



# 02 Contracts for Differences

Electricity Market Reform Briefing Paper  
October 2012

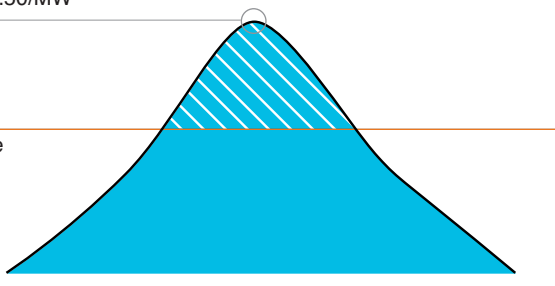
The second in our series of briefing papers which we will be issuing to summarise some of the current issues and progress around Electricity Market Reform (EMR) will look at some of the issues with Contracts for Differences (CFDs)

## Back to basics – what does a CFD do?

CFDs have been in force since the privatisation of the UK power market in the early 90s. Importantly they are not contracts for the purchase or sale of electricity, rather they allow a buyer and seller of power to allocate or “hedge” their financial risk. The seller of power (Generator) is usually paid an option fee by the buyer (Supplier) for granting the CFD. Money flows as “difference payments” between them, normally to the Supplier, under a CFD are usually in one of two ways:

Market price or “reference price” = £2.50/MW

Strike price  
£1/MW



The “hatched” area represents the difference payment of £1.50/MW between the reference price and the strike price, set for EMR by the Government, typically paid by the Generator to the Supplier. The hedge in a one-way CFD is in favour of the Supplier who receives the difference payment from the Generator. If the reference price falls below £1.00/MW to £0.50/MW the Generator still receives £1.00/MW and the Supplier bears the cost of the £0.50/MW difference payment – a two way CFD.

## What is EMR doing with CFDs?

Arguably nothing that CFDs were not designed to do – which is “stabilise returns to generators at a fixed level...” (draft Energy Bill). The EMR White Paper<sup>1</sup> issued back in July 2011 sets out in more detail DECC’s rationale for choosing CFDs as its main market instrument. The CFD will be a long-term contract combined with a Feed-in-Tariff and is proposed to be two-way.

## What are the issues?

### Briefly some of the issues are:

- **Counterparty** – it looks like there may be a move away from the generator – multi-supplier/counterparty model if the Climate Change Select Committee prevail. If there is a single counterparty with government backing this may enhance the “bankability” of the CFDs, however, there will remain interesting issues if you are a lawyer or not – around how the CFDs cope with any material adverse change and/or change in law. Certainty will be important to the market as the scope of any contract “re-openers” will need to be carefully considered.

For example, if the reference price of the CFD is based on a market index which, during the life of the contract is altered, then it will need to be adjusted to retain the status quo. Whether the new reference price is arrived at by an independent expert or otherwise, there may be issues around the finality of any decision taken.

- **Universality** - DECC in the draft Energy Bill state that CFDs will be largely standardised across technologies. However, they concede that variation in CFDs to recognise different risk profiles may be required e.g. early stage carbon capture projects. The Government will have a considerable task to ensure that the CFD meets industry requirements. The inclination will be to standardise as much as possible to keep costs down and encourage market entry.
- **Grandfathering** - is the principle that CFDs cannot be changed retrospectively once issued. No doubt there may be exceptions (see “Counterparty” above) and these exceptions and their scope will be critical to market acceptance. From a legal perspective, there is an issue in that a future Parliament is not normally bound by its predecessor. EMR and CFDs are designed to last well beyond the next election and the industry will need to live with the possibility of further change.

## Conclusion

CFDs have been around for a number of years but normally as an adjunct to a market, e.g. the Pool, and not as a central pillar as in EMR. It will be interesting to see if CFDs will be able to cope with their pivotal role under EMR. We should have more clarity when the draft Energy Bill is presented to Parliament scheduled for later in the Autumn.

If you require advice on any of the matters raised in this paper, please get in touch with any of our lawyers listed below, who have been focusing on keeping updated on EMR developments, or your usual Shepherd and Wedderburn contact.



**James Saunders**  
Partner

T: 0131 473 5288

E: james.saunders@shepwedd.co.uk



**Suzanna Wolstenholme**  
Assistant

T: 0131 473 5734

E: suzanna.wolstenholme@shepwedd.co.uk



**John Grady**  
Associate

T: 0131 473 5411

E: john.grady@shepwedd.co.uk



**Charlotte Phipps**  
Business Development Manager

T: 0207 429 4929

E: charlotte.phipps@shepwedd.co.uk