SCOTTISHPOWER

Rupert Steele OBE
Director of Regulation

Rachel Fletcher
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Dear Rachel,

Consultation on the potential requirement for new balancing services by National Grid Electricity Transmission plc (NGET) to support an uncertain mid-decade electricity security of supply outlook

We are grateful for the opportunity to respond to this important consultation. The nature of potential mid-decade security of supply risks were helpfully set out in Ofgem's recent Capacity Assessment report. The combination of weak spark spreads, the uncertainty of the speed of economic recovery and the closures forced by the Large Combustion Plants Directive, make the middle years of the decade especially difficult in security of supply terms as the 'missing money' problem is multiplied by uncertainties. We therefore welcome Ofgem's interest in possible ways to address these risks.

From our perspective, the most important question therefore is whether the proposed interventions are likely to be the most effective way forward and likely to be better than other options in avoiding unintended consequences. In particular:

(a) It will be necessary to be clear how the proposed Demand Side Balancing Reserve (DSBR) would interact with the proposed Demand Side Response pilot scheme that will form part of the enduring capacity mechanism. We are also unsure whether the proposals will offer an appropriate route to market for smaller embedded generation; and

(b) It will also be necessary to assess the real risks that the Supplemental Balancing Reserve (SBR) might backfire or contribute little net gain to security of supply – either directly or as a result of interactions with other market developments or regulations.

Our current view is that SBR, in particular, has very high risks of not delivering its intended aims and that there are a number of other options that would be more likely to be successful.

We think that the best approach would be to introduce the enduring Capacity Mechanism with an earlier first delivery year in 2015/16 (or 2016/17) and consider that the difficulties in achieving this may have been overstated – especially in comparison

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with those inherent in a new approach put together with far less discussion and scrutiny. We think any concerns about price formation in the capacity market in a period when new plants cannot enter the market can be met by use of a supply curve or capping prices at (say) the cost of new entry. And given the significant number of shovel-ready CCGT projects available in the GB market, a considerable degree of new entry will be possible in three or even two years, rather than the four needed to develop a project from scratch.

Another option might be to consider a system of administrative capacity payments available on an interim basis pending full introduction of the enduring mechanism.   This could build upon the analytical work that has already been done for the enduring mechanism.

In view of the risks described in our answers to questions below, we think that the SBR should only proceed in the event that it has been properly established that legal or other obstacles to delivering the market-wide approach cannot be overcome in time to meet the mid-decade challenges. We think that the DSBR has a lower risk of unintended consequences, but note that there a number of questions still to resolve for this product. Moreover, in the event that these novel products are to be introduced, this should only be for a clear and certain time-limited period and with a clear transition plan to the enduring approach.

If you wish to discuss any of these issues further, then please do not hesitate to contact me.

Yours sincerely,

Rupert Steele

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Director of Regulation

PROPOSED NEW BALANCING SERVICES BY NATIONAL GRID

SCOTTISHPOWER RESPONSE

1) **Do you agree with our assessment regarding the risk to mid-decade electricity security of supply?**

We agree with Ofgem's assessment that the market could be tight mid-decade. Given the current assessment, we would note that small increases in plant closures (including mothballing) or changes to demand projections could lead to a significantly increased Loss of Load Expectation. It is, therefore, very important to be prepared for such eventualities.

We agree with DECC's analysis over the longer-term of a significant 'missing money' problem, and, importantly, we consider that the particular circumstances of the current market are exacerbating this issue for investors. Thus, in addition to the longer-term challenge presented by increasing volumes of intermittent generation, there are a number of other current factors deterring investment in new and existing plant, including a rapidly increasing unilateral GB carbon price (with significant question marks as to its economic sustainability), post-recessionary demand growth uncertainty, low spreads, shale gas growth in the US and its associated impact on coal prices globally, and inframarginal rent dynamics. In this context, there is something of an asymmetry in current conditions whereby the perceived risks associated with making a significant new investment (or indeed material maintenance investment in an existing plant) can be much greater than not proceeding with the investment.

Indeed, current market conditions appear to be resulting in a market that is reluctant to assume the scarcity returns in future spreads that would allow for major outages to be amortised over a suitable period. We believe that this could result in additional plants becoming mothballed as periodic investment decisions in existing plant need to be taken. Further, and independent of current market dynamics, it is important to note that previous investment decisions have been facilitated by the existence of free carbon allowances.

This overhang of existing marginal plant, combined with forced closures of profitable coal plant under the LCPD and the uncertainties mentioned above is an unusual combination of circumstances. Any intervention needs to be carefully tested to ensure it will work in this situation.

2) **If so, do you agree with our view that it is prudent to consider the development by NGET of additional balancing services, which NGET would procure and use if there is need for them?**

We have said for some time that an operational market-wide Capacity mechanism would be needed from 2015 onwards for the effective maintenance of security of supply. We believe that a competitive system based on the availability of market-wide capacity payments offers the prospect of securing the vital investment in generation plant with least market distortion. Consistent with this, we consider that the Government should be fully exploring and testing the scope for an earlier delivery year under the planned Capacity Mechanism auction. In the event that this is not feasible, then an alternative approach for addressing the potential mid-decade challenge to security of supply would be the temporary deployment of administered capacity payments.

It is worth noting that the existence of a significant number of shovel-ready CCGT projects in the GB market means that new plant could (if competitive) respond to an auction in 2014 much earlier than winter 2018/19.

We consider that the development of the alternative interim approach of new balancing services (especially the SBR) should be seen as a last resort. This is due to significant concerns that we have around the possible unintended consequences of the proposed balancing services. In particular, we believe that the proposal for an interim strategic reserve through the SBR could result in serious market distortions that undermine rather than improve security of supply. Some key concerns are that:

- The proposals have the potential to erode forecast scarcity income for plant that has thus far elected to remain in the market and weather the rougher market conditions. This might result in such plant closing or becoming mothballed so that there is no net gain in capacity.

- Given that current spreads present an uncertain future for many existing gas stations, there is a serious risk that too many stations opt for a guaranteed rate of return in the reserve. Again, if the stations are ones which are currently operating, there could be a diminution rather than improvement in security of supply. This risk is significant given the need for a non-discriminatory approach to potential bidders.

- There is also an issue of fairness arising from the fact that plant that has already incurred investment costs associated with a major outage could be negatively affected by the proposed interventions.

- The existing capacity market proposal has been under consideration and scrutiny for over two years. We are concerned that the much less thorough process around the SBR proposal – which closely mirrors an approach which was rejected at an earlier stage and has a completely different and probably incompatible logic to the enduring system – could lead to further unintended consequences or missed interactions.

Finally, we understand the intentions underlying the DSBR proposal and are broadly supportive of this in principle. However, we would question the confidence that this product can offer the market, especially in the absence of any kind of penalty for non-delivery. We also have concerns that the proposed arrangements could conflict with existing balancing service arrangements (triad avoidance), as well as with the potentially overlapping pilot DSR arrangements which are planned to be auctioned for year ahead delivery under the enduring Capacity Mechanism design. We are also unsure whether the proposals will offer an appropriate route to market for smaller embedded generation. If this product is to be pursued, Ofgem will again need to check carefully for unintended consequences,

3) Do you agree with our assessment of the key factors we should have regard to when considering whether to approve any changes to NGET's Balancing Services Procurement Guidelines and associated documents?

We agree that the factors highlighted are key ones. As regards SBR, however, we believe that it will be difficult to achieve the intended outcome whilst maintaining an objective, transparent and non-discriminatory procurement process that minimises unintended consequences to market participants and the operation of the market.

Indeed, for the reasons set out above, we consider that the most likely route to an economic and efficient outcome would be through adopting a market-wide approach that is consistent with the enduring Capacity Mechanism design, such as an earlier delivery year. Any proposal that is not based on a market-wide competitive approach risks distortionary impacts and a sub-optimal outcome.

ScottishPower,
August 2013