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CONTRACTS FOR DIFFERENCE: A BRIEF GUIDE BY PROSPECT LAW LTD

What are Contracts for Difference?

Contracts for Difference (CfDs) are the UK Government's new and latest way of supporting low carbon electricity generation, and forms part of their "Electricity Market Reform" (EMR) programme. Since 2002 such generation was supported by the Renewables Obligation (RO), itself a replacement for the Non-Fossil Fuel Obligation (NFFO) which ran from 1990. The Government has announced the closure of the RO to new entrants (subject to certain very limited exceptions) on 31 March 2017, and the CfD scheme is the replacement support mechanism for low carbon generation. For the first 2 years most generators will have the choice of whether to seek support under the old RO system or apply under the new CfD system (called the 'choice of scheme'). The rules around choice of scheme are complex, and advice should be sought by any generators in this position.

A 'contract for difference' works by means of a contract between the low carbon electricity generator and a limited company, owned by the Government, called the 'CfD Counterparty'. Under this contract, the CfD Counterparty agrees to pay any difference between the market rate of electricity when it is generated and a pre-agreed higher figure called the 'strike price', thus allowing more expensive cleaner forms of generation to compete with cheaper fossil fuel fired power generators. The strike price is different for alternative technologies (and even sometimes different projects) based on how much subsidy is required to make the project viable. As wholesale electricity prices rise (as is expected) the amount of subsidy paid reduces, to the point that if the market price is above the strike price, it is the generator who has to pay the difference. A standard contract for difference lasts for 15 years.

CfDs are most often allocated in 'allocation rounds', the first of which is due to open in October 2014. These are currently expected to be held yearly.

What are the benefits of CfDs?

CfDs are, by design, intended to provide long-term revenue certainty to investors in low carbon generating plant and to lower the cost of capital by removing the wholesale market price for electricity risk from investors. By contracting directly with a private company, albeit one wholly owned by the Government, an amount of political risk is also removed from the scheme, especially when combined with suitable 'change of law' protection provisions.

In December 2013, the Department of Energy and Climate Change (DECC) published a consultation paper which set out annual strike prices for different renewable technologies up to 2019. This indicates to potential project developers and investors the maximum level of support they can expect to receive before accounting for any competitive tender process.

What are the risks involved?

The RO was a supply-led scheme, whereby as long as you met the published criteria you were entitled to accreditation under it; the CfD scheme is not. The CfD scheme is demand-restricted, and once the budget for each 'pot' in each allocation round is assigned no more CfDs will be offered. Up until the point a project is offered a CfD there is no guarantee of support. Given the rules on what stage the project must be at to apply, any costs incurred to advance a project to the application stage are at increased risk under the new scheme.

Under the new scheme the 'established technologies', such as onshore wind and solar PV, are subject to an competitive tender auction process in order to 'win' a CfD contract. The money for such technologies is set in the budget of an allocation round as a separate pot, and this means that there will be some developers who, if they ask for a strike price higher than the rest of the market, may end up not being offered a CfD and getting no subsidy at all. Given that allocation rounds are initially planned to be yearly, this means that capital is left in limbo for a considerable time if a CfD is not offered. It is possible to submit multiple bids in certain circumstances, but this must be done within the confines of the published rules.

DECC published the 'allocation framework' for the first allocation round (October 2014) in September, which sets out the detail of the application and CfD offer process. The allocation framework sets out eligibility and qualification assessment guidelines, as well as detailed auction rules and how bids from applicants will be valued. It is a complex document, which interlinks with others, but understanding this is vital to a successful bid.

What are the next steps?

- DECC will publish the final budget for the October 2014 allocation round in early October.
- The window for applications to be considered for the October 2014 allocation round will open on 14 October (moved to 16 October as per variation notice published on 25 September).
- The first CfD contracts will be offered to developers in early 2015, subject to any potential delays due to appeals.

Next Steps for Developers

- Any developer or investor considering the CfD scheme as the support mechanism for their project needs to be sure their project meets the application criteria in the timeframes required. This may require specialist advice.
- For developers considering utilising debt funding, it would be wise to involve the lender early on, and well in advance of making any bid.
- Any project that is likely to be the subject of the competitive tendering process will need to carefully model their project costs and potential income so as to be sure that the tender strike price they are considering provides sufficient support in all likely circumstances.

For more information on CfDs please feel free to contact Edward de la Billiere on: 07824 506022, or by email on: edlb@prospectlaw.co.uk