ESB International

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Dear Kersti & Ian

**Project Discovery: Energy Market Scenarios**

The issues which Project Discovery raises and the potential solutions which the project may put in place have a substantial bearing on ESB International's (ESBI's) current and future investments in the GB market. As such, ESBI welcomes the opportunity to comment on Ofgem's Energy Market Scenarios and will continue to play an active role as Project Discovery develops.

***ESB International (ESBI)***

ESB International (ESBI) has been a developer of independent generation projects in the GB market for over fifteen years. We currently have interests in the 350MW Corby power station, in the 850MW development at Marchwood, which is currently commissioning. We have also recently announced our latest 860MW development at Carrington and 960MW Centrum development in Burton upon Trent, which are planned to commence operation in 2013 and 2016 respectively. We also currently have a number of live transmission connection applications and offers for large Combined Cycle Gas Turbine (CCGT) developments at various locations across GB. It is ESBI's intention to build 3GW of thermal generation in Great Britain in the next decade.

In addition to expanding our conventional generation portfolio, we are also seeking to expand our GB portfolio of renewable generation sites, having recently announced the acquisitions of Fullabrook Down and West Durham wind farms. All these developments are set within the context of a €22billion package announced by the ESB group to facilitate the transition to a low carbon economy.

***Summary of ESBI's views***

In our view, Project Discovery has the potential to address inadequacies in market rules, particularly policy frameworks which combine to endanger medium term security of supply. However, we are concerned that if a comprehensive and robust assessment is not forthcoming and the project simply becomes a justification for increasing subsidy to some forms of generation, it runs the risk of increasing uncertainty and deterring substantial amounts of much needed investment.

We feel it is important to summarise our views on a number of key issues and themes that arise from the Project Discovery scenarios consultation. We hope that future phases of the project will address these in further detail.

*Context and scope of the review*

Project Discovery is useful in informing views on possible future scenarios for the GB electricity market. However, it is not clear what Ofgem's purpose is in undertaking the review at this point or how it intends to use any evidence, conclusions or recommendations arising from it. We are particularly keen to understand the scope of the Project Discovery, the extent to which it constitutes a root and branch review of market rules and policy frameworks and the extent to which Government is engaged. While we broadly support targeted action to address demonstrable deficiencies in market rules (such as delays in securing transmission access and an absence of market liquidity) and improved regulatory clarity and certainty, it is not clear that a fundamental overhaul of market arrangements at this stage would be beneficial to short and medium-term security of supply or the achievement of Government's environmental goals.

ESBI is keen to participate in a market which allows generators to compete on an equal footing and which is characterised by stability and transparency. We would fundamentally oppose any approach which sought to identify a 'right' answer in terms of generation mix and then sought to develop market arrangements to deliver that answer. Such restrictions would limit competition and could, in themselves, be discriminatory.

*Market for delivery*

We strongly support the idea that an effectively operating market can deliver the investment needed to ensure Government's environmental targets are achieved whilst delivering medium and long-term security of supply. That market should have defined boundaries and where additional mechanisms are used to facilitate Government policy, these should be explicit and reasoned. Wherever possible, the market should allow generators to compete on an equal footing and be characterised by stability and transparency.

We are of the view that the current market is facilitating the necessary investment required to achieve general energy policy objectives. We are in a period of transition whereby increasing amounts of renewable and nuclear generation will be delivered to help contribute to a reduced dependence on carbon-based generation. In order for short-term carbon reduction targets to be met in advance of that renewable and nuclear investment, lower carbon forms of existing generation technologies must be allowed to react to market signals and advance as required.

It should be recognised that the market framework is only one of a number of key considerations for investors. The Project Discovery consultation primarily concentrates on how the market and economic factors will impact security of supply. We would argue that other factors outside the scope of Project Discovery, such as the prevailing and future planning regimes are equally important to the successful delivery of GB's energy policy objectives. Any future analysis must incorporate assumptions on these other factors in order that meaningful comparisons can be made.

*Stability*

Market structure is clearly a key consideration in promoting and delivering the significant generation investment required over the forthcoming years. Ofgem is rightly reviewing the market and its current operation as part of Project Discovery, however, and as discussed previously, the ultimate aim of the review is unclear. A critical consideration for any party looking to invest is certainty over future market structures and the mechanisms supporting them. Investment decisions are supported by detailed analysis over the prospective life of a generation plant. In order for investors to be content that plants are to be commercially viable, there must be a large degree of stability in the regulatory and market structures within which they will operate.

As stated previously, we are of the view that the current market will deliver the significant investment required over the forthcoming years. However, if the outcome of Project Discovery is that fundamental change is required, industry must have a clear indication at the earliest possible opportunity as to what the intended outcomes will be. Without this certainty, investment will undoubtedly be deferred yet further to the detriment of both security of supply and environmental targets.

In recent times we have seen timely intervention by Ofgem and Government in other policy areas in which material deficiencies are apparent. In particular, we have seen DECC taking control of the process to reform the transmission access arrangements and Ofgem leading work to improve liquidity in the wholesale energy markets. We would urge Ofgem to ensure that major deficiencies are identified by Project Discovery before initiating major reforms of the current market framework.

*Ofgem analysis and approach*

As an investor in gas fired generation, we have carefully considered our ability to manage risk within an increasingly global gas market and are particularly worried by the inference that security of supply and a reliance on gas imports are intrinsically linked. The decline in the UK continental shelf clearly creates new challenges, though it is not clear that recent developments in international gas markets mean these challenges are clearly more significant than other relevant issues or markedly more serious than those faced, and managed, by other EU member states.

A significant assumption used for all of the scenarios is that there will be a shortage of gas supply in GB over the forthcoming years which will lead to significant spikes in wholesale gas prices. Indeed, the significant upward trends in costs to the consumer seen in all the scenarios result predominately from this assumption. Many observers are of the view that actual supply will be significantly less tight than that modelled within Ofgem's scenarios and as such we see the scenarios as overly pessimistic.

Other assumptions are, in our view, overly optimistic and understate the impact of a future generation mix containing significantly more variable generation sources, combined with closures under the LCPD and IED. In particular, we do not agree with Ofgem's assumption that balancing costs will remain at (roughly) today's level. The market will undoubtedly see much increased use of balancing actions to ensure supply and integrity of the transmission system. The costs associated with these actions will therefore also rise and be significantly more volatile. We believe Ofgem should look again at the assumptions underpinning this aspect of its modelling.

*Role of gas-fired generation*

We feel it important to stress the role that gas-fired generation has played in the GB generation mix to date and the key role it will play in the future. Over the past decade, gas-fired generation, in particular combined cycle gas turbine technology (CCGT), has replaced significant amounts of older, less efficient generation plant with poorer environmental performance (mostly coal and oil). CCGT generation has been shown to be relatively quick and cost effective to develop. Indeed, the majority of the significant carbon reductions seen in the GB energy markets over the last decade are directly attributable to the increasing amount of CCGT generation sites.

It is recognised across industry that the future low carbon generation mix will contain substantial proportions of renewable (mainly wind) and new nuclear generation, possibly with new "clean coal" supported by carbon capture and storage (CCS). As Ofgem recognises in its scenario analysis, this new plant may not connect for a prolonged period. In the meantime, GB has binding environmental targets and a widening supply gap which must be met. Significant amounts of ageing thermal generating plant will close as a result of the Large Combustion Plant Directive (LCPD). This will mean material amounts of current thermal generation will cease to operate prior to the new nuclear fleet connecting. In advance of this new technology being built and connected, CCGT generation has a crucial role to play in ensuring baseload and flexible supply is secured in the cleanest and most efficient manner.

As the needs of the energy market change with the shift to a low carbon generation mix, the role of CCGT generation will change from baseload to the flexible generation required to support an energy market dominated by variable renewable and nuclear generation. It is therefore crucial that Ofgem do not create disincentives to investing in the CCGT required in both the transition to a low carbon energy market and in the long-term. Ofgem must not, as a result of Project Discovery, create competition asymmetries by providing implicit and explicit support mechanisms for technologies whilst leaving gas-fired generation to "fend for itself".

***In conclusion***

ESBI is committed to building a portfolio of flexible plant which can provide baseload capacity in the short to medium-term and flexible capacity as the needs of the energy market change, within the short timescales which the market requires. We face real barriers to realising this objective and, in our view, it is important that momentum is maintained in these areas and that Project Discovery does not delay progress.

Our biggest concern, along with other investors in the GB market is volatility and instability in regulatory and policy frameworks. As noted above, we would support a robust assessment of the practical barriers to realising the investment which is necessary to maintain security of supply and targeted intervention to address these issues. However, we do not consider that launching a fundamental review of market arrangements at this point would be justified and consider that it would serve to further increase uncertainty for investors.

We would be particularly concerned were the Project Discovery scenarios used as a justification for policy intervention to support particular technologies or to attempt to ensure that a scenario came to pass. In our view, the current market framework is working and is capable of delivering the investment in new generation required to meet Government environmental targets whilst ensuring supply.

In ESBI's view, Project Discovery represents a useful and welcome opportunity to assess the significant number of interrelated issues which combine to ensure security or insecurity of supply in the round. It is an opportunity to step back and ask whether specific aspects of the regulatory regime can be improved and to consider, and make robust recommendations regarding any aspects of the existing policy framework which distort market outcomes, picks winners and undermines investment decisions.

We note the comments of John Cridland, CBI Deputy-Director General, in respect of Project Discovery. We tend to agree that: "The best way of delivering energy security, meeting our climate change targets and keeping prices affordable is by ensuring the UK develops a balanced mix of energy sources that includes wind and other renewables, nuclear, gas and clean coal." We also fundamentally agree that "Firms need to be able to invest in new energy infrastructure with confidence." We therefore look forward to participating in future stages of the project and assisting in developing recommendations which allow these objectives to be realised.

Should you wish to discuss this response further please do not hesitate to contact me.

Yours sincerely,

**Michael Dodd**
GB Regulation Manager

By e-mail