Department for
Energy Security
& Net Zero

Contracts for Difference Allocation Round 5

Annex: final stage assessment of the impact of preventing generators from delaying their CfD start date for commercial reasons

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Introduction

Context

1. The Contracts for Difference (CfD) scheme is the Government’s main mechanism for supporting new, low carbon electricity generation projects in Great Britain. The fifth CfD allocation round, Allocation Round 5 (AR5), will open to applications from developers of renewable technologies on 30 March 2023.
2. On 19 December 2022, the Government published a consultation that invited views on changes to the CfD Standard Terms and Conditions and Private Network Agreement for AR5. The consultation included proposed changes to clarify that the flexibility in the contract for generators to delay their CfD Start Date should not be used to maximise electricity generation revenue prior to starting their CfD contract.
3. An initial assessment of the impacts of this change (primarily on generators and consumers) was included within the consultation, which closed on 5 February 2023. This document sets out Government’s final assessment of the likely economic impact of the contract change to prevent generators from delaying their CfD start date for commercial reasons, following the consultation. The other contract changes detailed in the government response are not included in the assessment, as we deem them to have minimal impact.

Final assessment of impacts

4. The final assessment of impacts includes a more developed analysis than consultation stage, and has led to a greater degree of confidence in our estimate of the net impact of the policy. The previous assessment suggested the contract change could have a neutral or even a negative impact (cost) to consumers. The final assessment has identified additional potential benefits and costs through further internal analysis and responses received at consultation. However, only internal methodological improvements have changed the estimated net position of the contract change, which we now expect to be broadly neutral to both generators and consumers. This final assessment covers the impact of the contract change qualitatively and this approach is viewed as proportionate by Government.
5. The CfD scheme is funded by a levy on suppliers, where the difference between the wholesale price of electricity and strike price is paid through consumer bills. The strike price is determined at auction through a competitive process, where generators are incentivised to bid their ‘minimum viable price’ (a price which balances their estimated revenues and costs). If generator revenues are impacted as result of the contract change, we would expect a change to their strike price bid to reflect this so that their expected revenues are the same before and after the contract change. Generators can therefore offset lost merchant (market) revenue with higher strike prices, so that their lifetime revenues are the same before and after any contract change to prevent delayed CfD Start Dates. Therefore, in general, we expect the impact of the contract

change to be neutral overall to generators, and consumers, given their ability to reflect the change in revenue in their strike price bid.

6. The final assessment has considered the post-CfD cost differences between the counterfactual and policy option, that arise at the end of the contract period, which was set out as an area for further work in the initial Consultation document. The current appraisal period covers the length of a 15-year CfD contract, across multiple allocation rounds, and any additional years where generators delay without eroding their contract. This longer appraisal period is the key driver that has led to the revision of the assessment concluding that the impact of the contract change is cost neutral.

Potential benefits and costs

7. The final assessment identifies many of the same potential benefits and costs of the contract change as the consultation stage assessment. Some of the benefits and costs discussed below are a transfer of revenue between consumers and generators, so do not represent an absolute benefit or cost to society.

The key potential benefits of the contract change are:

a) Preventing foregone CfD payments (avoided generator payments to the LCCC when electricity wholesale prices are higher than strike prices) in the medium-term, from generators delaying their Start Dates if wholesale electricity prices remain high. Preventing foregone payments benefits consumers through downward pressures on electricity bills;

b) A longer-term reduction in CfD payments to generators at the end of the 15-year CfD contract period where the wholesale price is lower than CfD strike prices. The contract change would mean that generators finish their CfD contract and begin generating on merchant terms earlier than if current delays are allowed to continue;

c) Protection against any further unexpected spikes in wholesale electricity prices in the future (should they occur): The contract change prevents foregone payments in the case of future unexpected rises in wholesale prices, protecting the consumer from incurring additional costs. In this case, given price spikes are unexpected, we would not expect generators to be able to price the increase in revenue into their strike price, at least initially, meaning the contract change would only deliver savings to consumers;

d) A reduced risk of negative public reaction if generators continue to delay: If generators continue delaying, then this could damage the public's perception of the CfD scheme as a means of delivering new build renewable electricity generation at a low cost;

e) A reduced risk for electricity suppliers as generators' delays to their Start Dates mean that suppliers cannot effectively risk manage their exposure to CfD costs. This may otherwise result in suppliers mitigating this risk by increasing supply contract prices to consumers;

f) Sending a strong signal to industry that gaming of the CfD scheme will not be tolerated.

The key potential costs of the contract change are:

a) Potential impact on strike prices: In the medium-term, generators bidding into AR5 and beyond may price in potential financial gains from operating under merchant terms before their CfD contract starts, while wholesale prices are high. This involves a generator selling their electricity at current high market prices while avoiding the obligation to pay back into the CfD scheme. Closing off this opportunity could lead to higher strike prices as generators attempt to offset this 'lost' revenue, with these higher costs passed onto consumers. However, as explained below, this cost is assumed to be offset by savings to electricity consumers at the start and end of the CfD contract.

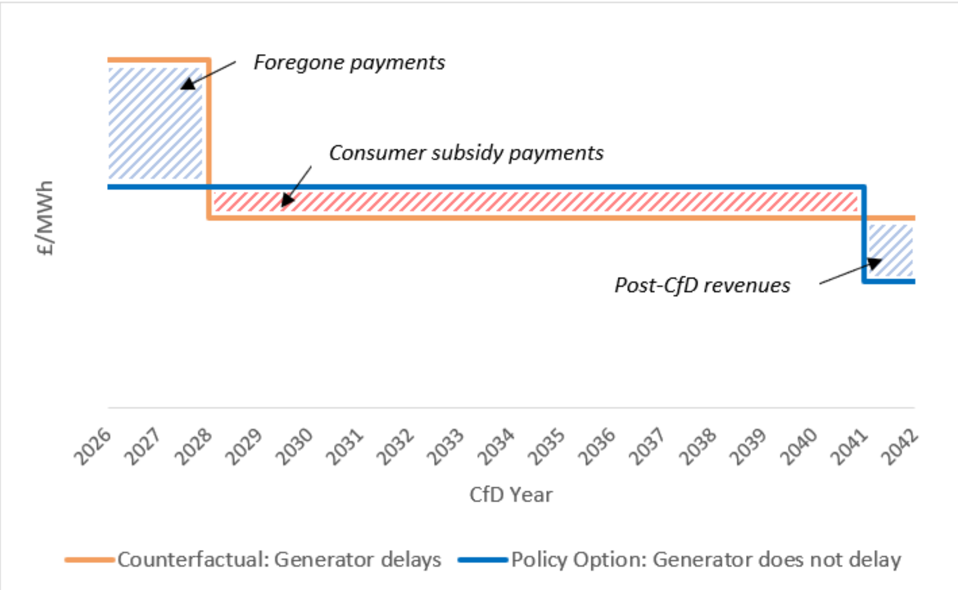
b) There is a degree of risk that the contract change could further reinforce a perception among some stakeholders that the UK is becoming a less attractive prospect for investment in renewables given recent macroeconomic events. However, we are retaining flexibility for delaying the Start Date if there are genuine delays, and generation on a merchant basis is permitted before the CfD Target Commissioning Window. In some scenarios this could even incentivise early construction.

Summary of Consumer Impacts

8. The contract change to prevent generators from delaying their Start Dates prevents foregone payments and reduces the extent of top up payments made to generators at the end of the CfD contract period. This is a benefit to electricity consumers through placing downward pressures on electricity bills. However, generators bidding into AR5 and beyond could have priced into strike price bids the potential upside from merchant generation and post-CfD revenues from utilising the Start Date delay. As a result, any contract change could lead to a corresponding increase in strike prices as generators attempt to offset this 'lost' revenue, resulting in a neutral impact to consumers overall.

9. An illustrative scenario demonstrates the impact of the contract change on the price paid to generators in the counterfactual and policy option and the subsequent impact on consumers (as shown in Chart 1 below).

Chart 1: Price paid to generators in the Counterfactual versus the Policy Option



''Blue" shaded areas represent a consumer benefit, and the 'red' shaded area represents a consumer cost.

10. In the counterfactual, the generator delays their CfD Start Date for commercial gain, for two years until 2028, and avoids the obligation to pay back into the CfD scheme. In the policy option, the same generator begins its CfD contract in 2026 and pays back into the CfD scheme the difference between the wholesale price and the guaranteed CfD

strike price. The first blue shaded area is the consumer benefit of preventing foregone CfD payments. This is a transfer from generators to consumers.

11. When closing off the opportunity for generators to benefit from foregone payments and post-CfD revenues, we would expect this to lead to higher strike prices as generators attempt to offset this 'lost' revenue. Hence, in the policy option, the price paid to generators for their generation is higher between 2028 and 2040 than in the counterfactual, with these higher costs passed onto consumers. The red shaded area is the consumer cost of increased consumer subsidy payments. This is a transfer from consumers to generators.

12. As a result of a delayed Start Date in the counterfactual, the generator is still operating on CfD terms in 2041 to 2042 and is paid its strike price for generation. Whereas in the policy option, the generator ends its CfD contract in 2040 after 15 years and operates on merchant (market) terms and is paid the assumed[1] lower wholesale price for its generation. In the counterfactual, the generator is eligible to receive top up payments from the CfD scheme, of the difference between the wholesale price and strike price in years 2041 and 2042. Whereas, in the policy option, the generator is not eligible to receive these payments, so no additional costs are passed onto consumer. The second blue shaded area is the consumer benefit of post-CfD revenues, representing a transfer from generators to consumers.

13. Separately, it is noted that a key benefit of the change would be protecting consumers against further unexpected spikes in the wholesale price in the future. Whilst the likelihood, size and scale of these future spikes is uncertain, it is plausible that were they to occur, the change could deliver significant net benefits to consumers by capturing foregone CfD payments that were not priced into CfD bids. Reasonable scenarios exist where a future unexpected price spike would lead the contract change to be a significant net saving for consumers overall.

Additional Responses to the Consultation

14. Question 5 of the consultation welcomed views from stakeholders on any impacts explored in the consultation stage assessment. Government received some responses on the potential benefits and costs of the contract change however, no new evidence on the impacts explored was received from the consultation, so revisions to the assessment have been made only from internal methodological improvements. In addition, no responses were received that presented alternative evidence to disprove the above assessment.

15. The consultation provided an alternative perspective to the assessment that allowing Start Date delays and therefore, enabling generators to have a 'merchant nose' could lead to lower strike prices, which may be viewed as beneficial to consumers. However, the above assessment demonstrates that, all things equal, we would expect any reduction in strike prices as a result of not making the change to be broadly offset by foregone CfD payments, meaning the net impact to consumers would still be neutral overall.

[1] Estimates of future wholesale electricity prices are associated with uncertainty, but there is a broad consensus that wholesale electricity prices will fall significantly as the penetration of renewable generation increases over time. This results from 'price cannibalisation', where the wholesale electricity price is depressed at times of high output from intermittent, weather-driven renewables such as solar and wind.

This publication is available from: https://www.gov.uk/government/consultations/cfd-contract-changes-for-allocation-round-5