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Dear Giles,

PROJECT DISCOVERY – TOP LINE COMMENTS

You asked if I could write with ScottishPower's initial views on your publication of 3 February. Because of the holiday season, our full response has been delayed – I hope to get it to you later this week.

On your five key issues highlighted: -

1) The need for unprecedented investment

We think that the majority of the investment needed in the future will be delivered by the existing industry, on balance sheet. The particular project finance model which lay behind the “dash for gas” in the 1990s depended on all market and procurement risks being contractually laid off on other parties; not only are the circumstances and the nature of the technology unlikely to facilitate this, but the model failed to deal with counterparty credit risk.

We think that market investors are more likely to invest in utilities than directly in the underlying projects, because the former offer both diversity of risk, and management teams with strong experience of the industry.

Nonetheless we recognise that the scale of investment required will be challenging. To be successful in securing funds into the UK it will be important to demonstrate an attractive investment climate, with appropriate rates of return, and significantly greater policy certainty than exists today.

2) Uncertainty around future carbon prices

We agree that the current carbon market suffers from instability, and in particular the lack of a supply side response to re-establish equilibrium conditions in the event that demand for emissions is misjudged by policymakers. It would be beneficial at EU level to look at ways that the carbon price could be made firmer and more stable.

Nevertheless, we do not think that a carbon price floor would be beneficial in a UK context, principally because of the impact on consumers and competitiveness when compared with the rest of Europe. This is the issue which led the French Government recently to abandon plans for a unilateral carbon tax.

Furthermore, we think that a carbon price underpin may not be effective in promoting new nuclear power, because it is unclear how important carbon will be as a factor in electricity prices over the life of a nuclear station, and indeed what the process of price formulation will be in a largely decarbonised power market. The problem is therefore something wider than simply instability in the price of carbon.

It could also be difficult to limit the benefits from CO₂ under-pin to new power stations, and this could make the mechanism less cost effective than a more targeted intervention to reduce investment risk for new low carbon generation.

3) Short term price signals insufficient for supply security

We broadly agree with Ofgem's analysis here. As the need for plants to earn their capital over shorter load factors grows, the investment case will become more difficult because of uncertainty – not only in the frequency and height of price spikes likely to arise in the market, but also in the willingness of the authorities to see consumers' bills rising accordingly. It will be very important to be sensitive to the latter concern in considering the proposed Market Power Licence Condition.

While sharpening the cash out incentives could help, we think that some form of capacity payment system – possibly on a certificate basis like the Renewables Obligation – looks like the best way to reduce risk here.

4) Growing UK interdependence on international markets

We agree that the UK will need additional gas storage as its dependence on international gas markets increases, though the combination of new pipelines from Norway and a variety of LNG projects has valuably increased the diversity of supplies available. A number of projects are currently held up in the planning process and it will be important for Government to make sure that this runs smoothly.

Beyond this, any interventions to encourage additional storage need to be carefully considered to ensure that they do not simply displace commercial storage. It may be best to consider interventions intended to increase the demand for storage rather than intervening in its provision.

5) High energy prices impacting fuel poverty, industrial competitiveness

This is clearly a very important consideration but in our view the principal determinant of the cost to consumers in a competitive market will be the cost of the various policy measures required to deliver decarbonisation and ensure energy security. Attempting to prevent those costs being passed to consumers would be counterproductive, make it much harder to attract the investment and increasing the cost of capital.


Indeed, given concerns that are expressed about the affordability of some elements of the emerging UK energy policy, it will be of crucial importance to investors that all stakeholders (Government, regulator and industry) are up front about the cost to consumers. It is unlikely that measures to take detailed decision taking on investments into the public sector will increase efficiency. Markets are generally better than the public sector at discovering efficiencies and delivering projects, despite the higher notional cost of capital.

Turning to policy responses, we are not sure that it is helpful at this stage to group them into packages. Although interactions are important, it is also necessary to look at the costs and benefits of individual items. It is probably best to consider packaging them once the individual elements have been assessed. In summary:

- *Underpinning the carbon price:* As discussed above, not likely to be effective or cost effective on a UK basis alone.
- *Stronger imbalance signals:* We agree these could be useful, but they are unlikely to be sufficient.
- *Improved demand side response arrangements:* We would be happy to look at these, though impact is likely to be fairly marginal.
- *Capacity mechanism:* This would in our view be beneficial in ensuring adequate capacity in the period 2015-2020.
- *Low carbon generation mechanism:* We think this would deliver nuclear better and more cost effectively than a carbon floor. Renewables should continue with their current level of support. A banded capacity mechanism could perhaps cover both low carbon and overall capacity support in a single instrument.
- *Centralised renewables market:* We are happy to study this further but doubt that it will have much benefit, or impact on cost effective delivery of renewables.
- *Replacement of the RO by feed-in tariffs:* Unlikely to have benefits that justify the disruption. Can also make system balancing harder in times of excess wind (as renewables don't "see" the negative value of the power they are producing at such times).
- *Replacement of RO by tenders:* Experience with the NFFO suggests this is difficult to work. If the tender is post-planning, how does an unsuccessful tenderer get back the development cost? If it is pre-planning, there is a risk that projects with good economics on paper but limited prospects of getting planning permission tend to win.
- *Tenders for gas storage:* These would displace commercial arrangements. It would be more appropriate to have a market based incentive to procure sufficient storage.
- *Tenders for generation:* These would displace commercial arrangements. It would be more appropriate to have a market based incentive to provide sufficient generation capacity.
- *Central buyer:* We agree with the widespread view that this would not be an appropriate solution.

I hope this is a useful summary. We will be in touch more fully shortly.

Yours sincerely,



Rupert Steele
Director of Regulation