IJGlobal
A Green Street Company

Progress, but more criticism, for the UK's CfD regime

olivia.gagan@ijglobal.com

11/03/2015

The UK's new contracts for difference (CfD) regime continues to invite criticism. The government has promised needed funding to several renewables projects, but the agreed prices may prove ultimately prove unprofitable.

In February 2015 the Department of Energy and Climate Change (DECC) awarded £315 million ($486 million) to 27 renewable power projects. The UK government, in the CfD's first round auction, favoured the lowest per MWh strike prices proposed.

The CfD regime is a departure from the previous methods that the country has used to support renewables, including the renewables obligation certificates (ROCs) system, and follows the 2014 passage of the Energy Act.

The 2GW of winning projects comprise two offshore wind projects, 15 onshore wind projects and five solar projects, and were selected from two pots - established technologies (onshore wind and photovoltaic solar) and maturing technologies (offshore wind and gasification).

Strike prices range from £50-119.89 per MWh. The winning onshore wind and solar projects proposed especially low prices in the first auction - as low as £50 per MWh, narrowly above today's wholesale electricity price of £45.

The DECC said that the auction has lowered solar power prices by as much as 58%.

Low bids?

The auctions will likely pressure developers to make renewables more competitive with conventional fuels, an important policy goal for the UK.

But in an effort to obtain subsidies, winners in the DECC's first round may have proposed bids beneath the levels at which they can make realistic returns. Sponsors now have to meet a number of conditions attached to the contracts, including providing evidence that they have sufficient financial resources to meet spending commitments over the next year.

"Generators bid blind into the first CfD auction," said Alex Harrison, a counsel specialising in energy and infrastructure at Hogan Lovells in London. "They and government will be hoping that it cleared at a sustainable price. Winners that fail to sign a CfD... or that fail to meet strict milestone requirements in the next 12 months risk disqualification from future auctions, but that would do little to hide the political embarrassment of a flawed auction process."

The milestone requirements include either spending more than 10% of total pre-commissioning costs or reaching final investment decision (FID) within 12 months. Projects that fail to meet the milestones will face a 13-month disqualification from future CfD auctions.

The ROCs system

The new CfD regime replaces the mature - and well-understood - ROCs system.

ROCs' financial burdens were passed to distributors, but ultimately to consumers' bills. Under the CfD regime, if the market price of electricity drops below the agreed strike price, applicable generators must pay the difference to the government. If the market price rises above the strike price, the government will pay generators the difference. The UK central government is funding CfD; the DECC and the Treasury are managing the programme.

Troubingly, uncertainty that arose in the first CfD auction may discourage funds from participating in development-stage greenfield projects. “Only utilities will be prepared to take the risk of develeoping these projects without a CfD already in place,” said a European fund manager. “We can’t come on board a project until we know that it’s won a contract. With ROCs you felt much more certain of your outcome.”

The majority of eligible projects did not win a CfD, and will now have to seek alternative sources of funding. The government fielded £4 of applications for every £1 of support from the CfDs. And the next round could invite even fiercer competiton - if first round losers compete with the next wave of projects.

Several projects in advanced development, including the 1.1GW Moray Firth offshore wind farm, may now face long financing delays, and some may prove unbankable. Developers have spent millions on these projects already.

2014 contracts

The DECC committed 58% of its available support before the first auction even began. The agency awarded £16.6 billion in subsidies to eight renewables projects in the middle of 2014, ostensibly to avoid development slowdowns while it structured the new regime.

In 2014 EDF’s £16 billion Hinkley C project signed a 35-year CfD, at a much-criticised price of £92.50 per MWh. The consortium developing the plant comprises Areva, China General Nuclear Corporation (CGN) and China National Nuclear Corporation alongside EDF - and does not include a single domestic sponsor.

This commitment to pay £17.6 billion over the lifetime of the contract left the DECC exposed to an EU investigation into state aid and a number of legal challenges from other countries, notably Austria.

Future auctions

The auctions for state support contracts are scheduled to take place each year.

Next year’s CfD budget will be confirmed in the third quarter of 2015, but the DECC has already earmarked another £50 million for established technologies. The DECC plans to allocate further CfD funding for renewables, carbon capture and storage facilities. It plans to grant more than £1 billion.