Are we ready to deliver the Contracts for Difference?

As the industry prepares to take part in the first ever CfD allocation round, Charles Yates analyses the risks around implementation

Contracts for Difference (CfDs) are the most important part of Electricity Market Reform (EMR), the biggest change to the UK electricity markets since privatisation in 1990. Implementation of the CfD has got serious and urgent in the run up to the first auction, which closes on 3 December this year. So it is timely to review where we are and what remains to be achieved before the end of the year.

Key expected milestones are:
• Applications by developers for 'minor and necessary' changes to the CfD contract, to be submitted by 29 September
• CfD applications, to be submitted by 27 October
• Appeals against decisions that projects are ineligible for the CfD, to be lodged by 18 November
• The deadline for signing CfD contracts is 27 January 2015.

There is currently lots of activity intended to ensure that the CfD gets off to a good start. The most visible elements are a plethora of workshops, and increasing content on the CfD web pages of the Department of Energy and Climate Change (Decc), the Low Carbon Contract Company (LCCC), National Grid, Ofgem and Elexon. Decc is leading an investor education programme to encourage the provision of finance for CfD projects. Critically, the key public sector players and their IT providers are putting in place the systems and procedures to allocate CfDs.

However, there are two key areas in which progress seems to be lagging. The first is policy: the budget for the 2014 CfD allocation round is expected to be announced on 30 September and events such as the fallout from the Scottish referendum may require further changes.

The second is the preparation by bidders for the first auctions. A well-prepared bid is based on a firm understanding of the economics of a CfD project - including the terms of project debt and power purchase agreements (PPAs), an appreciation of the dynamics of bidding in this auction, and a view on the auction strategy of competing projects and technologies. Simultaneously, bidders should gather the original documents which must be submitted with their CfD application (eg planning approval and connection agreements) and may request 'minor and necessary' variations to the contract.

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Implementation in a time of change There is currently a high level of major change and uncertainty in the power markets driven by electricity market reform (EMR), the CMA's Energy Market Investigation and the UK election in May 2015. All of these issues demand attention from the industry and all are interacting with each other, sometimes in complex ways. The consequences of these interactions are hard to predict and add to the challenges of smooth and effective implementation.

Some of the issues which the industry are currently grappling with are:
• The first Capacity Market auction, which will open on 16 December for up to 52.3 GW of capacity
• Payment of the Suppliers Obligation, which will fund the CfD and will start on 1 April 2015
• The Energy Market Investigation which could fundamentally change the structure of the energy markets is underway and is expected to run till the end of 2015
• The fact that for technologies other than solar, the CfD and Renewables Obligation (RO) will run in parallel until 31 March 2017. Many smaller developers have decided to stick with the subsidy they know, the RO, and put off adapting their business to the CfD

There is a danger of change fatigue as the implementation capacity of the public and private sectors are stretched. This increases risk, as systems and processes which interact are developed in parallel by separate groups.

With so much complex change under way simultaneously it is inevitable that there will be unintended consequences. For example, EMR may trigger the Change of Law clauses in existing PPAs, which could result in the PPAs being renegotiated. This is likely to be a commercially difficult and lengthy process.

2014 CfD allocation budget The budget under the LCF for the 2014 CfD allocation round will be key to the outcome of the auction. Decc's draft 2014 allocation budget is £50M for pot 1 (established technologies) for the period 2015 to 2020 and £155M for pot 2 (less established technologies) for the period 2016 to 2020. This budget is disappointingly small. The pot 2 budget, for example, is not enough to support a full-scale Round 3 offshore wind project. Just 600MW of onshore wind would use all of the pot 1 budget and, similarly, just 600MW of offshore wind would use all of the pot 2 budget

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Over the longer term, there is debate as to whether the Levy Control Framework (LCF), which sets out the limits of funding available, is consistent with the UK meeting its 2020 renewable energy target.

For electricity supply companies a pressing issue is forecasting the Supplier Obligation, which they will collect from consumers and pay to the LCCC. The size of the Supplier Obligation depends, among other things, on the difference between the market electric price and the strike prices. This price difference is volatile and hard to predict, which complicates the task of sizing and collecting the Supplier Obligation.

Work has started on a financial model to forecast the Supplier Obligation and importantly the range of uncertainty around that forecast. These published forecasts are an important tool to assist suppliers to manage their obligation and their customer billing in a competitive market.

Implementation risks The implementation of CfD systems and processes by both the public and private sector are underway but risks remain till the systems perform when they are used in anger.

Major areas of risk are as follows.

There may be gaps, overlaps and inconsistencies in the systems adopted by National Grid, LCC, Elexon or suppliers, and their respective IT providers. Perhaps the critical area in which systems have to integrate is the public-private interface: large volumes of data and payments need to flow accurately and on time over this interface from day one.

A risk in the CfD allocation process arises because there have been delays in the introduction of allocation portals for the CfD and Capacity Markey (CM). National Grid has introduced work-arounds, including issuing an Excel spreadsheet as the CfD application form. This spreadsheet has a number of built-in data entry checks, but it may not be as successful at catching data entry errors as the portal was intended to be. The concern is that the use of spreadsheets will require more human checking, which will allow more errors in the application process and delay the correction of errors that exist.

The CfD auctions will be complex. Each project is eligible for up to 10 flexible bids, which can vary in terms of price, project capacity (MW) and generation start date. National Grid has to take the sealed bids and select a combination of bids which is cheapest, makes fullest possible use of the allocation round budget and allows for the minimum of 100MW reserved for wave and tidal stream projects under the CfD and RO over the period 2014-2018. This

The novelty of the CfD makes implementation challenging

The CfD has the same core objective as the Renewables Obligation (RO), which is to encourage investment in renewables, but the mechanics of the schemes are significantly different. Along with these differences, the new CfD implementation bodies (the LCCC, EMR Settlement Ltd, etc.) and the novelty of the CfD compound the complexity and risk during implementation.

Key differences between the CfD and RO which impact on implementation include:

• The CfD is a private contract (see panel, next page) administered by a number of companies (LCCC, National Grid and Elexon) within a legislative framework, while the RO is governed by legislation and administered by government (primarily Ofgem)

• The RO is granted once a series of administrative tests are passed, while the CfD application process includes eligibility tests before a project is allowed to bid in the auction

• The CfD strike price is fixed for 15 years, but the subsidy per KWh paid to the generator will vary as the difference between the strike price and the market price varies. Indeed, the generator must pay the LCCC when the market price is higher than the strike price. In contrast, the value of a RO Certificate is determined once a year. The greater volatility of CfD payments requires more complex budgeting, payment and levy collection systems and procedures.

challenging process must be accurate and rigorous. It must respect the commercial sensitivity of the bids but at the same time release sufficient information about them to be transparent and reassure bidders that the process was in full conformity with the auction rules.

The LCCC was established in April this year and is responsible for the key roles of managing the CfD contracts, paying generators and collecting the Supplier Obligation. There has been little time to establish the company, recruit staff, prepare systems and processes and educate bidders for CfDs.

There is considerable risk of political intervention in the run up to the election, as energy - and particularly the cost of electricity - will be an important campaign issue. There is a risk that changes will be made to the CfD, or that other changes to the electricity markets - such as the 20 month electricity and gas price freeze in the Labour Manifesto - will have consequences.

My personal assessment of the CfD implementation process is that we are broadly on track in most areas and that the process is likely to run reasonably smoothly. This is based on an evaluation in the following fundamental areas:

Is the policy fit for purpose? The current policy is good enough for the auctions to attract an adequate volume of bids. However, the draft budget for the first allocation round indicates a lack of ambition and it is to be hoped that the final budget will be bigger

Will the auction and contract management systems and processes be ready on time? There has been slippage in the CfD application process, for example the start of the window to apply for CfD modifications has been delayed and the end date has not changed, which compresses the activity and makes it hard for bidders to make a strong case for a modification. This approach preserves the overall timetable at the cost of introducing extra risk by compressing some already tight activities

How much interest is there in participating in the first allocation round? Talking to project developers and banks, there is growing interest as CfD go-live gets close but it is rather last minute and patchy. Solar PV developers are engrossed in the dash to implement projects before the RO closes for PV on 31 March 2015. Small and medium sized wind developers prefer in most cases to stick with the familiar RO for the present

For me the key test will be looking back after the first auction to see if it has been oversubscribed by deliverable projects and a good percentage of bids are below the administrative strike prices indicating that competition is delivering value for money. NP

The CfD contract

The generic CfD contract is a private law contract between the generator and the LCCC; hence the LCCC can be sued for failure to meet its contractual obligations. However, EMR regulations limit this ability.

The LCCC cannot be sued in the event of non-performance caused by third party actions. So, for example, a generator cannot sue the LCCC for non-payment if it results from the LCCC not having received funds under the Supplier Obligation.

The legislation allows the LCCC to agree to changes to the CfD contract only if they are both minor and necessary. A minor change is defined as one that does not improve the returns or the risk profile of the generator and does not cost the LCCC more than £12,000. A change is necessary where the LCCC determines that an applicant acting reasonably could not accept the offer of a CFD without the modification. The LCCC has indicated that it will apply these tests strictly, to limit the number of contractual changes.

The CfD contains limited force majeure protection allowing the contract to be preserved where either party is affected by force majeure for a specified period. The force majeure clauses are based on the standard private finance initiative (PFI) contract and the circumstances in which they apply are carefully defined.

The termination provisions in the CfD contain events of default entitling the LCCC to terminate the CfD, including failure of the generator to pay amounts due under the CfD or failure to provide collateral. Termination events are limited to material breaches and 'cure' options such as remediation plans or payment suspensions are provided.

These limitations are important as they reduce the termination risk faced by generators. However, if the generator fails to complete construction of at least a defined part of the contracted capacity the contract may be terminated. If the generator fails to complete construction of the project by the end of the target commissioning window, the contract period will start to erode and if construction is not complete by the long-stop date, the contract can be terminated.