Keeping the lights on

Lawyers **Nick Churchward** and **Emma Andrews** outline how the Government's electricity market reform will support new renewable energy generation.

Feed-in Tariffs with Contracts for Difference (CfDs) are a core part of the Government's electricity market reform (EMR), announced as part of the Energy White Paper in July 2011. The Energy Bill is central to the Government's energy policy and its stated aims of keeping the lights on, keeping energy bills affordable and decarbonising energy generation.

CfDs will replace the Renewables Obligation (RO) as the main financial subsidy for development of renewable projects over 5MW, operating alongside the existing feed-in tariff regime which will continue to support small-scale (< 5MW) renewable generation. It is intended to also incentivise new nuclear and carbon capture and storage (CCS) projects. CfDs will be long-term (15 years in the case of renewable technologies) contracts allocated to eligible generators and funded by contributions from licensed electricity suppliers. A new Government owned company will act as the single CfD counterparty.

The fundamental basis of the CfD model is the provision of a pre-identified "strike price" to the generator for all eligible electricity generation (inclusive of financial subsidy). This strike price will operate against a reference wholesale market price. If this reference price is lower than the strike price, the CfD counterparty will pay the generator the difference between the two prices. Conversely, if the reference price is higher than the strike price, the generator will have to pay to the CfD counterparty the difference. This means that, provided the generator is paid close to the reference price by its offtaker, it should receive a predictable and stable revenue stream for its energy.

The draft Delivery Plan confirms that these prices are intended to be (at least until 31 March 2017, when the RO will close to new applicants) comparable to the support levels available under the RO (taking into account differences such as contract length and inflation indexation arrangements) adjusted to account for the increased certainty generators have from not bearing wholesale price risk which the Government expects to be reflected in lower costs of capital. From April 2017, strike prices are set by reference to the constraints of the Levy Control Framework and expectations of future technology costs. The intention is that the new regime will deliver savings to consumers of around £5 billion to 2030, relative to the current regime. The published strike prices are now being consulted upon and will be finalised and published in the first five-yearly EMR Delivery Plan due in December 2013.

A common misconception is that the strike price is the guaranteed revenue a generator will receive. This is not the case. Since the CfD payment relates to the difference (positive or negative) between the market-based reference price and the strike price, the generator takes the risk of not being able to find a route to market for its power at the reference price. Even if a generator enters into a power purchase agreement linked to a wholesale market price, which is the same as or similar to the reference price, generators are typically paid around ten per cent less than the wholesale price to take account of so-called "balancing risk" and cover other offtaker costs.

Developers wishing to apply for CfDs will have to satisfy National Grid, the appointed "System Operator", on four areas. Firstly, eligibility – the proposed project needs to be from a suitable technology such as those listed in the strike price table, as well as CCS and nuclear.

Secondly, there needs to be an achievement of a specified stage in the development process which will be prescribed for each individual technology. For instance, wind projects will require proof of planning permission and an accepted network connection offer.

Another key parameter concerns the capacity of the proposed facility, as a generator will only be able to claim CfD support for its contracted capacity.

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Generators will have to apply for additional CfDs to cover any additional capacity. DECC has confirmed however, that developers may vary capacity to a certain limited degree above or below their original proposal, without penalty. Developers will be able to exercise this flexibility part before and part after construction.

Finally, the developer will need to keep in mind the target commissioning date. Initially, CfDs will be allocated on a first come, first served basis. The System Operator will run the application system and determine an applicant's eligibility. When satisfied, it will instruct the CfD counterparty to enter into a CfD on prescribed parameters.

Once a "material" amount of the Government's CfD budget has been allocated, six-monthly technology specific allocation rounds are proposed to be adopted. Such rounds will allocate CfDs on the basis of objective criteria (to be confirmed) if there is more demand than available resource. The Government envisages that this could happen as early as 2017 with movement to technology neutral auction processes in the 2020s, by which time the Government hopes all low carbon technologies will be able to compete on an equal footing with each other.

Clarification of the finer details of CfDs will only become apparent over the summer. In the meantime, to address the risk of a hiatus in investment until the CfD regime is fully established, a 'Final Investment Decision ("FID") Enabling' scheme has been put in place. DECC is expecting to enter into Investment Contracts (an early form of CfD which will be awarded under FID Enabling) with successful applicants in March 2014, several months later than originally envisaged.

The draft strike prices have received a mixed response, with particular concern for some technology sectors. For example, the Government has indicated that dedicated biomass without CHP will not be supported under CfDs, and no strike price has been indicated. This, in addition to the introduction of the 400MW cap on the amount of capacity that can get "grandfathered" support under the RO, is worrying for the sector.

It is hoped by Government, and the renewables industry, that the CfD regime will provide sufficient confidence for investors to commit to the UK's much needed low carbon generation. However, more detail is still required on the operation of the CfD before any decisions will be made. The next six months is likely to be critical to the success of the Government's strategy for keeping the lights on.

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Draft strike prices[1].

Renewable Technology	**Draft Strike Prices (£/MWh) (2012 prices)[2]**				
	2014/15	**2015/16**	**2016/17**	**2017/18**	**2018/19**
Advanced Conversion Technologies[3] (with or without CHP[4])	155	155	150	140	135
Anaerobic Digestion (with or without CHP)	145	145	145	140	135
Biomass Conversion	105	105	105	105	105
Dedicated Biomass[5] (with CHP)	120	120	120	120	120
Energy from Waste (with CHP)[6]	90	90	90	90	90
Geothermal (with or without CHP)	125	120	120	120	120
Hydro[7]	95	95	95	95	95
Landfill Gas	65	65	65	65	65
Offshore Wind	155	155	150	140	135
Onshore Wind	100	100	100	95	95
Sewage Gas	85	85	85	85	85
Large Solar Photo-Voltaic	125	125	120	115	110
Tidal Stream	305	305	305	305	305
Wave	305	305	305	305	305

[1]Source: DECC: Electricity Market Reform: Delivering UK Investment, 27 June 2013 and DECC: Consultation on the draft Electricity Market Reform Delivery Plan, 17 July 2013
[2]The strike price will be indexed annually by reference to the Consumer Price Index.
[3]Standard and advanced gasification and pyrolisis
[4]Combined Heat and Power
[5]Based on biomass contracts ceasing to pay in 2027 (regardless of start date). The Government sees biomass as a transitional technology.
[6]Energy from waste without CHP is not supported under CfDs, which is consistent with the position under the RO.
[7]For larger hydro projects, DECC will consider how best to price CfDs and the appropriate length of contracts on a case by case basis, similar to the proposed approach for Tidal Range.