



Energy for
generations

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Energy Market Investigation
Competition and Markets Authority
Victoria House
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Via Email: energymarket@cma.gsi.gov.uk

Dear Sir/Madam

Energy Market Investigation: Statement of Issues

ESB welcomes the opportunity to comment on the Statement of Issues for the Energy Market Investigation being undertaken by the Competition and Markets Authority (CMA).

ESB

ESB has been a developer and operator of independent Combined Cycle Gas Turbine (CCGT) generation projects in the GB market for almost 20 years. We own, operate and trade the 350MW CCGT at Corby. Uniquely, we are also the only company constructing a CCGT at the present time, this £700m, 860MW development at Carrington near Manchester is expected to become operational in early 2016.

We are also developing further large-scale CCGT projects at other locations across GB, in particular our 1500MW project at Knottingley, West Yorkshire. We hope to receive a decision on the planning application, for this project, in early 2015.

In addition to our conventional generation fleet, our operational GB wind portfolio is 125MW including the 66MW Fullabrook Wind Farm in Devon, which at the time of commissioning in 2011 was England's largest onshore wind farm.



ESB views on Statement of issues

Significant new power generation investment is required to replace the one-fifth of existing thermal capacity due to close by the end of this decade at the same time as meeting the challenges of climate change. The Government's Gas Strategy published last year confirms support for gas generation and estimates that up to 26GW of new gas plant could be required by 2030. As the Big-Six vertically integrated supplier-generator companies' (big-six) balance sheets become increasingly stretched, new investment will need to come from a range of sources in addition to the big-six.

Independent generators, with a likely greater use of project finance structured deals, will play an increasingly prominent role in delivering the required capacity and investment. It has been estimated that independent generators need to deliver the majority of new onshore wind build and a significant proportion of offshore wind build. Approximately 50% of gas-fired generation projects currently consented or under development are owned by companies other than the big-six.

For example, for the Carrington project to achieve a positive investment decision, ESB provided 30% of investment from equity, the remaining 70% of the funding came from a syndicate of international banks. This was backed up with an 'internal' ESB Tolling agreement (a long term offtake agreement on pre-determined price terms). The market has long since ceased to support long term tolling agreements of the type that supported the building of ESB's previous Marchwood project and the banks will not take on market risk. Independent generators have to take on this wholesale market risk, so need to be confident that wholesale prices reflect market fundamentals.

As an independent generator in the GB market, ESB has long been concerned that the lack of liquidity in the wholesale electricity market unduly increases barriers to entry and it places independent generators at an unnecessary and significant competitive disadvantage compared to the big-six. This competitive disadvantage arises because of the significant additional costs, incurred by independent generators, in accessing the wholesale markets. These costs are incurred both as



a route to market for the generation as well as in using the wholesale markets as a means of managing the risks, as compared to self supply. Market participants face large buy sell spreads and poor volumes in both prompt (the period near demand from say a month ahead to on-the-day) and forward markets (a period out into the future from a month out to say upwards of 2 or 3 years out).

Forward power prices are not transparent, they can appear disconnected from market fundamentals. For example, many market commentators as well as National Grid and Ofgem are forecasting a tightening of plant margins (the margin of excess generation over peak demand) towards the middle of this decade, with a recovery later in the decade. However, the forward spark spreads (in effect the generator's margin after taking account of input fuel costs) seen in the wholesale markets remain low out into the future.

There is nothing inherent in electricity that should inhibit GB market liquidity, liquidity here compares unfavourably with some EU continental power markets, a churn rate of 3 (multiples of traded volumes compared to total demand) in the GB and a churn rate of up to high single digits on the continent. This lack of liquidity is even more pronounced when compared to the very closely related UK wholesale gas market. Even though the two markets here are governed by similar regulatory structures and a significant degree of common market participants, UK gas churn is regularly in double digits versus the 3 in power. Moreover, power market liquidity falls off markedly beyond the prompt, whereas gas market liquidity in the forward curve compares favourably even against the so-called benchmark of deep and liquid markets, crude oil.

The striking difference between the GB gas and power markets is that in gas, market participants have very varied degrees of vertical integration, of the largest suppliers only Centrica is significantly vertically integrated, whereas in the power markets all the big-six incumbent suppliers have adopted similar approaches of significant vertical integration. While the advantages of vertical integration have been demonstrated across a wide range of markets, in power, the uniform and significant degree of vertical integration is inhibiting liquidity.



Consequently, it is hardly surprising that the power market appears stuck in a vicious cycle of poor liquidity where churn rates have remained at around 3, other than during what now appears to have been an aberration around the introduction of the current NETA power market arrangements, more than a decade ago. The removal of the previous self-supply restrictions on the former incumbent electricity suppliers, soon after the introduction of NETA, may well have accelerated the decline of liquidity.

The power market needs a set of arrangements where a diverse range of business models and structures, including vertical integration, can flourish and co-exist, not one where companies have little choice but to vertically integrate.

Whilst Ofgem's recent liquidity reforms may deliver some improvements around the margins, they will not on their own kick start the power markets.

A significant and urgent injection of liquidity is required to bring in other wholesale market participants. Only with such a kick-start can we hope to have a market that becomes self sustaining, reaching a virtuous cycle of liquidity.

ESB supports this long overdue Energy Market Investigation by the CMA, it is essential that the CMA thoroughly investigates the underlying causes of and provides remedies for the market failures in the wholesale electricity markets. We also support the inclusion of Theory of harm 1, as this rightly describes the low levels of liquidity in wholesale electricity markets that create barriers to entry in generation as well as other inefficiencies in market functioning.



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We look forward to meeting with the CMA to discuss our concerns as well as possible remedies during the course of this enquiry. We will also be happy to share our further evidence for the market failures described here in the coming weeks.

Yours faithfully

A handwritten signature in black ink, appearing to read 'T. Majid'.

Tahir Majid
UK Public Affairs Manager