Mr Will Fletcher, Project Manager
Energy market investigation
Competition and Markets Authority
Victoria House
37 Southampton Row
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27 March 2015

Dear Sirs,

Response to the Energy Market Investigation Updated Issues Statement and working papers

A Introduction

1. MPF Operations Limited (MPF) is the owner of three modern gas-fired power stations in the United Kingdom: Severn Power (832 MW), Baglan Bay (500 MW) and Sutton Bridge (800 MW). MPF acquired these plants between October 2012 and December 2013 in order to establish a competitive new entrant generation business in the UK electricity market. MPF is funded by a range of international institutional investors and is advised by Macquarie Infrastructure and Real Assets (Europe) Limited (MIRA), which has long experience of investing in infrastructure and energy businesses globally.

2. MPF welcomes a wide-ranging review of the structure of the energy market and makes the following key submissions:

    a. We fully support the CMA's updated theories of harm 1 and 5 and see these as directly related. We believe the investigation should take a broader approach in its consideration of how the market rules and regulatory framework can distort competition and lead to inefficiencies in wholesale electricity markets. It should also consider, in this context, the various codes impacting wholesale markets either directly or indirectly which have a similar effect.

    b. The energy market has been subject to a series of well-intentioned regulatory interventions, assessed on a case-by-case basis to target particular market failures. However, MPF believes that the cumulative effect of these layers of regulation, and the overall effect on competition, have been overlooked at each turn. Intervention has effectively become a method of operation for regulatory bodies, without smooth transitions between their introduction or a rebalancing of the system.

    c. As a relatively new independent generator, our experience is that the impact of regulatory change is felt far more acutely by smaller participants, while large vertically integrated operators are able to absorb the regulatory risk and the unintended consequences. These large operators will challenge only those interventions which are critical to their existence (such as locational prices for constraints and losses). Smaller independent generators like MPF, on the other hand, are far more exposed to the regulatory cost/inefficiency and the unintended consequences of interventions such as, for example, the supplemental balancing reserve (SBR), reform of cash out

prices, changes to gas transmission charges, the capacity market, and the cumulative effect they have on the market. This asymmetry is heightened given that the smaller participants may be more affected by regulatory intervention and yet have less resources to devote to regulatory matters.

d. We do not subscribe to a view that any of those involved in the industry are deliberately setting out to disadvantage customers or to raise barriers to entry. However, the structure of the industry and associated weak signals through the design of incentives does mean that the industry's prospect of being competitive in the long-term is less than it could be.

e. This is reflected in the low levels of market entry (MPF is one of the few new market entrants in recent years). The regulatory environment has created a market which is unattractive to new entrants; rather than generating dynamic competition, the current environment favours the status quo, whereby much needed new entrants or smaller, efficient generators are not incentivised to invest or are disadvantaged, or both.

f. Each layer of regulation moves further away from a market that is fundamentally driven by competition and increases the potential for distortions of competition and resulting inefficiencies. MPF therefore believes that each new regulation should be subject to a thorough audit to assess its impact on competition, both as a result of the distinct piece of regulation and overall, as part of a body of regulation affecting the market.

3. We restrict our comments in this response to the theories of harm that directly impact us, namely 1, 2, 3a, 3b and 5; we leave those with more informed views to comment on theory of harm 4 which concerns energy suppliers.

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

4. We would urge the CMA to take a dynamic view of competition that includes not only short-term price setting behaviour but also the encouragement of a sustainable market, with no distortions, that provides clear and trusted signals for incumbents and new entrants alike.

Market Rules

Self-dispatch

5. We support the CMA's initial view that self-dispatch is leading to close to technically efficient operation of the system and that a centralised solution is unlikely to yield a more efficient solution.

6. We believe that self-dispatch encourages individual market participants to be innovative and competitive in the way their portfolios are operated and balanced. MPF's view is that individual participants will be better at managing the costs and implementation of technological, legal and market environment changes than a larger, non-competitively driven organisation. We believe that a centralised solution weakens the incentives to innovate, which over time will lead to inertia, and ultimately lead to increased costs.

7. Price transparency has been increased compared to the Pool, through participants needing to execute trades in the market to manage positions rather than submitting prices into an opaque 'black-box' as was the case before the introduction of NETA. Due to solutions not being

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algorithm based, it is arguable that any incentive for participant to try to 'game' is reduced. This is clearly necessary to allow a well-functioning market to emerge.

8. Post-gate closure the electricity system becomes centrally dispatched and it is important that the pressure to innovate and manage costs is as intense as possible. We believe the pressure to innovate could be greater. For example, changes to central systems that better reflect the operating characteristics of modern CCGT technology and potentially result in a more efficient operation of the wholesale electricity market have faced repeated delays in implementation.

9. In summary, MPF's current view is that a move towards more centralised dispatch would be an unnecessary and costly disruption.

Cashout prices

10. In principle, we strongly support cashout reform in order to make it more reflective of the costs of balancing. We believe this in turn should lower aggregate balancing costs and promote a more efficient system. Our view is that it is necessary to have cashout prices which provide proper market signals; recent efforts to make cashout more predictable to market participants should therefore continue and further development is needed.

11. In practice, we would encourage a balanced view of cashout reform that also considers the wider impact on market participants that moving to a single cashout price may have, for example, on the allocation of industry cashflows. Our concern is that disproportionately increased risks to smaller or less integrated businesses could result in exit or consolidation which would reduce competition and reinforce the position of the large vertically integrated players. As noted above, we support cashout reform and its implied incentives, however we think credit implications need to be considered in order make the market more friendly to new entrants. This will be an important step to take when the current cashout reforms have been implemented.

12. It is important the CMA considers the role and activity of the System Operator. It is essential that the System Operator provides accurate real-time information and system related forecasts so market participants can take as fully informed decisions as possible. The sharper incentives on market participants to balance must be matched by improvements in these areas.

13. We note that the scope of the CMA investigation appears to have been extended to also include changes to the market that have yet to be implemented and where there is no actual evidence that parties have been impacted. This could be seen to imply that the CMA has doubts regarding the effectiveness of current regulatory oversight governing these changes. We would consider this to be a significant issue for the development of competitive markets in this sector and would like to see a consultation and assessment process that is more geared to objective analysis and promotion of competition. The current situation is resource intensive and thus skewed towards larger, incumbent organisations.

14. We believe the CMA makes interesting points regarding Reserve Scarcity Pricing (RSP) and the role of the Capacity Market. Our view is that they represent complementary elements of the 'missing money' problem. We consider the capacity market as a forward contract to secure enough installed capacity to meet an institutionally set reliability standard. The key element is that a central buyer is procuring the "public good" of security of supply i.e. capacity rather than energy. RSP is simply a more developed version of single cashout pricing and the issue being addressed is not capacity related, but rather ensuring that the actions taken by the System

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Operator to balance the energy requirements of the system in real-time are transparent and cover all actions available. Market participants use this information to inform their own decisions on balancing and encourage the provision of energy flexibility for use in the real time market. Note that this may not always be the winter peak problem with which the capacity market is primarily concerned.

15. The energy scarcity/flexibility signal has been absent from the market to date as it cannot be seen in real time. We believe that both components are required to ensure there is sufficient reward for both capacity and flexible generation/demand to meet the real time requirements. As the challenge of intermittency grows and the generation mix changes, it is essential that enough capacity is provided onto the system with the right operating characteristics.

16. We believe the CMA is correct to identify that the interaction of different market arrangements and regulatory frameworks has the potential to cause concerns with competition and efficiency in the wholesale market. We would cite the introduction of SBR as a far more relevant and immediate issue than the potential interaction of EBSCR and the Capacity Market.

17. The introduction of SBR has effectively created a portfolio of bilaterally contracted assets under the dispatch control of the System Operator. Whilst capacity is provided by all the plants on the system, SBR capacity related payments are received only by those bilaterally contracted plant, at odds with the mechanism agreed upon for the capacity market. Whilst National Grid has endeavoured to design a system where the capacity is withdrawn from the market whilst under SBR contracts, the impact has been to in effect subsidise plants via these special arrangements.

18. As acknowledged in the CMA papers, in the period pre-capacity market delivery in 2018, the rewards to plants were expected to return through the energy price, in line with the design of NETA. The introduction of SBR has significantly undermined this concept. Such regulatory intervention in the basic operating principles of the market, and indeed inconsistency with the implemented capacity market rules, creates uncertainty for investors in the electricity sector meaning the impact of such measures can be considerably more than the immediate cost of the measure.

19. It is also clear that SBR contracts have been awarded to plants that were indicating to the market that they would remain open before they received a contract. The reasons for this could be that:

    a. the information provided to the market was incorrect;

    b. the value under SBR is greater than under the energy market (i.e. a subsidy); and/or

    c. the procurement process did not meet the claimed objective of being supplementary and was not achieved at least cost.

20. We believe that the distortion of competition caused by SBR should, at the very least, be minimised; SBR should not therefore be extended and the volume of capacity procured should not be increased. Moreover, SBR and the Capacity Market should not co-exist, given, in particular, the inconsistencies in their respective designs. Proposed amendments to the SBR volume procurement and operational methodology should also be subject to greater scrutiny.

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21. A further area for the CMA to consider is the role of interconnectors in the capacity market. Interconnectors are not subject to the same regulatory and legal regime as other capacity market participants and the supply of capacity is "footloose" in that is not tied to the UK system. Furthermore, the UK System Operator and EMR delivery body - the National Grid - owns and operates half of the BritNed and IFA interconnectors with potential additional projects being considered.

Absence of locational prices for constraints and losses

22. We support the view that further analysis is required in the area of locational prices for constraints and losses. In this regard, we draw the CMA's attention to the proposed changes to Electricity Transmission Use of System pricing that are due to be implemented next year under the Ofgem TransmiT programme. We believe that a balance needs to be struck between signalling through prices where this can alter behaviour and the risk of stranding assets somewhat arbitrarily; this latter situation introduces an unhedgeable regulatory risk into investment decisions for power generation assets that have a payback over several decades.

The Capacity Markets and Contracts for Difference

Capacity Market

23. We note that the CMA is still considering concerns raised by a DSR provider regarding discrimination in the capacity market. We urge the CMA to further examine the discrimination inherent in the capacity market design in favour of new build over existing plant. We consider the service required to be the availability of capacity at times of system stress. However, the regulations have been developed such that new build plant is eligible for contracts of up to 15-year capacity whereas existing, non-refurbishing, capacity only has access to 1-year capacity contracts. This is an unjustified discrimination between the two types of capacity provision and is liable to give rise to distortions of competition. For example, we believe that the consequences of this discrimination are likely to include:

    a. the premature closure of existing efficient gas plant;

    b. an over procurement of new plant, locking in capacity prices for 15 years;

    c. the resulting stranding of existing assets;

    d. the risk that new capacity does not get built, potentially prolonging the operation of old coal plant at the expense of more environmentally-friendly gas plant; and

    e. increased costs to consumers.

24. To exemplify this, the discount rate that would be applied to a 15 year fixed contract is less than the discount rate for 15 one-year contracts. Therefore, for providing the same service, over the same period, all other things being equal, existing plants are disadvantaged relative to new build. In this situation, there is no guarantee that the winner of a fixed term contract is more efficient, cleaner or more reliable. The only required differentiator is that it is "new". We believe that this is discriminatory and, more importantly, distortive of competition.

25. Discriminating against existing, flexible, efficient generation in this way contributes to the distortion of competition such operators face in the current regulatory environment. We believe that the Capacity Market's current design is ultimately economically inefficient, locking in long

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term capacity contracts which could have been secured more cheaply from existing plant (DECC anticipates prices in the energy market to fall over time).

26. This position has been justified by reference to balancing the distortions of competition against the distortions which could occur if margins tighten and the public interest of procuring new generation capacity, but this justification is flawed for a number of reasons. First, this disregards the negative effects on existing plant, many of which may close or be mothballed in the intervening years before the Capacity Market comes into play in 2018; if a large proportion of the unsuccessful plants are closed then the Capacity Market may have been detrimental to security of supply and will lead to an increased reliance on SBR. Secondly, only 5% of the capacity procured in the first capacity auction comes from new build, undermining the emphasis placed on this objective to the detriment of existing generation.

Contracts for Difference

27. A significant and increasing percentage of the UK's electricity generation will be tied into Contracts for Difference. The primary driver for this subsidy of otherwise uneconomic generation is to meet climate change objectives. MPF would like to make the following observations on this:

    a. firstly, in order to maintain system stability, flexible generation plant will be required; and

    b. secondly, contracts for difference will be indexed to the trading market which must have sufficient liquidity to be able to give a reliable and trusted reference price.

C Updated theory of harm 2: market power in generation leads to higher prices

28. We broadly agree with the CMA view that there is no issue with the exercise of market power in the wholesale generation market. Low prices and, in particular, the margins for gas-fired generation, are encouraging existing operators to exit the market. The current set of market arrangements does not adequately reward and incentivise investment in cleaner and flexible generation technology - this could cause prices to rise in the longer term.

29. Many of the sites that are advantageous for the construction and connection of new medium to large power stations with enough space to meet a future requirement to add the carbon capture and storage are in the hands of the Six Large Energy Firms. This could be used as a future barrier to entry for new entrants or provide a considerable cost advantage to those incumbent generators. We urge the CMA to consider options to allow third parties to have access to build on these sites in a competitive and fair manner, for instance, through 'use it or lose it' type of arrangements.

30. We believe that the CMA investigation should keep the adverse consequences of vertical integration under sharp scrutiny. The CMA investigation lists a limited number of benefits that are conferred onto a company that is vertically integrated. We believe that there are other benefits that have not been mentioned and these benefits give vertically integrated companies an advantage.

31. The netting of generation and supply positions, use of internal trades between the different business activities within these companies reduces the costs of credit via reduced collateral requirements and enhanced credit terms and reduces the external transaction costs incurred to

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manage their positions. These transaction costs can be substantial and involve broker fees, platform fees etc.

32. Flexible generators need to forward hedge the shape elements of their generation exposure. As a result they have to pay higher costs to manage this risk via the high bid-offer spreads on the extremely low liquidity, non-standard products or have to increase capital requirements and defer investment in order to carry this risk for longer until these shapes become more liquid. The offsetting of these positions between the retail and generation sides of vertically integrated generators provides them with a significant cost advantage. This discourages entry by new generators as the cost hurdle is higher and results in smaller generators exiting the market first or not entering the market at all.

33. A vertically integrated business may now, or in the future, appear to have separate retail, generation and trading/optimisation businesses. However, between the various businesses there will be a set of transfer pricing arrangements. These transfer pricing arrangements will cover services such as access to forward and prompt markets by generation/retail businesses; day ahead and real time trading; out of hours dispatch, balancing and contract notification services.

34. We believe that the CMA should consider measures to require generation and retail volumes to be hedged separately via the market with no internal netting.

D Updated theory of harm 3a: opaque prices and low liquidity in wholesale electricity markets distort competition in retail and generation

35. We believe the CMA should re-examine its view that current levels of liquidity are sufficient to allow independent generators to trade and hedge in the same way as the Six Large Energy Firms. The liquidity of seasonal baseload and near term liquidity is strong. However, the liquidity of seasonal shaped product is virtually non-existent. Furthermore, accessing the limited liquidity is expensive as it could be off market and require a structured trade solution (more expensive than standard products) or involve a large number of small sized forward trades Vertically integrated businesses can manage this risk by netting, trading internally or trading between themselves.

36. We would ask the CMA to develop its understanding with respect to the development of liquidity across the forward curve. The ability to manage trading positions and monetise the value of flexible generation assets is heavily dependent on liquidity and transaction costs across the curve rather than in the prompt/spot markets.

37. We note with some concern the points raised in the “Missing Money Problem in Great Britain” section in the Wholesale Electricity Market Rules working paper. The implication of vertically integrated players not pricing their generation economically due to regulatory obligations/interpretations and/or the appearance of profiteering, whilst rational, would mean that independent generators do not earn expected economic rents that are legitimately required in order to cover their fixed costs. The pervasive structure of large vertically integrated players creates an incentive to optimise and protect total corporate value which results in suppressed generation prices, an effective subsidy to their retail businesses, but which has the long term effect of discouraging investment in power generation assets, especially those with peak generation characteristics.

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E Updated theory of harm 3b: vertically integrated electricity companies act to harm the competitive position of non-integrated firms to the detriment of consumers either by increasing the costs of non-integrated energy suppliers or reducing the sales of non-integrated generating companies

38. We note the CMA did not receive any responses to the issues statement regarding foreclosure. We believe that the lack of response may be due to the difficulty respondents have in applying the concept of foreclosure in this context. We do not believe that vertically integrated electricity companies actively act to harm the competitive position of non-integrated firms and vertically integrated structures per se do not harm competition; however, we do believe that significantly vertically integrated structures do, when benefitting from economies of scale, result in behaviour that has the consequence of conferring a differential advantage such that sales of non-integrated generating companies are reduced. We would encourage the CMA to take a broader approach. The ability of vertically integrated electricity companies to net off generation and supply positions, net off trading transactions and execute transactions internally rather than going to market acts to increase the costs of non-integrated players. For example, if all of the generation and supply requirements from the vertically integrated players were to come to market then trading related transaction costs (bid-offer spreads, exchange fees, broker fees, elexon charges) could be cheaper as the same costs would be spread over a greater volume. With lower transaction costs, the sales from non-integrated generators would be greater.

39. By their very nature, vertically integrated players do not bring all of their retail and generation volumes to market as they may prefer to meet this from their own portfolio. Transfer price arrangements or other internal arrangements may make this appear the most economic option as it may ignore costs that the companies may charge an external provider or charge net costs as a cost/revenue gain on generation maybe offset by a retail position. An independent generator would not be offered the same terms of supply as all the costs of supply that generator faced would have to be included in the price.

40. We believe the CMA should review its approach to this updated theory of harm and more broadly at how vertically integrated companies can act to harm the competitive position of non-integrated players in more structural and subtle ways than foreclosure.

F 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

41. As a new entrant to the UK generation market, MPF has recent experience of many regulatory interactions needed to commercialise our assets. Even with considerable industry experience within the business, we have found the processes to be complicated and esoteric. Current systems and processes between market participants and the administrative institutions, such as National Grid and Elexon, have progressed little since NETA's inception. Whilst our interactions have always been satisfactory they would be better described as administrative rather than driving improvements and being customer-focused. As such, we believe that the innovation and change within the industry is significant but it is not matched by the non-competitive institutions. To be clear, MPF's view this not as an issue of expertise or the intentions of the people concerned, but one of appropriate incentives.

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As a relatively new entrant, MPF is keen to assist in the development of a trusted, efficient and sustainable UK generation market. Should you wish to discuss anything further please do not hesitate to contact me.

Yours sincerely

Phil Robinson

Head of Commercial

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