



# Nick Churchward

Partner



BURGES  
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## CfD and the implications for waste to energy

On Thursday 16 October 2014 the first allocation round for Contracts for Difference (“CfDs”) commenced and with it some of the most fundamental changes to the electricity market in a generation. This article explores how this regime is likely to affect the energy from waste sector and considers some of the practical, commercial and legal issues EfW developers should consider when submitting their CfD application and participating in any auction rounds.

### The CfD Contract

The CfD regime is very different to the Renewables Obligation (“RO”) and the Feed-in Tariff - regimes which developers and funders alike have got to grips with over the past decade. When issued and executed, a CfD will be a private law, bilateral contract, between a developer and the Low Carbon Contracts Company (“LCCC”). At its simplest, the CfD requires LCCC to pay a generator based on the difference between an electricity market reference price (“MRP”) and a project’s (CPI indexed) “Strike Price”. In all probability, Strike Prices will be determined by a competitive auction process. This will pitch different technologies within the same budget Pot against each other in a bid for financial support.

The contract is comprised of two physical volumes - some 400 pages of standard terms and a short “front end” CfD Agreement containing project specific details. Given the lengthy nature of the contract package and its (generally) non-negotiable status, some developers have taken the view that government will

amend the CfD if any serious commercial and/or legal issues come to light early on. However, the CfD has much more in common with a PFI style agreement than the renewables support regimes the industry has been used to. A good understanding of the contract terms, the contractual risk allocations and mechanisms as well as the supporting legislation and statutory guidance will be essential as a number of these provisions will need to be reflected across a range of typical project and funding agreements as (to a more limited extent) RO-related provisions have in the past.

### Application Issues

Despite National Grid (as the “Delivery Body” responsible for allocating CfDs) and DECC actively promoting and presenting the new regime around the country, potential applicants are still getting comfortable with the CfD application criteria and the required supporting evidence to be submitted. Planning and grid connection requirements are notable examples where there has been uncertainty, particularly where developers are looking to use independent connection providers for contestable works, share a grid connection, utilise a third party’s grid connected private network and/or construct CHP plants. Up-to-date technical and legal advice will be key.

### Bid Analysis and Strategy

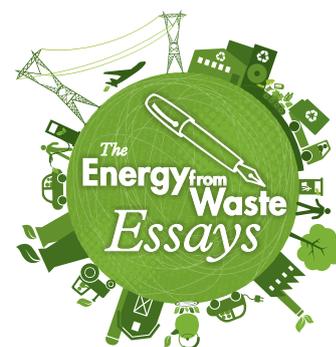
Simply put - it’s all about the Strike Price. In theory CfDs could be allocated without a competitive process if in any Delivery Year the total value of the payments which would be made to projects awarded a CfD (as calculated by the Delivery Body) would be less than the

relevant Budget Pot (see Tables 1 and 2).

But there is little doubt among market commentators that “constrained allocation” will occur, triggering a call by the Delivery Body for sealed bids and an auction based allocation of CfDs. The rules allow for multiple sealed bids (“flexible bids”) to be submitted to the auction and the updated Allocation Framework makes clear that the Delivery Body will rank all such bids in order of lowest to highest price, regardless of the year in which the applicant developer is looking to commission the project.

As such there will be a focus on Strike Prices and it is likely to become increasingly important for EfW developers to have certainty about their project costs and revenues (including gate fees) at the point of application for a CfD (or at least at the point when sealed bids are called for). If bidding a project with a Target Commissioning Date falling in a later Delivery Year, applicants may need cost and revenue certainty significantly earlier than would have usually been the case for a RO project. The greater the certainty over the financial model the greater the ability an applicant will have to submit a genuinely competitive CfD bid. Certainty over gate fee and other non-electricity revenues will be particularly critical because under the CfD regime there is no “potential upside” of above base case electricity prices to set off against the risk of falling gate fee revenues – if the MRP exceeds the relevant Strike Price then the generator pays the excess back to LCCC.

The one potential upside for applicants is the auction’s “pay as clear” approach which increases a successful applicant’s Strike Price to match the highest Strike Price bid by any other



successful applicant for the same Delivery Year, subject to a cap of the relevant technology’s Administrative Strike Price (see Table 2).

### What about power purchase agreements?

PPAs for CfD projects are going to be a little different to the commercial PPAs the industry has got used to. Drafting relating to ROCs will be removed but there will also be a raft of other provisions to be included to make the PPA compatible with the CfD regime. Issues which generators will need to have addressed include: dealing with contractual disputes where facts are common to both PPA and CfD; generators’ rights to curtail generation if the MRP goes negative; synchronisation of key timings, such as the “Start Date” in the CFD and the PPA “commercial operations date”; allowing changes to the built out capacity to match the flexibility afforded under the CFD and of course tracking the same MRP to be used in the CFD (and any changes to the MRP indices permitted under the CfD).

We may also see generators signing binding agreements with licensed suppliers at or around CfD application (with a “no-fault” break right) to guarantee PPA imbalance charges and so give greater price certainty to those bidding in an auction round.

Private wire or hybrid supply arrangements are also likely to become increasingly attractive to generators as the LCCC will still pay generators based on the difference between the MRP and the relevant Strike Price notwithstanding that private wire customers will generally pay a premium for private wire supplies to take account of avoided non-energy charges.

The two biggest single PPA funding issues are likely to be the imbalance risk

**Table 1. CfD Budget Release for this Allocation Round**

£m (2011/12 prices)	Delivery Year					
	15/16	16/17	17/18	18/19	19/20	20/21
<b>CFD Budget (2014 release)</b>	50	220	300	300	300	300
Pot 1 (established technologies)	50	65	65	65	65	65
Pot 2 (less established technologies)	-	155	235	235	235	235

**Table 2. Administrative Strike Prices and Budget “Pots” Prices**

Technology Type	CFD Strike Prices (£/MWh, 2012 prices)				
	2014/15	2015/16	2016/17	2017/18	2018/19
ACT (with or without CHP) (Pot 2)	155	155	150	140	140
AD (with or without CHP; >5MW) (Pot 2)	150	150	150	140	140
Biomass Conversion (Pot 3)	105	105	105	105	105
Dedicated Biomass (with CHP) (Pot 2)	125	125	125	125	125
Energy from Waste (with CHP) (Pot 1)	80	80	80	80	80
Geothermal (with or without CHP) (Pot 2)	145	145	145	140	140
Hydro (>5MW and <50MW) (Pot 1)	100	100	100	100	100
Landfill Gas (Pot 1)	55	55	55	55	55
Sewage Gas (Pot 1)	75	75	75	75	75
Offshore Wind (Pot 2)	155	155	150	140	140
Onshore Wind (>5MW) (Pot 1)	95	95	95	90	90
Solar PV (>5MW) (Pot 1)	120	120	115	110	100
Tidal Stream (0-30MW) (Pot 2)	305	305	305	305	305
Wave (0-30MW) (Pot 2)	305	305	305	305	305

Pot 1 = Established Technology; Pot 2 = Less Established Technology; Pot 3 = No budget is allocated for the October 2014 allocation round (this technology benefited in the “early CfD” Final Investment Decision Enabling Round in April 2014 ).

premium being charged and how this will be calculated (fixed price or percentage of market reference price) and PPA duration. CfD payments are calculated on the basis of the difference between the MRP and the relevant Strike Price, but under the PPA the generator will receive less than the MRP (as it will be net of imbalance charges).

Licensed suppliers have long argued that it is risky (and therefore expensive) to price balancing risk over the 10-15

PPA year terms traditionally required by debt funders.

The introduction of the Offtaker of Last Resort (“OLR”) mechanism, providing a guaranteed route to market for CfD generators via a statutory PPA is intended to allow a more liquid, shorter term PPA market to develop, which ought to be capable of pricing balancing risk more competitively. However, the existence of the OLR has not yet been heralded as the end to long term PPAs.

The OLR PPA prescribes a significant discount to MRP and there is an expectation in some quarters that funders will continue to insist upon a long term PPA back to back with the duration of CfD support. However there is some evidence that licensed suppliers are considering alternatives to the traditional approach of pricing balancing risk and we may see market review mechanisms being introduced to ensure that long term balancing risk remains competitive even within long term PPAs.

### **New Technologies, New Risks**

One criticism stakeholders across the renewables sector have been making of the CfD auction process is that Government could jeopardise future technology development and fail to take account of other benefits of EfW schemes such as reduced emissions and land use by reducing residual waste to landfill. As can be seen from the introduction of the 100MW “Minima” capacity reservation for wave and tidal projects and its ability to introduce “Maxima” capacity caps, the Government has the power to shape the composition of the UK’s electricity mix. It remains to be seen however whether it will use this ability to benefit generating stations that have additional positive social and environmental impacts.

### **Interaction between the RO, CfDs and the Renewable Heat Incentive**

Before making a 2014 CfD application developers should take time to consider the complex interaction between the RO, CfDs (and their supporting legislation) and the Renewable Heat Incentive (“RHI”). This should include an assessment of whether a project is eligible for the RO Grace Period introduced for ATT generating stations. There are a

number of anti-gaming and anti-hedging provisions in the RO and supporting CfD legislation. In addition, for the CfD technology band “EfW with CHP” there is currently mutually exclusive support available under CfDs and the RHI. Developers who are still in a position to opt between the RO (and take advantage of a Grace Period) and a CfD application should think very carefully before submitting any CfD application or RO full accreditation application as a failure to fully understand the rules and factor these in to your project development and financing strategy could have a profound effect on a project’s development, its eligibility for RO or CfD support and ultimately the project’s ability to attract funding in this very competitive funding environment.

### **Winners and Losers?**

An auction can’t be competitive unless there are losers – DECC has said openly that it expects (and indeed needs) there to be losers in CfD allocation to ensure real competition. The waste to energy industry is moving fast into an era of energy subsidy which is very different to what has gone before. There is less subsidy available for new projects and for the first time EfW technologies are literally competing for subsidy with other technologies.

To succeed with the CfD the industry will have to deploy some fresh thinking and be prepared to take tough decisions about project viability - particularly for projects developed with the RO in mind but which would now need to seek support under the CfD.

If you are being asked “How do CfD subsidy levels compare to the Renewables Obligation?” – that is the wrong question. Developers need to assume competitive allocation. The question is “How do we

achieve a successful and competitive Strike Price against the competing technologies?” To answer this question, more development resource will have to be applied to identify and deliver projects which can provide additional, bankable third party revenues such as heat and private wire sales in order to support competitive Strike Price bids and to consider funding routes which can deliver a cheaper cost of capital. DECC is looking for best in class projects across the technology spectrum.

There can be little doubt that many waste management industry players have embraced the transformation to resource management and energy generation businesses and have the innovative thinking required to succeed in the CfD environment. The challenge for the industry will be to properly understand the CfD mechanism and identify and develop projects which can be successful so that the sector can be home to (at least) its fair share of CfD winners.

<sup>1</sup> a private company owned by the Department of Energy and Climate Change

<sup>2</sup> For details of the technology groupings within the budget “Pots” see Table 2.

<sup>3</sup> <https://www.emrdeliverybody.com/Pages/AnnouncementAllItems.aspx> <https://www.gov.uk/government/publications/electricity-market-reform-contracts-for-difference>

<sup>4</sup> [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/360269/Updated\\_Final\\_AF.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/360269/Updated_Final_AF.pdf)

<sup>5</sup> <https://www.ofgem.gov.uk/publications-and-updates/renewables-obligation-enabling-financial-decisions-grace-period-guidance>

<sup>6</sup> [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/305781/Successful\\_Projects.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/305781/Successful_Projects.pdf)

