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Retail Markets
Ofgem
9 Millbank
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Dear Stefan,

The Retail Market Review – Findings and initial proposals

ESBI welcomes the opportunity to provide comments on the proposals contained in the Retail Market Review. In particular, we are pleased that Ofgem has recognised the lack of liquidity that exists in the wholesale electricity markets and the impacts it is having on the ability for independent, non-vertically integrated industry players to enter and participate in the markets.

This response provides a brief overview of ESBI and responds to the issues and proposals, contained in the consultation, that affect our operations in the GB market.

ESB International

In GB, ESB International (ESBI) 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 Corby power station and developed the 850MW plant at Marchwood, which was commissioned late in 2009. We are also at an advanced stage with our latest 900MW development at Carrington which is due to become operational early in 2015. Additionally, we own and operate the 406MW Coolkeeragh plant in Northern Ireland. We are also developing further large-scale CCGT developments at other locations across GB.

In addition to increasing our conventional generation fleet, we continue to grow our position in the UK wind market. Our operational and development portfolio will be around 165MW by 2012, comprising: the 24MW West Durham Wind Farm in Northern England; the 20MW Hunters Hill; and 15MW Crockagarron projects in Northern Ireland. Additionally, we are currently constructing what will be England's largest on-

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shore wind farm, at 66MW, at Fullabrook in Devon and we expect to start construction of our 38MW Mynydd y Betws Wind Farm in South Wales later this year. We are also active in the ocean energy sector.

ESBI views

We note and support the various proposals for promoting more effective (and transparent) retail markets. However, reflecting our status in GB as an independent generation-only company, this response focuses on Ofgem's findings and proposals for improving wholesale market liquidity. We are strongly of the view that an open, competitive retail market is supported by a liquid, diverse generation market and as such the focus of liquidity improvements should, at least, be equally upon independent generation as on independent supply.

Crucially, the measures contained in this review must be considered in conjunction with the range of measures contained in DECC's Electricity Market Reform (EMR), as there is strong overlap of purpose. As such, the most pertinent issues relate to the Mandatory Auctions and the Mandatory Market Making provisions and our response therefore focuses on these.

Liquidity in investment timescales

The energy markets face significant challenges over the forthcoming years. The dramatic decarbonisation of the energy sector that is necessary under Government policy requires unprecedented levels of investment to be made in GB's generation fleet. This investment covers renewable and other forms of low carbon generation as well as cleaner, flexible thermal generation that will ensure security of supply. We believe that an effective, liquid market with pricing freedom for non-mandatory products is the foundation that will ensure Government's aims are met.

In order that investment signals are provided, any proposals for improving liquidity must not simply focus on near-term products. If the mechanisms proposed by Ofgem are to be introduced, products must be designed to provide liquidity further along the curve where liquidity is particularly poor. Developers of generation not subject to Government or market support require a price signal a number of years in the future. In developing its proposals, we would seek for Ofgem to better define the types of products that would be available on the platforms and ensure they provide generation developers with appropriate

market investment signals.

Interaction with Electricity Market Reform

Government has proposed a number of fundamental changes to the electricity market to facilitate the achievement of its policy goals signalled by the introduction of a number of mechanisms that will provide assistance to low-carbon generation. The success of some of those measures will rely on a wholesale market that is liquid, transparent and able to provide a credible market reference price. We urge Ofgem to ensure that the proposals that come forward from the RMR are able to deliver these requirements and are capable of being implemented within the challenging timescales required by both Government and the market. Investors seek clarity following a period of significant market uncertainty before they make the investment decisions that are critical to delivering policy. Uncertainty is already creating an investment hiatus and any worsening of this effect will materially impact the UK's energy goals.

Credit

Whilst Ofgem has proposed mechanisms to improve liquidity in the wholesale markets, there have been no proposals to overcome the significant issues associated with credit that currently act as a barrier to smaller industry participants and exacerbate the lack of liquidity. The current OTC market structure requires smaller participants (with lower quality credit-rating) to provide credit support or collateral to counter-parties against the traded position they hold. For these smaller parties, the provision of significant credit support is often prohibitively expensive, if at all possible, and therefore limits participation in the wholesale market. The amounts and costs of credit support that parties are required to provide is therefore preventing improvements being seen in market liquidity.

We are strongly of the view that Ofgem should consider the issue of credit within any change proposals and that these changes should look to make credit arrangements more efficient and, where appropriate, less onerous. Ofgem should also be mindful that the credit arrangements associated with the enduring market arrangements will be subject to trading and credit frameworks being developed at a European level. These arrangements are being considered within proposed European legislation (the European Market Infrastructure Regulation and the Market in Financial Instruments Directive II) and therefore any changes made to the GB arrangements should be complementary with wider European policy and greater market integration.

Urgency

Improvements to liquidity are critical to both the ongoing operation of the wholesale market and the achievement of Government's policy goals. Whilst we recognise that any changes made to the existing market arrangements must be robust, we would urge Ofgem to ensure that proposals are brought forward as a priority in order that benefits to both market participants and consumers are realised as soon as possible.

Response to specific questions raised in RMR

Below are ESBI's responses to a number of the specific questions raised by Ofgem in its RMR consultation.

Question 9: Do stakeholders consider that our two proposed interventions (the MA and the MMM) could improve the ability of the wholesale market to meet independent participants' needs, and will ultimately improve the likelihood of retail supply market entry?

We are of the view that the high-level proposals could improve liquidity but if both are to be introduced, careful consideration must be made to ensuring that the two mechanisms do not act against each and result in liquidity actually being driven out of the market. It may be the case that it is administratively more efficient to introduce one mechanism that fulfils all of Ofgem's intentions. One centrally cleared platform trading products covering a range of clip sizes and delivery timescales may be a more effective option.

We would again urge Ofgem to consider liquidity improvements in terms of benefits to both independent suppliers and independent generators.

Question 12: On the basis that we could decide to take forward these interventions, do stakeholders have comments on the indicative design choices we have made, as set out in Appendix 2. In particular, views are welcome regarding our initial position on each of the following:

- *Volume requirements*
- *Product requirements*
- *Frequency*

- *Governance arrangements*
- *Participation*
- *Platform*

Mandatory Auction (MA)

Volume: Further clarity as to the definition of “collective annual volume”. We are of the view that an obligation on each of the Big 6 to place 20% of their individual total annual outputs on the MA may be appropriate but considerably more detail is required as to how that 20% will be defined and the types of products that would be provided. In addition, we would not want the obligation to be a collective one placed on the Big 6 as a group of companies. We believe that such an arrangement would inevitably raise the risk of collusive behaviour in order to coordinate volumes.

Product requirements: The range of products provided in the consultation appears appropriate. We would, however, stress that the range of products should facilitate market entry and participation from independent generators as well as independent suppliers and that excessive product fragmentation does not have the unintended consequence of actually reducing liquidity.

In addition, significant further detail is required on how Ofgem intends to develop a reserve price for the auctions as this is the critical factor that will determine the success or otherwise of the intervention.

Frequency: A monthly auction could drive a greater level of liquidity; however we would welcome analysis on the relative cost and benefits of more frequent auctions (weekly, for example).

Governance arrangements: Ofgem’s proposals appear reasonable. We believe that transparent and auditable reporting will be key to monitoring the success of the auctions and this roll should be undertaken by the independent trustee.

Participation: Ofgem’s proposal appears reasonable, although we would seek that Ofgem is alert to the risk that the auction does not drive liquidity from the rest of the wholesale market by forcing smaller

suppliers to only source power from the auction. The MA (which should be simple, transparent and robust in its design) should be complementary to the wholesale market, rather than replace it.

Platform: We would seek for the platform to be independent and in no way commercially linked to any industry participant. The costs associated with establishing any new platform and associated systems should also be considered with robust cost/benefit analyses provided as part of any future impact assessments.

Further, and wherever possible, any platform that is created should also be consistent and compatible with the development of Regional European Markets (REM) which will form the basis of future electricity trading across a single or regional-based European market.

Mandatory Market Maker (MMM)

Volume: Clarity is required on Ofgem's specification that the obligation on the Big 6 should be in the order of 20-50MW in total. As with the auctions we would not want to see a collective obligation structured in a manner that required coordination between the Big 6 to facilitate its fulfilment.

Product requirements: The range of products provided in the consultation appears appropriate, albeit we are of the view that considerably more detail is required on how regulated bid/offer spreads are to be derived and how these would be maintained through various different market scenarios. We would also stress that the range of products facilitates market entry and participation from independent generators as well as independent suppliers. Further, if both interventions are to be introduced, products across the two platforms must be complementary.

Frequency: We assume that the requirement would be for the Big 6 to continuously have a set volume available and that traded volumes would be instantly replaced. We believe this would provide additional liquidity, particularly in the more outer curve markets.

Governance arrangements: We expect that Ofgem will place reporting requirements on the Big 6 to report activity within the MMM arrangements, in accordance with proposed European legislation

Participation: Ofgem's proposal appears reasonable.

Platform: We would seek for the platform to be independent and in no way commercially linked to any industry participant. The costs associated with establishing any new platform and associated systems should also be considered with robust cost/benefit analyses provided as part of any future impact assessments.

Further, and wherever possible, any platform that is created should also be consistent and compatible with the development of Regional European Markets (REM) which will form the basis of future electricity trading across a single or regional-based European market.

Conclusion

To reiterate, we are strongly of the view that an open, competitive retail market is supported by a liquid, diverse generation market and as such the focus of liquidity improvements should, at least, be equally focused at independent generation as well as independent supply. Further, we believe that Government energy policy cannot be delivered without significant improvements to liquidity and as such we seek for Ofgem to place priority on implementing changes that will drive greater market liquidity at the earliest opportunity.

Should you wish to discuss any of the points raised in this response further, please do not hesitate to contact me.

Yours sincerely,

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