Brief

Contracts for difference: risks faced by generators under the new renewables support scheme in the UK

Natalie Kozlov*

The Energy Act 2013 received royal assent in December 2013. It implements the Feed-in-Tariff Contracts for Difference (the CfD) which is set to become the primary support scheme for low carbon generation in the UK by 2017. The CfD will be in the form of a long-term contract between a low carbon generator and a counterparty which is a state-owned limited liability company (the CfD Counterparty). It is intended to remove long-term price risk for low carbon generators which sell electricity into the market, thereby stabilizing their revenues and reducing the cost of financing their projects. This article comments on the uncertainties currently faced by generators (or developers) of existing (or planned) electricity generation plants in the UK brought on by the implementation of the CfD regime.

Under the CfD, which is offered for a term of 15 years for most technologies, the generator and the CfD Counterparty agree to pay the difference between (1) the strike price, which reflects the cost of investing in a specific low carbon technology eligible for the CfD, indexed to the Consumer Price Index; and (2) the market reference price, which is the market price for electricity at a particular point in time on the UK grid. The market reference price is calculated differently for baseload generators (season-ahead price, moving to year-ahead price when conditions allow) and intermittent generators (hourly day-ahead price). Where the market reference price is below the strike price, the generator will receive a top-up payment from the CfD Counterparty. Where the market reference price is above the strike price, the generator must pay back the difference to the CfD Counterparty.

1. Long-term support

Funding for CfD payments will be raised through a levy on all licensed suppliers in the UK and will flow through the CfD Counterparty to the generator via a settlement agent. The total annual expenditure on the CfD and other support mechanisms for low carbon

* Email: Natalie.kozlov@pinsentmason.com.

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technologies will be managed through the Levy Control Framework (the LCF). According to current government estimates, only one quarter of the £6.5 billion budgeted for the LCF for 2018/9 will be available for the CfD, the balance being committed to the small-scale Feed-in Tariff and the Renewables Obligation, among other schemes.[1] The CfD will be subject to a degression mechanism which will result in strike prices for most technologies falling over time. In addition, the CfD will be allocated through an auction process such that actual strike prices will be lower than the published strike prices for each technology,[2] which should relieve some of the funding pressures. Given how they are calculated, however, CfD payments will fluctuate with wholesale electricity prices over time. CfD payments may also need to be adjusted if a change in law occurs which has a specified impact, such as causing an unjustifiable discriminatory effect on a generator. Finally, a present risk to the successful implementation of the CfD is state aid approval. Given the involvement of state resources in the CfD framework (e.g., the CfD Counterparty), the CfD requires state aid clearance from the EU Commission. The UK is currently in discussions with the EU Commission on this point. If a full review is required this could significantly delay the implementation of the CfD.

An overarching issue is, therefore, whether enough money will be available and on time in order for the CfD to support the sufficient deployment of low carbon technologies in the UK to enable the UK to meet its legally binding renewable energy targets in the long term.

2. CfD allocation risk

A more immediate concern for developers will be CfD allocation risk. CfD allocation will be managed through an auction process which is currently being developed. Based on information currently available, auction participants will be assessed according to their sealed bids for strike prices such that participants with bids with the lowest strike prices will be awarded a CfD first. The CfD budget has been divided into two groups—established technologies and less established technologies.[3] Established technologies, such as onshore wind and solar photovoltaic, are not meant to be in competition with less established technologies, such as offshore wind and wave and tidal. In reality, if the CfD attracts a strong pipeline of projects, all technologies applying for a CfD will be competing from the outset.

CfD allocation risk is likely to be a particularly relevant concern in light of the significant pressure on generators to meet set milestones in the CfD contract. If the generator fails to trigger the 'start date' by the final day of the 'target commissioning window' any delay (not due to force majeure or caused by the network operators) will proportionately reduce the term of CfD support. Most significantly, within 1 year of signing the

[1] <https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/268221/181213_2013_EMR_Delivery_Plan_FINAL.pdf> accessed 10 February 2014.

[2] <https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/268221/181213_2013_EMR_Delivery_Plan_FINAL.pdf at 37> accessed 10 February 2014.

[3] <https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/271919/Competitive_allocation_consultation_formatted.pdf> accessed 10 February 2014.

CfD the generator must have spent at least 10 per cent of the project costs or otherwise demonstrate that the project is underway and that the financial commitments required to commission the project have been approved. In other words, generators can only apply for a CfD once they are certain of the project's robustness assuming that a CfD is obtained. The CfD milestones are intended to ensure that only projects which are sufficiently advanced to have a realistic prospect of progressing through to commissioning are eligible for a CfD. However, the strict timeline set by the milestones risks jeopardizing investment in projects which, for example, hit delays in raising external finance or require the developer to start incurring costs, or even begin construction, prior to securing financing. Such a project may not go ahead if the developer believes the likelihood of being awarded a CfD is too low to justify incurring these initial costs in the first place.

3. Bankability of the CfD

The question of how the CfD Counterparty will rank in the priority of payments to creditors and possibly other parties in the event of the generator's default will affect the bankability of the CfD. Under the CfD, a form of direct agreement is provided to project finance lenders to whom the generator's rights under the CfD are assigned by way of security and who are secured by at least first ranking security over the generator's assets. The direct agreement enables such lenders to step into the role of the generator on occurrence of an event of default. The CfD Counterparty may, however, have to compete with lenders which are subordinated to the senior lender and, potentially, offtakers under associated power purchase agreements. Some lenders may deem this sharing of security as unacceptable. Overall, if the CfD is less attractive compared to other investment contracts for energy or infrastructure assets, this may adversely impact the competitiveness of low carbon generation projects which compete with other investment contracts for funding.

4. Commercial risks for smaller generators

The collateral requirements and payment risks under the CfD may make the CfD not commercially viable for smaller generators in particular. If the strike price is above the reference price and the generator fails to pay the CfD Counterparty on time on three occasions within a rolling 12-month period, it will be required to provide collateral in the form of cash or an irrevocable standby letter of credit from at least an A-1 rated financial institution in favour of the CfD Counterparty. The generator may need a parent company guarantee to secure the letter of credit. Additional payment risks are faced by generators if they are unable to sell their output at the market reference price, for example because a generator sells its power through a power purchase agreement at a discount to the market price. Finally, as the change in law provisions are two-way, a qualifying change in law which is to the benefit of a generator may require the generator to pay compensation to the CfD Counterparty.

5. CfD Counterparty risk

The CfD Counterparty is responsible for managing and collecting payments under the CfD; it collects the supplier levy when the strike price is above the reference price through bilateral contracts with suppliers, and collects payments from generators through powers in the CfD contract when the strike price is below the reference price. Recourse is limited to the amounts received by the CfD Counterparty under the supplier obligation. All licensed suppliers in the UK will be required to pay the supplier levy, which is based on an annual forecast of CfD costs (set 3 months before payment is due) and subject to subsequent adjustments to reconcile the actual costs of the CfD for the relevant period, which are likely to be between 14 and 28 months after year end. In order for the CfD Counterparty to have sufficient funds to make CfD payments and to meet immediate draw down requirements suppliers will also be required to contribute to a reserve fund.

Whether the settlement structure contains sufficient protections against the risk of actual default is one question. A related but different question is whether financial providers will be comfortable with the cascade of payments upon default. The CfD contains a full suite of covenants, undertakings, events of default, and termination provisions. However, the CfD Counterparty is in essence a conduit for money flows between multiple payers and payees. In addition, the Energy Act 2013 allows for the designation of more than one CfD Counterparty (where this is deemed necessary). This structure may cause unease from a project lender's perspective in terms of its enforceability against, and accountability of, the CfD Counterparty.

6. Accounting for the CfD

A generator applying for a CfD may face challenges relating to the fair valuation of CfD assets. Whether the CfD will be treated as an executory contract or a derivative contract on the generator's balance sheet will determine the calculation of the liabilities under the CfD. Namely, if the CfD is recognized as an executory contract the payment obligations under the CfD will be calculated on the basis of electricity actually generated. However, if the CfD is recognized as a derivative contract the payment obligations will have to be accounted for from the date the generator signs the CfD contract and may be a volatile (and potentially very large) liability on its balance sheet.

7. Risk profiles

The CfD is premised on the assumption that the revenue stabilization which it provides, among other things, makes it a more effective support scheme for low carbon generators when compared with the Renewables Obligation. This view is not necessarily shared by developers. For example, when assessing the impact of the CfD at a portfolio level for vertically integrated energy companies, the reduced exposure of the generation business to wholesale electricity price volatility may remove the benefits of hedging price risks in

the downstream business. Without this benefit of hedging energy companies may not be able to justify individual generation projects which will be assessed on a standalone basis.

8. Conclusion

The CfD provides eligible generators with long-term electricity price stability and limited counterparty credit risk. It will, however, be introduced into layers of pre-existing economic processes, contracts and hierarchies. The success of the CfD will depend on how quickly investors can get comfortable with the contractual framework. New financing models may be established over time which address investors' concerns and regulatory uncertainty will pose less of a hurdle. It remains to be seen whether the issues discussed reflect initial nervousness as a result of a changing regulatory regime or describe more justifiable concerns with the scheme over the long term.