RESPONSE TO THE CONSULTATION ON ENERGY MARKET REFORM ON BEHALF OF NON-FOSSIL PURCHASING AGENCY LIMITED

Background to Non-Fossil Purchasing Agency Ltd ("NFPA")

NFPA was set up by the then twelve Regional Electricity Companies ("RECs") in their capacity as Public Electricity Suppliers ("PESs") in 1990, to act as their agent in discharging their responsibilities under the Electricity (Non-Fossil Fuel Sources) (England and Wales) Order 1990. This, and subsequent orders required the PESs to contract for the purchase of specified quantities of nuclear generation and specified quantities of renewable generation, the latter from plant which was to be constructed as part of the contractual arrangements.

In this role, NFPA operated a portfolio of contracts comprising a relatively large number of small scale (sub approximately 30MW) renewable generation projects; a smaller number of slightly larger scale (30MW to 50MW) renewable generation contracts; and contracts covering nuclear output. Of these three categories of contract, the first group were fixed price, effectively fixed FIT contracts, and the second two were CfDs struck against the then Pool Purchase Price. NFPA was also involved in the tender process, together with the DTI and OFFER, which resulted in the awarding of the renewable contracts to developers/generators. There were, in total, five renewable NFFO Orders, the last of which was in 1998. The first two renewable orders were of relatively short duration and all the contracts had terminated by 1998. The last three orders provided for the construction of the relevant facility and for output to be delivered and paid for for up to 15 years, and most of the contracts pertaining to these orders are still extant.

The main delivery provisions of the nuclear contracts terminated in 1998 with the privatisation of the then Nuclear Electric, although, since the payments were in arrears because Government had deemed it undesirable to raise the Fossil Fuel Levy to a high enough level to discharge the amounts due in full, payments continued for a short while to discharge this debt.

With the opening of the electricity supply market to full competition, the replacement of the Electricity Pool by New Electricity Trading Arrangements ("NETA"), and the imminent arrival of the Renewables Obligation, it was inappropriate for the NFFO arrangements, which applied only to a subset of electricity suppliers, to persist in their then form.

It was, however, necessary to maintain the integrity of the generators' contracts to avoid disturbing investor confidence and, therefore, the Electricity from Non-Fossil Fuel Sources Saving Arrangements Order 2000 (SI 2727)(the "Saving Order") was made. This required the PESs to make arrangements such that the capacity which was to be made available via the (three) extant renewable NFFO orders remained available to the electricity market and to nominate an entity (the "Nominated Person") to hold new contracts with the generators and developers which must be on substantially the same economic terms as their original contracts.

NFPA was restructured to fulfil that role and is the Nominated Person under the Saving Order. In this role, it is the contract counterparty to some 267 contracts representing 1473MW, 203 of which are currently generating, under the three Non-Fossil Fuel Orders let in 1994, 1995 and 1998 (these

figures rise slightly if NFPA Scotland is included, see below, to 314 contracts covering 1624MW, with a total of 242 generating).

NFPA itself does not sell electricity to end consumers and does not, therefore, take physical delivery. It deals with the electricity from the generating stations with which it is contracted by selling the output on to electricity supply companies. This it does by holding on-line auctions for the rights to the output of the generating stations (currently, these are held twice a year for the forthcoming six month period).

NFPA is owned by NFPA Holdings Limited ("NFPAH"), which, in turn, is owned by the electricity supply arms of EdF Energy, Eon, RWE npower, Scottish and Southern Energy and Scottish Power. The reason for the ownership being with these specific companies is that they are the successor companies to the PESs with whom the original obligation to enter into the contracts, as described above, rested. Consequently, the obligation to ensure that NFPA as the Nominated Person continues to discharge its responsibilities under the Saving Order is on these companies.

Importantly, the Saving Order specifies that the on-sale of the output from the facilities must be carried out on an arm's length basis. This was achieved by including in the formal arrangements which had to be approved by Ofgem the terms of a Management Agreement between NFPA and NFPAH which prevents NFPAH from involvement in the day to day operations of NFPA (this is, of course, vital because the companies who are shareholders of NFPAH typically compete in the on-line auctions with other companies who are not shareholders).

A subsidiary of NFPA, NFPA Scotland, carries out a similar role in respect of the equivalent legacy SRO contracts in Scotland on behalf of Scottish Power and Scottish and Southern Energy in their role as successor supply companies to the two PESs in Scotland.

The turnover of NFPA and NFPA Scotland in the current financial year will be in the order of £276 million.

Since the current operations began in 2001, the two companies have paid a total of £1.2 billion into the Fossil Fuel Levy and the Fossil Fuel Levy Scotland.

A further subsidiary of NFPA, NFPAS, hosts on-line auctions of Renewable Obligation Certificates ("ROCs") on behalf of commercial sellers and also auctions Renewable Transport Fuel Obligation Certificates for commercial sellers. As auctioneer, NFPAS charges sellers a commission fee.

Responses to the Specific Questions in the Consultation Document

The responses below are grouped using the numbering in the Executive Summary.

Feed-In Tariffs Questions 3 to 11.

The different forms of feed-in tariff considered in the consultation are likely to have different impacts on potentially eligible generators depending on their technology, locations and also their size.

A large scale nuclear generator is likely to have the resources, market presence and expertise to enable it to sell its electricity at the market wholesale price, or close to it. This is likely to mean that,

if it has a CfD referenced against a wholesale market price, the contract will perform as it is intended to, thus providing the anticipated revenue without discount and smoothing out variations in the underlying price of wholesale electricity.

A smaller scale renewable generator is much less likely to occupy such a benign landscape. Such a generator is unlikely to be as successful in obtaining value for his output in the market. This is particularly so if the technology is such that his output is unpredictable (e.g. wind). Although, in economic theory at least, the generator could compensate for this by bidding for a higher strike price, in practice, it is far from clear that it would be able to judge at all easily by how much to adjust the bid.

This means that, if CfDs are to be used for all players, some attention will be needed to ensure that neither of two undesirable outcomes results. The first possibility is that the capacity required does not get constructed because of the difficulty of obtaining the intended reliable income stream via the CfD. The second is that the uncertainty results in unnecessarily high strike prices and consequently unnecessarily high costs for the new support mechanism.

Issuing contracts on the basis of a Fixed FIT would clearly circumvent this. If CfD FITs are to be used for all generation, it may be necessary to consider options for the smaller and intermittent generators, perhaps by providing for the use of a reference price calculated on the basis of the price such generators could obtain by selling their output through centralised on-sale auctions.

Although probably to a lesser degree than is the case between technologies, there may be a differential effect between those currently active in the market and new investors. New investors may be more attracted to the 'straight' FITs available in other jurisdictions, if this question is not satisfactorily addressed.

Implementation Issues Questions 30 to 38

Again, there is a difference between very large scale nuclear (and perhaps CCS) and renewables. It is hard to see how a formal open competitive tendering operation can be made to fit the small number of schemes and the very large financial commitments inherent in construction of nuclear plant. The need to ensure value for money for the electricity consumer will remain vital, but the competitive element in the process in this case is likely to have to be handled via negotiations rather than a formal tendering procedure.

For most renewables plant, a formal tendering operation with clear rules and an open transparent procedure should be feasible. A number of key lessons can be learned here from the NFFO tender process, which had several good features, and any issues and perceived flaws can be addressed quite readily against the current policy background.

One key feature to be addressed is that, under NFFO, developers did not know when the next tender round would be or, even have certainty that there would be another round. This can be solved by simply announcing a timetable of tender rounds, preferably covering a number of years. This should feed into the contract structure: a contract holder should have to meet suitable conditions precedent in the contract by particular dates (for example signing a connection agreement with the relevant distribution or transmission operator). If these are not satisfied, the contract would be

terminable by the counterparty and the capacity of the next tender round could be adjusted to take account of the failure rate of relevant earlier rounds.

Question 38 asks for views on the options for calculating the level of the Obligation post 2017. The option of fixing the ROC price is the least desirable of these. Many power purchase agreements between generators and suppliers specifically refer to calculations based on the buy-out price and recycle values under the obligation. In practice, such a fundamental change as fixing the ROC value would be likely to trigger change of law provisions in these contracts. This would clearly produce a highly undesirable hiatus affecting existing investors – at a time when establishing confidence amongst market players will be crucial. Continuing to use both the target and headroom would probably be problematic when the obligation is no longer the main policy initiative for delivering the target quantities of renewables, which leaves the second option in the list, headroom only.

Nature of the CfD FIT Counterparty

The Consultation Document does not specifically ask questions on what body ought to be the counterparty for the CfD FIT contracts. However, that this role is undertaken efficiently, effectively and with the confidence of the market participants will be very important to the successful delivery of the policy.

As described above, NFPA has considerable relevant experience in many of the important areas of delivery. It already handles a large number of contracts for the construction of renewable generation and the payment and on-sale of the output from these plants. To do this, it has robust IT facilities (including the necessary off site facility duplication to ensure resilience in the event of technical breakdowns). NFPA is also well used to dealing with very large cash flows and therefore has the appropriate financial procedures and controls. It has staff with the appropriate experience and expertise including, albeit from the days of the Pool, operating nuclear and renewable CfD contracts. It also has a track record of managing contracts covering some 20 years. NFPA is well known to renewable generators and electricity suppliers and also the arrangements underpinning the financing of the current portfolio of contracts are well understood by financiers.

NFPA's current corporate structure would need to be modified to enable it to discharge any new responsibilities stemming from the EMR. Currently NFPA is owned by NFPA Holdings ("NFPAH") which, in turn, is owned by the successor companies to those on whom the original NFFO obligation was placed. NFPA's operational costs are capped at an indexed figure, currently of £1.88 million. If this cap were to be breached (it never has been), NFPAH, via its shareholders would be liable for the shortfall. As described above, these arrangements make sense in the context of the NFFO contract portfolio. It would not seem sensible or equitable to maintain these arrangements in respect of any new responsibilities which arose under the EMR.

If it were decided to impose on all electricity suppliers (or, perhaps more realistically, on all 'large' suppliers) the obligation to implement and maintain the new FIT arrangements, then it would be sensible to provide that the governance included representation from all those suppliers.

An alternative approach would be to legislate such that the Secretary of State nominated a particular body to fulfil that role without the need to mandate supply companies to establish the body. In this case, appropriate arm's length governance arrangements within the NFPA Group may be sufficient.

The key benefit of Government appointing or nominating NFPA is that key staff, financial procedures and controls and the majority of the business processes which would be needed to operate the CfD FITs are already in place.

Further Information

NFPA would, of course, be pleased to answer any questions and provide any further information required.

8 March 2011