

The proposed LT2 RFP: Strategic challenges, system needs and other musings

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Overview

With the global [energy transition](#) well underway, new electricity generation construction is booming. In 2023, a record ½ million MW of solar and wind assets were installed globally. By 2030, a staggering minimum of 1 million MW of generation is expected to be added annually on a global scale. This massive uptick in demand for new electricity generation has profoundly impacted the global supply chain for renewable energy, particularly wind and solar. Amid this international surge in demand, Ontario's Independent Electricity System Operator (IESO) has recently completed the Long-Term 1 (LT1) RFP and will soon be commencing the Long-Term 2 (LT2) RFP procurement process.

[Pelino Colaiacovo](#), Managing Director at Morrison Park Advisors, spoke with [John Vellone](#), Partner and National Leader of Energy, Resources and Renewables Sector at BLG, in the first installment of BLG's web series in collaboration with the [Association of Power Producers of Ontario](#) on May 14 to discuss the LT2 RFP, share insights into the questions and uncertainty it raises and explores the risks and opportunities this program may provide for developers, producers and financiers.

Background

The Province of Ontario is emerging from a period of relatively low electricity generation. With a growing population, rapid reshoring of local manufacturing facilities and uncertainty about nuclear refurbishment & new builds, significant new generation is required to support the province's increasing load.

Through efforts to source reliable energy production in the 2030s and beyond, the Independent Electricity System Operator (IESO) is embarking on a series of procurements. The LT2 RFP aims to source roughly 2000 MW of electricity generation from wind, solar, and biomass sources, and it may also include a separate component focused on hydroelectric resources and long-duration storage.

Global context

While this is an important development for Ontario's grid, it's critical to note this is a relatively small procurement on a global scale. Suppliers are racing worldwide to satisfy current demand related to the energy transition, especially in the wind turbine space. While solar appears to be less affected than wind, these issues present in RFP processes as quality control challenges, unreliable delivery dates, uncertain costs and difficulties in accommodating prolonged decision-making.

Specifications for LT2

The LT2 offers an appealing opportunity to developers, financiers and producers looking to invest in Ontario electricity generation. However, several issues have arisen in the engagement process thus far.

In the webinar, Pelino Colaiacovo explored the following potential issues that may arise out of the LT2 process for entities seeking investment opportunities:

- **Contract Terms:** The LT2 proposes 20-year contracts for wind, solar and biomass. While 20-year contracts are typical in Ontario, 30-year contracts are the norm in other jurisdictions, including British Columbia, Quebec and Saskatchewan. The expected project life of these developments is typically 30 years, and a matching contract term would enable developers to efficiently plan for the entire life of a facility, resulting in lower cost of capital. 20-year contracts create uncertainty for the last third of a project's life span, which will likely increase costs that will be passed down to ratepayers.
- **No RFQ Process**—The IESO has indicated they don't plan to do an RFQ process as was done in LT1 and ELT1. In that process, participants had to demonstrate financial stability and project expertise. Instead, significant financial deposits may be required, which will likely increase risks and associated costs.
- **Bid Models** – The LT2 will involve a fixed-price bid with deposit-at-risk and fixed-target COD with damages if late. It appears that developers will be required to take all of the risk associated with global supply chain problems to satisfy the proposed bid structure. "It raises the question, what is the competition really about?" posed Colaiacovo. "Is it cost-of-capital, location, natural resources? Or is it just the willingness to put up deposits and take risks? What is the IESO intending to draw out of the competition?"
- **Province-wide scope** – Other provinces' RFPs have focused on regions of interest for bids. Instead, the IESO has simply shared information about transmission availability and congestion issues. Colaiacovo suggests that if there are needs or transmission zones that would be beneficial for people to focus on, the RFP process could be structured to be regionally specific. In the LT1 process, 65,000 MW of projects were registered, and 20,000 MW of those projects were disqualified in the deliverability assessment. It's likely that developers who were disqualified will raise prices in future bids to recoup their sunk research costs.
- **Municipal support resolution required** – There may be costs associated with convincing municipalities to be willing hosts to generation projects.
- **Rated criteria**—**Questions remain about what will be included in the rated criteria, which is said to comprise 20 per cent of the score. However, only one criterion is currently known:** Indigenous participation.
- **Expiring contracts optionality** – There is an option for expiring contracts to participate in LT2 or the alternative MT2. These bidders may have an advantage

because they can be more aggressive in their assumptions with a fallback option of participating in MT2 – which is not open to other bidders.

- **Parallel process for Hydro and Long-Duration Storage Process**—These are 40-year contracts. Is this a separate RFP, or will they be compared to the 20-year contracts? It’s unknown how the formula for comparison will look.

LT2 Formula

Colaiacovo proffers that the proposed formula for wind, solar and biomass projects may be the most prominent issue with the LT2 procurement. These projects have historically been contracted on an energy basis. With LT2, the IESO is suggesting a contract-for-differences structure instead.

Contractual Payment =

Monthly Minimum Revenue (from Contract) – Deemed Revenue (from Market)

Monthly Minimum Revenue =

Contracted Capacity * Production Factor * Hours * Contracted Price (annual)

[Note: “Production Factor” was an annual variable, now likely monthly]

Deemed Revenue =

Contracted Capacity * Production Factor * Hours * Actual DA LMP (month avg)

[Note: For wind/solar, “monthly average Actual DA LMP” will likely be based on hours that facilities were expected to bid into DAM according to IESO forecasts. For technologies like Hydro, where there is no official forecast available, simple monthly average will be used]

The contract formula has raised numerous questions in the engagement process, including: **how will this impact the cost of capital and availability of capital for these projects in Ontario?**

The proposed formula is a *market-focused contract structure* that is more akin to the gas plant contracts for differences. New wind, solar and biomass projects will need to adapt and are likely to pursue business along one of the following three vectors:

- **Partly merchant facilities** - If a developer builds a traditional solar or wind farm, the new contract structure results in a partly merchant facility. This will reduce debt available to projects, may increase their interest rates, will require a higher equity IRR and will **drive up bid prices**.
- **Hedging** - Projects will need to create a synthetic fixed-priced contract through hedging. This will likely increase operating costs and thus **drive up bid prices**.
- **Include a battery project** – Projects could develop hybrid projects that include battery storage, in addition to generation equipment, to increase reliability. This reduces uncertainty but increases need for capital and operating costs and thus **drives up bid prices**.

“Do the math and show your work” – key takeaways

LT2 provides opportunities for wind, solar and biogas project developers while raising many questions. This proposed RFP may increase risk, resulting in increased capital costs, likely leaving the ratepayer with increased costs. Questions remain around how the projects will be funded and if they will have to assume significant hedging costs under this proposed model.

Given the information available, it may seem that the proposed market structure and contracts favour generators with characteristics similar to gas-fired plants, such as adjustable output, speed of development and ease of entering a market. On the other hand, intermittent generators like wind and solar plants face high capital costs, low fuel costs and low output flexibility because they are driven by resource availability. Given these conditions, the contract structure may appear to be a bad fit for renewable technologies. And public analysis of LT2 is not easily available to support a conclusion.

The potentially unfavourable conditions, coupled with supply chain uncertainty, could cause bidders to walk away from risky projects or potentially not even launch a bid. It may take some time for capital markets to gain comfort in this model. Many are waiting to see how the IESO’s market renewal project, expected to be implemented in 2025, will impact the LT2.

While the LT2 presents risks and uncertainty for developers, financiers and producers alike – it also offers many opportunities. While adopting a new structure like that proposed for LT2 is challenging for electricity markets, organizations that get comfortable with this change can leverage it to their advantage.

If you missed the webinar and would like to receive a recording, please [contact us here](#).

BLG has a knowledgeable and robust Energy and Renewables team. If you have any questions about the LT2 RFP or any contracts related to energy procurement projects, please reach out to any of the key contacts below.

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