LCPDelta

RO and FiT indexation options

NEC/NESF

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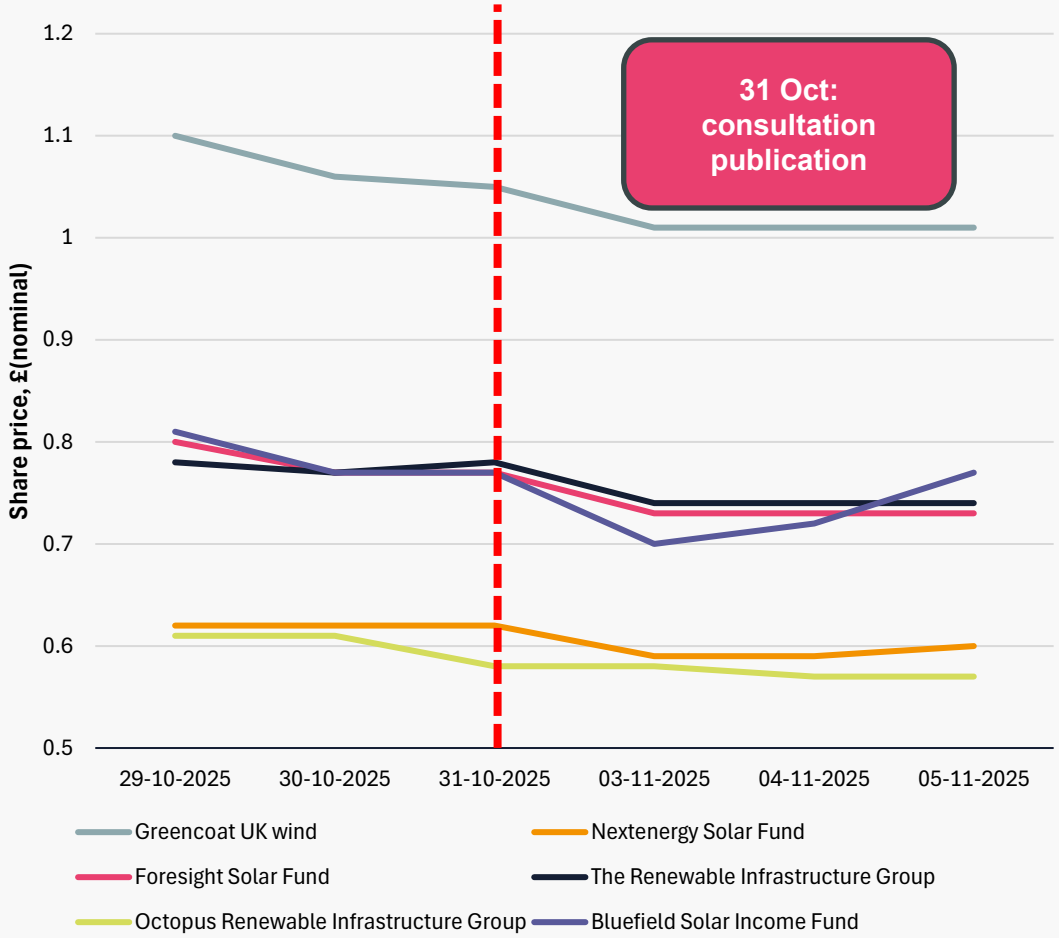
Retroactive policy changes impact investor confidence

Changing indexation metrics will increase the cost of capital for future projects

- The share prices of the six main listed renewable infrastructure funds dropped by 5% on the day of the release of the consultation. Share prices have not recovered since then, compared to the FTSE250.
- Share price drops are caused by a combination of a loss in expected revenue and lower investor confidence. The latter impacts the cost of financing funds can access in the future for new renewable projects.
- The consultation's Option 1, so moving the indexation metric from RPI to CPI, is regarded as the government's intended outcome. If we assume that the share price drop is based entirely on this Option, we can estimate the Option's impact on investor confidence.
  - Net Asset Value (NAV) is expected to drop by an average of 2% across the funds in response to Option 1. Using the average financial parameters published by the listed funds, we can estimate the increase in the discount rate necessary to reach a 5% drop in share prices. This is **0.72%** and it is expected to affect future projects as an increase in the cost of capital.
- Option 2, so nominally freezing payments for most of the remainder of the duration of the support scheme would be a major intervention in a government support scheme, previously unseen in Great Britain.
  - A major retroactive change to government support schemes took place in the early 2010s in Spain, where the government reduced the Feed-in-Tariff payments of solar PV owners by about 30%. We can estimate the increase in the cost of capital in response to the change that took place in Spain using global renewable project cost of capital databases and Spanish government bonds in the time period between 2008 and 2014.
  - If we assume that the two changes are comparable, we can estimate the increase in the cost of capital to be the same, at **2.50%,** for Option 2.

Reduction in listed renewable infrastructure fund share prices



Higher capital costs impacts future CfD payments

Clearing prices must rise to account for increased risk

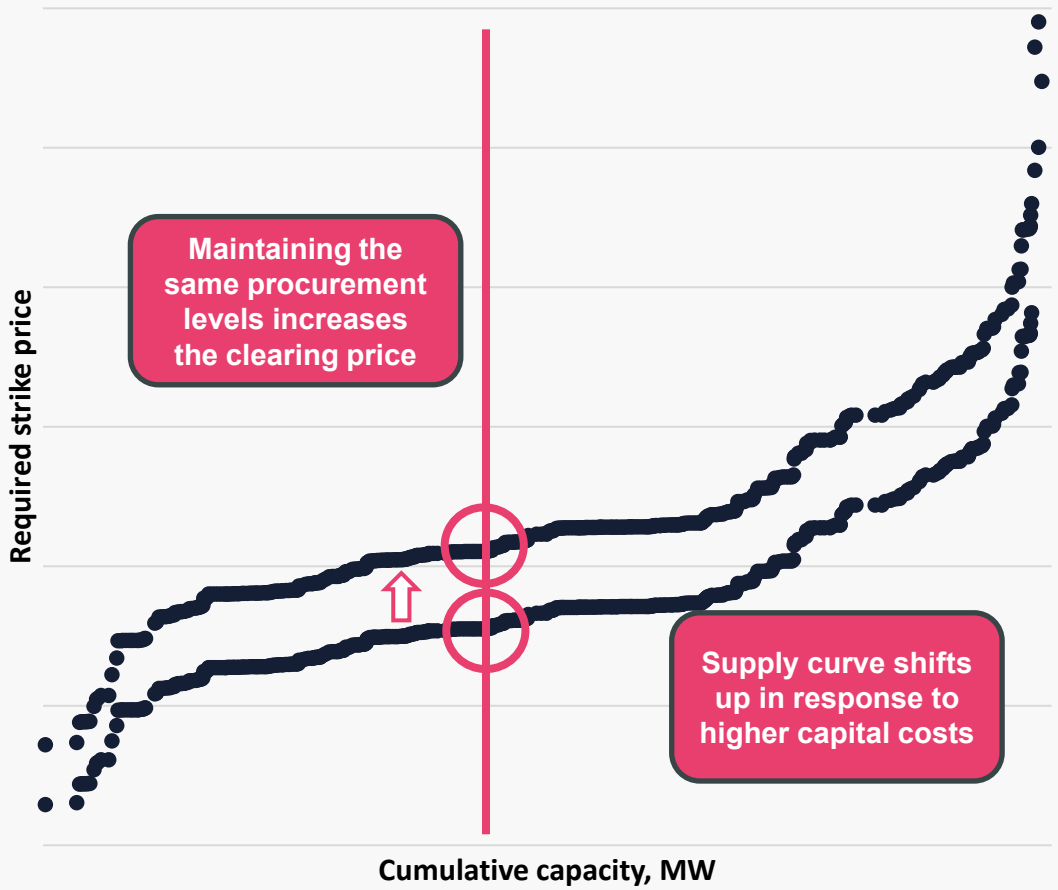
- An increase in capital costs increases the hurdle rate for future renewable projects participating in Contracts for Difference auctions. In turn, this leads to an increase in the expected bids, shifting the supply curve up. Assuming that DESNZ intends to procure enough capacity to maintain the power decarbonisation pathway, this will increase the clearing prices of future auctions.
- We used our in-house financial model for CfD projects to calculate the average expected increase in the necessary strike price across the three main intermittent renewable technology types. The biggest impact is expected in the first few auctions, with later auctions seeing smaller increases in clearing prices.

Table of estimated average increase in the CfD clearing prices for different technologies[1]

Option	Impact	Offshore Wind	Onshore Wind	Solar
Option 1	Change in CoC	0.72%	0.72%	0.72%
	Change in Clearing Price, %	2.88%	4.79%	4.80%
	Change in Clearing Price from AR6, £(2024, real)/MWh	2.33	3.26	3.26
Option 2	Change in CoC	2.50%	2.50%	2.50%
	Change in Clearing Price, %	10.57%	17.16%	17.28%
	Change in Clearing Price from AR6, £(2024, real)/MWh	8.56	11.68	11.76

[1] Values included are for the first auction after the change. Later auctions see lower increases with prices going back to normal by the end of the RO/FiT schemes.

Supply curve shifts in response to increased capital costs

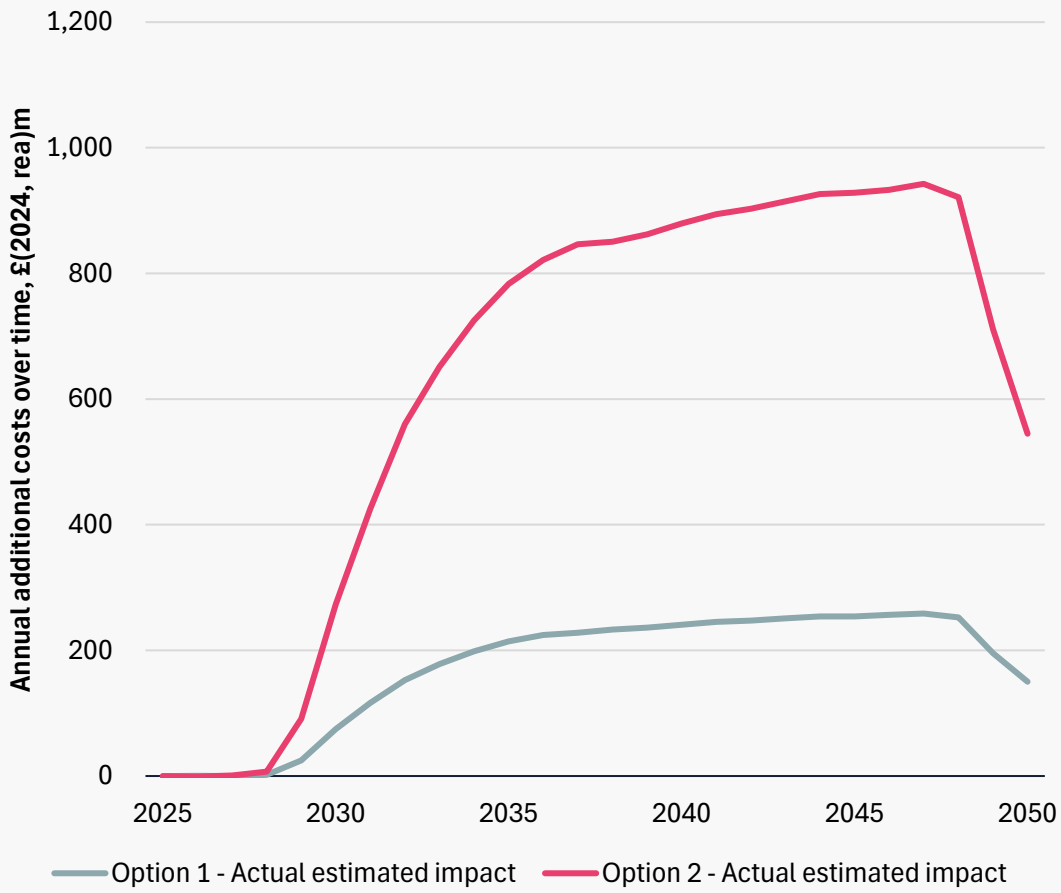


Higher future CfD spending reduces savings

Small initial savings are followed by extended increase in consumer costs

- The expected net annual average household bill impact from the indexation change would make up a small part of the annual price cap under all scenarios.
- Total consumer costs are going to change in two different ways as the indexation metric of the legacy renewable support schemes changes.
  - First, spending is reduced on these support schemes in the early years of implementation. This will have its greatest impact between now and the early 2030s, as there is still relatively large volumes of RO and FiT recipients in the market, and the impact of the indexation change compounds.
  - Second, as the increase in cost of capital increases the CfD clearing prices of future auction rounds, support payments for CfD recipients will go up. As most assets with CfD contracts expected to come online by 2030 already have a contract in place, this effect will take until the early 2030s to start having an impact. The full impact of this additional cost will not materialise before the mid-2030s.
- Overall, this will lead to a sharp reduction in consumer savings from the mid-2030s onwards compared to what DESNZ expects. In this time period, there is less and less benefit from the indexation change as the RO and FiT schemes run out, while more and more CfD generators are coming online at higher strike prices.
- It is worth noting that DESNZ assumes that the impact of this policy change will end by the end of the RO and FiT schemes. However, higher CfD clearing prices will be locked in for years after.

Annual additional consumer costs from higher CfD support payments over time

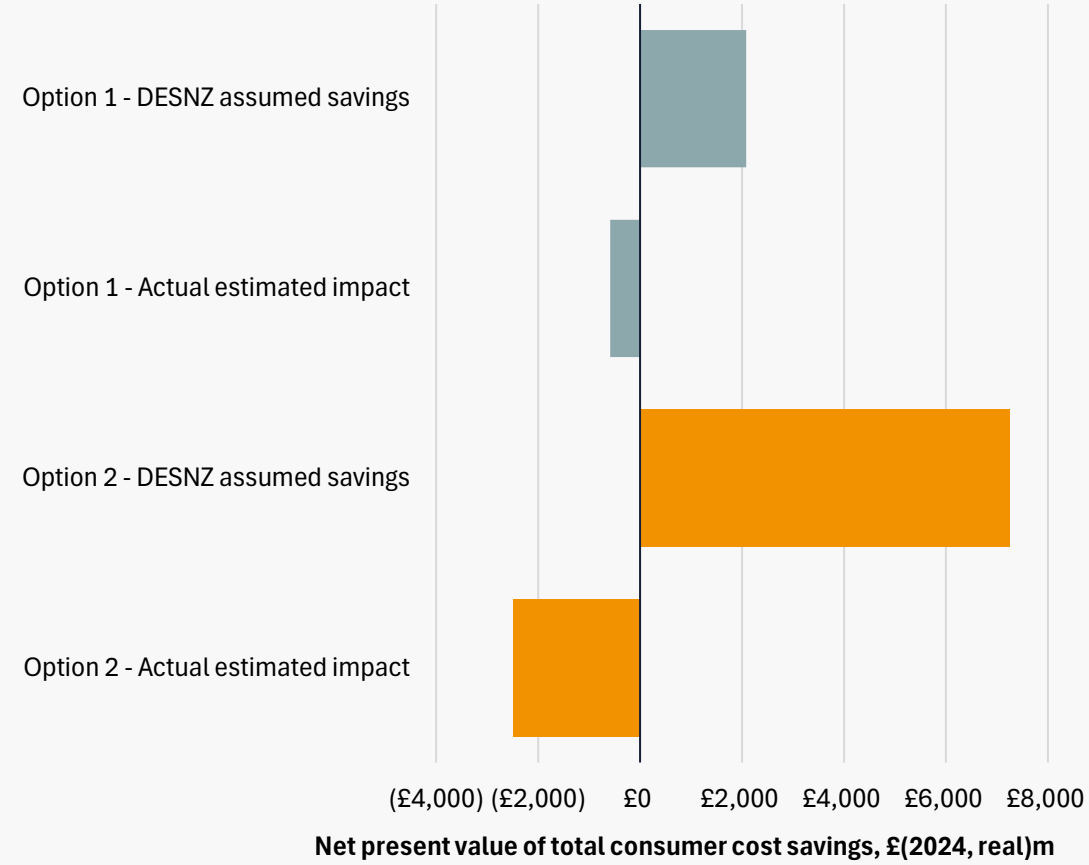


Overall net negative impact on consumers

Increased CfD payments can lead to negative overall consumer cost NPV

- Higher CfD auction clearing prices while maintaining the same renewable deployment will increase CfD support payments in future years.
- The government consultation highlights only savings from this indexation scheme, but the increased cost of capital dents these savings and may lead to an overall net cost to the consumer.
- Under **Option 1**, an average increase of 0.57% in the cost of capital reduces the net present value of consumer costs between 2026 and 2050 to £0.
  - We estimated the impact of Option 1 to be 0.72% assuming that the share price drop is entirely due to the expectation that Option 1 will be chosen by government. In this case, the indexation change is expected to be a £584 million cost to the consumer overall due to increased cost of capital leading to a sustained increase in CfD costs which outweighs the short term forecasted saving benefits of the indexation change.
- **Option 2** returns higher savings under DESNZ assumptions, but these also reduce significantly in response to an increase in the cost of capital. An average increase of 1.89% wipes out all savings.
  - If investors perceive Option 2's 'clawback' mechanism as similar to the retroactive revenue change in the Spanish renewable support schemes, the cost of capital may rise by 2.5%. This would lead to an overall cost of £2.49 billion to the consumer.

Net present value[2] factoring in savings from change in indexation and increased costs from higher costs of capital, 2026-2050



[2] Using the social discount rate, 3.5%.

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