Competition & Markets Authority

ENERGY MARKET INVESTIGATION

Summary of hearing with Drax on 9 March 2015

Background

1. Drax welcomed the findings of the investigation as presented in the updated issues statement (UIS) and working papers. Drax agreed that there was no evidence of excessive profitability or unilateral market power (UMP) in generation. Drax also believed that sufficient liquidity existed to promote competition and that vertical integration did not lead to market foreclosure.

2. Drax agreed that the UIS raised new and pertinent points for the purpose of the investigation, chiefly the principles behind locational pricing.

3. Drax noted the Competition and Markets Authority's (CMA) concerns over micro-business profit margins and rollover contracts. It felt the current definition of micro-businesses was unworkable and should be reconsidered to give protection to those businesses who needed it, while allowing a more competitive environment for others. In addition, Drax did not believe that the CMA's findings on higher profitability in the small and medium-sized enterprises (SME) sector was born out by its own experience.

4. Drax believed that rollover contracts operated in customers' interest and led to lower prices.

5. Drax believed that code governance and oversight was a complex and technical area that was difficult to simplify. Nevertheless, it welcomed the extension of theories of harm to cover this.

Market rules and regulatory framework

6. Drax agreed that self-dispatch was as efficient as a pool system (central dispatch) in running the wholesale market. Both centralised dispatch and self-dispatch tried to achieve the lowest short-run marginal cost dispatch, which, on the whole, self-dispatch achieved. A move to a centralised dispatch would see the decision-making process (around finding a market and selling power) removed from the generators and passed to a central body, which would create a highly complex situation.

7. Drax said the current balancing system and cash-out prices worked well as dual cash-out encouraged companies to balance. While Drax believed the proposed reforms were a move in the right direction, it had concerns regarding the proposals:

- The adoption of Price Average Reference 1 (PAR 1) could lead to extreme pricing signals.
- Extreme prices did not affect the forward markets to the extent that the marginal price of plant did.
- Prices could become volatile due to the loss of multiple units or adverse weather conditions. This could lead to independent generators facing huge losses and, their expulsion from the Balancing and Settlement Code (BSC) in the event that they could not meet their financial obligations, leaving those customers to which it had sold energy short.

8. The capacity market was designed to lock money in, particularly as it provided some certainty about future values, which it was hoped would encourage the build of new energy plants. The difficulty in capturing value from the cash-out price meant that cash-out was a poor investment tool.

9. Drax had two units which cleared the capacity market auction at £19.40 a kilowatt. Future auctions prices may clear at a range of prices and contract tenure. In any one year there were likely to be multiple rates being paid to multiple generators, but all were subject to the same within year wholesale price. The market was not protected from boom and bust economics.

10. Drax said that both the demand uncertainty around customers and the threat of very high cash-out prices could impact on the retail side and could lead to additional risk premia in the market.

Contracts for Difference

11. Drax supported the introduction of Contracts for Difference (CfDs) to support low carbon investment. CfDs would reduce the cost of capital for generators, which would feed into consumer bills and with strike prices (the price for each unit of electricity) guaranteed for a period of 15 years for most generation technologies, generators and investors would have additional certainty regarding revenues. CfDs would provide a floor to the power price and because CfDs operated under a contractual framework, they removed some of the uncertainty associated with the Renewables Obligation (RO).

12. Drax believed that the appropriate level of competition existed in the market with regard to the setting of the ‘strike price’ with the CfDs. But with the strike price dependent on the type of technology used, the introduction of competition must be accompanied by a level playing field for the competing technologies.

13. Drax was concerned that with regard to the total system costs, some technologies that were wind or sun related (‘intermittent’) did not bear the cost of both their imbalances and the grid system needed to support them.

14. Drax had argued that within the CfD system, the costs of connection and balancing costs, particularly for offshore wind, needed to be built into the CfDs. This approach would be more representative of the total costs to consumers.

15. Drax would ideally engage in a straight competitive process for CfD contracts, but with established and non-established technologies in the market, and non-established technologies came at a higher cost, it was hoped savings would eventually feed into the supply chain over time. The balance for the Department of Energy and Climate Change (DECC) was to ensure that the new, or less established, technologies were given the opportunity to win CfD contracts, which in time would lead to a technology-neutral auction.

16. Drax said there were fewer concerns over the competitive process regarding biomass conversions, which accounted for a large part of the CfD budget. There was a debate as to whether the biomass technologies were established or non-established and Drax was of the opinion that the technologies were non-established as there were not many large-scale biomass conversion plants across Europe.

17. There were also some very specific risks associated with converting coal plant to run on biomass [✂].

18. The European Commission had asked the government to consider merging technology Pot 1 (established technologies) and Pot 3 (biomass conversion), leaving Pot 2 (less established technologies) as separate, for any allocation rounds taking place after 2017 and the government was considering its position.

19. Drax had converted two coal units to biomass under the RO and a third unit, which had a pending investment contract, was due to be converted between July 2015 and July 2016, though this was subject to state aid approval. Drax would like to convert a fourth unit in due course, and had discussed this with the government, but this was dependent on money being allocated to Pot 3 for biomass conversion.

Locational pricing

20. Drax noted that distribution losses were four times as high as transmission losses. Locational prices would add complexity to the market and the financial benefits would be very small compared to fuel costs for the energy industry.

21. Drax was based centrally in the UK, not currently at the extremes of the transmission system. Locational pricing would lead to an increase in the marginal cost of northern generators and a reduction for southern generators, with a knock on effect for retail prices. As the generation and demand geography changed over time, transmission losses for any individual generator or retailer would become more difficult to predict. The introduction of zonal losses would significantly impact the profitability of existing northern generators. This could create grid instability problems in the event of plant exit.

22. It was currently possible to estimate the likely figure for transmission losses when selling power one year to 18 months ahead. Introducing zonal transmission losses would make an accurate estimation of losses much more difficult.

23. The current generation system was based on generation lead transmission. Without a central body to plan generation and transmission for the next 25 years, it was important to have signals that identified where generation and transmission was needed.

24. The market had allowed power stations to decide their location, with the transmission system connecting accordingly. Zonal charging would send a signal that power stations would be built where the transmission system was and no developer would conceive of locating a power station near a constraint.

25. If constraints or zonal losses were created due to the way in which National Grid operated and/or built/maintained the transmission system, or because of transmission outages, there was significant uncertainty on where the costs of these losses would be allocated. The uncertainty was unsettling and a company may assume when developing a plant that it may not reach full output.

26. Drax urged caution regarding the efficacy of locational signals. Transmission Network Use of System (TNUoS) charges had acted as a locational signal for decades. Its overriding signal was that generation was not needed in the north of GB, with more generation required in the south. Due to voltage problems and stability of supply issues in Scotland, this turned out not to be the case.

There was still a requirement for generation in Scotland. While the signal said that the power stations in Scotland should be closed, when one was, the system security in Scotland was compromised.

27. Drax was keen to emphasise that zonal losses and zonal charging produced a huge amount of instability. It was very difficult to identify a charge and a signal that would confirm where a power plant was required both now and in the future. It was also true that if power stations were built only in locations where transmission systems existed, then how would a transmission owner receive a signal with regards to where the transmission facility should be built?

28. Drax was concerned that the government's policy on renewable generation would not take into account the full costs of the various renewable technologies. When it considered the choice between offshore and onshore wind, biomass and wave power, the government should take into account the costs of connection charges and intermittency.

29. Drax said that a new EU network code was imminent, which would require national regulators to consider market splitting. The aim was to consider whether market boundaries should be based on transmission characteristics rather than member state borders. Drax would need to understand how this would work before it could assess the implications.

30. Drax believed that all renewable generation, particularly intermittent, should participate in the balancing market.

Renewables obligation certificates

31. Drax said that the 'big-6' energy companies were the main purchasers of Renewables obligations certificates (ROCs) and hence vital to the functioning of the ROC market and they determined how many ROCs they bought. If they held back buying 1% to 2% of the annual market in an attempt to drive up the discounts they could achieve from generators, this constituted a large section of the market that Drax could not access.

32. Drax believed that market power was skewed with regard to ROCs. Firstly, there was the buyout versus the ability to buy ROCs. At the beginning of the year you could assume that in the ROC market there would be 10% head-room, as predicted by DECC. As more data becomes available, the market could start to look oversupplied and by deferring purchasing, a company has the ability to influence the price which was paid for the ROCs.

33. Secondly, the working capital and cash flow did not benefit smaller generators. The ROC was skewed so that there was a working capital benefit

for suppliers and it was more likely that a generator would wish to sell in order to manage its working capital and take a larger discount earlier on. Again, some suppliers could exercise market power over the prices that they extracted for early sales of ROCS.

34. Drax believed that changes to the ROC market design could address some of its concerns around market power and it had pushed for a fixed ROC price to be introduced after 2017 (when the RO closes to new projects). DECC was minded to introduce fixed ROC but not until 2027. Drax believed this would lead to a more level playing field in the ROC market for both buyers and sellers and should be introduced as early as possible.

35. Drax believed that a fixed ROC regime increased transparency and could benefit customers. More certainty around the pricing and the cost of ROCs would be reflected in the pricing structure and a proportion of any discount would be passed to customers' bills. Increased certainty would also reduce marginal costs, with dispatch costs subsequently reduced.

36. Drax currently had a large number of ROCs to sell and believed a discount of [✂]% against the buyout price was feasible. A further cost would be incurred to monetise the ROCs and Drax had access to two credit facilities that allowed it to monetise ROCs early.

37. Drax felt that it would be beneficial to show that customers were charged the same amount of money that Drax was paid under the ROC regime. Drax was concerned that money could be taken by suppliers for a no-risk position, created by regulation.

38. Drax said that both it and a number of independent generators had expressed concerns about transparency and the mechanism National Grid used to manage the generation market, particularly around the letting of contracts for Supplemental Balancing Reserve (SBR).

Liquidity

39. Drax did not view liquidity as a problem and there were no obstacles with regard to selling its power 18 months ahead. Drax would like to be in a position where it could sell power five or ten years ahead, but this was unlikely as the consumer demand did not exist.

40. Ofgem's introduction of the mandatory market maker had brought the certainty of having two trading windows, each 1-hour long, on a daily basis. There were concerns as to whether this was sufficient as liquidity was

concentrated into the windows. It could be difficult to access certain products outside of these windows.

41. There was no evidence that the windows had improved liquidity. Spreads were pretty tight in the short term. Broadening the windows was a risk the market makers would have to bear.

42. Encouraging people to access the markets would increase liquidity and ensure that people could enter and exit the market efficiently, knowing they could trade their volume at some point during the day.

43. Drax was concerned that the Markets in Financial Instruments Directive (MiFID) could decrease liquidity quite dramatically, particularly if two markets were created for physical players and the financial sector. The market had already witnessed banks withdraw their historically provided liquidity and Drax's access to the market would be affected if banks were put into a separate market or there were further withdrawals. Accessing financial markets would come at a higher cost as the exchanges were more expensive to trade in.

Vertical integration

44. [✂] Suppliers were subjected to an increasing and prescriptive level of regulation, which Drax believed reflected a change in emphasis by regulators from a position where their primary duty was to promote competition to one where they must also protect consumers.

45. [✂]

46. A number of new suppliers in the energy market had reached a threshold where they were subject to increased regulation, particularly the Energy Company Obligation (ECO), which obligates larger suppliers to deliver energy efficiency measures to domestic premises. This changed the relationship with the customer from one that was conducted at a distance to one where you had to visit peoples' homes.

47. Drax asked the CMA to consider if the ECO market could be restructured, possibly allowing ECO-buyout (along the lines of the RO) which would stimulate a more efficient method of meeting and delivering ECO obligations and removing the burden from suppliers.

48. Small suppliers faced a number of challenges, such as meeting their environmental energy efficiency obligations, for which failure to do so could lead to large fines, and the six largest energy companies competing more

aggressively with regard to their domestic tariffs, including television advertising.

49. Drax felt that small suppliers currently operated in a relatively benign environment. Wholesale prices had fallen, allowing them to offer lower retail prices to the market and the real test would be how smaller suppliers would deal with increased wholesale prices.

Regulatory intervention

50. Drax said that increased focus on regulatory compliance was time consuming and inhibited its ability to introduce innovation to the energy market. A move to a more principle-based form of regulation may allow Drax to focus on customers rather than regulation.

51. Drax engaged with regulatory consultations, but said that Ofgem did not always produce a cost benefit analysis for regulatory change.

Small and medium-sized enterprises

52. Haven only supplied electricity to business customers, [✂].

53. Haven said that the roll-out of smart-meters would be challenging. As a small supplier, it did not have its own metering business and it would need to work with independent metering providers, of which there were only a small number. There was a risk that Haven would not have the buying power to deliver what it needed to.

54. Haven said that the regulatory definition of SMEs was not practical for its day-to-day business given customers' uncertainty regarding energy consumption and balance sheet values. Haven treated all of its SME customers as micro-businesses and its definition of SME's was based on customer-buying behaviour. [✂]

55. [✂]

56. Haven believed that a micro-business should be redefined as an entity that consumed less than 12,000 kilowatt (kWh) hours annually. [✂]

57. Many of those businesses consuming over 12,000kWh were limited companies and aside from all the obligations expected of a business in its day-to-day operations, Haven believed the current protections for micro-businesses were in fact a cost burden rather than items that delivered anything of practical benefit.

58. Haven believed there was very little difference in the way in which a domestic customer and the owner of a small shop managed their energy consumption. Haven only offered fixed-term contracts and if it felt it could provide a cheaper bill for a very small energy customer, it would pursue the sale.

59. [✂]

60. Winning a new customer was an expensive process and a certain amount of trust was required to develop a relationship. Haven prepared quotes for companies who were nearing the end of their contracts and it would emphasise its relationship with Drax [✂].

61. [✂]

62. In addition to acquiring customers via telesales, Haven received a lot of business via brokers as brokers had achieved a higher degree of penetration into the section of SMEs in which Haven was interested. [✂]

63. There were a number of brokers operating in the energy sector. [✂]

64. [✂] Haven hoped the third party intermediary (TPI) reforms would bring greater transparency to the TPI market.

65. Haven believed the broker market was very competitive, but this would not be the case if brokers required [✂].

66. All of the deals that involved brokers were negotiated. Haven worked with brokers to keep them informed of developments in the market. On the horizon was the new CfD Supplier Obligation Charge and brokers would need to be aware that this was a new tax which needed to be recovered from sales.

67. [✂]

68. Haven was aware that Opus was actively engaged in the small micro-business market and via its telesales operation had achieved customer numbers running into six figures.

69. [✂]

70. Some customers would contact Haven ahead of their contract ending to negotiate a better price and Drax would attempt to accommodate this. For those who did not contact Haven or had given notice that they wished to end their contract, they would be ‘rolled-over’ onto a new contract. [✂]

71. Customers that gave notice to end their contract, but did not agree a renewal with Haven, and did not go to another supplier were offered ‘out of contract

terms’. Prices for this were set comparatively high as Haven did not know how long it would retain the customer and this led to considerable uncertainty in the costs of supplying them compared to the more normal annual or longer contracts.

72. Whether the price paid for the auto-rollover contract was in line with the current cost or had increased from the initial cost of the contract was dependent on the market conditions when the customer initially signed-up and the subsequent movement. Scope existed to negotiate the rollover contracts, which were cheaper than the out-of-contract terms.

73. Customers could give 30 days’ notice before the end of their contract, which had recently decreased from 90 days. Customers would receive a letter with their new terms about 60 days before the contract ended.

74. Some suppliers had stopped offering rollover contracts and offered a 30-day contract at a higher rate instead. Haven believed it had been successful in attacking the prices of these 30-day contracts. Haven believed that rollover contracts were in a customer’s best interest and though Ofgem had looked at the issue of rollovers on a number of occasions, it had not yet found a problem with them on balance.

Code governance

75. Drax agreed with the CMA’s finding that code governance was a complicated process, but there were areas where efficiencies could be found, for example, in bringing governing processes together, having single panel bodies and establishing single points of contact to help people enter the market.

76. Drax believed the Code modification process needed to be managed carefully to ensure it was not harmful for investors or for those players already in the market. The industry code administrators handled the process well

77. The Significant Code Reviews (SCR) process was intended to streamline the modification process, bringing different modification proposals together and working out a direction of change. Unfortunately, SCR appeared not to have achieved this and work streams that were intended to last 12 to 18 months had continued for up to five years. One problem was that there appeared to be a process whereby principles-based reform was directed, when modification proposals were required.

78. Drax believed SCR as a tool to implement change was not used effectively. It would be helpful if the sector regulator had the necessary means to co-ordinate the modification processes to make sure it worked effectively. This

did not mean, though, that the regulator could push through an agenda without considering the effects on the industry.

Profitability

79. [✄]

80. [✄]

81. [✄]

82. It achieved a reasonable level of profitability for its biomass business, though there were challenges in achieving this. Drax's cost base could fluctuate as it was foreign currency denominated, and though ROC income provided some stability, the power market was volatile. Drax had an extensively hedged programme to manage the currency fluctuations.

83. Drax was due to start a review of its coal business if margins fell further. The coal business could be at risk if the carbon tax increased and the review was intended to determine the strategy for coal under a whole different range of commodity assumptions.

84. Drax was in agreement with the CMA's cost of capital analysis. At 12 to 13 terawatt hours, Haven accounted for half of Drax's generation profile. Drax's cost to capital basis had changed due to RO support and the possibility that it may have a CfD, but the market perception was that this was not the case. Drax believed that some market participants and investors did not give it due credit for the fact that it was now more vertically integrated than when it purchased Haven.