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31 March 2010

To
Ian Marlee
Ofgem, Trading Arrangements

DONG Energy response to Ofgem consultation on Project Discovery – Options for delivering secure and sustainable energy supplies

DONG Energy would like to thank Ofgem for the opportunity to comment on the findings and conclusions of the Project Discovery analysis. DONG Energy is highly committed to the UK energy sector with over 308MW installed offshore wind assets, some of the world's largest offshore wind projects under construction or in the pipeline, an 824MW CCGT plant in South Wales commissioning in 2010, and significant gas reserves in the area West of Shetland. Ofgem's Project Discovery findings and policy proposals are thus of vital importance to us and our business.
We appreciate Ofgem's initiative to consider measures that may help to bring forth investments that can ensure security of supply in the future UK energy market and help achieving the environmental objectives stated by the government. We have outlined some key points, which are of high importance to us below:

- Stable and predictable frameworks for investments and honouring of guarantees on which previous investments have been made
- A liquid and transparent wholesale electricity market with price signals that reflect supply and demand
- Addressing cross-border issues in energy markets
- Better opportunities for demand side involvement in order to help balance the system
- Diligent consideration and monitoring of new initiatives to assure they function as intended

We agree with Ofgem's depiction of the next decade as a period with significant challenges in terms of achieving the necessary development of the UK electricity and gas sectors. We are however sceptical of some of the remedies proposed by Ofgem for tackling this situation as we believe mechanisms of the liberalised market has performed well in the UK so far. In our view, the issues identified do not directly lead to the conclusion that the market cannot manage the upcoming challenges. Rather, we see it as a mixed consequence of insufficient incentives, distorted price signals, political uncertainty and other constraints, which do not allow the market to deliver the optimal and desired outcome. If the right framework and incentives are present we believe that it will automatically attract the necessary investments.

Stable and predictable investment frameworks
We would like to stress the critical importance of confidence in the market set up and regulatory stability in relation to investments in electricity and gas infrastructure. Analysis and forecasts may create/initiate the basis for projects. However when deciding on investments with significant upfront costs

and lifetimes up to half a century, it is at the end of the day confidence in the market, the rules and the regulation as a whole that forms the base for such investment decisions. Therefore, if investors are not confident that the rules observed today will apply tomorrow, no amount of subsidy or other incentive can bring forth these investments.

DONG Energy is one of the companies that has acted and expanded its UK business significantly in the period Ofgem describes as a period with a very challenging investment environment. Up to now, we have committed ourselves to invest billions of pounds in offshore wind, a CCGT plant and other gas assets. In light of this we are very concerned that Ofgem do not bring more focus to the protection of the conditions on which previous investment decisions were made. Specifically we believe that suggesting a whole new support mechanism for renewable energy and only mentioning grandfathering of existing projects in one sentence *"...existing RO-qualifying plant would need to be grandfathered (the potential for buying out these arrangements could also be considered)" paragraph 4.64* does not put enough emphasis on this important issue as the potential implications could be serious. Current renewable projects are based on expectations of ROCs and the price of these – watering down of the ROC support would be detrimental to current projects and also effectively put a stop to any further build-out of renewable energy in the UK. An example of the importance of grandfathering is the current lack of grandfathering for biomass, which has deferred many biomass projects. Therefore we welcome DECC's timely review of grandfathering of ROCs for biomass.

We would also stress the need for financial support to renewable to have a long term perspective. For instance, the current ROC banding for offshore wind farms should be extended beyond 2014 in order to avoid "stop-go" effects in deployment and hence higher costs.

Liquid and transparent markets with appropriate investment signals

We believe decisions on investments in new generation capacity is better left to the market, and, as stated above, we believe that the desired outcome will materialise if the right incentives and framework is present. Clear forward price signals that correctly reflect gas and electricity demand in the market will ensure that the necessary investments are deemed profitable and we therefore propose that most power should be traded in a liquid and transparent market place. We acknowledge that Ofgem is addressing this important issue in the current consultation on market liquidity and hope that arrangements will soon be put in place to address the current deficiencies and facilitate entry into the marketplace by new and independent power producers.

The drawback of introducing sharper price signals is that intermittent technologies might be adversely hit by this. We therefore propose Ofgem should re-evaluate the balancing mechanism to ensure the mechanism is appropriate for an energy system with large amounts of non-dispatchable energy.

We support the suggestion of a minimum carbon price as this would incentivise low carbon technologies. We also believe it is important to incentivise investments in very flexible production plants ('peaking plants') that are only in demand at times of tight energy supply. The purpose of ensuring deployment of such plants would be to reduce the variability of power prices and thereby reducing uncertainty as well as the potential 'downlift' to average power prices that intermittent plant is subject to. As illustrated in the UK intermittency study undertaken by Pöyry (*Implications of intermittency*, 2009), the expected capture price for wind plants is very sensitive to the installed capacity of highly flexible plants. We suggest further investigations to be undertaken in order to determine whether support to flexible plant would be a cost effective way to improve the economics for intermittent renewable technologies.

Cross border issues in gas markets

DONG Energy considers it important to focus on a number of cross-border issues in gas markets rather than on "fine-tuning" current arrangements within market areas. In the context of cross-border alignment it is of utmost importance to address inter-TSO issues as well as inter-regulator issues (investments/Joint Open Seasons, asset base, tariffs etc.).

European regulators should develop mechanisms to secure coordinated approval of investments within a natural, regional scope, including exchange of information and joint assessments of relevant projects. DONG Energy encourages market integration within EU - the aim should not necessary be full market mergers; but rather the development of natural regional market areas with seamless interaction.

Demand Response

DONG Energy is both supporting and pursuing the opportunities for increased demand response - most notably in our home market - as we believe this will be a key ingredient in the future energy markets. There are many benefits from an increased level of demand response, especially with regards to the system balance and capacity margins. It is however important that demand response is based on a market oriented setup, where commercial entities pass on cost reflective price signals to final customers through new innovative solutions and contracts.

Monitoring of new initiatives

Initiatives undertaken to address some of the main obstacles for increased capacity - such as the issue concerning grid connection queues (to be addressed by implementation of the connect and manage – socialised costs model) and simplification of the process concerning development consents (by introduction of the IPC) – will help many projects come forward. It is however important that these initiatives are functioning as they were intended and therefore we find it crucial that the Authority monitors these and addresses any malfunctions.

An initiative, which would also urgently be reconsidered and improved, is the new Offshore Transmission Owner (OFTO) regime. If this is not redesigned and implemented in the best possible way, it could have severe adverse consequences for generators and potentially jeopardize the on-time deployment of many offshore wind projects.

With regards to the gas business, we believe substantial parts of the congestion management/capacity allocation issues within EU market areas have been solved - or are on their way to be solved. Therefore the market also here needs some time to absorb and to adjust to these changes.

To sum up, DONG Energy very much supports an approach that carefully considers such serious subjects as security of the sustainable energy supplies at lowest possible costs. We therefore support initiatives that will improve price signals and ensure more effective demand response. Furthermore we believe it is important to incentivise investments in very flexible production plants ('peaking plants') and also support the implementation of a minimum carbon price. We do however not believe that the drastic market reforms suggested by Ofgem are beneficial at this point when large investments are needed, as it would undermine investor confidence. Instead, the energy system should continuously be optimised through gradual improvements that will support the operation of the market mechanism. We believe that such improvements along with the initiatives undertaken to address other obstacles for capacity build-out will bring forward necessary investments. Hence to improve the investors' confi-

dence, we suggest Ofgem to rule out some of the most radical policy proposals as for example the Single Energy Buyer, as done in the 2010 budget by the Government.

Yours sincerely,

Thomas Dalsgaard

Vice President, Regulatory Affairs

CHAPTER: Three

Question 1: Do you agree with our assessment of the current arrangements?

Generally, yes. We agree with the problems Ofgem has identified and do find that there are market improvements worth exploring, but that overall the solutions presented creates too much uncertainty.

Question 2: Are there other aspects of the current arrangements which could have a negative impact on secure and sustainable energy supplies, or costs to customers?

We believe that the market by-and-large has performed well in the UK so far. We do however also acknowledge that regulators need to address issues, which hinders the optimal market outcome. Examples of such obstacles which have been addressed with new initiatives recently are the grid connection issue and the development consent issue.

An issue, which in the future might become relevant to address is the electricity transmission charging arrangements, as much of the renewable energy is produced far from the consumers and thereby incur significant transmission charges.

Question 3: Do you agree that the five issues we have highlighted are the most important?

1) The need for new investments in power production capacity is unquestionable if security of supply is to be up held. If furthermore, the ambition of reducing carbon emissions is to be reached, much of the new capacity must be within renewable or other technologies which is characterised by having high investment costs, but low running costs
2) The current carbon price as set by the EU ETS is not currently reflecting the true cost of carbon. This has two effects; 1) renewable technologies are not coming forward, 2) carbon intensive technologies are subsidised. Therefore we agree that the low carbon price is one of the issues that are most important
3) The value that consumers place on undisrupted supply of electricity should be reflected in the prices as this would incentivise the build-out of flexible capacity and thereby help to ensure the system balance and a diverse capacity mix
4) The interdependence with domestic markets is in our view a positive element as it ensures liquidity and provides consumers with the most cost effective supply.
5) The transition towards a low carbon economy should be undertaken with a focus on minimisation of costs. However, additional cost to consumers cannot be avoided as more production of electricity will be based on the more expensive low carbon technologies. If this results in some consumers not being able to afford the desired levels of energy, it should not be considered an issue relating to the energy markets, but rather a matter of social redistribution. The issues should therefore be addressed directly via the benefits system and not indirectly via the energy market

Further we would like to mention the issue of revenue cannibalisation for intermittent power production as a consequence of the 'downlift' on power prices. As significant amounts of wind capacity is introduced into the system, more electricity will be produced in periods with high winds, depressing the offtake prices for wind and thereby cannibalising revenue for the wind plants. Our analysis suggests that the intermittency effect could be as much as 5-10% in 2030, depending on the deployment rate of wind capacity. We believe that this issue should be a focus area and be closely monitored by the au-

thorities, as it potentially could make renewable intermittent power production economically unviable and thereby obstruct build-out.

Question 4: Do you have any comments on our description of what might happen if no changes are made to the current arrangements?

We are not convinced that the scenarios presented do represent the most plausible outcomes for the energy sector if no actions are taken. Generally, the description lacks evidence in the form of forecasts and presentation of underlying quantitative analysis or modelling, which makes it difficult to assess the validity of its results. In any case, we do not consider it relevant to assess a situation with no change at all, as the energy markets should continuously be refined through incremental improvements to the current arrangements.

CHAPTER: Four

Question 5: Do you believe that our policy packages cover a sufficient range of possible policy measures?

As there is no quantification of the effects of any of the proposed policy measures, we find it difficult to assess whether they cover a sufficient range or not. However we do find some of the proposals rather extreme and do not believe that such radical market intervention is needed or has been justified.

Question 6: Do you have suggestions for variants to these policy packages?

We do not believe that too much focus should be placed on the packages, but rather on an objective evaluation of each of the proposed policy measure separately.

Question 7: What other policy measures do you believe should be considered, and why?

We think that a review of the balancing setup for wind is warranted as the current setup is designed to accommodate a system based on predictable and stable production technologies. With the introduction of new and more unpredictable production technologies such as wind, the current balancing mechanism could result in excessive costs for these technologies and therefore it may be appropriate with a discussion of the balancing setup for wind.

CHAPTER: Five

Question 8: Do you agree with the assessment criteria that we have used to evaluate the policy packages?

In our opinion simplicity and clarity of regulation deserves to be mentioned in its own right (although it could be considered to be covered by "implementation issues"), as complexity and consequential uncertainty for investors is likely to increase investment costs and costs to consumers. We agree to the assessment criteria stated. We note that we do not believe that a qualitative assessment of the policy changes is very informative. When suggesting such extensive market reforms, we would expect more than an initial high level assessment of the implications.

Question 9: Do you have any comments on our initial assessment of each of the packages?

See answer to question 8

Question 10: Do you agree with our summary of the key benefits and key risks of each policy package?

As key risk for three out of the five policy packages you have stated "May not be sufficient to address the financing challenges...". We think this underlines the need for a more thorough investigation and detailed modelling of the potential consequences of each of the proposals.

Question 11: Do you have a view on which package is preferable, or alternative policy measures or packages that you would advocate? We are particularly interested any analysis you may have to support your views.

Yes, if reforms of the UK energy market are needed, which seems to be the case in some scenarios, we would argue for policy package A – Targeted Reforms. The measures in this policy package would help bring forward investments in not only new low carbon capacity, but would also help manage the energy market more efficiently through demand response.
These relatively limited reforms do not only seem to promote the desired outcomes, but also supports the image of a relatively stable and consistent investment environment, which is at least as important as the right incentives.

CHAPTER: Six

Question 12: Do you agree with our assessment of the timing for important investment decisions?

Yes, we believe that the lead time assessment is a good estimate of when investment decisions are made. As we have stated earlier in our response, we believe that the market will provide the most cost effective solution given the right framework and incentives, but investment decisions will not be taken until the investment are needed in the market. Therefore, for example a CCGT which is needed in 2016 will not have FID taken before perhaps 2012. This is yet another argument that a need for radical changes to the current market arrangements cannot be concluded from a simple projection of future plant capacity derived from the number of investment projects that are under development.

Question 13: Do you believe that early actions should be considered?

We believe the market arrangements should be amended in due time to avoid changes will take investors by surprise and retain trust in the market regime. We also believe that such important changes as proposed here should be based on thorough analysis in a process with close interaction and involvement of all relevant stakeholders. Specifically for the proposals in this report, we believe that more analysis need to be undertaken before any conclusions are made with regard to the current market framework's ability to deliver the needed investments.

Question 14: Do you think that the issues are such that policy measures should be considered as a package or should they be considered on a case by case basis?

As stated above, we believe the policy measures should be evaluated on a case by case basis.