Briefing note | October 2013

Full consultation on Contracts for Difference and Capacity Market

The UK Government has launched a full consultation[1] on two major aspects of UK Electricity Market Reform: Feed-In-Tariff Contracts for Difference (CfDs, providing financial support for low carbon electricity generation), and the Capacity Market mechanism (boosting security of electricity supply). The consultation paper builds on much of the detail of both schemes which has previously been announced. This briefing looks at some of the key new aspects announced in the consultation paper and sets out a timetable of next steps for implementation of CfDs and the Capacity Market and some wider Electricity Market Reforms.[2] Responses to the consultation paper must be provided by 24 December 2013.

Key issues

Contracts for Difference:

- Standard terms and conditions format to be used
- CHP projects paid for first 5 years based on power output in design certificate

Capacity Market:

- RHI, NER300 and UK CCS demo programme not eligible
- Restrictions on auction entry for non-operational capacity
- Rules for longer agreements including financial collateral for 10 year agreements
- Penalty capping set at 101-150% of revenue
- No "change in law" protection

Next steps timeline included

Contracts for Difference

The consultation paper does not add a great deal to the information previously published by the Government about the CfD. The Department of Energy and Climate Change (DECC) has, however, given a stronger indication of its proposed approach to some key questions about the CfD mechanics and how CfDs will apply to particular technologies.

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[1] The DECC consultation webpage contains the consultation document, impact assessments and a number of sets of draft regulations and rules to implement the CfD and Capacity Market mechanisms.
[2] For further basic descriptions of the CfD and Capacity Market details, see our briefings: Draft CfD contract and allocation process published – August 2013; More detail emerges on Electricity Market Reform – July 2013; Energy Bill – a milestone but still more work to do – November 2012

CfD Mechanics

To provide greater flexibility and simplicity for the generators and the CfD counterparty, DECC's preferred approach is for CfDs to take the form of a standard set of terms and conditions. DECC intends that each generator would sign a cover sheet incorporating the standard set of terms and conditions. The cover sheet will then set out the key project-specific details including:

- project name, location, technology, capacity and grid connection details;
- commissioning targets;
- applicable strike price;
- any technology specific requirements such as fuel management and sampling for biomass or energy from waste projects; and
- modifications to the standard set of terms and conditions.

What Are CfDs?

The new system of FIT CfD payments for generators of low carbon electricity, including nuclear power, is proposed to replace the existing Renewables Obligation.

CfD payments provide a contractual form of guarantee to generators as to their level of revenue – it removes the volatility in power prices. Generators will continue to sell their electricity into the market and then receive variable payments based on estimated market electricity prices (the reference price) to ensure that they obtain the agreed "strike price". As a result, a generator may receive payments to "top-up" its electricity sales to the strike price; on the other hand a generator will be obliged to pay back money where the electricity reference price exceeds the strike price.

Setting the strike price is the critical element for DECC – it needs to be sufficiently high to encourage the development of low carbon energy projects, but not so high that developers are over-incentivised, leading to a 'gold rush'.

Application to particular technologies

DECC has announced special rules for dedicated biomass projects with CHP. To mitigate the risk of a CHP plant losing heat customers (impacting its power output and reducing CfD support), DECC proposes to introduce a safeguard whereby CfD support will be paid for the first 5 years on the power output as assessed in the design certificate (the generator will also be required to provide evidence of the intended heat load and supply arrangements in the design submission).

For renewable generation projects that are delivered in phases, such as large-scale offshore windfarms, DECC has confirmed that each subsequent phase of multi-year projects will receive the strike price available for the first phase.

Capacity Market Mechanism

The consultation paper provides a greater level of technical detail on how the Capacity Market will work including on all aspects of the auctioning of capacity, eligibility, resulting capacity agreements and mechanics of delivery and payment. In addition, it contains detailed proposals setting out how Demand Side Response (including on-site generation and small scale storage) will participate. Draft rules for the Capacity Market have also been published. A number of new elements have emerged including those set out below.

Capacity Market

A Capacity Market is a mechanism to ensure adequacy of electricity supply at all times. It does this by procuring commitments from generators to be ready to provide generation capacity at times of stress during the committed period, and rewarding them by paying them for making that capacity available.

Eligibility

Plants claiming the Renewable Heat Incentive for generation of renewable heat will be excluded from the Capacity Market (building on the previously announced exclusions for capacity benefitting from other forms of low carbon incentives including the CfD). Also excluded will be plants attracting funding from the European Commission's NER 300 low carbon fund for innovative renewable energy or carbon capture and storage (CCS) demonstration projects, and the UK CCS demonstration programme.

DECC has decided to run a two year pilot (probably from summer 2014) to include permanent electricity demand reduction (EDR) measures within the Capacity Market. EDR would not however be eligible to take part in the first capacity auction in 2014.

Opt-out notifications

The pre-qualification process will begin around 4 months before auctions take place. At that point, all eligible licensed generators will have to declare whether they will take part in the Capacity Market or opt out of the auction. DECC proposes that plant capacity which is opted out of an auction but remains operational will be able to opt back in for all subsequent auctions. Restrictions on the ability to enter future auctions will, however, be placed on generators that declare capacity either temporarily non-operational or intended for closure or decommissioned for the relevant delivery year. This is to encourage generators to provide their capacity into the auction.

Capacity Agreement duration

While capacity agreements will generally last 1 year, longer agreements of 3 or 10 years will be available for capacity providers who are making major capital investments (e.g. building new plant or major plant refurbishment). DECC has proposed detailed qualification criteria for these longer agreements, key elements including:

- 3 year agreements: capital expenditure threshold of £125/ kW (2013 prices) will apply, with 50% of capital to be expended within a year of contract award, and work to be completed within a further year.

- 10 year agreements: capital expenditure threshold of £250/ kW (2013 prices) will apply, with 50% of capital to be expended within a year of contract. Collateral to be provided (e.g. by letter of credit – see box inset for full list) to cover 100% of a plant's potential exposure to the significant termination fees which would apply if the agreement was terminated for breach of the agreement (e.g. £7.5m would be payable for a new plant with 520MW capacity obligation). This is likely to be an expensive requirement to maintain.

DECC is seeking views on potentially offering even longer duration agreements (say up to 25 years) in order to reduce prices.

Penalties and Penalty Capping

Penalties for failure to deliver capacity when needed will be based on the "value of lost load" (VoLL) which is the hypothetical value to customers of preventing blackouts. Based on DECC's current modelling and calculations, with VoLL set at a level of £17,000 / MWh, this might result in a penalty payment of £2,075 per MWh of failed delivery. This could result in substantial penalties for even a short plant outage, which is likely to be a concern for investors.

DECC proposes capping a provider's penalty exposure for an individual unit at somewhere between 101% and 150% of its annual Capacity Market revenue.

Changes in Law

DECC is proposing that once a capacity agreement has been signed, changes to legislation or scheme rules affecting a capacity provider or particular unit will not result in changes to the agreement duration, clearing price (price received by successful bidders at auction) or the de-rated capacity of the plant. This will be of concern to capacity providers who might suffer increased capital or operating costs through changes in legislation (e.g. environmental standards) which cannot be offset in increased remuneration from the Capacity Market. This position differs from that taken for CfDs for which detailed "change in law" provisions apply.

Acceptable types of Collateral for 10 year agreements

Approved letter of credit or equivalent bank guarantee
Cash deposit / prepayment (before delivery of service)
Advance payment (after delivery or service)
Escrow account
Performance Bond given by an insurance company
Bi-lateral insurance
Independent security

Next Steps

Following is a timetable for the next steps for the CfD and Capacity Market elements of Electricity Market Reform[3]:

By end of December 2013 (expected):	➢ **Energy Bill to receive Royal Assent**
End of 2013: publication of:	➢ **Final EMR delivery plan with confirmed CfD strike prices and Capacity Market reliability standard** ➢ **Updated CfD contract terms**
Early 2014:	➢ **First early CfDs signed as investment contracts (under the Final Investment Decision enabling for Renewables Programme)**
Late Spring 2014:	➢ **Government Response to the current consultation** ➢ **Final regulations laid before Parliament (following receipt of State Aid approval)**

[3] More detailed timetables are set out in the consultation paper.

July 2014:	➢ ➢	**Regulations enter into force** **First pre-qualification process for Capacity Market begins**
Second half of 2014:	➢	**First CfDs under enduring regime signed**
November 2014:	➢	**First capacity auction for delivery of capacity from 1 October 2018 to 30 September 2019**
April 2015:	➢	**Earliest date for first CfD payments**

It is worth remembering that other aspects of electricity market reform are either in place or are still being developed:

- **Carbon Price Floor**: The Carbon Price Floor was introduced in April 2013.
- **Wholesale market liquidity**: Ofgem intends to complete its work on reforms to promote wholesale market liquidity with a final decision on intended measures before the end of the year and expected implementation in early 2014.
- **Emissions Performance Standard (EPS):** the Government remains committed to introducing an EPS aimed at preventing future unabated coal-fired generation. Powers to introduce an EPS are included in the Energy Bill. A consultation on certain detailed arrangements will follow Royal Assent of the Energy Bill. Operational plants would become subject to the EPS around 2017/2018 at the earliest.

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