



CfD Allocation Round 2 – the Framework is here, game on!

10/2/2017

On Wednesday (the 8th of February), alongside a number of detailed documents about the form of the CfD that is being auctioned this year, BEIS published the really crucial piece of the puzzle: the Draft Allocation Framework. Those of you who read my blog from November, when the Draft Budget Notice was published, will recall that in order to make an informed estimate of how far the £290m budget will go, we need the reference prices that will be used to assess the budget usage of each MWh produced. These crucial numbers are contained in the Draft Allocation Framework, so we can now have a stab at working out how the round will play out.

From a quick skim, the Framework looks very similar to the AF for AR#1, and indeed there are large swathes of it that must have been cut-and-pasted, as they will not be necessary this time round: there is only one Pot and no minimum (a maximum is being imposed for the fuelled technologies but I don't think it will be troubled). The only real interest lies in the reference prices, and they are published in Appendix 2 (p6 of Schedule 2, p36 of the overall document). It's a short table:

Reference Price (in 2012 prices)

	2021/22	2022/23
Reference price £/MWh	39.86	42.60

There are a number of things to note about these numbers. The currency is 2012 £ – it's always important to remember the common currency of EMR, and indeed where there are discrepancies. For instance, the budget for this round is commonly quoted as £290m, but this is in 2011/12 money, while in 2012 money it is £295m. Such details can make the difference between success and failure. So be sure to get all the money years aligned in your spreadsheet.

There are only reference prices for the two delivery years. This is odd, as offshore wind projects are very likely to phase delivery over the three years they are able to do so (particularly if they are large projects) and therefore one would expect the greatest budget draw *after* 2022/23. Without reference prices, you can't calculate the budget usage, so it seems strange that there aren't clear prices for the two years after the delivery years available for first Target Commissioning Date (TCD). The Allocation Framework for AR#1 had reference prices up to 2020/21, even though the available delivery years only went up to 2018/19 – and the nearest Pot 2 came to breaching the budget in that Round was in 2020/21. In my calculations I have been using £42.60/MWh after 2022/23, but I am seeking clarification from BEIS about this point.

Finally, these numbers are *considerably* lower than those published by DECC in late 2015, which is the last time Government officially published its forecasts of wholesale electricity prices. Then, the

numbers for 2021/22 and 2022/23 were about £50/MWh, so there has been a c.20% reduction. This is not wholly surprising given the stubbornly low wholesale prices now and the much lower forecasts of fossil fuel prices that BEIS published in November 2016 compared to late 2015. It does however have an impact on how much capacity can be afforded; the question becomes whether the cost reductions that we have seen in the offshore sector recently can significantly outpace this reduction in reference prices.

Now that we have reference prices (at least for the two delivery years), the only other variables we need are the exact timing of project delivery and the strike prices bid. Timing becomes important through the application of the 'Year 1 factor', though with an assumption of flat reference prices after 2022/23, this effect has limited impact. It may become important if BEIS publishes reference prices for 2023/24 and 2024/25 that are higher. In the interest of brevity I'm not explaining this here, but ask me if you're interested in this detail.

If we assume that the TCDs of all phases are set in the middle of the initial delivery years, then we can take a look at the impact of different strike price scenarios. For the purposes of this calculation I'm positing that two equal-sized projects are successful, one with a first TCD in 2021/22 and the other a first TCD in 2022/23, both of which deliver in three equal phases. With strike prices of £92.50/MWh, two projects of 750MW could be afforded, except that the budget would be breached in 2025/26 if the reference price were to remain at £42.60. However, the reference price would only have to rise to £45/MWh in 2025/26 for this amount of capacity to become affordable.

If we take the same delivery scenario of two equal projects but a clearing price of £82.50/MWh (which is where most Pot 1 capacity is cleared in AR#1), then two 900MW projects could be afforded. If we were to speculate further that strike prices could go as low as £72.50/MWh (which is roughly where Borssele 3&4 and Kriegers Flak ended up if you assume about £10/MWh for transmission), then there is an even greater leap up to 2,400MW overall being affordable in two 1,200MW projects – it's interesting to note that the closer you get to the reference price, the steeper the rise in affordable capacity.

So, what does this mean for the overall result of the round? Back in November I hedged my bets a bit and said that I thought 1-2GW of capacity was possible from the budget available. I'm now feeling confident that we should see *at least* 1.5GW of capacity from the round, given that clearing prices of circa £90/MWh are looking conservative after the last six months. I'd say the result is likely to be nearer to 2GW, and could possibly be higher than 2GW if bidders are willing to sacrifice profit margins in order to win. The game is afoot!