

ESBI Investments, 3rd Floor, Regent's Place, 338 Euston Road, London NW1 3BT, England.
Tel: +44 (0) 207 544 8631 **Fax:** +44 (0) 207 544 8580 **Web:** www.esbi.ie

Ian Marlee
Ofgem
9 Millbank
London
SW1P 3GE

31 March 2010

Dear Ian,

Project Discovery: Options for delivering secure and sustainable energy supplies

ESB International (ESBI) is pleased to respond to Ofgem's second Project Discovery consultation on options for delivering secure and sustainable energy supplies. As an independent developer of efficient conventional and renewable electricity generation, the issues and questions raised as part of Project Discovery are key considerations and could critically impact our business.

ESBI has been a developer of independent Combined Cycle Gas Turbine (CCGT) generation projects in the GB market for over fifteen years. We currently have interests in the 350MW Corby power station and in the 850MW development at Marchwood, which commissioned in late last year. We also recently announced our latest 860MW development at Carrington which is planned to commission around 2014. We are also considering other large CCGT developments at various locations across GB. It is ESBI's intention to build 3GW of thermal generation in GB over 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 Fullbrook Down and West Durham windfarms. All these developments are set within the context of a wide-ranging programme announced by the ESB group to facilitate the transition to a low carbon economy.

Summary of ESBI's views

In our response to Ofgem's Energy Market Scenarios document we stated that Project Discovery has the potential to address the inadequacies in market rules which currently undermine investor confidence and have the potential to undermine medium term security of supply. However, we also expressed concern that Project Discovery could increase market uncertainty and deter substantial amounts of much needed investment.

We also questioned Ofgem's rationale for undertaking the review at this point and queried how it intends to use any evidence, conclusions or recommendations arising from the project. We were 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.

ESBI Investments is a trading name of ESB International Investments Limited.

Directors: John McSweeney, Suzanne Ward, Paul Tobin, John Redmond.
Registered Office: Stephen Court, 18-21 St. Stephen's Green, Dublin 2, Ireland.
Registered in Ireland No. 137736



While we remain concerned about the increased uncertainty that Project Discovery may create, we recognise that there are issues to be addressed, particularly in the electricity market, to ensure that the overall market arrangements are fit for purpose and capable of delivering the key objectives of energy policy. However, we note that many key decisions, particularly regarding the methods through which the UK can achieve climate change targets, lie with Government. Ofgem's role should be to provide clear advice to Government but not to implement "second best" options if it considers the Government is not adequately addressing an issue. We therefore welcome Ofgem's statement that: "we recognise the need for a stable environment for investment, and do not advocate change lightly".

As a developer of gas-fired and renewable generation projects, we place significant value on clear and consistent energy market arrangements. This allows us to invest with increased confidence, and through the new entry we bring to the market, increase competition to the benefit of customers. As ESBI has recently developed the Marchwood project and is currently in advanced stages of investment appraisal at other sites, we feel we are particularly well placed to comment on the impact of the current market arrangements on investment decisions. Our views on the issues raised by Project Discovery for both the gas and electricity markets are set out below.

The Gas Market

We would caution Ofgem against making significant changes in the gas market, given that the arrangements have worked well to date. This was particularly demonstrated during the significant system stresses of this winter, when supplies were maintained and gas prices remained relatively low. There has been a strong and steady stream of new investments in gas production capability in the last five to ten years, and while there may be some concerns about the adequacy of overall storage capacity in Great Britain, many of the problems associated with developing storage facilities appear to arise from planning difficulties rather than underlying problems with the market arrangements. We would also argue that part of the reason the gas market arrangements have worked well has been the relative absence of major policy interventions and the fact that, to a substantial degree, the market has been allowed to deliver (which may in itself provide a lesson for the electricity market).

We do not consider that Ofgem has made a strong or persuasive case for significant changes to the gas market arrangements (beyond improving cash-out arrangements), and note that Ofgem's case appears primarily to rely on a view that the future will be different from the past, without clearly demonstrating why the current arrangements would be insufficiently able to meet those challenges.

Electricity market

We share Ofgem's view that there may be more significant issues to address in the electricity market than the gas market. These issues relate to both the impact of market arrangements and the approach which has been taken to delivering policy objectives.

It is challenging to analyse the present and future viability of gas fired generation in a market characterised by frequent changes in market policy and mechanisms. This is especially the case where changes are implemented to specifically promote a particular type of technology. Recent examples of such changes are: measures designed to deliver nuclear generation such as a floor to the carbon price; measures which could directly affect the costs and risks facing gas fired generation, such as requirements to fit Carbon Capture and Storage; an imposition of a requirement for gas fired generators to have distillate fuel capability; or other obligations such as mandating gas storage. Before Ofgem considers any of these options further, we would seek for it to undertake a thorough and well evidenced review of the potential costs, benefits and impacts on investment that they would give rise to.

ESBI is broadly supportive of measures that enhance the efficiency of market arrangements which Ofgem sets out. Changes to the cash-out regime, to provide sharper and more cost-reflective price signals, are likely to be particularly important as the amount of renewable generation on the network increases and the requirement for flexible plant grows. Investors in this flexible generation will need certainty that they will be able to recover costs during a small number of running hours. We also consider that a number of the initiatives, such as Ofgem's important work on liquidity in the wholesale market, to which we have responded separately, have the potential to deliver significant benefits by addressing the impediments to new entry and competition and falling traded volumes. We would urge Ofgem to progress these issues as a matter of urgency and seek to understand the impact of addressing them before proceeding with a more fundamental overhaul of market arrangements.

Ofgem's proposals

We consider that Ofgem has set out a comprehensive range of options for revising market arrangements. However, we remain concerned that Ofgem has not been clear on the causes of the concerns and deficiencies which it highlights. In our view, understanding the underlying cause of an issue is the first stage in identifying the most appropriate and proportionate solution to addressing it. Failing to do so creates a risk of putting in place second-best solutions and/or further distorting market arrangements. We further note that the breadth of Ofgem's proposals create significant uncertainty. We are currently in the process of making very large-scale investment decisions, all of which we must review within the somewhat uncertain context of Project Discovery.

We note that Ofgem state that:

"Although our scenarios do not indicate concerns over supply security until beyond the middle of the current decade, the timescales required to secure finance, mobilise supply chains and deliver the infrastructure needed suggests that the period around 2012 and 2013 could be important for investment decisions critical to future secure and sustainable energy supplies. Hence, there is a window of opportunity between now and then to implement any policy measures that may be necessary to make sure that investment takes place in a timely fashion."

ESBI would encourage particular caution in this respect. The decisions which will be needed to deliver fit-for-purpose capacity in the middle of this decade will be taken in the near term. Investors, such as ESBI, who are considering investment opportunities in a range of markets, would be particularly concerned if market arrangements were in a state of flux for a period of years. It is vital that Ofgem undertakes the appropriate analysis as soon as practicable and rules in or rules out the most radical options proposed by Project Discovery such that investors are better able to reflect them in decision making.

ESBI recognises the significant challenge involved in delivering renewable generation and is committed to contributing to the realisation of the UK's legally binding renewable targets. This is complimentary to our corporate commitment to transforming the ESB group of companies into a low carbon business. We consider that the best method of delivering these challenging targets is via a clearly specified, market-based policy framework which allows investors to make informed long-term decisions. In our view, the regulatory and policy approach taken to date has, to an extent, been piecemeal with winners being picked and market distortions created

Ofgem's document draws attention to the challenges the energy markets face in the forthcoming years. There are, however, challenges and market uncertainties that also impact investor decisions which are correctly not covered within the scope of Project Discovery but should be acknowledged in parallel. These include barriers to development inherent within the planning system, uncertainties around provisions for CCS and technology policy that repeatedly picks "winners". We would seek for Ofgem to, wherever possible, propose and support market arrangements that were technology neutral and based around effective competition within liberalised markets.

Issues to address

As noted above, we remain hopeful that Project Discovery can contribute to the development of competitive markets which deliver Government policy goals. A key aspect of this would be the implementation of proportionate measures to address demonstrable market deficiencies. We are also hopeful that should changes be made following Ofgem's findings, these are made relatively quickly and without prolonged periods of uncertainty. We would urge Ofgem to consider and analyse the following issues:

- *Are policy objectives sufficiently stable and transparent?* – The scenarios that Ofgem identified in the Energy Market Scenarios document clearly indicate that achieving carbon reductions and security of supply at reasonable costs for consumers is likely to be a huge challenge. At the heart of many of the issues raised by Project Discovery is a lack of clarity about the objectives that energy policy is seeking to achieve. The UK market has been characterised by frequent changes in priority and there remains a fundamental question as to whether it is possible to deliver secure supplies, carbon reductions and low costs to consumers. Unless market participants face a clear, transparent and unambiguous policy framework there will always be a perception that investment is risky.
- *What is the impact of seeking to deliver objectives via market provision and market intervention?* – If policy objectives have been defined there follows a question as to what the best tools for delivering them are. In GB this has involved a focus on the market to deliver new generation capacity (particularly in the case of thermal generation) but, increasingly of late, direct intervention to support certain technologies. We are of the view that this approach creates unintended consequences, increases risk and, all too often, makes future intervention inevitable without necessarily delivering the benefits the intervention was designed to achieve. We believe that the liberalised markets should be given the opportunity to deliver as they are best-placed to find the optimum solutions to the energy challenges ahead, at least cost to consumers.
- *What is the impact of market structure and conduct on the delivery of objectives?* – A well functioning market needs multiple buyers and sellers and highly liquid markets. The consolidation that has developed has, to some extent, limited competition and blunted price signals, as well as arguably increasing costs to customers. Restoring a more openly competitive dynamic to the GB market, developing robust reference prices and increasing the liquidity in the traded markets would be expected to significantly increase its attractiveness for new entrants.
- *Does the market design frustrate or facilitate delivery of policy objectives?* – Finally, the question arises as to whether the observed problems are being driven by the fundamental design of the market. Will a market based on bilateral contracting between buyers and sellers, with a relatively small central agency, inevitably lead to the problems currently seen in the market? If this is the case, can an alternative structure avoid these outcomes and deliver additional benefits? In our view a wholesale market restructuring would bring with it significant cost, both in terms of time and money and could, unless other issues are also addressed, provide little incremental benefit.

Next steps

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 are of the view that the current market is capable of facilitating the investment required to achieve energy policy objectives.

We are committed to building a portfolio of efficient 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 progress continues to be made in addressing the current problems within the market such that progress is not hindered.

We also stress that the energy policy framework and market design are not the only concern 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 are equally important to the successful delivery of GB's energy policy objectives.

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