

CfD Round 2 auction:

Positive winds for offshore - But don't get blown over just yet

Following the announcement of the results for Round 2 of the CfD auction, we explore what they mean for the offshore wind energy sector and the deployment of renewable electricity generation. We consider the incentives for bidding behaviour present under the CfD auction design and the implications these may have on auction results.

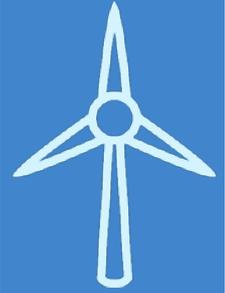
CONTEXT

Results were declared for Round 2 of the Contract for Difference (CfD) auction on 11 September to much industry interest and comment. At a clearing price of £74.75/MWh for 2021-22 and £57.50/MWh for 2022-23, three offshore wind projects (Triton Knoll, Moray East and Hornsea Project 2) won contracts. In total, they represent 3.2 GW of offshore wind capacity.

Some have suggested that the ability of offshore wind developers to clear at such low prices represents a watershed moment in the industry, demonstrating the competitiveness of offshore wind with not only nuclear, but also traditional thermal generators, such as CCGTs. While we too believe the results from this auction undoubtedly present a good news story for offshore generation and for the CfD auctions more generally, we urge a little caution in interpreting results.

As many commentators have noted, it is important not to extrapolate directly from the prices submitted in these auctions to infer the current levelised costs of offshore wind. Some have attempted to dampen enthusiasm by highlighting the additional costs that come with intermittency. Some suggest that these additional costs may be of the order of £10/MWh – not insignificant. But even allowing some headroom on these estimates, the auction results suggest that the cost of offshore wind energy is rapidly becoming more competitive vis-à-vis traditional technologies.

In this article, we instead focus on the incentives under the CfD mechanism and the implications for bidding behaviour. We argue that individual views of technology developments, low penalties for non-delivery and a strong desire of offshore wind developers to ensure a successful bid must be taken into account. Once these factors are considered, we suggest that recent auction results may reflect the most optimistic estimate of future offshore generation costs in the early 2020s.





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TECHNOLOGY COSTS

Results of Round 2 of the CfD auctions are for delivery between 2021 and 2023. Recent years have seen technological improvements for offshore wind projects which have allowed costs to decrease. Thus, the bid prices of successful projects are likely to represent a forecast of technology costs that developers will face in the future, rather than those which are present today. Of course, this is as it should be – bids should be priced to reflect projections of costs to deliver on future agreements rather than on existing technology and costs. But this does introduce an element of judgement in determining an appropriate bid price. The level of ambition of these forecasts when bidding into the auction may have been influenced by other considerations, such as those suggested below.

PENALTIES FOR NON-DELIVERY

Following success in bidding for a CfD, the penalties for non-delivery are not particularly strong. Developers do bear the costs of bidding for, and entering into, a CfD. And, in the event of non-delivery, they are not allowed to make a new application at the same site for 13 months following (whether resulting from a refusal to sign the CfD contract or termination of a CfD contract which is in place). However, with no additional financial penalty for successfully bidding into the CfD auction but subsequently failing to deliver, bid prices may not be much more than ‘cheap talk’. Developers can walk away from the contracts relatively easily if the reality regarding future technology costs does not meet their expectations.

THE WINNER’S CURSE

The “winner’s curse” was coined as a term in relation to bids for offshore oil drilling rights in the Gulf of Mexico back in the 1950s. It reflects the tendency for bids in auctions to be priced above intrinsic value (or as would be the case in the

context of renewable CfDs, below reflective cost estimates) when there is incomplete information about the true value. This may be due, for example, to factors such as the strength of intent to ensure success in the auction in the hope that the clearing price may be above the submitted bid. It may also reflect the inevitable outcome that, in the presence of multiple bidders of similar technology types, those with the lowest cost projections are most likely to be successful. Experience with auctions (e.g. for telecom spectrum) confirms that the winner’s curse is particularly problematic where uncertainties are present in relation to ‘common cost components’ (i.e. those that are similar or the same for a number of bidders). These common cost components are prevalent for those offshore wind projects participating in the auctions. The winner’s curse may have led to ambitious assumptions of winning bidders regarding the future pace of technology development, which in turn could result in lower-priced bids.

AN OPTION FOR FUTURE DELIVERY

It is possible that the successful bids of offshore wind projects recently witnessed in the CfD auction may reflect their *real option* value – i.e. the value of the option to develop those projects, or not develop them, subject to any penalties the developers would have to pay for non-delivery. Lowering bid prices for the real option value may be a rational bidding strategy, especially if low penalties for non-delivery allow successful bidders to ‘wait and see’ whether the technological developments that they are hoping for are realised before committing to delivery.

Global experience demonstrates the scale of challenge in turning successful auctions into high realisation rates. For example, some renewable electricity auctions in France and Brazil have achieved realisation rates of less than 30%.



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In the presence of significant further cost reductions, successful offshore wind projects may well be able to deliver against the strike price in their CfD contracts. Like others, we hope they can. If not, incentives to deliver these projects may merit a further review.

Regardless of outcome, the prices witnessed reflect a very positive direction of travel for offshore wind generation. And if we witness delivery against the clearing prices seen in this auction round, this would confirm the watershed moment for offshore wind that many have claimed.

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