



8 May 2012

Attn: Camilla Egginton, GB Markets

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Dear Sirs,

Response to Consultation on Retail Market Review: Intervention to enhance liquidity in the GB power market

Introduction

Carlton Power welcomes the opportunity to respond to Ofgem's consultation on interventions to enhance liquidity in the GB power market.

As Carlton Power is not a retail company and does not have a direct interest in the retail market, we will therefore limit our responses to the questions concerning liquidity in the wholesale market.

It is our view that a well-functioning retail market which provides value for money to consumers presupposes and requires a competitive wholesale market and hence a structurally sound generation sector. It is therefore our opinion that Ofgem should see liquidity, competition and the creation of effective price signals in the wholesale market as goals in themselves. Such a wholesale market will reduce barriers to entry into generation as well as lead to a better functioning retail market.

As we explain in this letter, we welcome the suggestion of some form of mandatory auction ("MA") but believe that this must be combined with either a) prohibiting buy-side activity by the vertically integrated Big 6 companies or b) the imposition of choice markets on obligated parties. We also believe that the detailed design of the new arrangements will be crucial to ensure that these achieve the intended objectives and that the mechanism adopted does not become self-defeating. The appendix attached to this letter contains more detailed responses to your specific questions, including more detailed comments on possible mechanism design.

The problem being addressed

The UK electricity sector is jointly dominated by the incumbent, vertically integrated Big 6 companies. As a result of the combination of this market structure and the bilateral (as opposed to pool) based trading rules under BETA, non-vertically integrated market entry into both generation and retail is exceedingly difficult and rarely sustained.

However, given the significant calls on the balance sheets of the incumbent Big 6, entry by new non-vertically integrated investors into the generation sector is essential for attaining the Government's

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security of supply, decarbonisation and affordability objectives. To facilitate such investment, the wholesale market has to generate price signals along the curve which are transparent, cost reflective and resistant to gaming, particularly by vertically integrated companies. Furthermore, wholesale markets need to offer new entrants products which allow them to manage their risk exposure through appropriate financial hedges and trading strategies.

Core objectives

To enhance competitive pressure in both retail and wholesale markets Ofgem has identified three core objectives for the GB power market, namely:

- Availability of products which support hedging
- Robust reference prices generated along the curve and
- Effective near-term markets.

In our view, these are just some of the features of a wholesale market which is competitive, liquid and generates effective price signals. It is the creation of such a wholesale market, rather than the attainment of some partial indicators, which we suggest should be Ofgem's overriding policy objective.

Key observations

The degree to which the vertically integrated "Big 6" companies dominate the UK electricity market from generation to wholesale to retail is a structural problem for the market and ultimately for consumers. Market structure is at the root of the competitive problems Ofgem has identified. We believe there is a need to directly address vertical integration in the sector if a lasting solution to the competitive problems identified by Ofgem is to be found. The alternative, behavioural regulation, becomes more and more complex and tends to show limited success over time. The history of unbundling requirements between networks and other business areas, as reflected in successive EU Directives and UK regulations and law, supports this contention.

The proposed mandatory power auctions should, if designed correctly, improve liquidity, transparency and competitiveness in the UK wholesale market. However, we have significant reservations regarding the design and completeness of the interventions proposed by Ofgem.

Our concerns are based on the requirement that the auction should be designed in such a way as to

- Obtain maximum liquidity benefits
- Ensure that gaming of the auction rules and process is unprofitable for vertically integrated companies
- Ensure that price discovery and effective market entry is facilitated
- Ensure that participants have the commercial freedom so that (a) they can react to the price signals generated, (b) creative contracting solutions can be found, (c) product innovation takes place and (d) regulatory intervention and risk is kept to a minimum.

We provide more detail on these key objectives below.

Obtain maximum liquidity benefits

Given that vertical integration is at the heart of the problems which Ofgem is seeking to address, our preference would be for an auction design which does not allow for participation by obligated parties in the auction on the buy-side. Such a requirement typically characterises the Virtual Power Plant (“VPP”) auctions implemented internationally to enhance market liquidity, transparency and facilitate market entry. VPP have successfully taken place in countries such as France, Belgium, the Netherlands, Spain, Portugal, Germany and the US.

Independently of its design, the participation of the vertically integrated Big 6 as buyers in the MA will significantly reduce its liquidity and pro-competitive effect. As a conservative estimate one could assume that the Big 6 would buy volumes equivalent to their market share, thus distributing only a fraction of volumes to other/new players. It also opens up significant gaming opportunities for the vertically integrated Big 6.

The need for auctioning off large volumes is significantly reduced if the vertically Big 6 are not allowed to participate on the buy-side or if choice markets are introduced (see the following section.)

Ensure that gaming of the auction rules and process is unprofitable for the Big 6

For the mandatory auction to enhance liquidity and competition in the wholesale market and for Ofgem’s objectives to be met, gaming of the MA by the vertically integrated Big 6 needs to be unprofitable, i.e.

- the downside risk of gaming needs to exceed the upside advantage obtainable, and
- market arrangements need to be sufficiently transparent for gaming to be clearly detectable and therefore “unprofitable” as it carries the risk of regulatory intervention or further reform when detected.

The potential profitability of gaming is driven by the volume and the price risk faced by an obligated party. The volume risk is a function of the percentage of annual generated output auctioned. The price risk is a function of the bid-offer spread attained.

In our view, the scope for profitable gaming is more limited a) the higher the volume auctioned, b) the lower the volume the vertically integrated Big 6 are allowed to buy and c) the more restricted the bid-offer spread which can be obtained.

Ofgem is currently only focusing on the volume auctioned and the volume the vertically integrated Big 6 are allowed to buy through the auction. We are concerned that this approach will lead to the requirement for detailed behavioural regulation, with a significant risk of unintended consequences, increasing the need in turn for yet further regulatory intervention. This detailed intervention approach will also increase the regulatory and commercial risks and limitations for new market participants looking for innovative market entry strategies and contracting and trading solutions.

Our preference would be for the introduction of choice markets instead of buy-side restrictions. Limiting the bid-offer spread available to obligated parties to (very close to) zero directly takes away any potential for profitable (individual) price manipulation and ensures that the auctions result in effective price signals. Since choice markets also take away the need to regulate the buy-side

volumetrically, this proposal deals with the problem as to what would happen under Ofgem's proposals if there is simply not enough demand for product, but the proposed buy-side rules prevent the market from clearing.

Whether there is scope for collective tacit collusion in a choice market with only six (large) sellers is a function of the transparency of the market arrangements and the effectiveness of market governance. Hence we favour auctions on a single platform for all the auctioned volumes to enhance liquidity and transparency. There should be extensive information publication requirements for that platform as well as governance arrangements which, after appropriate consultation, leave very little room for market participants or forums to impact the fundamental design choices.

Ensure that price discovery and effective market entry is facilitated

Market liquidity is not an end to itself. Enabling price discovery and effective entry into wholesale and retail markets has to be at the heart of the reforms. The key requirement to facilitate new entry into the generation market is a correctly functioning and competitive wholesale market where prices reflect true costs and fundamentals of supply and demand. This will give financiers and developers the confidence to plan and make investments on the basis of a reasonable judgment of the risks.

The lack of transparency created by vertical integration and associated opportunities to distort and manipulate the wholesale and retail markets has made it almost impossible for new participants to enter the UK generation market. Effective reform is urgently required to prevent a "stitching up" by the current players which will leave the UK paying more than it needs for electricity whilst still not delivering the investment required for a low carbon, secure supply.

Ensure that participants have commercial freedom

Market-based approaches allow market participants to react to price signals and profit incentives by finding new sources of competitive advantage, including innovative contracting solutions and trading strategies. If Ofgem's approach results in extensive behavioural regulation and interference with price discovery, then the effectiveness of price signals and market participants' ability to react to them are curtailed. Regulatory rather than commercial risk is a yet more concerning source of risk, and regulatory rather than market failure a major source of market distortion.

Further information on Carlton Power

Carlton Power Limited is a UK independent power station developer and has managed projects in the UK and Europe since the company was founded in 1995.

To date, we have been involved with the construction of over 1800MWs of installed electrical capacity and a further 2380MW of consented plants in the UK.

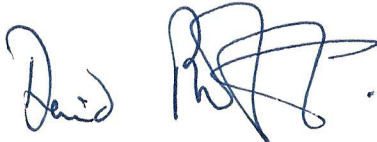
Recommendations

We urge Ofgem to seek structural solutions to vertical integration. Should divestments and self-supply limitations continue to be unattractive to Ofgem, then international best practise suggests that the use of carefully designed virtual divestiture through VPP auctions (from which the Big 6 are excluded from the buy-side) is the most effective way to deliver Ofgem's objectives.

It would be highly unusual to allow an obligated party to participate on the buy-side of a VPP auction. If Ofgem nevertheless does want to enable the vertically integrated Big 6 to participate on the buy-side, then we recommend the use of choice markets, rather than of various volume-based buy-side rules. Such an approach would help avoid over-regulation and enable effective market entry as well as preserve commercial freedom and the incentive for innovation in the wholesale and retail markets.

Carlton Power is a long-standing and committed investor into the UK generation sector and hence we take a keen interest in the success of Ofgem's wholesale market initiatives. We look forward to providing Ofgem with continued support through active stakeholder engagement.

Yours faithfully,

A handwritten signature in blue ink, appearing to read 'David Philpot', with a stylized flourish extending to the right.

David Philpot, General Counsel
For and on behalf of Carlton Power Limited

Appendix

Detailed comments on Ofgem's consultation questions

CHAPTER: One

Question 1: Do you agree with the objectives we have identified?

Response: Ofgem's objectives detail features of a wholesale market which is competitive, liquid and generates effective price signals. It is the creation of such a wholesale market, rather than the attainment of some partial indicators, which we suggest should be Ofgem's overriding policy objective. In particular, market liquidity is not an end to itself. Enabling price discovery and effective entry into wholesale and retail markets has to be at the heart of the reforms.

Question 2: Do you think there are other objectives we should be considering?

Response: We suggest the following further secondary objectives:

- Finding lasting solutions to the distorting effect of vertical integration on competition in wholesale and retail markets: We suggest that lasting solutions are likely to be based on structural measures rather than behavioural ones;
- Use international best practice: Establishing effective market based approaches which reflect international best practice as for instance gleaned from VPP auctions and
- Regulate for competition: Avoiding the extensive use of behavioural regulation.

CHAPTER: Two

Question 3: Do you agree with our views on market developments since summer 2011?

Response: In our view the wholesale market continues to be dominated by the vertically integrated Big 6 companies. Prices don't reflect the true costs of generation. As a result the market doesn't encourage competitors to the large vertically integrated utilities at any level (retail supply, wholesale trading or generation). This has adverse implications for current and future consumers and for investment in the industry.

Hence we agree with Ofgem that, despite recent high profile gestures by certain vertically integrated companies, true liquidity in the UK wholesale market continues to be too low to support effective market functioning in both retail and wholesale.

The retail supply market is effectively a process of re-structuring wholesale market products to retail products. Without the availability to source and continuously adjust a wholesale market position a retail business will become costly and far too risky. The cost is related to transaction costs with large bid-ask spreads as well as imbalances left due to lack of products and/or volume in the market. Risk is driven by both the amount and price of imbalances.

In addition to the barriers to entry in the retail supply market, it is our view that low liquidity in the wholesale market combined with low competition in retail allows the total market price level (both wholesale and retail) to remain higher than what a fair and competitive market outcome would be. Competitors to dominant suppliers would always compare the wholesale and retail markets, while the dominant suppliers may sell most of their volumes in the retail market and actually avoid selling (or in the extreme case buying) in the wholesale market keeping the price level artificially high. We do not have direct evidence that this is so in the UK market, however Ofgem's own findings in terms of very low to negative net margins in retail could be an indication that further studies should be done to investigate the behaviour and actions of market participants.

Question 4: What specific further developments would be necessary to meet our objectives?

Response: In our view the proposed reforms are a step in the right direction. However their implementation needs to be re-focused on

- finding a structural solution to the underlying root cause of the problems, namely extensive vertical integration, or
- at least on building on international best practise in limiting the vertically integrated companies' ability to distort markets.

We suggest that market-based (rather than regulatory approaches) such as VPP auctions without buy-side participation by obligated parties or choice markets are fruitful avenues to pursue in this context.

Furthermore, in our view vertical integration gives rise to transparency issues between retail and wholesale markets which the RMR does not address. An arena that Ofgem should investigate further in our view is the margins in Generation vs. Retail especially for the large players. Sustained negative margins in Retail would be an indication that there may be benefits other than purely monetary that drives players' interest in Retail, giving grounds for significant concern. As an extension to this obligated parties could be required to publish accounts of their margins, to publish transfer prices between retail and generation, and even to allow third parties to trade with them on such transfer prices.

However, even if the RMR is implemented successfully (i.e. introduces market based mechanisms which allow for effective price discovery and market entry into both wholesale and retail), the high levels of political risk caused by the disarray in the UK's electricity sector policy, due to the EMR, will continue to act as a deterrent to investment and market entry.

Question 5: Do you agree that objectives one and two are current priorities given market developments?

Response: See our answers to Questions 1 and 2

CHAPTER: Three

Question 6: Do you agree that the MA is the appropriate mechanism to meet our immediate objectives?

Response: See our answers to Question 4 above regarding entry barriers which in our view these reforms do not address.

In addition, to affect positively the likelihood of effective entry into the wholesale and retail markets, the MA must be designed in such a way that it

- a) does not impede existing successful entry strategies
- b) it increases the ability of viable new entrants to raise finance and
- c) provides an additional route to market which was not open before the reforms.

The provision or securing of a Power Purchase Agreement (“PPA”) or a Tolling Agreement (“TA”) is the only viable entry strategy for non-vertically integrated market participants to date. Companies such as Carlton Power can only invest in new generation assets on the back of a PPA or a TA. Providing PPAs or TAs has been an important risk mitigation strategy for significant new wholesale market participants such as e.g. Statkraft. The reforms would have significant unintended consequences if they reduced the willingness of counterparties to provide PPAs or TAs, or their attractiveness in terms of the contractual conditions and risk distribution offered. To ensure that this is not the case, the MA has to be implemented with a sound understanding of the commercial structures and strategies underpinning market entry to date. It would be perverse if Carlton Power and other successful investors and new entrants saw their business model threatened as a result of the RMR.

Whether the MA as outlined by Ofgem gives sufficient assurance for entirely new generators to raise the finance needed to enter the market, or for existing independent generators to be able to expand their business activities, depends upon the detailed design of the MA.

Well-designed VPP auctions have succeeded in other jurisdictions in providing market participants with new routes to market or with additional risk management tools. We believe, based on experience from other countries, that if the MA takes the form of a best-practice VPP auction, then there will be many interested buyers participating in the MA, and should initial prices be low, many more buyers will enter, either as pure wholesale players or independent retailers.

In designing the MA the bankability of the relevant contractual relationships and the risk exposure entailed will be key. The bankability of the associated contractual relationships will in turn and in part be dependent upon the resilience and credit rating of the counter parties and the reliance that can be taken on the availability of an open functioning market over a long term, say 15 years.

The risk exposure of new entrants and independent market participants will be driven by volumes, length of products, the scope for gaming by the vertically integrated Big 6 or for hiding true profits, and the credit rating of the relevant counterparties.

We support a well-designed MA, which has proven to improve competition and liquidity in other markets when implemented as a best-practice VPP auction.

Question 7: Do you agree that, at the present time, the other mechanisms identified would not be appropriate for Ofgem to pursue?

Response: We do not follow Ofgem’s arguments for dismissing self-supply restrictions and believe that the current market issues that Ofgem is seeking to address in the Retail Market Review are, in part, consequences of the move away from the fundamental self-supply restrictions introduced at the time of UK privatisation.

The international evidence on VPP auctions is that inhibiting obligated parties from participating in the auctions is essential for the auction's ability to achieve the regulatory objectives of facilitating market entry and promoting wholesale market liquidity. Such a prohibition on participating on the buy-side of the auction amounts effectively to a self-supply restriction for the obligated volumes. The fact that Ofgem dismisses this basic design feature leads to the anticipated problems which Ofgem in turn tries to address through complicated regulatory approaches for the buy-side which reduce the effectiveness of market functioning.

CHAPTER: Four

Question 8: Do you agree with the key features of the MA we set out?

Response: The MA as outlined is silent on numerous key design features which will drive its success. We strongly favour following international best practice and instituting an MA which takes the form of a VPP auction with the following features:

Participation: No buy-side participation for obligated parties. In the absence of this provision, the imposition of choice markets for obligated parties.

Auctioned annual volumes: In the absence of choice markets, Carlton Power would wish to see a significant volume; however it should be seen in relation to whether the vertically integrated Big 6 should be allowed to buy. We believe they should not, and thus a volume of 25 per cent is sufficient. If they are allowed to buy, we believe much higher percentages are needed to achieve the same effect, perhaps up to 40-50%.

Auction format: An internet based, simultaneous (for multiple products) ascending-clock auction with discrete rounds and dynamic bidding, rather than the use of sealed bids.

Products: To enable new entrants into the retail markets to buy the term and shape structure they need, the MA should utilise small minimum bidding units of 1MW – 5MW.

The products should be grouped into product groups which reflect the extent to which they are substitutes (in separate groups) or complements (in the same group) – typically base-load products of different durations would be in the same product group and separate from peak-load products.

Information disclosure: The auction rules should require information disclosure of aggregate demand and end of round price for each product at the end of each round and also after the final round.

Auction frequency: VPP auctions are typically quarterly. However, the proposed monthly auctions are likely to have significant liquidity benefits. If designed appropriately they seem to strike an appropriate balance between enhancing liquidity through frequent auctions and limiting the associated costs to market participants, especially as many of the auction participation costs (in terms of IT systems and traders) are fixed.

Supply flexibility: Ofgem should consider the potential benefits of an auction design in which the price relationship for product (groups) with different durations is pre-specified rather than the quantities to be sold of the different durations, especially if the term structure of prices is reasonably well understood. The resulting supply flexibility will allow liquidity to gravitate to products for which there is genuine demand and minimises the probability that a product fails to sell. With fixed

quantities for sale there is a genuine possibility that sufficient genuine (non Big 6) demand will fail to materialise for a given product (especially the longer-term ones).

Reserve price: Reserve prices are not required if aggregate demand in the auction is clearly going to be significantly higher than supply. At least initially this is unlikely to be the case for the MA. An independent monitor might be required to help set an appropriate reserve price by using information from previous (international) auctions to calibrate the verification methodology. The reserve price will have to balance the objectives of providing the sellers with protection against insufficient demand while ensuring that there is no unmet demand as a result of an excessively high reserve price. As the MA matures, we anticipate that no reserve prices will be needed.

Governance: Ofgem oversight – As we have stated a few times in our response, the design of the interventions is key to their effectiveness. We therefore strongly suggest that Ofgem consider the design carefully in order to maximise their effectiveness, and ensure that very little room is left for market participants, or forums, to impact the fundamental design choices.

Platform: In our view the MA must use existing market places and existing trading arrangements to minimise its distortion of the market.

To ensure optimal liquidity benefits and limit the credit requirements for market participants, we suggest that a single internet based platform should be used for the auction and that a given product group should be auctioned in a single process, i.e. we are somewhat disturbed by the implication of Ofgem's Approach 2 (page 37) that individual Big 6 companies might be allowed to use different platforms, resulting in e.g. six different auctions for one and the same product.

Carlton Power hence supports Approach 1 to the set up and governance of the auction since, properly implemented, this is most likely to lead to an efficient auction outcome, including a lower probability of gaming on the sell-side.

Question 9: Do you consider it appropriate to have buy-side rules in place and do you have any comments on the detail of such rules?

Response: As we have stated before, the participation of the vertically integrated Big 6 as buyers will significantly obstruct the purpose of the MA and we have a strong preference for the auction design to follow international best practice and to limit obligated parties to the sell- side. To illustrate: if a volume of e.g. 50 TWh is offered to the market and the vertically integrated Big 6 buy relative to their market share 80-90% of this, then only 5-10 TWh is really released into the market outside the Big 6. In addition, the Big 6 have the largest capability to carry risk, the largest scale giving them the lowest operational costs and are sellers giving them low/negative transaction costs. All of these factors mean that the vertically integrated Big 6 could be expected to buy more than their relative market share, possibly outcompeting the independent participants altogether, thus leaving the MA without effect at all.

We understand that Ofgem is trying to limit the scope for gaming by the introduction of buy-side rules. The potential profitability of gaming is driven by the volume and the price risk faced by an obligated party. The volume risk is a function of the percentage of annual generated output auctioned. The price risk is a function of the bid-offer spread attained.

In our view, the scope for profitable gaming is more limited a) the higher the volume auctioned, b) the lower the volume the vertically integrated Big 6 are allowed to buy and c) the more restricted the bid-offer spread which can be obtained.

Ofgem is currently only focusing on the volume auctioned and the volume the vertically integrated Big 6 are allowed to buy through the auction. We are concerned that this approach will lead to the requirement for detailed behavioural regulation, with a significant risk of unintended consequences, increasing the need in turn for yet further regulatory intervention. This [detailed] intervention approach will also increase the regulatory and commercial risks and limitations for new market participants looking for innovative market entry strategies and contracting and trading solutions.

Our preference would be for the introduction of choice markets instead of buy-side restrictions. Limiting the bid-offer spread available to obligated parties to (very close to) zero directly takes away any potential for profitable (individual) price manipulation and ensures that the auctions result in effective price signals. Since choice markets also take away the need to regulate the buy-side volumetrically, this proposal deals with the problem as to what would happen under Ofgem's proposals if there is simply not enough demand for product, but the proposed buy-side rules prevent the market from clearing.

Whether there is scope for collective tacit collusion on a choice market with only six (large) sellers is a function of the transparency of the market arrangements and the effectiveness of market governance. Hence we favour auctions on a single platform for all the auctioned volumes to enhance liquidity and transparency. There should be extensive information publication requirements for that platform as well as governance arrangements which, after appropriate consultation, leave very little room for market participants or forums to impact the fundamental design choices.

CHAPTER: Five

Question 10: Do you consider that there are benefits and risks to the approaches that we have not identified?

Response: Please see our key observations and answers to questions 6, 7, 8, 9

Question 11: Which approach do you consider is best placed to deliver our objectives at least in terms of cost and risk?

Response: Please see our key observations and answers to questions 4, 6, 7, 8, 9

Question 12: Do you consider that both approaches are able to meet our objectives?

Response: Please see our key observations and answers to questions 4, 8