



Making a positive difference
for energy consumers

The Rt Hon Claire Coutinho MP
Nuclear Projects and Development
Department for Energy Security and Net
Zero (DESNZ)
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Dear Secretary of State,

Ofgem's response to the consultation on modifications to the Sizewell C Regulated Asset Base licence

We¹ welcome the opportunity to respond to this consultation² on the Secretary of State's proposed modifications to Sizewell C's electricity generation licence ('the licence').

Ofgem regulates the gas and electricity markets in Great Britain. Our principal objective is to protect the interests of current and future gas and electricity consumers. The Nuclear Energy (Financing) Act (the Act), which achieved Royal Assent on 31st March 2022, formally extends our statutory duties to cover designated nuclear Regulated Asset Base (RAB) licensees. We have, and continue to, provide advisory support to DESNZ development of an economic regulatory regime (ERR) for nuclear RAB licensees. The Act also names us as a statutory consultee on the economic licence.

We have been working with DESNZ in an advisory capacity in the design of the regime and development of licence conditions. As such we have had the opportunity to discuss with DESNZ the content of the draft economic licence and have already provided advice relating to its contents. We welcome the commitment DESNZ has made to working constructively with us.

¹ References to the "Authority", "Ofgem", "us", "we", "our" are used interchangeably in this document. The Authority refers to GEMA, the Gas and Electricity Markets Authority. The Office of Gas and Electricity Markets (Ofgem) supports GEMA in its day-to-day activities.

² [Regulated Asset Base Licence Consultation: Modifications to Sizewell C Limited's electricity generation licence \(publishing.service.gov.uk\)](https://publishing.service.gov.uk)

Our view is that, on the whole, the current draft of the licence (which should be read alongside our Economic Guidance) strikes a suitable balance between:

- a) providing certainty to investors, which may be necessary to provide confidence for investment in a new regulatory regime; and
- b) retaining appropriate regulatory discretion for Ofgem to make decisions in the future, particularly in relation to the operations phase, which is required to ensure that the balance of risk between consumers and investors remains appropriate under future conditions and consumers continue to be protected.

We note, however, that the ERR, its fairness to consumers and taxpayers and attractiveness to potential investors, is predicated on an appropriate degree of certainty around the underlying project costs and contracts. As such it is important to ensure all aspects of the project are appropriately progressed before making licence modifications. This is especially pertinent given the ongoing challenges being experienced by EDF with the construction of Hinkley Point C, which shares many design elements with the proposed Sizewell C plant.

When considering responses to this consultation, our expectation is that DESNZ will continue to ensure that value for money for consumers is a priority consideration in any analysis and decision making around potential changes to the licence, and that any changes made are well justified and evidenced. In addition, it is vital that DESNZ also takes into account the effect of any potential changes on the overall operability of the licence and Ofgem's ability to effectively discharge our obligations over time.

Finally, we note our expectation that, prior to revenue commencement, the Secretary of State will ensure that there is a robust case that the project is likely to deliver value for money. We consider this should be informed by the terms of the economic licence and related documents (i.e., the Government Support Package) as well as supply chain contracts and the expected construction costs.

We look forward to continuing to engage with and support DESNZ on the development of the ERR for Sizewell C, as well as for any future nuclear projects that the Secretary of State may decide to designate.

In the interests of transparency, we will be publishing this, our full response, on the Ofgem website.

In response to this letter, if you would like to discuss further, please contact my colleague

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Yours sincerely,
Gordon Hutcheson
Deputy Director, Low Carbon RAB

Appendix: Our response to the five consultation questions

1) Do consultees consider that the licence modifications outlined within this consultation strike a reasonable balance between the need to support the financeability of the licensee and the need to safeguard consumer interests?

Government has taken the decision to use the Regulated Asset Base (RAB) model to fund large-scale nuclear projects, including Sizewell C. Inherent to the RAB model is a sharing of costs and risks between consumers and investors, with the proportion of risk transferred to consumers deemed necessary by the Department for Energy Security and Net Zero (DESNZ) to attract private finance at a cost that represents value for money for consumers and taxpayers. In line with our principal objective, Ofgem has been engaging with DESNZ in an advisory capacity to ensure that, in the design of the economic regulatory regime (ERR) and the allocation of risk, the interests of existing and future energy consumers are protected.

The licence modifications in and of themselves do not explicitly consider 'financeability' in the way that Ofgem would interpret the term in relation to our existing approach to regulation. We consider this is appropriate, noting that our statutory duties require us to have regard to the need to secure that licence holders are able to finance the activities which are the subject of obligations on them. Our Economic Guidance provides further details of how we would expect to consider 'financeability' for Sizewell C.

More broadly, there are aspects of the draft economic licence that we consider are likely to aid financeability. For example, the incentive package, sharing factors for over and underperformance and protections in place, are designed to provide an appropriate level of risk reduction to facilitate private investment so that the project remains financeable whilst safeguarding consumer interests. We are broadly supportive of the inclusion of revenue floors and liquidity support mechanisms, which are there to protect the licensee against extreme downside risks in relation to plant availability and to ensure sufficient in-year liquidity. This builds on regulatory precedent in other regimes Ofgem administers, including electricity interconnectors and Offshore Transmission Owners (OFTO).

Any changes made to this draft licence will need to be both carefully considered and subject to robust analysis to assess their impact upon consumer value. The licence modifications allow for Ofgem to have an appropriate level of discretion at the Post Construction Review (PCR) so that the balance of risk can be maintained. We are required to consider financeability when applying our discretion, alongside our principal objective to protect the interests of consumers, and will consider the need for the licensee to maintain suitable levels of investment when making decisions such as setting the Regulatory Weighted Average Cost of Capital (RWACC) and notional gearing. This discretion offers protection against changes in circumstances for both consumers and investors, ensuring we can take the right decisions at the time.

One specific area of the draft economic licence we want to highlight are arrangements around early closure. We understand Government's position that, to make Sizewell C an investible proposition, consumers rather than the licensee and investors should bear the cost of the decommissioning of Sizewell C in all circumstances. Of particular concern is that, in an early closure scenario, unless the Secretary of State otherwise directs, the licence will be only partially revoked to facilitate continued funding for decommissioning by consumers. Whilst we agree that it is important that decommissioning liabilities are adequately funded, and we support the inclusion of the Funded Decommissioning Plan (FDP) building block on that basis, we do not wish to see a situation where consumers bear the cost of paying for the decommissioning of a nuclear plant from which they may have seen little or no benefit as regards low-carbon, low-cost electricity and security of

supply. We would welcome a commitment from the Secretary of State prior to these licence modifications coming into force that, should early closure occur, they would consider all funding options available before making any final decisions on recovering any potential shortfall from consumers.

2) Do consultees consider that the incentives and penalties placed on the project through the modifications will support the efficient and timely delivery of the project, ensuring greater value for money for consumers?

In line with our principal duty, Ofgem is primarily concerned that existing and future consumers' interests are protected and, to that end, that the project achieves value for consumers in the form of a reliable source of electricity that will contribute to the UK meeting its 2050 net zero target. During the pre-PCR phase, before the nuclear plant is generating electricity, consumers will be paying the whole cost of the project via supplier levies. Any delays to the project or cost overruns will increase both the amount of consumer money needed to reach the operations phase and the time before consumers benefit from the electricity the plant will generate, thus negatively impacting upon the value of the project for consumers. Likewise, despite cost-sharing mechanisms, a proportion of cost overruns below the Higher Regulatory Threshold (HRT), and potentially all costs above the HRT, will be funded by consumers over the whole expected plant operating life.

As such we consider that the conditions of the economic licence can only work effectively where the underlying project cost and schedule estimates are robust prior to the Final Investment Decision (FID). The effective operation of cost, schedule and quality incentives can only be considered alongside the quality of the underlying supply chain contracts. This is particularly acute given likely investor perception around the likelihood of large construction projects in general, and nuclear power projects in particular, to experience schedule delays and cost overruns (e.g., Hinkley Point C). We expect, therefore, that DESNZ will ensure relevant supply chain arrangements are suitably robust before making economic licence modifications, and that the technical aspects relating to relevant licence conditions (e.g., around the capacity incentive) are appropriately scrutinised.

During the pre-PCR phase, the primary drivers for the project achieving value for consumers are cost (capital and operational spending), schedule (time taken for the plant to be constructed and operational), and quality (specifically Sizewell C's operational capacity). In considering the overall effectiveness of the construction phase incentives, they need to be assessed together as a package. We are, in the main, content that the package of incentives is likely to support the efficient and timely delivery of the project, whilst providing sufficient protection for the licensee and investors to temper the inherent complexity and uncertainty of a nuclear project. The incentive package takes a broadly consistent approach with existing regulatory precedent to incentivise efficient cost, scheduling and quality.

Any changes to the package of incentives would need careful consideration and analysis to ensure that they retain the strength necessary to ensure that the risks of the project are mitigated and that consumer value is achieved, and that any potential changes are considered in the round, including against, for example, supply chain contracts and assessments around deliverability.

3) Do consultees consider that the operational performance incentives included in the proposed modifications encourage the right behaviours?

The draft economic licence sets out the main obligations and incentives on the licensee that we would expect, based on our understanding today, to be necessary or desirable. We broadly consider that we have sufficient powers around, for example, enforcement to ensure we can hold the licensee to account in relevant areas. Furthermore, the licence incentivises the licensee to maintain plant capacity through life, maximise availability, spend efficiently and optimise the price achieved around sales of electricity in the wholesale market.

While this suite of obligations and incentives is more limited than we would place on gas and electricity network companies under the RIIO³ regime, we consider that it is likely to be appropriate given the different nature of the ERR being implemented for Sizewell C and the underlying differences between a nuclear power plant compared to a gas or electricity network. In this context, we agree it is appropriate that there is a strong incentive in place to encourage the licensee to maximise plant availability to achieve value for money for consumers, with a range of measures to help mitigate the potential financial impact on the licensee for any unplanned outages.

Some degree of flexibility for Ofgem to make adjustments to the operational phase incentives is important, as PCR is 10+ years hence and Ofgem will need to make decisions based on conditions at that time to appropriately incentivise the licensee whilst having regards to financeability. We will also have the ability to ensure that targets for incentives are appropriately set over time, taking into account relevant evidence around expected performance over each price control period. Our Economic Guidance sets out further details of how we would expect to approach decision making in this area.

Notwithstanding these points, after considering the broader incentive package that is being proposed for the post-PCR phase of the regulatory regime, we recognise that there are some overlapping and potentially conflicting features of the framework, which may build unnecessary complexity into the revenue mechanics. We consider there are opportunities to simplify some of the revenue mechanics set out in the draft licence, without impact on the allocation of risks or the core policy objectives. Specifically:

- *Significant unavailability revenue support to be treated as a difference payment adjustment rather than part of allowed revenue.*
- *Aligning thresholds to a single revenue floor.*
- *Removing one of the revenue support repayment building blocks and having a single repayment mechanism.*
- *Providing all unplanned outage support on in-year basis.*

We look forward to working with DESNZ to test the viability of some simplification in these areas and will provide further detailed explanations.

4) Do the modifications set sufficiently clear expectations and boundaries for how the project company should operate in the market over time, and do the modifications contain sufficient flexibilities to account for future uncertainties in the energy market?

DESNZ has taken the decision that Sizewell C should participate in the wholesale electricity market. At a basic level we consider it imperative that, if Sizewell C participates in the market, it faces appropriate obligations and incentives to ensure any risks of market distortion are minimised. We consider all relevant areas, including licence obligations, incentives and liquidity support, should be viewed as a package and assessed based on

³ RIIO stands for Revenue = Incentives + Innovation + Outputs

whether, taken together, they are likely to incentivise the right behaviours. We would not expect Ofgem to set a trading strategy for Sizewell C, as this will be for the licensee to determine. We note that Sizewell C will be unique in being the only electricity generator with this form of economic regulation.

We, therefore, agree with the principle applied in the licence to broadly mirror the existing Contract for Difference (CfD) regime. This includes both incentivising Sizewell C around the price achieved in the market and using the Baseload Market Reference Price (BMRP) as the benchmark for this incentive, noting that BMRP is used for baseload CfDs (e.g., Hinkley Point C and Drax). Sizewell C will also have a licence obligation around potential market distortion and will continue to be bound by other relevant rules like REMIT⁴.

While the licence sets out the details of the market price incentive, it does also note that we have the ability to make a determination in this area at the PCR. Our Economic Guidance provides further information on our likely approach. Some degree of flexibility in this area is important to protect the interests of consumers and the licensee, as we acknowledge the difficulty of predicting future market characteristics 10+ years from now.

5) Do consultees think that the modifications provide Ofgem sufficient oversight in its capacity as economic regulator of the licensee?

We recognise that DESNZ needs to strike a balance between providing enough certainty in the licence to attract private investment while giving Ofgem an appropriate level of discretion to discharge our duties. We are broadly comfortable with the licence in this regard. In acknowledgement of the uncertainty inherent in a new regime with necessary discretion on future decisions, Ofgem has provided Economic Guidance which sets out the approach we would expect to take in exercising that discretion in the economic regulation of the licence. This is a novel approach and is designed to address potential concerns in relation to areas of the ERR that the licence does not cover or does not cover in detail.

The discretion granted to Ofgem in the licence, particularly in relation to the setting of the RWACC and the calibration of incentives for the operational phase, provides protection against changes in circumstances for both consumers and investors, and ensures that we can take the right decisions at the time. We expect there to be a long construction phase (10+ years), over which time several relevant factors to the economic regulation of a nuclear licensee may change. It is right that we are able to make evidence-based regulatory decisions with full awareness of market conditions. Both investors and consumers stand to benefit from this approach rather than one which attempts to lock key parameters in advance. This is standard practice in other regulatory sectors, such as the RIIO price controls, where we review and modify licences at the start of each price control.

There are certain areas of the licence which require us to accept Secretary of State discretion (e.g., waiving Commercial Operations Date (COD) requirements where Sizewell C has notified that it is likely to miss Scheduled COD, funding of any FDP shortfall, licence modifications). It is important for all parties to be clear on the boundaries between ministerial decisions and Ofgem's in line with our duties. DESNZ should appropriately consider the necessity of these types of condition.

Should DESNZ consider making any changes to the discretion currently provided to Ofgem in the conditions set out in the draft economic licence, we would expect DESNZ to consider fully the potential adverse consumer impacts that may result from such changes, and to consult further with Ofgem.

⁴ REMIT is Regulation (EU) No 1227/2011 on wholesale energy market integrity and transparency.