scenarios (FES) projects an increase from 2.8 GW storage capacity today to between 4.5 GW (Steady Progression) and 15 GW (Leading the Way) by 2050. This is additional to Vehicle to Grid (V2G) or battery storage.
- In the ESO FES analysis, 37-45% of storage (GW) is modelled as long-duration storage, with an additional 1.5 GW of pumped hydro needed by early 2030s.

Long duration storage also has the potential for system wide economic benefits:

- Long-duration storage and flexibility, such as Pumped Storage Hydro (PSH), can help the ESO manage the system (and keep costs to consumers under control) in a variety of different ways, including by providing stability services and by reducing the curtailment of wind.
- According to Imperial College, investment in long-duration flexibility can help to reduce total system costs by between £44m and £316m per annum by 2050, depending on the amount and location of long-duration flexibility deployed.

Storage capacity (GW) – ESO Future Energy Scenarios



Source: KPMG analysis of National Grid ESO, Future Energy Scenarios 2021, Data workbook, FLX1

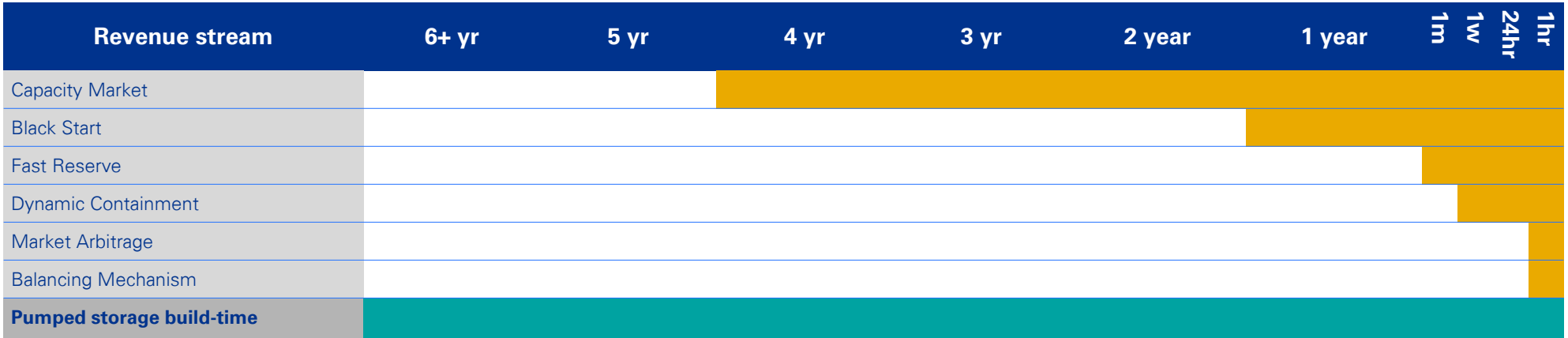
Market challenges may limit financeability of long-duration storage

Potential barriers to successful financing and delivery of long-duration storage

Barrier	Description	Implication for project
Revenue uncertainty	Revenues from the provision of flexibility and long-duration storage services can be uncertain and volatile with no longer term certainty regarding the levels of likely revenues.	In assessing whether to provide debt financing for a project (and at what cost) debt providers analyse what are likely to be the minimum available cashflows from the project available to cover the interest payments on any loans due. Variable or uncertain revenues or costs may result in uncertainty over cashflows available to service any debt in the project which may explain why such projects have faced challenges securing finance to date.
Cashflow uncertainty	Long-duration storage projects (such as PSH) face variable costs of charging, such as pumping of water back up to the reservoir. The price of the energy to do this is driven by the market, can be highly variable and therefore also has an effect on the uncertainty of cashflows.	
Long project development lead times	For some long-duration storage projects (such as PSH) there can be long project development lead times (e.g. 5 to 7 years) and over this period it is not certain as to what revenues the developer will earn once operational (see below.)	Without an understanding of the likely revenue profile, lenders may potentially be unwilling to provide debt finance to project developers.
High capital requirements	New-build long-duration flexibility is capital intensive. On its own the cost of new-build long-duration flexibility is high. On its own this is not an investment barrier. However, a high capex requirement compounds the revenue uncertainty and cashflow uncertainty and further increases the risk profile of the project.	Projects with high capital costs combined with revenue and cashflow uncertainty are likely to have a risk profile which exceeds the level of risk at which investors or lenders are willing to provide finance[2].

[2] Ofgem *"Cap and Floor regime: unlocking investment in interconnectors."*

Existing support mechanisms do not align with the development timescales for some long-duration storage such as PSH



Potential approaches to address the market challenges

- Based on existing literature and our understanding of the GB energy market, we identified existing regime types with potential to address the investment barriers identified on the previous page;
- The four shortlisted options are described in the table to the right
- We also considered:
  - A '***Market-only' model***: this would have the potential to perpetuate the financing issues for long-duration storage that we observe today; and
  - ***Directly funded grants,*** these did not necessarily have the potential to meet Government value for money criteria.

Potential revenue support regimes subject to evaluation

Regime Type	High-level description
Contract for Difference	If wholesale power prices fall below a defined level during certain time periods, providers receive a £MWh strike-price for electricity discharged onto the system.
RAV Model	Long-duration storage assets become directly regulated with allowed revenues determined by Ofgem based on a Regulated Asset Value (RAV) and a regulated allowed cost of capital.
Reformed Capacity Market	The existing capacity market (CM) could be reformed to send stronger long-term price signals for low-carbon flexibility. This could include a new T-[x] auction for technologies with longer lead times. It could also include split auctions allocating low carbon capacity first, allowing a potentially higher clearing price.
Cap and Floor	Revenues (or margins) are subject to minimum and maximum levels. Below the 'floor' customers would top-up revenues, and earnings above the 'cap' would be returned (in whole or in part) to customers.

Assessing the approaches: framework

Below is the framework we used to evaluate the four options to identify a preferred regime type to overcome the financeability challenges facing capital intensive long-duration storage and flexibility projects. This assessment framework is based on a range of published Government and Ofgem documents regarding the selection of appropriate energy policy options[3].

A suitable regime must…	… be deliverable and effective at bringing forward new long-duration storage and flexibility…	… take into account market fundamentals…	…align with wider government energy and economic policy objectives.
Demonstrate that the proposed regime for long-duration storage and flexibility can meet requirements of policy-makers, investors, and customers	**Complexity (and cost) to establish** Regimes which are complex and costly to develop are less likely to gain traction; unless they have a clear and significantly better benefits case than alternatives.	**Risk apportionment** Allocation of technology and delivery risk should be appropriately distributed across consumers, industry and government.	**Achieving value for money** Costs to implement and run must be outweighed by benefits to consumers through lower bills; can include through long-term economic benefits of a low carbon economy.
	Facilitate system needs The regime needs to support new projects in a way that maximises delivery of future system needs. This is core to justification of the case for intervention.	**Incentivise efficiency** Compatible with price signals that promote short run efficiency (best utilisation of existing assets) as well as low long run marginal cost in new technologies.	**Advancing the low carbon economy** In the places which stand to benefit the most by boosting productivity and driving regional growth.
	Address the market challenge The regime and design need to effectively address the market failure – i.e. solve the problem faced by long-duration storage projects.	**Competitive pressure** The regime should reveal the best solutions and should be: technology neutral; compatible with competitive tendering; have a pipeline of potential participants.	**Levelling up: Jobs & Investment** This transition to Net Zero provides Government with a real opportunity to invest in regions across the UK to grow jobs and investment.
	The first three criteria regarding effectiveness and deliverability are treated as 'essential'. Any regime-type scoring a 'red' against one of these is considered not suitable, irrespective of how it scores against the remaining criteria.	**Avoid market distortions** The GB power market has multiple existing and overlapping market frameworks. This regime needs to interact with these without inefficient or distortive market behaviours.	**Maintaining security of supply** Protecting the delivery of energy to consumers is a welfare issue which transcends cost and decarbonisation challenges on the political agenda.

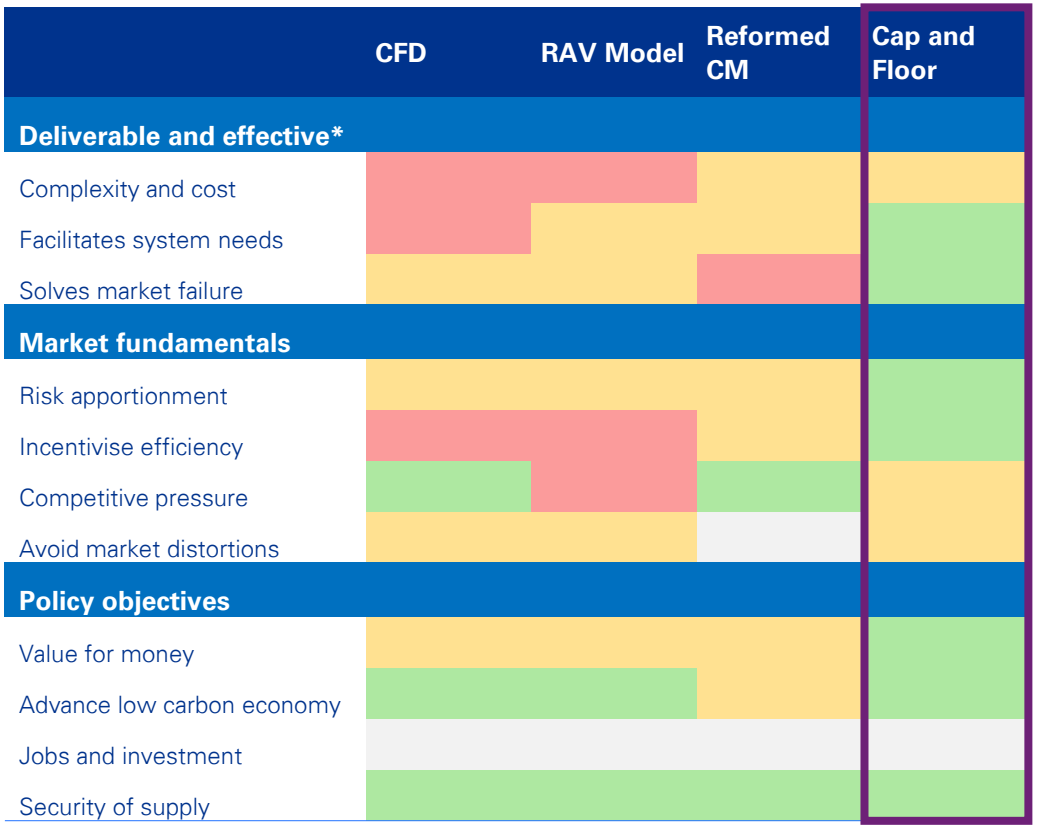
3. See BEIS (2021) "*Facilitation of the deployment of large-scale and long-duration electricity storage: call for evidence.*", Ofgem "Cap and Floor regime: unlocking investment in interconnectors and HM Government (2020) "The 10 point plan for a Green Industrial Revolution."

Assessing the approaches: findings

A Cap and Floor income stabilisation mechanism has a number of characteristics that have the potential to address the market challenges facing capital intensive long duration energy storage projects. The basis behind our analysis is summarised below.

- The **Cap and Floor** regime has the potential to provide sufficient certainty to investors that income will cover the cost of debt which has the potential for unlocking finance for new projects to go ahead.
- While a reformed **Capacity Mechanism** can provide stable minimum revenue streams, it is not the preferred option because CM-payments appear unlikely to be sufficient to service debt costs for large-scale investment (see the summary of our analysis on page 14.)
- The **RAV-model** may be unlikely to provide sufficient incentives for asset operators to respond to market signals and carries minimal competitive pressure to drive efficiency.
- **Contract for Difference (CFD)** has the potential to be unsuitable because this type of regime typically incentivises export of power irrespective of market conditions and therefore may not reflect the operating characteristics (or value) of storage assets. Equally a Dispatchable CFD (as being considered for Power CCS projects) is likely to be overly complex and risk market distortion.

Summary of assessment of income support mechanisms



**The deliverability and effectiveness are treated as 'essential' criteria. Any regime-type scoring a 'red' against one of these is considered not suitable, irrespective of how it scores against the remaining criteria.*

Key to assessment framework

Rating	Description
High	Regime type strongly aligns with the criteria. Or, where the regime type does not align with the criteria, potential mitigations are easily identifiable.
Moderate	Regime type does not fully align with the criteria but mitigations are possible. However, potential mitigations may either only partially resolve the issue or may be complex to implement.
Low	Regime type does not align with the criteria and suitable mitigations not readily identifiable.
Neutral	The regime type neither algins with nor undermines the criteria relative to the status quo.

Developing cap and floor for long-duration storage

The Cap and Floor regime currently in operation for interconnectors has been successful in attracting private sector investment into the sector.

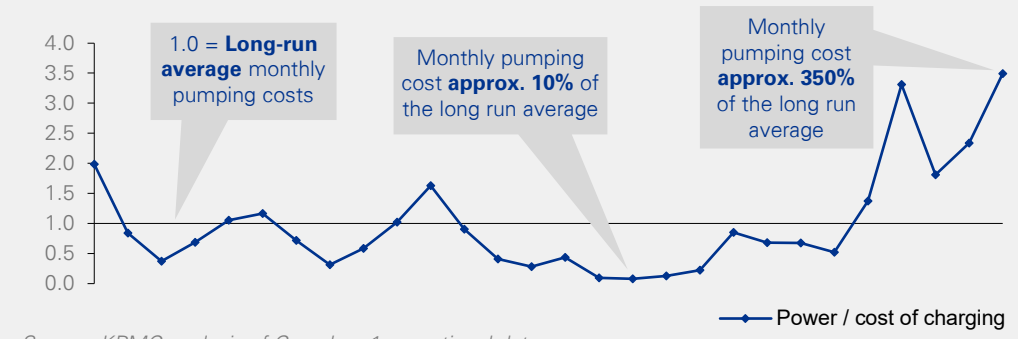
A similar regime would be beneficial in facilitating investment into long-duration storage and flexibility.

However, there are specific design issues to consider:

- **The costs of "charging" storage, should be excluded from the Cap and Floor and netted off from revenue.** This is because these costs tend to be determined by the market and are therefore unpredictable. This cost unpredictability (shown for Cruachan 1 in the figure to the right) together with volatility of revenue is unlikely to secure finance.
- **The assessment framework for projects in their development phases and eligibility criteria need to be specified with an element of flexibility to adapt to the wide range of available long-duration storage** and flexibility solutions that could be made available under the scheme.
- **A mechanism (a 'system efficiency incentive') will be needed to incentivise** operators' to ensure efficient operation of the asset and maximising system and consumer benefits.

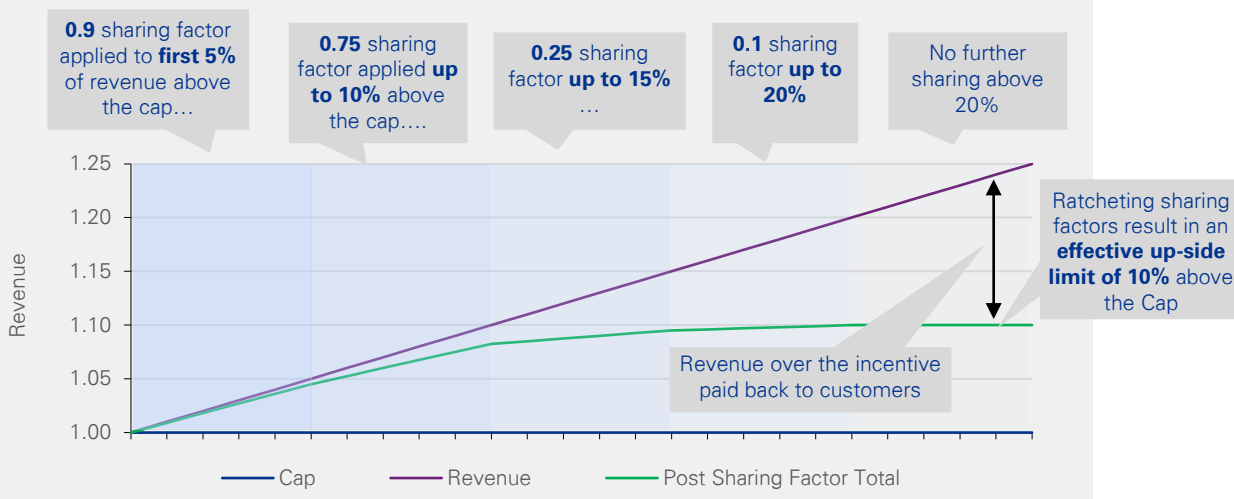
A framework of this design is likely to significantly increase the potential for projects to access cost effective debt funding and allow the project development to move forwards.

Variability of 'charging costs' for pumped storage hydro



Source: KPMG analysis of Cruachan 1 operational data

Sharing factors provide a finite incentive above the cap



Source: KPMG Analysis

Summary design of the cap and floor regime

Recommended key characteristics of a Cap and Floor regime for long-duration storage and flexibility

Aspect	Description
The basics	
Objective of the regime	• Regime seeks to de-risk large scale, capital intensive long-duration flexibility projects.
Regime length	• 25-years
Reconciliation	• Annual reconciliation of revenue against the Cap and Floor
Eligibility	
Capital intensive	• Minimum capital intensity of £0.5m/MW
Large-scale	• Minimum response capacity 100MW (*indicative, pending further assessment of system need*)
Longer-duration	• Minimum response duration of at least 5-hours
Low Carbon	• Maximum 0g CO2/kWh carbon intensity of direct emissions when exporting to the grid
Flexible response	• Maximum response time to full-output not more than 15mins
Assessment and award process	
Process	• Three stage assessment process administered in application windows by Ofgem
Assessment	• Projects require individually positive cost benefit analysis results (CBA) as well as collective positive CBA for all projects within the window
Cap and Floor	
Cap	• Revenues recover capex, opex and an allowed cost of equity (with system efficiency incentive above the cap)
Floor	• Provides recovery of debt service requirements
'Net off' charging costs	• Developers protected from volatility of costs to 'charge' storage assets
Availability and incentive	
Availability target	• Minimum availability target of 75%
Penalty for low availability	• No floor payments in years where availability target not met
Investor protection	• Loan scheme available to cover cost of debt if floor payments not received – up to a limit of 4x the floor level
System efficiency incentive	• Up to 10% incentive above the cap to maximise system benefits – shared with consumers through sharing factor

More detail on subsequent pages.

Implementation

The regime would be awarded to projects via an administrative process led by Ofgem.

- We are proposing that the award process would include three stages, similar to the existing interconnector cap and floor regime:
    - Initial assessment;
    - Cost assessment; and
    - Post-construction review.
- An administrative process is likely to be more appropriate:
    - Long-duration projects tend to have diverse characteristics making competition challenging; and
    - Ofgem would assess the cost benefit of the proposed projects to ensure alignment with the regime objective and value for money to consumers.
- The regime would be available to developers through application windows to be set by the regulator.
- The award process would be supported by annual reporting both during the construction and operation phases.
- Aligning the implementation of a cap and floor regime for long-duration storage with existing regimes (such as for interconnectors) has the advantage of being understood and trusted by developers and investors.
- The implementation of the process will be subject to delivery of legal and regulatory approval.

Summary

- The cap and floor regime may offer a relatively straightforward solution to the current market challenges;
- It may have the potential to de-risk investment, enabling cheaper financing, without unduly favouring or subsidising a particular asset type; and
- It is complementary to the existing market framework, avoiding distortion and incentivising efficient system outcomes.

A1

Appendix

Cap and Floor versus Reformed Capacity Market

A Cap and Floor is expected to be a more economic and effective means of supporting long-duration flexibility than a reformed CM.

We understand that there is an increasing debate in the industry and with policy makers as to whether modifications to the existing CM would be a sufficient long term solution to the issue of revenue support for long-duration storage. Further development of the CM to reflect the changing requirements of the energy market is likely to be necessary given the extent and nature of the changes required to deliver Net Zero by 2050. In the specific case of support for long-duration flexibility, there are additional merits associated with a revenue Cap and Floor (which is complementary to the CM) compared with a CM-only approach. These are set out below.

	Reformed Capacity Mechanism	Cap and Floor
Solves market failure	• Long-duration flexibility can provide a range of services but may not be able to bid economically into a capacity mechanism at a price that is cost effective on a capacity-only basis. As such, long-duration would not necessarily receive support in a competition design to procure capacity at lowest cost. • This is demonstrated by the fact that existing clearing prices have been insufficient to address the market failure of providing the revenue certainty required to unlock financing for long-duration flexibility projects. • Addressing this draw-back would impact on the value for money delivered through a capacity mechanism.	• Under a Cap and Floor, only the absolute minimum level of underwriting is provided by customers to enable financing requirements to be met. • The regime is set on the basis that assets are competing across multiple revenue streams – including provision of capacity. This provides improved value for money for customers compared with relying solely on the capacity mechanism. • In addition, the 25 year time horizon of the proposed Cap and Floor also spreads the underwriting of the capital costs over a longer period, reducing the potential burden to customers in any single year.
Value for money	• A reformed capacity mechanism could be developed to enable long-duration flexibility to compete successfully (for example through separate auction pots - similar to the CFD 'Pot 2'). This would result in a higher clearing price for these technologies. • This could enable a clearing price that is high enough to meet the minimum requirements for financing. However, in years where other non-capacity revenues streams are sufficient, consumer payments under the CM to long-duration flexibility would be uneconomic (i.e. consumers would be overpaying for the capacity procured through the CM).	
Facilitate system needs	• A capacity mechanism is focused on ensuring the provision of sufficient capacity to meet peak demand. Therefore, an efficient CM would not bring forward any flexibility of greater than 4 hours, unless high de-rating factors are applied across the curve.	• The proposed Cap and Floor approach targets those projects that have the technical capabilities to provide a range of system benefits and actively appraises the value of these to consumers through the CBA and Ofgem-led assessment process.

A2

Appendix – Potential design blueprint

Potential income stabilisation mechanism

Mechanism Design	Summary
Objective of the regime	• Regime seeks to de-risk large scale, capital intensive long-duration flexibility projects.
Eligibility requirements	• Capital intensive: Minimum capital intensity of £0.5m/MW • Large-scale: Minimum response capacity 100MW (*indicative; pending further assessment of system need*) • Longer-duration: Minimum response duration of at least 5-hours • Low Carbon: Maximum carbon intensity of 0g CO2/kWh • Flexible response: Maximum response time to full-output not more than 15mins
Assessment and award process	• Three stage assessment process administered in application windows by Ofgem; (1) Initial Assessment, (2) Cost Assessment, (3) Post-construction Review • Projects require individually positive CBA as well as collective positive CBA for all projects within the window
Regime duration and start dates	• Regime length of 25 years • Regime starts at the earlier of the full commissioning date, or 12-months after the planned commissioning date
Setting the Cap and Floor	• Cap and Floor levels to be set *ex ante* (finalised at Post Construction Review) • Annualised and flat in real terms to provide consistent levels over the life of the regime • Cap and Floor set on the basis of the established building blocks approach (with an incentive on efficient outcomes at the cap)
System efficiency incentive	• Up to 10% incentive above the cap to maximise system benefits – shared with consumers through sharing factor
Relevant revenues	• All revenues earned by projects to be considered relevant for purposes of comparison to the Cap and Floor levels • This includes; Wholesale market arbitrage; Capacity Market; Balancing Mechanism; Balancing Services and other Ancillary Services.
Cost of Debt (returns at the Floor)	• Two approaches to cost of debt available for developers to identify at the Initial Assessment • 'Actual' and 'Notional' Cost of Debt approaches available
Cost of Equity (returns at the Cap)	• Cost of Equity calculated on basis of the established CAPM approach • Project specific considerations (incl. Betas) to be applied
Refinancing	• A refinancing gainshare of 50:50 in place for projects which opt for the 'actual' cost of debt approach

Potential income stabilisation mechanism

Mechanism Design	Summary
Availability	• Availability Target of 75% • No floor payments available in years where availability target is not reached
Force Majeure	• Unforeseen costs beyond the developers control may be added to the Cap and Floor levels following an ex post review by Ofgem
Depreciation	• Straight-line depreciation over 25-years of the regime • Depreciation fully recovered within the regime period
Assessment period	• Annual reconciliation against Cap and Floor levels
Regulatory reporting	• Annual submission of costs and progress against timelines during construction • Annual submission of revenue and availability data for reconciliation assessment • Reporting on charging costs (e.g. pumping costs for pumped storage hydro)
Decommissioning	• Cost assessed ex ante and included in Cap and Floor levels • Re-opener only in the event of legislative change
Tax	• Allowance included in Cap and Floor levels ex ante • Re-opener only in the event of legislative change

Potential income stabilisation mechanism

Area of uncertainty	Uncertainty Mechanism
Variable opex volatility	• Pumping costs netted-off revenue before determining performance against Cap and Floor levels through annual reconciliation.
Non-controllable costs	• Pass-through. *Ex post* adjustment of Cap and Floor levels through annual reconciliation based on actual costs incurred.
Decommissioning	• Re-opener. *Ex ante* allowance; a review may be triggered by legislative change.
Tax	• Re-opener. *Ex ante* allowance; a review may be tiggered by legislative change.
Availability	• *Ex post* review through annual reconciliation. Adjustment by actual availability for 'Exception Outages' and 'Allowed Outages'.
Force Majeure	• *Ex post* review through annual reconciliation. Adjustments to Cap and Floor level for efficiently incurred unforeseen costs beyond developers control.
Refinancing	• Gainshare applied through annual reconciliation. (Only applicable under 'actual cost of debt' approach).

A3

Appendix – Scope of services and basis of preparation

Scope of services summary

KPMG was retained by Drax Corporate PLC to investigate whether any market challenges existed that may limit the development of long-duration energy storage and, if those challenges existed what options may exist to address those challenges

Step	Scope
Mobilisation meeting	- Confirm timelines and form of deliverables - Confirm key contacts and internal stakeholders

Part 1: KPMG to prepare an independent analysis of:
i. the extent to which changes in the GB energy market could impact the demand for long-duration storage and flexibility;
ii. identify potential market challenges to the provision of that flexibility; and
iii. Identify options for addressing those challenges.
	- Analysis by KPMG regarding:
	  - Case for longer-duration flexibility
	  - Existing challenges to investment
	  - Options and assessment criteria for potential stabilisation mechanism.
	- Short summary document covering the following:
	  - Existing challenges to investment
	  - Objectives for the new stabilisation mechanism

Part 2: KPMG independent assessment of the relative merits of the different options for addressing those challenges from an energy market perspective.	- KPMG prepare detailed proposals for design of the new support mechanism - Overview of market impacts and potential mitigations
Draft Report and Power Point	- Draft KPMG report - Prepare 10-12 page KPMG summary of key findings

Basis of Preparation

Disclaimer

This presentation summarises KPMG's findings to assist Drax in determining design proposals for a income stabilisation mechanism for long-duration flexibility. This report has been prepared on the basis set out in the Agreement Letter (19 April 2021).

Our work was conducted between April and May 2021 and this document prepared in June 2021 as part of our overall engagement to provide a report on the design for a proposed income stabilisation mechanism.

This presentation has been prepared solely in connection with and for use in accordance with the terms of our Agreement with Drax. This presentation is provided on the basis that it is for Drax's information only and that it will not be copied or disclosed to any third party or otherwise quoted or referred to, in whole or in part, without our prior written consent.

Limitations

We have not verified the reliability or accuracy of any information obtained in the course of our work, other than in the circumstances set out in the Agreement dated 19 April 2021. We have indicated within this report the sources of the information provided. We have not sought to verify independently those sources unless otherwise stated within the document.

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