Department for Energy Security & Net Zero

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Sir Geoffrey Clifton-Brown MP
Chair, Public Accounts Committee
House of Commons
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Dear Sir Geoffrey,

I am writing to you following my appearance before the Committee on Monday 3 March, alongside Ashley Ibbett, Sarah Redwood and colleagues from Ofgem.

At the hearing I undertook to provide the Committee with details of the Heads of Terms agreed with Drax Power Ltd, as announced by Minister Shanks in the House on 20 February. I am pleased to enclose a paper setting out these terms. It is important to note that while these Heads of Terms are not legally binding, they form the basis of an agreement which both parties intend to translate into a contract forthwith.

The Heads of Terms include a robust set of sustainability requirements for biomass used at the plant that represent a step-change from current arrangements. They also introduce an Excess Returns Mechanism for higher-than-expected profits during periods of high electricity prices, protecting consumers and ensuring that a significant share of profits can be returned to consumers in these circumstances.

The paper also sets out the details of the strike price agreed with Drax, and the operation of the generation collar which serves to move the station from providing baseload power to dispatchable capacity, ensuring that consumers benefit from lower prices for electricity when renewable supply is plentiful.

Given that we are in the process of translating these Heads of Terms into a final contract it would be preferable not to publish the enclosed paper at this time, I am of course happy to update the Committee once the contract has been finalised.

I am copying this letter to the Chair of the Energy Security and Net Zero Committee and the Comptroller and Auditor General.

Yours sincerely,

Jeremy Pocklington

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Low-Carbon Dispatchable CfD: Summary of the Heads of Terms Agreed with Drax

Duration: 1 April 2027 to 31 March 2031

This arrangement will commence on 1 April 2027, the day after existing support arrangements conclude, and be limited to four years in duration.

Strike price: £113MWh (2012 prices) or £155/MWh (2023-24 prices)

The Strike Price will be £113MWh (2012 prices), indexed to the Consumer Price Index.

Note, there is a partial strike price reopener that provides short-term protection against foreign exchange movement on US sourced biomass up to the point of contract signature. The mechanism adjusts the strike price that will be in the final contract based on changes in the GBP/USD forward exchange rate between the Heads of Terms (HoTs) agreement and contract signature (expected Summer 2025). This only relates to 80% of the assumed fuel cost, which is the proportion the generator plans to source from the US. There's a close limit on the maximum increase but no floor on potential reductions to protect the consumer.

Generation collar: caps the annual load factor eligible for subsidy at 27%

The generation collar (GC) CfD is designed to incentivise the plant to dispatch at full capacity during times of greatest system need by obliging generation up to the level of the floor, whilst limiting output beyond this through the imposition of a cap on the total generation eligible for support. Imposing a generation floor carries the further benefit of limiting the generator's commercial optionality, for example, by reducing the scope for them to sell fuel rather than generate at times of high demand.

The capped load factor and agreed strike price are projected to result in a halving of the subsidy that Drax will receive during this contract period, compared against their current arrangements (under the Renewables Obligation and CfD). This is equivalent to savings of nearly £6 per household per year, compared against current arrangements.

Generation Floor

For each season, the generator must produce a minimum amount of electricity, the 'generation floor' or '**Minimum Aggregate Metered Output' (MAMO)**. There are two types of MAMOs:

- Facility MAMO - Minimum output required from each of Drax's four generating units.
- Station MAMO - Combined minimum output from all generation units at the station.

The generator will be required to achieve the Facility MAMO and the Station MAMO. If the generator fails to achieve the Facility MAMO or Station MAMO in any Season, a **Minimum Output Shortfall Payment** will be payable (see below). The shortfall payment will be calculated as the shortfall in generation multiplied by the shortfall price (which is set to 35% of the **Baseload Market Reference Price (BMRP)** for the Season).

If the generator fails to achieve at least 75% of the Facility MAMO in more than one Season during the Term, a termination right will arise for the facility concerned.

The MAMO is operationalised in the contract through a **Minimum Load Factor (MLF)**, which is higher in Winter, reflecting energy security requirements determined by NESO. The Facility MLF is set below the level of the Station MLF in both seasons, to allow the generator a degree of flexibility in how it allocates generation between Facilities whilst ensuring adequate fuel is available at Station level to respond to periods of anticipated system need. The respective Facility- and Station-level MLFs are set out below:

- Summer Facility MLF = 0%[1]
- Winter Facility MLF = 22%
- Summer Station MLF = 11%
- Winter Station MLF = 33%

Generation Cap

There is a cap on how much electricity output will be eligible to receive subsidy. This cap is called **Threshold Aggregate Metered Output (TAMO)** and applied only to the Station. As with the MAMO, the TAMO is higher in winter than in summer, ensuring that Drax generation aligns with periods of greatest system need.

The TAMO is operationalised in the contract through a Threshold Load Factor (TLF), which varies by season:

- Summer TLF (STLF) = 16%
- Winter TLF (WTLF) = 38%

If the total Station output exceeds the **TAMO** during a season, any extra output **will not receive difference payments** (support).

Excess Returns Mechanism on Profit

This agreement has been calibrated to provide Drax with a limited return over the contract period. However, should Drax make higher than anticipated profits in an extreme price scenario, a profit clawback mechanism is in place to protect the consumer.

There will be lower and upper profit thresholds:

- Lower threshold: £160m per annum; 30% share of profits above that level to be returned to LCCC (the Low Carbon Contracts Company, the CfD counterparty).
- Upper threshold: £210m per annum; 60% share of profits above that level to be returned to LCCC.

For example:

- If Drax make £200m profit, the ERM payment due would be £12m.
  If Drax make £300m profit, the ERM payment due would be £69m.

The final ERM payment will be calculated based on profits across the four-year term. Please note that the ERM and the broader contract value has been calibrated against what a reasonable rate of return for the capital employed in the asset would be. Note, that we consider the central expected return on investment to generally be below both that of regulated

[1] The Summer Facility MLF is 0% to enable the generator to optimise the use of their assets when operating at a very low Station load factor over summer.

monopolies or the average FTSE return for a set of equivalent unregulated, asset-heavy businesses.

Enhanced sustainability criteria

The CfD also substantially tightens sustainability criteria through:

- Increasing the proportion of biomass that must be sustainably sourced from 70% to 100%.
- Reducing the supply chain emission threshold from 55.6gCO2e/MJ to 36.6 gCO2e/MJ (aligned with international best practices e.g. EU's RED III).
- Including provisions to exclude material sourced from primary and old growth forests from receiving support payments.

Enhanced sustainability compliance arrangements

Should Drax not comply with the sustainability criteria, then subsidy payments for electricity generated from whole consignments of biomass generation can be revoked and there is a termination right for repeated material breaches of those requirements. The GC CfD will also include enhancement to the current biomass monitoring, reporting and verification requirements, for example relating to audit processes and the use of voluntary certification schemes.

Capacity Shortfall Payments

Drax shall be required to ensure the Installed Capacity of the Facility is not reduced below the Maximum Contract Capacity, which is expected to be 645MW at each of Drax's four generating units. Drax will be required every Winter season to demonstrate that each of its units can generate at the expected capacity, with consequences for failing to do so including Capacity Shortfall Payments and a termination right for more than one breach. This will ensure that the energy security benefits of retaining Drax's capacity are maintained throughout the contract term.

Termination rights and consequences

There will be additional termination rights for LCCC beyond those in the AR6 CfD, including:

- Material Breach: A material breach of the Generator Representations and Warranties set out in the Heads of Terms.
- Failure to achieve the Facility Minimum Aggregate Metered Output in more than one season.
- Failure to meet the required capacity in more than one season.
- Repeated and material failure to meet the Sustainability Criteria.
- A cross-termination event (involving termination of an existing related subsidy or future power BECCS contract).

A **Termination Amount** will be due to LCCC following a Generator Default Event. This will be payable for both pre- and post-start date terminations. The Termination Amount owed if there is one year remaining in the term is in line with the termination payment that would be due under a one-year Capacity Market contract. If this CfD is terminated more than one year from expiry, the Termination Amount would be greater.

Force Majeure and Relief Events

Relief may be granted to the generator against its obligation to pay MAMO or Capacity Shortfall Payments if there is either i) a Material Disruption to the biomass supply chain rendering it uneconomic to procure alternative fuel, or ii) a Catastrophic Outage at more than one generating unit which is expected to last more than 9 months. The application of this relief will be set out in more detail in the full contract. The maximum relief will be equal to the lesser of the generator's profit for the year and the aggregate Shortfall Payments subject to relief.

The Force Majeure provisions from the AR6 CfD will continue to apply.

Qualifying Change in Law (QCiL)

Certain adjustments will be made to the QCiL provisions and compensation to ensure they are suitable for the GC CfD. The QCiL provisions will also be revised to ensure no overlap with any potential future power BECCS contract.