

Contracts for Difference: an EMR CfD Primer

This primer briefing is the first in a series of briefings describing the principal mechanisms introduced as part of the UK Government's Electricity Market Reforms (EMR), namely:

- **Contracts for Difference;**
- **Capacity Market Mechanism;**
- **Carbon Price Floor; and**
- **Emissions Performance Standard.**

The EMR reforms have three key aims: to bolster the security of electricity supplies, encourage the decarbonisation of the power sector and keep energy affordable.

This briefing looks at the Contract for Difference (CfD).

What is a CfD?

A CfD is a financial instrument designed to provide the beneficiary (for our purposes, the generator) with a fixed level of pricing for its power output. It has been introduced as part of the EMR reforms, replacing Renewable Obligations Certificates for new larger scale projects as the principal mechanism for subsidising renewable generation.

A generator will still be required to enter into a contract for the sale of its actual power output (a route to market Power Purchase Agreement, "PPA"), and will be paid for that power according to the commercial deal that it negotiates. However, in parallel with this, the CfD guarantees the generator that it will receive an amount equal to the CfD "strike price" for its power output. If the CfD "reference price" (i.e. the price that the CfD calculates is the market price which notionally the generator should be able to obtain for its output) is lower than the CfD strike price, the generator receives a top-up payment under the CfD equal to the difference between the strike price and the reference price. If the reference price is higher than the strike price then it is the generator who pays the difference to the CfD counterparty for each MWh it sells.

A key risk for the generator under this structure arises if and to the extent that there is a mismatch between the price payable under the route to market PPA and under the CfD reference price. For any period where the CfD reference price is higher than the PPA price, the generator's income will be less than the strike price. Any loss of income in respect of such periods may or may not be mitigated by additional income resulting from periods when the CfD reference price is lower than the PPA price.

Key issues

This briefing describes:

- What CfDs are and how they work
- How CfDs are allocated and the results of allocation round 1
- The key terms of the CfD contract

CfD Allocation Methodology

Eligibility

The criteria for a project to be allocated a CfD are technology-specific. As well as using a qualifying low carbon technology, projects will need to have secured planning permission (and, where applicable, a marine licence and offshore Crown Estate rights) and accepted a grid connection offer.

There are requirements for minimum and maximum capacity sizes depending on the type of technology involved. For example, onshore wind, solar PV and hydro projects must be over 5 MW (below this figure, projects are eligible for the microgeneration feed-in tariff). Other eligible renewable technologies¹ such as offshore wind projects have no minimum project size (although see further below under "Offshore Wind Phasing"). Also larger projects (300 MW or over) will have to obtain government certification that the project will make a material contribution to the development of industry supply chains from the point of view of competition, innovation or skills.

CfD Allocation using Administrative Strike Prices / Auctions

CfDs are awarded to generators in allocation rounds. Most developed renewable technologies have maximum strike prices set by the Government on an administrative basis. However, if the allocation becomes subject to an auction, generators receive strike prices set by the auction instead, (this occurred in the first allocation round).

The Government's initial CfD budget established separate "pots" of funds for different technology types². These pots were divided between projects commissioning in six successive delivery years between April 2015 and March 2021. However, during the first allocation round, the Government only published administrative strike prices for years 2015/16, 2016/2017, 2017/2018 and 2018/19 and therefore applications in this round could only be made for these years. Eligible generators then made an application for a CfD for a specified level of capacity, choosing a "Target Commissioning Date" which fell within their chosen delivery year.

The allocation process was then as follows:

- (a) Firstly the Delivery Body (National Grid) determines whether there are sufficient funds in each pot to offer CfDs to each applicant for that pot, based on the administrative strike prices.
- (b) If sufficient funds are available, CfDs are allocated accordingly on the basis of the administrative strike prices.
- (c) If there are insufficient funds for a certain pot, then the allocation of all CfDs for that pot are subject to competitive auction run by National Grid. This is a sealed bid auction process, which is based on the strike price established by the auction for a specific delivery year and rewards the least expensive projects with CfDs. The projects which bid for a higher strike price than that set by the auction do not receive a CfD.

Different strike prices are set (either administratively, or by auction) for delivery of projects in different years. The administrative strike prices for the first allocation round are set out in Annex 1 Part A. Note that the actual strike prices achieved in the first allocation round through the auction process³ were, in many cases, considerably lower than the administrative strike prices (which are set out in Annex 1 Part B). The second allocation round has been postponed and the Government has indicated that plans for this round will be set out in Autumn 2015.

For nuclear and immature technologies such as CCS and large tidal, strike prices are part of a bespoke package negotiated directly with the Government.

¹ In addition to offshore wind, these include dedicated biomass with CHP; energy waste with CHP; hydro; Anaerobic Digestion; gasification or pyrolysis of biomass or waste; landfill gas; geothermal heat; landfill or sewage gas; tidal; wave; nuclear and CCS.

² Pot 1: Established technologies. Pot 2: Less established technologies. Pot 3: Biomass conversion. See Annex 1 Part A.

³ Announced on 26 February 2015.

Strike prices increase in line with the consumer price index (CPI) and can also be adjusted during the term of the CfD in certain circumstances, for example in case of a Qualifying Change in Law (see below for further details).

Appeals

Applicants will be able to have eligibility decisions reviewed by the National Grid, and appeals against eligibility decisions and contract allocation can be made to Ofgem.

CfD contract

Generators enter into CfDs with the CfD Counterparty, Low Carbon Contracts Company Limited, a private limited liability company owned by the Government and funded by a levy on electricity suppliers.

For renewable generation projects, the CfD consists of an agreement containing information about the specific project and incorporating the published CfD standard terms and conditions. For phased offshore wind projects, there are a number of permutations of agreement to choose from.

Term

CfDs for renewable energy generation last for 15 years (but see below regarding the Target Commissioning Window).

The terms of CfDs for nuclear and CCS will be individually negotiated. The Hinkley Point CfD agreed between EDF Energy and the Government has a term of 35 years, although this is currently subject to legal challenge in the European Courts.

Delivery Incentives

There are three key incentives that encourage generators to plan and achieve their projects in a timely manner:

- **Substantial Financial Commitment Milestone:** Generators need to provide evidence of financial commitment to proceed with the project (either in terms of pre-commissioning spend or other evidence of financial commitment). This has to be provided within one year of signing the contract. There are additional requirements for specific technologies.
- **Target Commissioning Window Period (TCWP):** The TCWP establishes the earliest and latest dates between which the contract can begin. The length of the TCWP is set by the Government on a technology-specific basis (see Annex 2 for the relevant periods). A generator will choose when the TCWP will begin and end although the Target Commissioning Date must be within the TCWP. The generator will then aim to build and commission its project and satisfy all relevant conditions precedent by the end of the TCWP. If it does not do so, the fixed term of the CfD starts at the end of the TCWP, but payments will only be made for periods after all the conditions are satisfied.
- **Longstop Date:** The CfD Counterparty has rights to terminate the CfD contract unless the project is commissioned and other conditions precedent are satisfied by the Longstop Date. This date is again a technology-specific period running from the end of the TCWP (see Annex 2 for the relevant periods).

Capacity Adjustments

The CfD standard terms and conditions give additional flexibility to generators, allowing them to provide less capacity than proposed in their applications as set out below. Capacity can be reduced by:

- (a) an unlimited amount, due to an unforeseen construction-related event which makes the planned capacity uneconomic – at the latest by three months before the Longstop Date (without penalty).
- (b) 25% of the initial estimated capacity adjusted, if applicable, by (i) above; before the Substantial Financial Commitment Milestone (without penalty).

The CfD Counterparty can terminate the CfD if the capacity ultimately installed falls below 95% of the initial estimated capacity (as reduced under (a) and (b) above)⁴.

Offshore wind phasing

Phasing of offshore wind projects, of up to three phases, is available for projects under 1500 MW where at least 25% of capacity has been commissioned in the first phase of the project. Each phase must be over 5 MW. Subsequent phases will receive the strike price applicable to Phase 1. In the first allocation round, Phase 1 has to complete by 31 March 2019 and the Target Commissioning Date for the last phase has to fall within two years of the Phase 1 completion date.

Termination rights

The following key events allow the CfD Counterparty to terminate the CfD:

- (a) Conditions Precedent:
 - failure to achieve initial administrative conditions precedent within 10 business days of the date of the CfD;
 - failure to meet the Substantial Financial Commitment Milestone; and
 - failure to satisfy relevant operational conditions precedent by the Longstop Date, in particular in relation to commissioning at least 80% of project capacity.
- (b) A Qualifying Change in Law preventing completion of construction or permanently preventing generation, or in certain cases causing reduced output or other changes relating to sustainability requirements.
- (c) Key breaches of the contract, such as insolvency, fraud, metering non-compliance, failure to make a relevant payment, insufficient installed capacity (in which case the generator will be required to make a termination payment).

Note that under (a) and (b), there is no entitlement to a termination payment, although compensation may be due under change of law provisions, which may be by way of strike price adjustment. The compensation events for the generator in the event of a change of law are limited to unforeseen changes of law specifically targeted at, or unduly discriminating against, the technology, the project or the project company. Furthermore, the generator may have to pay compensation to the CfD Counterparty if the change in law results in savings to the generator.

Payment

The CfD terms require the CfD Counterparty to give a billing statement to the generator within five business days following the end of the relevant invoice period. Any payment to the generator must be made within 28 days of the end of the period. Conversely, where a payment has to be made by the generator to the CfD Counterparty, it must be made within 10 business days from delivery of the statement.

The liability of the CfD Counterparty to make payments is limited to amounts it has received from electricity suppliers.

⁴ The percentage for wind projects is subject to a number of options.

Annex 1 – Strike prices

Part A – Administrative Strike prices in First Allocation Round

Technology Type	POT	2015/16	2016/17	2017/18	2018/19
Energy from Waste (with CHP)	POT1	80	80	80	80
Hydro (>5MW and <50MW)	POT1	100	100	100	100
Landfill Gas	POT1	55	55	55	55
Sewage Gas	POT1	75	75	75	75
Onshore Wind (>5MW)	POT1	95	95	90	90
Solar PV (>5MW)	POT1	120	115	110	100
Tidal Stream (0-30MW)	POT2	305	305	305	305
Wave (0-30MW)	POT2	305	305	305	305
Offshore Wind	POT2	155	150	140	140
Geothermal (with or without CHP)	POT2	145	145	140	140
ACT (with or without CHP)	POT2	155	150	140	140
AD (with or without CHP >5MW)	POT2	150	150	140	140
Dedicated Biomass (with CHP)	POT2	125	125	125	125
Biomass Conversion	POT3	105	105	105	105

Extract from Contracts for Difference Round Guidance – Contract for Difference Allocation Round – 2014 – National Grid, 3 October 2014

Part B – Strike prices achieved in First Allocation Round

Project Name	Developer	Technology	MW	Strike Price (£)	Delivery Year
BHEG Walsall	BH EnergyGap (Walsall) Ltd	Advanced Conversion Technologies	26	114.39	2018-2019
Energy Works (Hull)	Energy Works (Hull) Limited	Advanced Conversion Technologies	25	119.89	2017-2018
Enviroparks Hirwaun Generation Site	Enviroparks Operations Ltd	Advanced Conversion Technologies	11	119.89	2017-2018
Wren Power and Pulp	Gent Fairhead & Co. Ltd.	Energy from Waste with CHP	49.75	80.00	2018-2019
K3 CHP Facility	K3CHP Ltd	Energy from Waste with CHP	45	80.00	2018-2019
EA 1	Scottishpower Renewables (UK) Limited	Offshore Wind	714.00	119.89	2017-2018 ¹
Near na Gaoithe	Near na Gaoithe Offshore Wind Limited	Offshore Wind	448	114.39	2018-2019
Dorenell Wind Farm	Dorenell Limited	Onshore Wind	177	82.50	2018-2019
Kype Muir Wind Farm	Banks Renewables (Kype Muir Wind Farm) Limited	Onshore Wind	104	82.50	2018-2019
Clocaenog Forest Wind Farm	RWE Innogy UK Limited	Onshore Wind	96	82.50	2018-2019
Mynydd Y Gwair Wind Farm	RWE Innogy UK Limited	Onshore Wind	40	79.99	2017-2018
Nanchlach Wind Farm	Nanchlach Limited	Onshore Wind	39.1	82.50	2018-2019
Solwaybank Wind Farm	Solwaybank Energy Limited	Onshore Wind	37.5	82.50	2018-2019
Sneddon Law Community Wind Farm	Sneddon Law Community Wind Company Limited	Onshore Wind	37.5	79.99	2017-2018
Coire Na Cloiche Windfarm	Coire Na Cloiche Windfarm LLP	Onshore Wind	30	82.50	2018-2019
Bad a Cheo Wind Farm	RWE Innogy UK Limited	Onshore Wind	29.9	82.50	2018-2019
Tralorg Wind Farm	PNE WIND UK Ltd	Onshore Wind	20	82.50	2018-2019
Moor House Wind Farm	Banks Renewables (Moor House Wind Farm) Limited	Onshore Wind	16.4	82.50	2018-2019
Achlachan Wind Farm	Achlachan Wind Farm LLP	Onshore Wind	10	82.50	2018-2019

Common Barn Wind Farm	Common Barn Wind Farm Ltd	Onshore Wind	6.15	82.50	2018-2019
Wick Farm Solar Park	Hadstone Energy Limited	Solar PV	19.1	50.00	2015-2016
Charity Farm	Lightsource SPV 136 Limited	Solar PV	14.67	79.23	2016-2017
Royston Solar Farm	Royston Solar Farm Limited	Solar PV	13.78	50.00	2015-2016
Netley Landfill Solar	REG Netley Solar Ltd	Solar PV	12	79.23	2016-2017
Triangle Farm Solar Park	Cambridshire County Council	Solar PV	12	79.23	2016-2017

1 EA1 will be built in three phases: 2017/18 is the delivery year for phase 1

Crown Copyright: Extract from "Contracts for Difference (CFD) Allocation Round One Outcome" – DECC 26 February 2015

Annex 2

Target Commissioning Window Periods and Longstop Periods

Technology	Target Commissioning Window Period	Longstop Period
Advanced Conversion Technology	12 Months	12 Months
Advanced Conversion Technology with CHP	12 Months	12 Months
Anaerobic Digestion	12 Months	12 Months
Anaerobic Digestion with CHP	12 Months	12 Months
Dedicated Biomass with CHP	12 Months	12 Months
Biomass Conversion	12 Months	12 Months
Energy from Waste with CHP	12 Months	12 Months
Geothermal	12 Months	12 Months
Geothermal with CHP	12 Months	12 Months
Hydroelectricity	12 Months	12 Months
Landfill Gas	6 Months	6 Months
Onshore Wind	12 Months	12 Months
Offshore Wind – Round 2	12 Months	24 Months
Offshore Wind – Round 3 /STW	12 Months	24 Months
Sewage Gas	12 Months	12 Months
Solar Photovoltaic	3 Months	12 Months
Tidal Stream	12 Months	12 Months
Wave	12 Months	12 Months

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