SLAUGHTER AND MAY/

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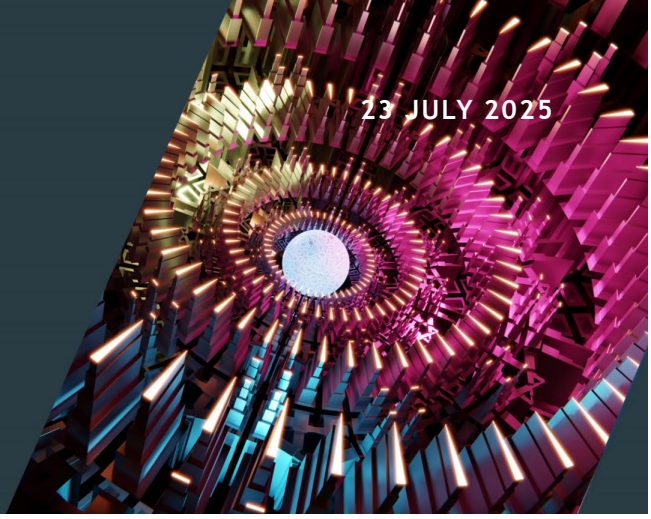
NEW NUCLEAR IN THE UK: PUBLICATION OF SIZEWELL C'S GENERATION LICENCE



This week, the Department for Energy Security and Net Zero ("**DESNZ**") has published the finalised special licence conditions which are proposed to be incorporated into the generation licence (the "**Economic Licence**") to be granted to Sizewell C Limited ("**SZC**"), the generation company developing the Sizewell C nuclear power station.

This follows on from the announcement made by the UK Government that it had reached commercial close together with La Caisse, Centrica, EDF and Amber Infrastructure as co-investors in SZC, with the UK Government taking an initial 44.9% stake, La Caisse taking a 20% stake, Centrica taking a 15% stake, EDF taking a 12.5% stake and Amber Infrastructure taking an initial 7.6% stake. Slaughter and May advised Centrica on its investment in SZC.[1]

The Economic Licence sets out the economic regulated asset base ("**RAB**") model which will apply to SZC. It is the lynchpin of the regulatory construct put in place by DESNZ for the Sizewell C project which allowed that commercial close decision to be taken, and marks the culmination of DESNZ's efforts to revive private investment in large-scale nuclear generation projects in the UK.

The Economic Licence is the first which is intended to be granted by DESNZ under the Nuclear Energy (Financing) Act 2022.[2] DESNZ will hope it is not the last – it has high hopes for the successful deployment of the RAB model to enable the financing of other large-scale nuclear projects beyond Sizewell C, as well as emerging nuclear technologies such as small modular reactors and, in the longer term, nuclear fusion.[3]

In this article, we outline the key features of the Economic Licence and explain in high level terms how it enabled DESNZ to secure private investment for the Sizewell C project.

The Overall Principle for SZC's RAB

At its core, the RAB model which is proposed for SZC provides for the ringfenced company to receive an "**Allowed Revenue**" for each year of the initial regulatory period – which will run from the date that the Economic Licence comes into effect (the "**Licence Modification Date**") until c. 60 years after the commencement of full operations.

Whilst the Economic Licence will permit SZC to earn an Allowed Revenue, it does not provide any direct revenues: instead, SZC will be required to collect its Allowed Revenue from market sales of electricity, and will also enter into a "**Revenue Collection Contract**" with the Low Carbon Contracts Company Limited ("**LCCC**"). Under the Revenue Collection Contract, the LCCC will ensure that:

1. In periods where SZC is forecast to collect less market revenues than its full Allowed Revenue (including in the construction period), the LCCC will make monthly difference payments to SZC to ensure it collects its full Allowed Revenue; and

2. In periods where SZC is forecast to collect more market revenues than its full Allowed Revenue, SZC will be required to make monthly difference payments to the LCCC in respect of any excess.

The Allowed Revenue itself is made up of a number of different "building blocks", and different principles apply during the two distinct phases of the Sizewell C project, which are:

1. the so-called "**Pre-PCR Phase**", which covers the construction and commissioning phases of the project as well as its first three years of full operations, and

[1] Press release

[2] See our 2021 article on this: A new generation of power generation - UK Government legislates for RAB model to fund nuclear new builds

[3] Explanatory Notes – Nuclear Energy (Financing) Act 2022

ends on completion of the post-construction review ("**PCR**"); and

2. the "**Operations Phase**", which covers 60 years of full commercial operations thereafter, until the end of the initial regulatory period.

We explore these in turn below.

Overview of the Pre-PCR Phase

Allowed Revenue

During the Pre-PCR Phase, SZC and its investors are responsible for funding the project's construction, commissioning and its initial operations.

On the Licence Modification Date, the project will be attributed an initial RAB by DESNZ: this will represent the capital investments made to the project by EDF and DESNZ prior to the Licence Modification Date. Every year thereafter during the Pre-PCR Phase, this RAB will be increased to reflect all capital expenditure properly incurred in the relevant year (as confirmed by Ofgem).

SZC's Allowed Revenue in the Pre-PCR Phase will largely consist of an allowed return on that RAB value, which will be fixed at the Initial Weighted Average Cost of Capital ("**IWACC**"), to be set by DESNZ at the Licence Modification Date.

SZC's cost of debt will fluctuate over the construction period, and in order to avoid this affecting equity returns under the IWACC, the Allowed Revenue in the Pre-PCR Phase also includes an important "Cost of Debt Adjustment" ("**CDA**") building block, which will counterbalance any movements in the cost of SZC's debt.[4]

In addition, SZC will receive revenue allowances for eligible opex costs, tax liabilities, its funded decommissioning programme, certain pre-defined pass-through costs, and for social benefits and communications costs.

The fact that SZC will be entitled to receive an Allowed Revenue through the construction period represents a marked departure from the deferred returns which arise in CfD-financed projects, and was critical to the investibility of new nuclear projects in the UK (in particular noting the difficulties faced by EDF at Hinkley Point C which is being funded under a CfD model where no financial support or return will be paid to investors until the project begins electricity generation).

Incentives during the Pre-PCR Phase

In order to ensure that the Sizewell C project is delivered on time, on budget and in line with the expected specification, the Economic Licence embeds a number of incentives which impact SZC's (and its investors') returns based on performance against these objectives. In overview:

- **Capex Incentive:** The Economic Licence includes a monetary "**Lower Regulatory Threshold**" ("**LRT**") and a monetary "**Higher Regulatory Threshold**" ("**HRT**"), both set in real terms.
  - SZC is incentivised to deliver the project for an overall cost below the LRT: if it does so, then half of the savings would be added to the RAB at the PCR, increasing investors' returns.
  - Once the LRT is reached, however, then for all subsequent capex only half of additional eligible spend will be added to the RAB, reducing investors' returns.
  - The HRT acts as a maximum limit on spend beyond which the RAB cannot grow any further (absent a new statutory decision by DESNZ at the relevant time).[5]
- **Schedule Delay:** The Economic Licence includes a "**Scheduled COD**" by which SZC must target to have completed construction and commissioning of both generation units.
  - Delays beyond this date trigger a reduction in the IWACC: first by 50 basis points if COD is not met within two years of the Scheduled COD, and then by a further 50 basis points if the delay extends beyond four years. If COD is not achieved within eight years of the Scheduled COD, Ofgem may impose penalties of up to 10% of SZC's turnover.
  - In parallel, the permitted yield payments from SZC to its investors (generally capped under the Economic Licence until COD) are further reduced in delay scenarios, with any further shareholder payments prohibited (until actual achievement of

[4] The CDA building block includes some incentivisation for SZC to raise private debt efficiently. However, the initial debt package which has been secured will not be subject to such incentivisation mechanism.

[5] A number of other mechanisms become engaged once total spend reaches the HRT, which are beyond the scope of this short overview note.

COD) if the delay exceeds six years beyond Scheduled COD.

- **Capacity delivered:** At the PCR, the capacity of each generation unit is assessed against a **"Baseline Target Capacity"**. Underperformance or overperformance against this capacity target results in a proportional adjustment to the RAB value, subject to a mirrored cap and floor.

- **Opex Incentive:** Because the Pre-PCR Phase also includes the first three years of operations of the two generation units, the Economic Licence includes an overall **"Opex Allowance"** for that period. To the extent SZC is able to achieve savings in its actual opex as compared to that Opex Allowance, then it would be entitled to retain 50% of any savings. Conversely, if its actual opex overshoots the Opex Allowance, then only 50% of such overspend would be paid for under SZC's Allowed Revenue (with investors/SZC having to cover the remaining 50%).

Generally, this incentive regime is designed to strike a fair balance between sharing benefits or costs between investors and consumers, and also provides the utmost clarity to investors upfront, aiding in the investibility of the project.

Overview of the Operations Phase

Allowed Revenue

SZC's Allowed Revenue in the Operations Phase largely follows the same principles as during the Pre-PCR Phase, with two notable differences.

First, from the beginning of the Operations Phase, SZC's RAB will be depreciated (with the intention for the RAB to be depreciated to zero by the end of the initial regulatory period), with a Depreciation building block representing such depreciation being paid out as part of SZC's Allowed Revenue.

Second, SZC's return on capital during the Operations Phase will no longer be set by reference to the IWACC, but will be set by reference to a Regulated WACC (**"RWACC"**) determined by Ofgem at the PCR and for each five-year **'Control Period'** thereafter until the end of the initial regulatory period.

Incentives during the Operations Phase

As with the Pre-PCR Phase, the Economic Licence includes performance incentives designed to encourage SZC and its investors to run the power plant optimally and cost-efficiently. Although Ofgem will retain its regulatory discretion to select a right mix of incentive mechanisms, the Economic Licence currently anticipates that the incentives which ought to apply are:

- **Totex:** At the PCR and for each subsequent Control Period, Ofgem will grant SZC a **"Totex Allowance"**. As with the opex incentive mentioned above, to the extent SZC is able to achieve savings in its actual totex as compared to that Totex Allowance, then it would be entitled to retain 50% of any savings. Conversely, if its actual totex overshoots the Totex Allowance, then only 50% of such overspend would be paid for under SZC's Allowed Revenue (with investors/SZC having to cover the remaining 50%). The cumulative impact of this totex incentive and the market price incentive (see below) will be capped and floored, limiting SZC's potential upside and downside.

- **Market price:** At the PCR and each Control Period thereafter, Ofgem will confirm what reference market price SZC should seek to achieve when selling its generation output into the market. This reference price is likely to correspond to the Baseload Market Reference Price. If SZC achieves an average sales price in excess of the market reference price, it will be entitled to retain the **"Market Adjustment Sharing Factor"** (currently anticipated at 50%, but to be set by Ofgem) proportion of the upside. Conversely, if SZC achieves an average sales price below the market reference price, it will share in the Market Price Adjustment Sharing Factor proportion of the downside. As noted above, the cumulative impact of this incentive together with the totex incentive is subject to a cap and floor, limiting SZC's exposure and its potential upside.

- **Availability:** At the PCR and each Control Period thereafter, Ofgem will set annual **"Availability Targets"** for SZC's generation output. This target will reflect production at full expected capacity for an entire year, less an allowance for planned and unplanned outages. If SZC fails to achieve the Availability Target in a year then a proportional reduction will be applied to its Allowed Revenue for that year. This regime is however not symmetric, and any overperformance on the Availability Target will not result in an increase in SZC's Allowed Revenue – instead, SZC would be permitted to retain any proceeds received from market sales of electricity generated during the additional period of availability.

- **Through-life capacity:** This applies in the same way as the capacity incentive described above. Any variance in measured capacity beyond 2% from the Baseline Target Capacity will trigger a proportional increase or decrease to the RAB, subject to the same cumulative

overall cap and floor as noted above in respect of the capacity incentive.

Overall Regulatory Design and Investor Protection

The Economic Licence represents a sophisticated approach to infrastructure financing, strategically crafted to attract long-term institutional capital by optimising risk allocation between investors and consumers. Central to its appeal is the introduction of regulated cash flows during the construction phase, significantly advancing the investment payback timeline compared to traditional models, and mitigating investors' exposure during the very lengthy construction periods of large scale nuclear power projects.

Through clearly defined IWACC and RWACC mechanisms, the Licence ensures that investors benefit from predictable and controlled returns across the entire asset lifecycle, effectively mitigating volatility and enabling precise internal rate of return projections. Periodic recalibration mechanisms, coupled with indexation of Allowed Revenue components, further provide resilience against inflationary pressures, enhancing investor confidence in long-term yield stability.

Investor protection is reinforced through mostly symmetrical and bounded incentive structures. Caps, floors, partial sharing of costs and performance deviations, and regulatory backstops collectively limit downside risks from construction overruns, operational underperformance, and adverse market price fluctuations. Conversely, the Economic Licence incentivises efficiency by rewarding under-budget delivery, capacity outperformance, and market sales exceeding reference prices through measured RAB adjustments and structured incentive-sharing mechanisms, offering modest upside potential without destabilising equity alignment.

Government Support Package

Whilst the Economic Licence provides a stable investment framework, it does not address tail risks (where costs rise above HRT) or other nuclear-specific risks (in particular the increased political risks faced by nuclear power projects, nuclear-specific insurance risks, risks of nuclear incidents). Those have been addressed by DESNZ through a separate Government Support Package, which is beyond the scope of this summary overview.

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