ASSOCIATION OF ELECTRICITY PRODUCERS

OFGEM REPORT
PROJECT DISCOVERY: Options for delivering secure and sustainable energy supplies
Ref: 16/10 3 February 2010

RESPONSE FROM THE ASSOCIATION

- The UK must ensure that it is an attractive destination for large-scale investment in new energy infrastructure.

- The electricity market has worked well but the framework of environmental policy within which it is meant to operate is not sufficiently robust and coherent to encourage the massive investment which the industry faces.

- Some changes are necessary, to compensate for the absence of robust and coherent environmental policy and to give confidence to investors.

- Given the right policy framework, a competitive market remains the means by which cost-effective solutions will be provided and the market should be preserved.

- Ofgem’s Policy Package E is unacceptable and was an unhelpful distraction.

- Further review must follow a well-considered programme that minimises any additional uncertainty for investors.

INTRODUCTION

1. Ofgem’s Project Discovery is a study of whether the current arrangements for the gas and electricity markets are adequate for delivering secure and sustainable electricity and gas supplies over the next 10 – 15 years. Within that context Ofgem is consulting on whether it has correctly identified the key issues and which of its suggested policy packages are best suited to addressing those issues.

2. The themes underlying Ofgem’s analysis of the key issues and potential policy packages to address them would , in the opinion of the Association, be better addressed in the round, rather than by reference to specific questions itemised in the consultation paper and this response has been structured accordingly. Our response focuses on Ofgem’s analysis of the key issues and identifies the elements of the various policy packages which would be best suited to address them, in the most timely and cost-effective way. Indeed, the manner and timing of any change is of vital importance to investor confidence. The Association recalls the length of time that was required to develop and introduce the ‘New Electricity Trading Arrangements’ (NETA) in 2001 and it is attracted to the suggestion in the

recently published Energy Market Assessment[1] that for a review a well-considered programme is essential.

KEY ISSUES – GENERAL COMMENT

3. It is self-evident that a pre-requisite establishing a framework for implementing any given set of objectives is clarity as to the nature of those objectives. In its most recent Energy White Paper[2] the Government set out its four policy goals:

- to put the UK on a path to cutting carbon dioxide emissions by around 60% by about 2050, with real progress by 2020;
- to maintain the reliability of energy supplies;
- to promote competitive markets in the UK and beyond; and
- to ensure that every home is adequately and affordably heated.

4. With the introduction of the Climate Change Act 2008, the Secretary of State was placed under a duty to ensure that carbon dioxide emissions were reduced by 80% by 2050. He is also obliged to prepare such policies and proposals as he considers will enable the 5 yearly carbon budgets (which have now been set for the period up to 2022) to be met. At the same time the Secretary of State (and Ofgem) is under a duty to exercise his powers under the Gas Act 1986 and Electricity Act 1989 in the manner which he considers is best calculated to further the principal objective of protecting the interests of existing and future gas and electricity consumers, wherever appropriate by promoting effective competition, having regard to:

(a) the need to secure that all reasonable demands for gas and electricity are met;
(b) the need to secure that licence holders are able to finance relevant activities; and
(c) the need to contribute to the achievement of sustainable development

5. In doing so the Secretary of State, and Ofgem, must have regard to various other subsidiary factors. Ofgem's principal duty then is to protecting the interests of consumers, primarily through competition, not least by ensuring security of supply, but also having regard to the need to contribute to the achievement of sustainable development – a consideration that embraces a number of factors and not solely carbon emissions.

6. At an EU level the UK is committed to the Energy Policy for Europe set out in the Presidency Conclusions of the Brussels European Council (8/9 March 2007 which identifies the following three objectives:

(a) increasing security of supply;
(b) ensuring the competitiveness of European economies and the availability of affordable energy; and

[1] Energy Market Assessment. HM Treasury. Department of Energy & Climate Change. March 2010.
2 Meeting the Energy Challenge, A White Paper on Energy, May 2007, Department of Trade and Industry

(c) promoting environmental sustainability and combating climate change.

7. In its Energy Scenarios Document Ofgem helpfully identified potential synchronicities that may exist between these objectives in that investment in low carbon generation by diversifying energy sources will increase security of supply and, if properly managed, reduce cost. Nevertheless, these objectives are by no means perfectly aligned, particularly bearing in mind the increase in the 2050 carbon dioxide emissions reduction target. The first issue to be addressed is therefore to establish a clear framework for security of supply and energy decarbonisation taking into account the cost of achieving these targets and the impact on economic competitiveness and social well-being. Thereafter, the task of Government and Regulator is to facilitate the achievement of these policy objectives in the most cost-effective way possible.

8. The "key issues" identified in the present Consultation Document are among the main obstacles to cost-effective implementation and we comment on them in turn with reference to the policy packages outlined by Ofgem.

INVESTMENT AND RISK

9. The Association agrees that unprecedented levels of investment need to be sustained over many years if the Government's aspirations with respect to security of supply and carbon dioxide emissions are to be realised. Given the state of capital markets, attracting investment will be challenging. In order to attract investment, the UK must offer an environment in which a rate of return, which is attractive taking into account the cost and risk of participation, is available to investors. Self-evidently, for this objective to be achieved in the most cost effective manner, the cost and risks of market participation should be minimised. A fully competitive market remains the most efficient way of balancing risk and reward.

10. The Association will respond separately to Ofgem's Consultation Document "Liquidity Proposals for the Wholesale GB Electricity Market, but notes Ofgem's conclusion that "overall the GB generation market is not highly concentrated".

11. Policy packages C and D in particular perhaps imply a highly centralised approach, which could sacrifice the benefits of full competition. There is no credible evidence that such a centralised approach would result in the more cost-effective achievement of policy objectives. We see no reason to believe that a centralised purchasing function would be more effective at achieving the desired outcomes then a well-designed competitive market. There is even less reason to believe that it could do so at an acceptable cost. Policy Package 'E' is unacceptable and it was an unfortunate distraction.

12. The Association recognises that there are particular concerns as to the current regime's ability to attract the required level of investment in low carbon generation at an acceptable price. Investment of this kind, however, is heavily dependent on maintaining stability of policy and care must be taken to avoid undermining existing investment signals which could lead to a hiatus in development. If a change to the Renewables Obligation were

to be contemplated there should be a clear commitment to grandfathered rights for projects that are already under development.

13. Any major reform of the market arrangements should not be embarked upon without a full cost-benefit analysis. The Association is concerned that the piecemeal approach to incentivising renewable energy production, for instance through the introduction of Feed-in Tariffs and the banding of ROCs seems to give less emphasis to the cost of meeting the objectives of security of supply and meeting carbon emissions and renewables targets. Any proposals for a centralised dispatch mechanism for renewables markets should also take into account the additional costs and risk that this would create for conventional forms of generation and overall security of supply. The suggested tenders for renewable energy capacity as envisaged in options C, D and E should be dismissed out of hand as they will inevitably produce the inefficiencies that occurred under the NFFO schemes which were abandoned in favour of the Renewables Obligation.

14. The generation sector has recognised the role that coal-fired generation (with carbon capture and storage) and new nuclear generation could play in achieving the UK's energy policy objectives. What potential investors in new nuclear power appear to agree on, however, is that the current EU carbon market does not, as yet, provide an adequate signal to take projects beyond the development phase. In the light of the other changes in the market framework, individual members will have their own views, about whether any further incentive is required to stimulate new investment in nuclear power.

15. The structure of the market is by no means the only potential obstacle to investment in new plant. Investment in the transmission network is important and so is a clear, equitable and effective mechanism of charging for connection to and use of it. It is critical that Ofgem's RPI-X@20 project enables network owners to better comply with their duties to develop and maintain efficient, co-ordinated and economical systems and to facilitate competition in the energy markets by making new connections available in a timely and cost-effective manner. Although the Association welcomes the Planning Act 2008 as potentially helpful for large scale energy infrastructure projects, it is as yet unproven, and under threat. The Town and Country Planning Act regime continues to be a major barrier to investment in smaller projects, and can still have a highly disruptive effect on major infrastructure developments, National Grid Gas plc's difficulties in obtaining consent for the Tirley pressure reduction installation to support the Milford Haven LNG facilities being a case in point. Low carbon generation is beset by a series of other obstacles, that can only be alleviated by prompt and properly resourced action by Government and regulatory bodies; radar in the Wash for example, and the approval process for nuclear generating plant. At EU level, the Industrial Emissions Directive, which followed soon after the Large Combustion Plant Directive, introduced additional risk and uncertainty.

16. The creation of the right climate for investment is not solely a matter of market design, energy regulation and planning law. Other stimuli to investment, such as changes to Corporation Tax to allow for faster pay-back from gas storage and power generation projects, should also be considered.

CARBON PRICE

17. The management of price risk is an integral part of any competitive business and the generating industry has never asked for certainty with regard to the carbon price, but for more long-term certainty about emissions allowances, against which companies can make a judgment about future carbon prices. The industry looks to the EU to set the appropriate level of allowances in the EU Emissions Trading Scheme and leave companies to pursue the most cost-effective way of maintaining electricity supply within environmental limits. Among electricity companies, however, confidence that the EU scheme will provide the necessary certainty appears to have diminished considerably – hence the open debate about the UK unilaterally taking further measures, such as the introduction of a carbon tax to underpin carbon prices as suggested in policy packages A, B and C.

18. Some companies feel strongly that such a measure would increase certainty and underpin new investment, but, not all are convinced that this is the right mechanism, arguing that the cost of flexible thermal generation in the UK would increase, thus threatening investment in such plant and that, as decarbonisation progressed, the rewards from a floor price would diminish.

19. The pros and cons of a floor price supported by a tax need to be better understood as do other measures that might shorten payback periods for high capital cost investments, such as new nuclear power projects.

PEAK DEMAND AND INVESTMENT SIGNALS

20. The Association believes that short term price signals at times of peak demand may not reflect the value that consumers place on security of supply. The problem is exacerbated by proposals such as the new market abuse licence conditions that expose generators to regulatory risk in the event that they attempt to take advantage of short term prices to cover the cost of long-term investments. Furthermore, sharpening the existing incentives would increase risk both for wind farms, which will be exposed due to the intermittency of wind, and for investors in new flexible fossil-fuel fired plant, since extreme shortages cannot be relied upon to materialise with adequate regularity to enable them to recoup their investment. Increased risk inevitably results in increased cost and the market rules should be designed to eliminate unnecessary risk, not exacerbate it. A market-driven, innovative approach to trading would probably mitigate some of the risks. The question of introducing some form of capacity or availability payment is an issue that the Association has addressed in the past. The Association is not advocating such a mechanism, but, there might be some support for it, if unintended consequences could be avoided. The Association would be happy to take part in a study on the issue if the proposal were to be pursued.

21. The imposition of enhanced obligations as outlined in policy packages 2 and 3 would be a retrograde step towards centralised and potentially arbitrary control and decreased efficiency. By and large, the current duties of the transmission system operator and the existing market arrangements strike the right balance between operational responsibility for system control and market response to long term signals. If there is indeed, as Ofgem

suggests, a significant disparity between the information currently available to the system operator and market participants, the appropriate remedy is greater transparency, not centralised control.

22. The market will deliver the most efficient response to supply and demand and price risk management. If, taking into account the characteristics of the plant and its site, it is economical for existing plant to maintain a store of back up fuel for use at times of peak demand it will do so. It is important, however, that the market should have confidence in peak pricing, enabling operators to make sound commercial decisions around the reliable provision of peak capacity, whether this is from peak production, storage, demand control or fuel switching.

23. It is worth noting that the major failures that have occurred in the UK's gas and electricity market were in fact attributable to factors well outside the remit (or potential remit) of UK regulatory authorities. Moreover, the market has coped well with the failures of major suppliers and generators.

24. The Association would support a well-considered programme of review which is not so long as to be disruptive to new investment. The practicalities of implementation clearly dictate that, unless there is an overwhelming case to the contrary, the current arrangements should be maintained, adjusted as appropriate to create the right market signals in the light of clearly defined policy objectives. Whatever changes are introduced, they must be thoroughly thought through, involving stakeholders from across the market, including smaller players. Clearly, electricity can play a major enabling role in the transition to a low carbon energy industry – initiatives in the heat and transport sectors may stimulate electricity demand - but, as an important part of the solution, the sector should not be over-burdened with its share of the cost of meeting policy.

INTERDEPENDENCE WITH INTERNATIONAL MARKETS

25. Interdependence with international markets is not a threat but a reality, which offers benefits in terms of potential sources of supply as well as risks. The appropriate response to this reality is to ensure that the UK remains an attractive environment in which to invest. Proposals B to E would have a detrimental effect in this respect.

26. Liberalisation of the EU gas market and the UK's access to diverse sources of imported and domestic gas enhance the UK's ability to secure access to gas, although the investment necessary to address gas quality constraints on imports to the UK needs to be addressed more urgently than Ofgem suggests. Government, Ofgem and the industry need to play their full part in making the most of this market and encouraging continued liberalisation of it. Solutions to the UK's exposure to possible failures in gas supply should be sought in the context of the European market. In addition, thought should be given to ensuring a more strategic use of the UK's remaining undeveloped reserves.

27. The UK's exposure to the international gas market should not be overstated. As its dependence on gas has increased, so has the range of ways in which its gas is supplied and

stored – interconnectors, LNG terminals and storage facilities. With regard to storage, there are nine existing sites, two more under construction, nine more with planning consent and a further ten in various stages of design. Where Government has influence on these developments, it should seek to ensure that investment in this market remains attractive for transport, storage and ancillary facilities – among other things, ensuring that the Planning Act is effective and continuing to press for greater liberalisation in the rest of Europe. 'Strategic' storage or mandatory storage levels should not be necessary and this may, in fact, bring to a halt other important investment.

COST

28. The need for new investment to maintain security of supply whilst meeting the Government's objectives with respect to carbon emissions will inevitably lead to increased costs for consumers. A fully competitive market driven by the correct signals and free from excessive regulatory intervention and burdensome centralised control remains indisputably the most cost-effective mechanism for attracting the necessary investment and delivering the desired outcome. This implies targeted evolutionary reforms - with particular reforms being developed for management of peak demand and investment in low carbon generation. The evolutionary process should be well planned, well signaled, and restricted to areas in which the benefits of change are clear and substantial, and supported by detailed cost-benefit analysis.

29. The Association is concerned as to its members' exposure to the increasing use of mechanisms which subject them and their customers to additional and unnecessarily high costs, in pursuit of a variety of policy objectives. The public would benefit from greater transparency as to the impact on the price of their energy supplies of pursuing individual policy objectives.

CONCLUSION

30. The Association recognises the need for measured evolutionary change to the existing market mechanisms. It is not, however, advocating change in the nature of a 'new NETA.' The Association looks forward to engaging with Ofgem and Government with a view to refining the market arrangements to provide the best possible platform for investment in new generation of all types. Any proposal for a mechanism to support the price of carbon in the UK should, however, be subject to cost-benefit analysis and if implemented, must be introduced with due concern for its impact on other mechanisms.

31. More generally, the Association regrets the overall direction of Ofgem's report, which appears to signal a lack of faith in the market mechanisms which have served so well the UK electricity industry and its customers. If there is a failure, it lies in the ability of policy-makers to provide a robust and coherent framework for environmental policy which is sufficiently compatible with the market to give investors the confidence that they require.

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