



## **Energy Supply Probe – Initial Findings Report**

### **International Power Response**

#### **Introduction**

International Power (IPR) is a UK-based FTSE-100 independent power generation company with interests in over 45 power stations and some closely linked businesses around the world. It has a total net ownership of 21,000 MW across 20 countries.

In the GB wholesale electricity market, IPR is a sizeable independent generator. With its partner Mitsui & Co., Ltd of Japan, IPR owns and operates 7% of GB's generating capacity, which represented 6% of the market by output in 2007. IPR's portfolio includes the 1,050 MW coal-fired plant at Rugeley, Staffordshire, a 1,200 MW cogeneration plant at Saltend, Hull, a 500 MW CCGT station in Deeside, North Wales, 2,088 MW of hydro-electric pumped storage capacity in Snowdonia, and a 140 MW oil-fired power station at Indian Queens, Cornwall.

In addition, through its newly created retail venture, IPM Energy Retail Ltd., IPR is in the process of establishing a supply business, targeting medium-sized I&C customers. Its aim is to provide an alternative route to market for our generation portfolio, to help protect the business from market risks resulting from poor wholesale liquidity.

Ofgem's report provides a comprehensive view of the current health of the domestic/SME supply markets in GB. It also includes some limited discussion of related wholesale market issues. Our overall impression is of a retail market that is not fundamentally broken, but which does require some important maintenance to tackle barriers to entry and improve customer engagement.

#### **Liquidity in the wholesale electricity market, and vertical integration**

We note from Ofgem's discussions with a range of suppliers that wholesale market liquidity is a key concern, particularly for those small suppliers that feel that they do not have sufficient access to the wholesale market in order for them to effectively manage commercial risks.<sup>1</sup> This is clearly a problem in relation to all of the various supply markets, not just the domestic sector.

However, liquidity is also a challenge from the independent generators' perspective. Adequate liquidity is essential to support the business model of all independents seeking to provide a much needed

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<sup>1</sup> We further note the recent demise of BizzEnergy and E4B

'competitive fringe' in the wholesale market. Whilst small suppliers want to be assured that they can have open and fair access through the market to the generating capacity of the Big 6 companies, as an independent generator, we rely on those companies having a purchasing requirement to provide them with an imperative to trade.

In this context, the definition of liquidity is important. A narrow definition would simply quantify aggregate market traded volumes as an indicator of overall activity. However, the health of the market should be examined in a number of ways to get a true picture. From our perspective, a 'liquid' market is one where we are reasonably able to transact the volumes/shape we require, at the time we wish, and at a fair price.

This broader definition necessarily requires broader examination of restrictions on trading in order to establish the true status of liquidity. Credit, for example, is one area that can hinder access to an otherwise apparently 'liquid' market. We believe that this has been a major contributor to the problems faced by the small independent suppliers.

At present IPR believes that liquidity is just adequate to support its operations, however this position is fragile, and subject to change. In particular the planned merger between EdF and British Energy has the potential to dramatically reduce market liquidity, as a result of the additional vertical integration of generation and supply volumes within the combined entity.

High levels of vertical integration, coupled with weak competition in the retail market, create the opportunity for the Big 6 (who are generally balanced or short of power to meet customer requirements) to extract more value from retail, and help suppress price signals in the wholesale market. In this case, the generation businesses of these companies are not operating on the same footing as independents. For instance, there are few, if any, examples of new build merchant projects being actively progressed by independent players, whereas significant levels of new build are already under construction by the Big 6. Poor liquidity will exacerbate the situation whereby the large suppliers do not feel able to rely on market volumes to meet customer requirements, and therefore improve the 'balance' of their own portfolios. This behavior can lead to a downward spiral in liquidity.

We therefore agree with Ofgem that "the issues of liquidity and vertical integration are closely related". IPR remains concerned therefore that the problem of poor liquidity in the electricity market is addressed by Ofgem, and that the various drivers understood, in order that the application of regulatory policy can be consistently applied to further competition in the market.

### **Other Wholesale Market Issues**

The BERR Committee Inquiry has questioned whether wholesale market issues should form a more central role in Ofgem's Probe. Ofgem has listed in the Report, a number of activities that it has recently undertaken to address various wholesale issues (e.g. monitoring of National Grid's balancing costs and cashout work.) We think that Ofgem was right to examine the market from the customer perspective under the Probe, but it is also important to follow up on related key wholesale issues. We believe that these are: market structure and transparency, the level of vertical integration, and trading liquidity. We

would question whether the wholesale market initiatives listed by Ofgem actually start to address any of these concerns.

### **Ofgem's Proposed Remedies**

The initiatives proposed under Actions 1 and 2 (Para 1.36 and 1.37 of the Report) appear to be sensible, and backed up by extensive survey work and analysis.

Under Action 3 (Para 1.38), we support Ofgem's proposal to require the Big 6 suppliers to publish *separate regulatory accounts* for their supply and generation businesses. This is a small step towards making the market more transparent, allowing increased scrutiny of business unit performance. This may help to determine more clearly whether, for instance, generation choices are made efficiently, and on the same basis as independent generators.

The *review of regulatory obligations* (that could act as an undue deterrent to new entry) is also a welcome proposal. In undertaking this review, Ofgem need to be conscious that a number of the detailed remedies proposed could in themselves unnecessarily increase the regulatory burden on small suppliers and new entrants like ourselves. The Big 6 will be much better placed to implement changes to bill formats etc. In a number of cases it is not clear whether a proposed remedy put forward by Ofgem would apply only to the Big 6, or in fact to all suppliers – this requires clarification in the context of this action.

We also support Ofgem's proposal to begin "urgently" a *programme of work to examine wholesale market liquidity*. We note that Ofgem also wishes to "explore with the Big 6 suppliers how best to achieve a significant increase in liquidity". It is also important of course that the views of other market participants are taken into account in this respect.

We understand that this work programme has not yet been commenced by Ofgem, and we urge it to expedite this important project. In particular, getting to grips with how to measure liquidity is a key requirement (under the bilateral BETTA market availability of trading data is very patchy) taking into account our broader definition above.

The role of *vertical integration* is also highly relevant to this project, particularly in light of the proposed acquisition of British Energy by EdF. However, we are concerned that this work will be conducted too late to prevent a transaction which is likely to further reduce market liquidity. Post-structural regulatory measures (such as a requirement to auction generation volumes) are a possible condition (or even a more widely applied measure to the Big 6) and could assist liquidity. However, getting the market structure right is more important in order to achieve permanent improvement to the market, and facilitate strong levels of competition.

The final item under Action 3 is the potential for "*additional powers to guard against potential market abuses*". This is an initiative that we do not support. We cannot find any justification or evidence presented in the Report that would lead to consideration of this proposed action. Ofgem will be fully aware of the outcome of the previous attempt to introduce a specific "Market Abuse Licence Condition" on large wholesale generators. The Competition Commission's ruling in January 2001 determined that

the introduction of sector-specific market abuse framework (in addition to generic competition legislation) would represent excessive regulation, with the potential to deter new market entry to the detriment of consumers. We are not aware that anything has changed in the intervening period to suggest that this conclusion would be any different today. Indeed Ofgem is currently investigating the Scottish generators under Competition Act provisions. If Ofgem were to pursue this option, we would expect it to provide a much more detailed rationale and explanation of its thinking.

Action 4 relates to small business customers. We agree with all measures proposed here. In particular it is clear that there are problems with switching in that a significant number of accounts that are due to be switched are “won back” by incumbent suppliers that improve their offer to the customer before the new supplier takes over the account. This provides a significant barrier to competition for new entrants, who often may have already hedged the supply requirements for these new customers. In order to foster competition in the markets it is therefore critical that a new code of practice tackles this issue and prevents such tactics.

Action 5 (Para 1.40) goes beyond some of the proposed new guidelines and codes of practice, and considers a more onerous licence-based approach for the Big 6, to tackle price differentials between classes of consumer. We are not convinced that these will be necessary given all of the other remedies proposed.

### **Next Steps**

We note that Ofgem intends to discuss and agree the proposed supply market actions with the Big 6 companies, and also progress the proposed actions (subject to this consultation) relating to the wholesale market.

The supply-related actions, focused on providing clearer information to customers, appear to represent a welcome set of measures to enable the supply markets to operate more efficiently. There is a danger however, that some of the proposals are overly-prescriptive, and where they apply across the whole market (rather than just to the Big 6) this additional ‘red tape’ could act as an additional barrier to entry. Ofgem needs to ensure therefore that there is a clear net benefit to competition.

On balance, we do not believe that the concerns identified in the report are sufficiently serious to warrant a market investigation reference to the Competition Commission. Ofgem does not find any evidence of cartel behaviour amongst the Big 6, and identifies that there is a very high level of consumer engagement when compared with other markets. It is clear that improvements can be made, but it should be possible to progress these as an evolution of the current regulatory framework, without the need for a (disruptive) Competition Commission investigation.