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Camilla Egginton
GB Markets
Ofgem
9 Millbank
London
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Dear Camilla,

Retail Market Review: Intervention to enhance liquidity in the GB power market.

ESBI welcomes the opportunity to respond to Ofgem's consultation on its proposal to introduce a Mandatory Auction to the GB market, to improve wholesale market liquidity. As an independent owner and operator of GB generation assets, we are acutely aware of the negative impacts that the current lack of liquidity brings. Whilst there has been some improvement in levels of liquidity in the prompt markets, there has been no change in the lack of liquidity along the forward curve. We therefore welcome Ofgem's move to improve liquidity but believe there remains significant further development that must be done before a full appraisal of the proposals is possible.

This response provides a brief overview of ESBI, followed by a summary of our views on the general issues raised in Ofgem's consultation. We then provide responses to the specific questions within the consultation.

ESB International

ESB International (ESBI) brings together our worldwide generation, engineering and related services businesses.

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

ESBI Investments is a trading name of ESB International Investments Limited.

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station and developed the 850MW plant at Marchwood, which was commissioned late in 2009. We are also at an advanced stage with our latest 860MW development at Carrington which is intended 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 projects at other locations across GB, in particular our early-stage 1500MW project at Knottingley, West Yorkshire.

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, comprising of: the 24MW West Durham Wind Farm in Northern England; the 20MW Hunters Hill; and 15MW Crockagarron projects in Northern Ireland. Additionally, we recently completed commissioning of England's largest onshore wind farm, at 66MW, at Fullabrook in Devon and we have started construction of our 38MW Mynydd y Betws Wind Farm in South Wales. We are also active in the ocean energy sector.

With increases in physical interconnection, in particular the commissioning of the East-West interconnector later this year, coupled with the further development of the regional market, our operations in Ireland will become increasingly linked with the GB market.

Summary of views

ESBI continues to believe that an open and competitive retail market must be underpinned by a competitive, liquid wholesale market that supports the participation of independent generation and the diversity it provides. We remain concerned that Ofgem's focus is on providing regulatory intervention to primarily encourage and support new entrant supply companies to the retail market. We strongly believe that a more competitive generation market, with improved price discovery, can deliver significant benefits for consumers and should therefore be treated as an equal priority to stimulating greater retail competition.

We note that there have been recent developments in liquidity in some areas of the market; however, we remain firmly of the view that current levels of liquidity are insufficient to support the effective participation of independent generators and suppliers in the wholesale market. Whilst we welcome recent announcements by a number of the large integrated companies on supplementing liquidity in the prompt and day-ahead markets, we would argue that this is providing additional liquidity in markets that already

have reasonable levels of liquidity. We note that there has been no discernable improvement in liquidity further along the delivery curve as a result of this greater prompt liquidity. We therefore support Ofgem's view that a mandated regulatory intervention is required, particularly to provide a stimulus for this longer term liquidity.

Mandatory Auction

Of the proposed interventions, we cautiously agree that a Mandatory Auction (MA) could deliver greater benefits than the alternatives proposed in previous consultations. However, there remains a significant amount of detail that must be developed before we are able to fully appraise whether the MA is the most appropriate mechanism for delivering Ofgem's goals. We would seek for Ofgem to provide further detail on, inter alia:

- The types of products that sit within the mandated volumes
- The form of the auction
- The operation of the buy-side restrictions
- How Ofgem intends to measure/monitor volumes
- How annual mandated volumes will be set

In addition, we have a concern that introducing the MA could drive all liquidity within the market to that platform, therefore removing the flexibility that a liquid bilateral market should provide for market participants. To mitigate this, we would seek that Ofgem ensures that the MA acts as a stimulus for liquidity to organically grow in the bilateral market alongside the MA, rather than replacing it.

A key factor to ensuring a liquid market is encouraging financial institutions to participate, supplementing generation and supply company participation. We strongly believe that financial participants could play a role in bringing additional liquidity, churn and product innovation to the market and that this could help remove some of the barriers currently seen for smaller players to participate in the market. We note that throughout the RMR process, Ofgem has agreed with this assertion but we are concerned that, to date, there appears to have been little engagement with the financial institutions that will be key to bringing greater liquidity to market. We would therefore seek for Ofgem to address this as a priority.

Generation investment and interaction with EMR

The GB energy markets face a period of significant challenges over the coming years. Government, through its Electricity Market Reform (EMR), has proposed a suite of measures to address the challenges of decarbonisation whilst ensuring security of supply, all at a cost that consumers can afford. These measures may help achieve those policy goals but they are predicated on a competitive, liquid wholesale market. The policy measures being introduced through EMR will require robust market-based reference prices. The contracts for difference (CfD) to support low carbon generation and capacity payments to provide security of supply will each require reference prices at different points along the curve, from day-ahead through to (possibly) several seasons in the future. We urge Ofgem to ensure that the MA, if implemented, will deliver the liquidity required to provide robust reference prices that are able to be derived within the challenging timescales required from the EMR process. Uncertainty is creating an investment hiatus at a time when investment should be accelerated and we would seek that Ofgem does not exacerbate this hiatus in delivering its MA proposals.

A considerable amount of cleaner, flexible thermal generation will be required to meet the challenges of increased amounts of intermittent and inflexible generation, as well as replacing plant closures due to environmental legislation. The introduction of a Capacity Market may go some way to delivering an investment signal for such generation but it will only work in conjunction with a market that has liquidity in longer dated products that will provide investment signals, within investment lead times.

As such, we welcome Ofgem's recognition of this issue in proposing to mandate the sale of products out to season+5. However, we require significantly greater detail on the types of products that will make up the proposed auction volumes before we are able to conclude whether they will stimulate the liquidity to support investment decisions, particularly for independent generation.

Credit

Throughout the RMR process, independent market players have highlighted that one of the foremost barriers to effectively participating in the market are the significant issues associated with credit. We continue to believe that current credit arrangements act as a barrier for smaller market participants and exacerbate the lack of liquidity. The provision of large amounts of credit or collateral support is often prohibitive, or indeed sometimes impossible for smaller parties and limits their participation in the wholesale market.

We have previously stated that Ofgem should consider the issue of credit within the remit of any policy intervention to improve liquidity. Any changes should make credit arrangements more efficient and, where appropriate, less onerous. The MA proposals contain little or no mention of how credit arrangements could be improved and we would strongly urge Ofgem to include this within the scope of its more detailed development of the MA.

Platform

If the MA is to be introduced, our strong preference is that it should be done through a single platform in order to better facilitate efficiency and limit cost for those participating across it. In addition, we would expect Ofgem to adopt a process that delivers this as soon as possible and at least cost to industry. In order to encourage smaller independent players to participate, the charges and credit requirements for using the platform must not be so onerous as to preclude those smaller players from taking part in the auction.

As stated above, a key factor in improving liquidity is that there should be a greater number of financial institutions participating in the market. In order to attract these players and ensure an enduring solution we are of the view that, once introduced, the platform and MA should be as free from regulatory intervention (and resultant uncertainty) as possible in order to establish confidence in its operation and resulting reference prices.

Post-implementation review

The introduction of the MA would constitute a major market intervention and significant change to the current market arrangements. Whilst we would not want Ofgem to introduce undue uncertainty, we strongly believe that such an intervention should be subject to post-implementation review in order to determine the success, or otherwise, in improving liquidity. In its final proposals, Ofgem should therefore include a prescribed process for future assessment of the success of the MA in stimulating liquidity, as well as possible parameters within the auction that could be adjusted to further improve liquidity, if it is deemed necessary.

Responses to specific questions

Below are ESBI's responses to the questions raised in Ofgem's consultation.

Q.1. Do you agree with the objectives we have identified?

In general, yes we agree with the objectives of the intervention, however we remain concerned that Ofgem's focus appears to remain on promoting small suppliers to the market and that there is insufficient consideration of independent generators' requirements for effective access to robust trading of material volumes, in investment timescales.

Q.2. Do you think there are other objectives that we should be considering?

No, we believe the objectives are sufficiently broad.

Q.3. Do you agree with our views on market developments since summer 2011?

Yes, we agree with Ofgem's views. Whilst there has been some improvement in the volumes being traded in the prompt markets, particularly over the N2EX platform, these improvements merely augment an already liquid market. We share Ofgem's concerns that there has been little progress in driving liquidity further along the curve and that spreads remain wide relative to other, more liquid markets.

Q.4. What specific further developments would be necessary to meet our objectives?

In order to better achieve objectives one and two, we would like to see material volumes being traded further along the curve and across a range of products that allow independent generators and suppliers to access the market and adequately hedge their positions. We believe this would organically lead to greater participation from financial institutions, which is critical to achieving a truly liquid market and the meeting of Ofgem's objectives. For smaller participants to access these products, we would welcome Ofgem looking at the trading terms that apply in the current market and to the proposed MA. One-sided or unduly onerous trading terms, in particular around credit and collateral requirements, will likely render any policy or market intervention ineffective in achieving its goals.

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

Yes, we agree.

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

As stated earlier in this response, we cautiously support Ofgem taking forward its MA proposal but are concerned that significant further detail is required on key aspects of the proposals before a proper assessment can be made. We would urge Ofgem to provide this further thinking as soon as possible in order that uncertainty is reduced for industry participants.

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

Of the options presented, it is our view that the MA has fewest issues and is therefore the most appropriate to be taken forward for further development.

Q.8. Do you agree with the key features of the MA as we set out?

The very high-level features that are presented in the consultation appear reasonable. However, there is considerable further development that needs to be done before it can be established whether the MA will, firstly operate as intended and secondly provide the source of liquidity that Ofgem hopes. Below are some of the areas we would welcome that clarity as a priority.

Form of auction

At the highest level, Ofgem has not provided detail on the form of auction that will constitute the MA. Different forms of auction will have very different outcomes and Ofgem should provide further thinking on this area at the earliest opportunity.

Products

In its consultation, Ofgem raises the possibility of changing EFA calendar-based products to standard calendar-based products. We would strongly support such a move, as it would make cross-border trading easier and significantly more efficient, resulting in improvements for market liquidity. We would welcome this change to be made at the earliest opportunity.

Volume

We agree that 25% of generation volume is a reasonable starting point for the MA. We have concerns that the relatively narrow buy-side restriction effectively reduces the amount that could come to market to a much lower level. However, we are content to wait to see if the prescribed volumes, coupled with the buy-side restriction deliver the intended improvements in liquidity.

Ofgem must also provide additional detail on how it will calculate the annual and subsequent monthly volumes that must be auctioned. The ex-ante calculation appears a reasonable starting point but there needs to be consideration how year-on-year output variations should be dealt with. For example, Ofgem may wish to consider using a multi-year rolling average, which may provide a more stable mandatory auction volume.

Q.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?

In order for the MA to work as intended, we agree that buy-side rules are required and it is therefore appropriate that they be put in place. For us to make a proper assessment of the buy-side restrictions, we must know the form that the auction will take. We are of the view that different auction mechanisms would have different outcomes in relation to the buy-side restriction, we would therefore welcome Ofgem's further thinking on the auction mechanism it intends to use.

Q.10. Do you consider there are benefits and risks to the approaches that we have not yet identified?

On the whole, Ofgem has identified most of the risks associated with its two approaches. The only additions we would make would be:

- The risk of delay in delivery, which would undermine the effectiveness of the measure. We believe this could be more likely under approach two but must be a consideration for both approaches.
- That under approach two each obligated party selects a different platform. To access the additional liquidity of the MA, independent players would incur significant cost and inefficiency.

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

In order to avoid the risk of further inefficiency and cost, our preference would be for approach one, using (if possible) an existing platform.

Q.12. Do you consider that both approaches are able to meet our objectives?

We do not believe approach two would meet Ofgem's objectives, primarily due to the difficulties that independent players would encounter, as discussed above.

Conclusion

We welcome Ofgem's continued focus on improving liquidity and cautiously support its proposals to introduce a mandatory auction. However, we urge Ofgem to provide the critical further detail that will underpin these high-level proposals, as it is this detail that will determine the success, or otherwise, of this major market intervention. ESBI looks forward to continuing to participate in the development of Ofgem's proposals.

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

Yours sincerely,

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By e-mail