

25th March 2010

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Dear Ian

Project Discovery: Options for delivering secure and sustainable energy supplies

1. JCRA Energy is writing in response to Ofgem's request for submissions pertaining to the latest stage of its Project Discovery programme. JCRA Energy welcomes the opportunity to respond to this request and would be happy to discuss this with you in depth at a future date if required.
2. JCRA Energy provide experienced independent advice to participants in the energy markets, enabling them to plan and budget in a commercial manner. As part of J.C. Rathbone Associates, which has more than 20 years' experience in financial risk management, we help our clients generate improved profitability and the services we offer are always tailored to the unique circumstances of each client.

CHAPTER THREE: APPRAISAL OF CURRENT ARRANGEMENTS

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

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?

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

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

3. As stated by Ofgem, the main criteria against which the current gas and electricity supply arrangements should be assessed is both their ability to "keep the lights on" on a day-to-day basis, as well as their ability to ensure investment in new assets. Crucially, the arrangements must meet these obligations in a manner which is both efficient and effective.

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4. The electricity market, for example, has endured the introduction of NETA and the subsequent slump in the wholesale market and its implications, as well as the departure of companies including Enron and TXU. Throughout these and other incidents, supplies have continued without any sizeable disruption and no consumer has been left without electricity due to the financial failings of its supplier. Likewise in the gas market, the UK's transition to a net importer has been managed in a similar manner, aided by the increasing volume of import capacity that has been brought online.
5. It is certainly the case that gas and electricity supplies have been maintained largely without incident in the post-privatisation era, although the manner in which the UK energy market has operated to ensure such stability can be called into question.
6. Historically, Ofgem's response has been that "the market will deliver" and that this will be reflected in the price of electricity and gas. However, the question should not be, "The market will deliver, but at what price?" but rather, "The market will deliver, but at what cost?" Unfortunately, it is the industrial and commercial (I&C) sector that typically faces these costs in the event that they have supply contracts that are directly and immediately linked to the wholesale market.
7. Ofgem's traditional focus has been on ensuring stability and security of supply for domestic customers at an affordable cost, with such supplies being maintained largely at the expense of non-domestic customers. The same is also true of measures such as energy efficiency and carbon reduction, with industrial and public sector energy users required to take the lead on such areas. As such, there has been a disproportionate focus on non-domestic customers to address supply-demand imbalances with resultant implications for their operations and – ultimately – their bottom line.
8. At the end of the day, while the industrial sector has long been an important source of flexibility (particularly in the form of demand side response) it exists to produce goods and services, and not to provide supply flexibility or security as a primary business function.
9. With regard to the five key areas that have been highlighted, it is certainly the case that the UK is facing an unprecedented need for investment in the energy sector and effectively the re-invention of its electricity network for the demands of the 21st Century. The fact that it is facing this challenge at the same time as financial market uncertainty, demands for wide-ranging technological innovation in the sector, and similar pressures across much of the world means that – if the situation is not adequately managed – the UK runs the risk of experiencing a "perfect storm" of simultaneous challenges that jeopardise supply security and market stability.
10. The possible developments suggested highlight some of the likely outcomes, although it should be stressed that these arrangements are not occurring within a political vacuum given the upcoming general election. Such indications must be considered against the backdrop of a potential shift in policy and a change in government.

CHAPTER FOUR: POSSIBLE POLICY RESPONSES

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

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

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

11. The UK energy market has been seen as an international trailblazer with regard to the process of privatisation and deregulation. In all instances, these markets have sought to take the most relevant and best suited aspects of the UK experience and apply it to their own. At the same time, the UK's own history of privatisation has been an adaptive process, with the respective industries that have been opened to competition facing a structural and regulatory learning curve.
12. While this has been met with mixed success, the overall experience has been positive. However, in looking to move forward, the UK must now seek comparable markets and structures upon which to base the shape of its future industry structure. What looks almost inevitable at this stage is that the historic axiom of Ofgem and its predecessors that "the market will deliver" needs to be replaced. In its stead – and justifiably so – appears to be one of "we don't know if the market will deliver, but we need a Plan B to ensure investment".
13. Although the energy companies would most likely reject any claims that they had failed to invest in recent years, it is likely that they would view state control of their investment plans as being undue interference in commercial matters. There is also the prospect that any degree of state involvement would breach EU guidelines on competition and market intervention.
14. In the case of the gas market, the issue of strategic gas storage is one that has been debated extensively since the 2006 Energy Review. Indeed, if the UK's growing dependency on imports has highlighted any one characteristic of the country's gas market, it is its lack of gas storage. Given that the UK only has storage capacity equivalent to around five per cent of its annual demand, a greater reliance on imports implies the need for a greater "safety net" – something that gas storage is well placed to provide. However, the private sector has experienced considerable difficulty in achieving progress in developing new gas storage assets, and these underlying problems must be addressed to ensure that gas storage capacity – from whatever source – can be developed in a timely and cost-effective manner.
15. The planning regime has previously led to large delays and repeated appeals for gas storage projects, although it remains to be seen how the revised 2009 planning regulations will operate in practice with regard to storage applications. Public safety is rightly a key factor in any new energy development, but the "NIMBY-ism" of wind farms have increasingly been joined by an undue level of fear about storage. Such issues only serve to highlight the need for an informed and non-partisan discussion about gas storage projects, and the need for Government to carefully consider any application or appeal regarding gas storage.

16. The electricity sector is effectively in the same position now as the gas sector was in the late 1990s – it is widely accepted that there will be a capacity shortage without investment, but it is not apparent where that investment will come from or what form it will take. Unlike the situation faced by the gas sector, it is not only the UK's electricity supplies that are facing the prospect of considerable change, but also the way in which that electricity will be delivered will also change.
17. With regard to the latter point, the ongoing RPI-X@20 consultation may well provide an indication on the future structure of transmission and distribution charges and hence how incentives should be structured. Here, there should be specific requirements on National Grid in its role as system operator for both the gas and electricity networks to both minimise the costs of balancing the networks and minimise the impact of their actions on the market through appropriate incentive arrangements.
18. As far as the actual investment in new generation capacity itself is concerned, one of the areas that has been highlighted is the potential for re-introducing capacity payments as a means by which to promote new investment. While a return to one aspect of the post-privatisation Pool structure, the use of capacity payments would represent an important signal for the developers of new plant, with their use having been established as part of the Single Electricity Market (SEM) project in the integrated Irish and Northern Irish markets. However, any use of capacity payments would have to be introduced and managed in such a way that it did not lead to a repeat of the problems they caused in the days of the Pool.
19. What is welcome is Ofgem's acknowledgement that the current arrangements cannot be guaranteed to provide the needs faced by the UK electricity sector. They have managed to deliver "marginal" change, i.e. additional generation units as required, but are untested in delivering the kind of system overhaul needed in the coming decade. This is compounded by the fact that there will be a considerable amount of investment in a short timescale, while the kind of investment is in very large projects (e.g. nuclear), untested projects (clean coal) and areas subject to uncertainty on a national and international policy standpoint (carbon).
20. Two points must be stressed. Firstly, any change from the prevailing legislative and market structures cannot take place within a national or international political vacuum – it must be fully compliant with the relevant policies as to do otherwise could potentially compound the existing situation as legislative uncertainty could paralyse investment. This is particularly true in the case of the Industrial Emissions Directive, the progress of which must be carefully monitored and adapted to as it moves through the European legislature.
21. Secondly, while change to the gas and electricity industry codes can – under normal circumstances – only be proposed by the signatories to those codes, Ofgem must not allow vested interests in the sector to dominate the reform process, nor must it allow itself to be subject to any degree of regulatory capture.

CHAPTER FIVE: ASSESSMENT OF THE FIVE PACKAGES

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

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

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

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 in any analysis you may have to support your views.

22. The primary comment that we have with regard to the scenarios is that there is an onus on Ofgem, government and other stakeholders to be proactive to ensure that – in the event that the more extreme price scenarios emerge – that there is a plan of management and adaptation in place.

23. While, as stated above, Ofgem is eyeing a “Plan B”, it also needs a “Plan C” that minimises the impact on consumers of the potential for an increase in energy prices of 52 per cent from current levels by 2016. Again, this should look at all customers, not just domestic users, and should provide that there is not a disproportionate burden on industrial and commercial customers.

CHAPTER SIX: TIMING

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

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

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?

24. Given that there is a possibility of a change in government at the general election, and as the bulk of any required changes will be taken by government, Ofgem should be as proactive as possible in addressing the challenges that it faces. This must, of course, not be taken independently of the political process but rather be undertaken in conjunction with it. In general, well-thought out and developed actions should be taken as early as is permissible.

25. With this in mind, the nature of the challenge facing the UK energy sector is such that while there is a need for coordinated action, it may not always be possible to take this action as part of a package of measures, as highlighted by the different timescales indicated by Ofgem for new investment and potential periods of supply difficulty. As such, there is merit in looking at the needs of the sector on a case-by-case basis but always within an overarching framework.

We trust that this helps with your inquiry. However, should you wish to discuss this in more detail, please do not hesitate to contact me.

Yours sincerely



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Consultant