Roger Witcomb
Panel Chair
Energy Market Investigation
Competition and Markets Authority
Victoria House
Southampton Row
London WC1C 4AD

27 March 2015

Dear Mr Witcomb

Response to CMA's Energy Market Investigation Statement of Issues

Green Frog Power welcomes the opportunity to comment on the excellent work being done by the Competition and Markets Authority in the Energy Market Investigation. The energy market has many layers of complexity and is very dynamic and always evolving, which makes it both very interesting and difficult to analyse. This industry is also key to the wellbeing of all individuals and businesses, and as such it is very important that the functioning of this market is rigorously reviewed to provide confidence to all stakeholders.

We have provided comments regarding the updated theories of harm 1 and 5, and comments on the working papers on Wholesale Market Rules and Capacity.

Green Frog Power Ltd, 17 The Courtyard, Gorsey Lane, Coleshill, Birmingham B46 1JA, United Kingdom
Tel: +44 (0)1675 437777 Fax +44 (0)1675 437770 Email desk@greenfrogpower.co.uk
Company number 07056616 Website:www.greenfrogpower.co.uk.

Updated theory of harm 1: the market rules and regulatory framework distort competition and lead to inefficiencies in wholesale electricity markets

1. Green Frog Power agrees with the revised theory of harm as a fundamentally important review of the regulatory underpinnings of the electricity market.

2. We agree with the assessment that the current system of self-dispatch is not in itself detrimental to competition, and we agree that a central-dispatch model would not provide material improvements in regard to technical efficiency, compared to the self-dispatch model.

3. We disagree with the view that the PAR1 element of cash-out reform would lead to "too high" prices, or that there is any plausible means by which to withhold generation or otherwise manipulate cash-out prices. We believe there are far too many market participants for the latter to be feasible.

4. As for "too-high" prices, in the context of a market that is competitive, technically efficient and with many players, the issue at hand is missing money (at the peaks) rather than too-high prices. We believe that this too would self-correct in the absence of barriers to entry and in a fair playing field.

5. In reference to Paragraph 45, we take exactly the opposite view. We think that it is critical that cash-out reform, as Ofgem originally proposed, occurs at the same time as implementation of the Capacity Market.

6. Delaying the introduction of clear and meaningful price signals would be highly detrimental to the ambitions of improving the competitiveness and efficiency of the electricity market. Indeed, we are not aware of any successfully functioning, efficient market that relies on muted non-informative price signals to achieve the optimal outcome.

7. As far as the concerns about over-compensation if the RSP and the Capacity Market co-exist, our view is that the real danger lies in delaying the implementation of cash-out reform. We believe that this will have the effect of reducing the credibility of the intentions of the regulator and the government to improve competition and sharpen price signals. If the market does not believe that these reforms will happen, they will not be priced into Capacity Market bids. Not reforming because of fear of over-compensation will then become a self-fulfilling prophesy and it will never be feasible to sharpen price signals. The slower cash-out reform is brought in the greater the risk of over-compensation when it is.

8. DECC have included the cash-out reforms in their analysis of net cost of new entry (CONE), one of the principle auction parameters. We would also like to point out that the auction price cleared well below this price. Whether or not cash-out was considered by the marginal plant on the auction (we think it was), it seems clear that the potential over-reward is unlikely.

9. We believe it is important to ensure that the market prices are reflective of market dynamics. Any muting of these signals causes distortions that are likely to favour market incumbents.

10. To this end, we think it is more important to ensure that the rules are fair for all, thereby allowing and enabling competitive market forces to ensure that unfair practices are not rewarded.

Updated theory of harm 5: the broader regulatory framework, including the current system of code governance, acts as a barrier to pro-competitive innovation and change

11. Green Frog Power agrees with the view that the complexity of industry codes and the possibly unbalanced influence of market incumbents, mainly vertically integrated utilities. “Stacking the deck” with incumbents may very

well have the effect of ensuring that the regulatory framework remains comfortable for those incumbents, possibly at the cost of efficiency, distortions and innovation. We welcome a review of these issues.

12. We think it is reasonable to review and ascertain whether industry codes could perhaps be consolidated and made more simple and consistent.

13. We note with particular approval that credit requirements have been highlighted in the context of industry codes. As with other market entrants, we find the numerous and varying credit requirements are a barrier to entry, administratively as well as financially. We therefore welcome this review.

Wholesale Market Rules Working Paper

Central versus self-dispatch

14. Green Frog Power agree with the assessment of the CMA that there is no material efficiency difference between central and self-dispatch *if the cash-out reforms proceed as Ofgem originally proposed*.

15. The current system favours larger players who hedge a significant portion of their positions in advance of the settlement period. Smaller players and new entrants are more sensitive to the transaction costs that forward trading entails. So long as the balancing market, by design, mutes market signals, larger players will have an institutionalised head start.

16. All elements of cash-out reform are crucial for insuring that prices are reflective of market conditions and that the appropriate price signal is given to ensure the optimum level of investment. We believe that cash-out reform will improve price signals and liquidity, thereby increasing the opportunities for small players to diversify and manage their risk more effectively by engaging in a wider variety of trading activities.

17. In the absence of full cash-out reform and a committed regulatory stance on effective price signalling, it is not clear to us that centralised dispatch would improve the functioning of the market in any significant way, or indeed make any difference at all (bar the cost of implementing it).

Cash-out and Balancing Mechanism

18. Green Frog Power wholeheartedly agrees with all of the elements of cash-out reform proposals as originally brought forward by Ofgem. Single Pricing, Reserve Scarcity Pricing and VOLL pricing for disconnections are all integral design corrections required for improved market functioning. Each of these components of reform is intended to improve the market functioning by sharpening the relationship between market dynamics and market prices. It is true that partial reform is better than no reform, but only slightly. We think it is key that momentum is maintained on all these reforms to avoid a slow, drawn-out and more expensive transition to an efficient market structure.

19. We disagree with the view that PAR1 pricing will result in parties exercising market power. The concern seems to be that it will be easier for a so-inclined market participant to ascertain if they are the last megawatt available and so influence the clearing price. The theory here is that it is less likely that a single party will be able to have this influence if the average is taken over 100 or 250 or 500 megawatts.

20. This premise seems flawed. Looking at the Capacity Market Register, a cursory glance indicates that about half of the CMUs are under 50 megawatts, and these are spread amongst a diverse and numerous owners.

21. When one considers the small-scale capacity that may yet come forward in the Transitional Capacity auction, not to mention the activities of those low-carbon technology market participants that are not in the Capacity Market, it

seems clear that it would be quite a heroic undertaking to successfully influence the dispatch order and marginal price in the balancing mechanism. It would in fact have a failure rate and cost of undertaking of equally high magnitudes, making it an unlikely strategy for any of the dozens of market participants in the GB market.

Cash-out and the Capacity Market

22. Green Frog Power do not agree with the stated concerns about the Reserve Scarcity Price (RSP). It is not a plausible concern that significant portions of the market will attempt to spill into a short market in order to achieve the RSP. In the first instance, this would be a very risky strategy to pursue on an ongoing basis. In the second, if this strategy did turn out to be a reliable source of high incomes for a short period of time, other participants would adopt a similar measure, and the "short" episodes would disappear, rendering the strategy valueless. Hence, we do not believe that the implementation of the RSP would necessarily result in regulatory uncertainty, as posited.

23. We also do not agree that the different VOLLs used in the Capacity Market and by Ofgem in cash-out design will cause any serious issues in the short or medium term. By design, VOLL is being phased in to cash-out, and the level of VOLL planned for 2018 takes into account that the Capacity Market will be in its first delivery year and that the market will have time to adjust to the higher level.

24. DECC meanwhile have incorporated the cash-out price into their calculations of the net cost of new entry (CONE), rather than the VOLL they estimate in terms of security of supply.

25. But the key point is that, from the perspective of investability and proper market functioning, credibility is crucial – no matter how much an investor might believe that the "true" VOLL is £17k/MWh, the higher the

administrative price is set, the less likely the investor is to believe that the regulator will stick with it in the long term. Indeed, this is one of the key reasons that the Capacity Market exists.

26. Because of the differences between the administrative pricing used in cash-out and the higher VOLL used to determine security of supply it is clear that the two mechanisms are serving complementary, yet different, purposes. For this reason, we do not agree with the assessment that there is a risk of over-reward.

27. We agree that it is prudent to investigate whether market participants have taken the possibility of receiving £6,000/MWh income into consideration when determining their Capacity Auction bids. We would however caution that the results of such a study may not be conclusive. The capacity auction is new and there is some uncertainty about the Rules and exactly how they may evolve in a meaningful way.

28. Crucially, and not a little ironically, there is some concern that Ofgem may choose not to progress with the full suite of reforms, possibly because of views expressed in this report. In other words, regulatory uncertainty may very well be priced into capacity auction bids. If this is so, it is not necessarily indicative of a non-competitive over-reward to market participants, but rather the reasonable market-driven reward for taking on additional risk.

Green Frog Power Ltd, 17 The Courtyard, Gorsey Lane, Coleshill, Birmingham B46 1JA, United Kingdom
Tel: +44 (0)1675 437777 Fax +44 (0)1675 437770 Email desk@greenfrogpower.co.uk
Company number 07056616 Website:www.greenfrogpower.co.uk.

Penalty mechanism

29. Within the Capacity Market the penalty mechanism provides an incentive to ensure best endeavours are made to deliver the agreed capacity obligation. Green Frog Power is supportive of the current penalty regime, as we feel it meet the right balance between risk and reward. We also believe that a more penal regime would directly harm competition.

30. Many successful auction participants, including ourselves, rely on debt financing to build new plant. The financing of our construction plans, compared to a large vertically integrated equity financed project, is far more sensitive to potential risks to future income flows.

31. When designing the Capacity Market penalty regime, DECC took the concerns of smaller generators, and, most importantly, their financiers, into consideration.

32. We worry that the CMA may be looking to unwind this approach, citing a concern that perhaps the penalty is too generous to guarantee delivery of capacity.

33. We wish to highlight the importance of not just the cost of finance for generation projects (which is an acceptable competitive advantage for some market participants, as it should be), but whether it would be possible to finance the projects, *at any price*, if the penalty regime were to be perceived as too risky. This would certainly have a detrimental impact on market competition, with very little, if any, obvious benefit.

Demand Side Response

34. Green Frog Power dispute the views concerning the inappropriateness of the Capacity Market payment design, such that suppliers are liable to pay based on their share of demand during winter weekday peaks. We think it is important that the Capacity Market price signal is consistent with the peak demand it is designed to meet. We think it would be a mistake to adopt a less sharp signal, for example overall market share, as is used for the CfD supplier obligations.

Yours sincerely,

Graz Macdonald
Head of Regulatory and Policy Analysis
Green Frog Power Limited