Invesco
Perpetual

Miss Jas Jandu
Department of Energy & Climate Change
3 Whitehall Place
London
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22nd February 2011

Dear Miss Jandu

This letter forms our submission to the consultation process launched by DECC on Electricity Market Reform. It does not attempt to cover all of the issues contained within the proposals but instead focuses on what we believe are the most important elements. We are also happy to participate in further consultation if asked to do so.

Key points

- Carbon Price Floor (H M Treasury consultation)

The aim here, we believe, is to provide some clarity around future electricity prices such that the risks facing new nuclear investment are reduced to some extent. The issues here are first, timing and secondly how this mechanism interacts with FITs.

(i) Timing - we are concerned that setting a carbon price floor too high too early makes no difference to the arrival of new nuclear generation but can significantly change the economics of fossil generation. This could lead to premature capacity retirement so eroding reserve margins to dangerous levels. This could in turn increase our economy's reliance on unpredictable, uncompetitive and incredibly expensive wind generation.

(ii) We are also concerned that the interaction of a carbon price floor and FITs will add further complexity to an already confusing picture. This confusion will make investment decisions much harder to evaluate. Higher risk will inevitably lead to higher hurdle rates for new investment.

- Feed in tariffs

In general we support the concept of FITs with CFDs for low carbon generation. The attraction in principal is increased clarity for investors. The problem with FITs is that they may be set too low for some forms of renewable generation and so could fail to stimulate the required investment. There is also some confusion surrounding their interaction with the carbon price floor. Furthermore we are also concerned about what happens with the ROC regime before and after 2013. We believe that the ROC regime has backed the wrong technology by providing huge incentives for wind developers at the expense of other renewable investment which can sustainably mitigate carbon at much lower cost. This has brought forward wind investment but at great cost to the economy and with little progress made on climate change goals. Wind generation's performance has proven to be especially disappointing especially at times of peak energy demand.

DECC, we believe, must, with some urgency, look again at the ROC banding of biomass generation, either co-firing or conversion, and new build. This sustainable, despatchable low cost renewable form of generation has been ignored by the previous government and appears to continue to lack the support it urgently needs. We have a substantial investment in DRAX plc and have helped to fund the Company's investments in biomass infrastructure and co-firing to date. We are ready to provide further substantial finance to fund further investment in biomass co-firing, conversion and new build but this investment will not proceed without a level playing field in the ROC regime.

If this form of sustainable renewable generation is provided with an appropriate subsidy it could, at significantly lower cost, reduce the economy's dependence on expensive, non despatchable wind generation and provide it with reliable, low cost renewable base load capacity. Of course it also would accelerate our progress towards meeting our demanding climate change goals.

- Capacity Payments

There is a considerable degree of uncertainty about these proposals. Our view is that the government will need to incentivise fossil generation to stay on the system as the country negotiates the period of tighter reserve margins later in the decade. Capacity payments should be the mechanism that delivers this incentive in an environment where the market may not. Capacity payments should be paid to all economically valuable capacity on the system i.e. a level playing field. Any other mechanism would be distortionary and create further uncertainty for investors. What is required in this already confusing and unpredictable environment is more clarity and simplicity.

- EPS

No specific comments here other than to say that CCS is for the foreseeable future, a non viable technology from an investors' perspective.

Conclusions

As the UK electricity market evolves into a more regulated world it may become more difficult for equity investors to make informed investment decisions. We hope that the Government recognises that clarity is very important. This is already a very challenging area of investment. It does not need to become more so.

It is our view that delivering the right outcome for the economy and the climate will mean that the Government will have to be prepared to allow investors in this space to earn attractive rates of return. Penny pinching the upside will disincentivise the investment required to find the lowest cost renewable investment that the UK economy so desperately needs.

Yours sincerely

[redacted]