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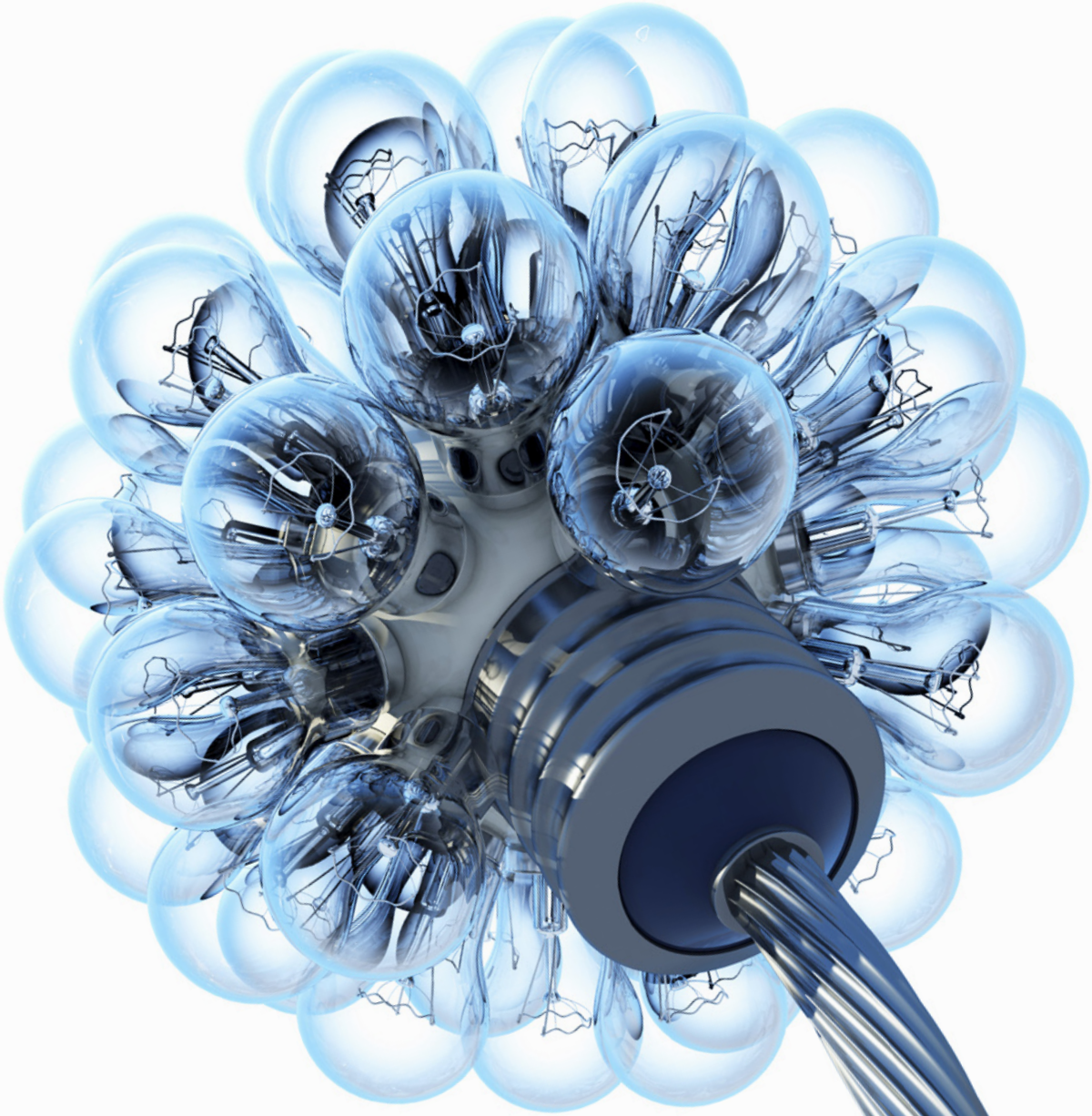

Update on UK Electricity Market Reform – Liquidity Proposals

March 2011

Budget announcement on carbon price support

On the day of production of this brochure, the Government announced in the Budget some further details of the Carbon Price Support component of the Electricity Market Reform proposals. The additional details include figures for the support rates for 2013-14 (and indicative figures for 2014-15 and 2015-16). The Government is targetting a price for carbon (inclusive of the EU ETS) of £30 per tonne in 2020.

Anti-avoidance provisions will be introduced with effect from 23 March 2011 for supplies which will be subject to the carbon price support rates. There is also a proposed change to the treatment of Combined Heat and Power (CHP) to give CHP a reduction on the carbon price support levy (in a way which appears analogous to the proposed treatment of Carbon Capture and Storage), subject to State Aid approval. However it is also proposed to remove from CHP the benefit of Levy Exemption Certificates (LECs) for electricity supplied indirectly to a consumer. The net financial outcome for CHP of the proposed changes will therefore depend on the difference between the reduction in the new levy compared to the loss of the LECs for indirect supplies and what proportion of the CHP electricity supplies are indirect as opposed to direct. Market participants should urgently review existing offtake arrangements relating to CHP plants which apply after 1 April 2013 to determine how these changes are treated for the purposes of any "financial balance" provision which seeks to allocate change in law/tax risk.

Carbon price support rates from 1 April 2013

From 1 April 2013, the 'carbon price support rates' for CCL and, in the case of oils, fuel duty will be equivalent to £4.94 per tonne of carbon dioxide (tCO2). The rates will be:

Supplies of commodity	1 April 2013 to 31 March 2014	Unit
Gas	£0.00091	per kilowatt hour (kWh)
Liquefied petroleum gas (LPG)	£0.01460	per kilogram
Solid fuel (e.g. coal or coke)	£0.01188	per kilogram
Fuel oil	£0.01568	per litre
Gas oil	£0.01365	per litre

Indicative Carbon price support rates from 1 April 2014

Indicative rates for 2014-15 and 2015-16 will be equivalent to £7.28/tCO2 and £9.86/tCO2 respectively. Based upon these carbon prices, the indicative carbon price support rates for future years will be:

Supplies of commodity	Indicative rate for 1 April 2014 to 31 March 2015	Indicative rate for 1 April 2015 to 31 March 2016	Unit
Gas	£0.00134	£0.00181	per kWh
LPG	£0.02150	£0.02912	per kilogram
Solid fuel (e.g. coal or coke)	£0.01749	£0.02369	per kilogram
Fuel oil	£0.02310	£0.03128	per litre
Gas oil	£0.02011	£0.02724	per litre

UK Electricity Market – Liquidity Review

On 21st March 2011, Ofgem published its findings and initial proposals following its Retail Market Review. This document builds upon the findings of its 2008 Energy Supply Probe.

The proposals contained in this document include important implications for the UK Wholesale Electricity Market Review (**EMR**) and this note therefore supplements our earlier note in relation to EMR.

Ofgem has concluded that further action is required to ensure that energy retail markets in Great Britain work in the interests of consumers. There are a number of features that worry Ofgem, including:

– ***Complexity of pricing information***, the preponderance of ***evergreen deals*** and the number of ***sticky customers*** reduces supplier switching.

– ***Concentration*** of regional markets in GB, particularly for electricity, where the former incumbents (i.e. the businesses that previously belonged to the regional electricity companies) still hold strong market shares in their home regions.

– ***Customer segmentation*** permits higher margins to be generated from sticky customers (who may also be the most vulnerable) which when taken together with the market shares of the Big 6 unacceptably raises entry barriers in the energy supply market.

– There is a ***lack of liquidity and transparency in the wholesale markets***, which may protect the advantaged position of the Big 6.

– There is further evidence of competitors pursuing ***similar pricing strategies***.

Ofgem's view is that taken together these features are likely to lead to consumer harm by weakening the intensity of competition among suppliers. Ofgem therefore considers that further action is required and its proposals put out for consultation are to:

– ***Improve tariff comparability*** so that customers can more easily compare prices.

– ***Enhance electricity wholesale market liquidity*** by improving access to wholesale markets for new entrants and independent suppliers and generators.

– ***Strengthen and enforce Probe remedies (domestic and non-domestic)*** to address continued poor performance by relevant companies.

– ***Improve reporting transparency*** to address concerns around the reporting requirements of vertically integrated utilities.

Ofgem's proposals are ambitious and suggest that it is keen to find an industry-wide solution to what it regards as the current deficiencies in the market. However, Ofgem will need to secure the agreement of the Big 6 to its proposals, otherwise it may face the dilemma of having to backtrack or relinquish responsibility for reforming the market by handing the matter over to the Competition Commission.

As regards Ofgem's concerns about customer stickiness and a lack of switching, there are some interesting parallels with the current debate about the perceived lack of competition in retail banking. One of the main issues that has been highlighted by the OFT in that market is that customers do not switch because of the 'hassle factor' and because they do not know how much their current account is costing them, so that it becomes difficult to make comparisons between different banks. Ofgem cites the extensive literature on behavioural economics and uses this to downplay the results from a recent Ipsos MORI poll, which reported that 77% of customers did not switch because they were happy with their current supplier. In Ofgem's view, this statistic masks an underlying issue of widespread lack of customer engagement in switching suppliers.

The question is, however, whether it is the job of regulators (or indeed competition authorities) to second-guess decisions made by rational consumers, in a paternalistic attempt to guide them towards what regulators think is best for them. There is also the point that, if the real market failure is a lack of customer switching, it is not obvious that breaking up the incumbents, through either mandatory divestments or virtual arrangements such as auctions of wholesale power, will necessary solve the problem. This point was made pithily by John Fingleton, the Chief Executive of the OFT, in his recent appearance before the Treasury Select Committee. Asked whether divestments of banks were necessary to ensure more competitive market outcomes, Fingleton responded: "*If you don't tackle the inertia issue and the switching issue, having 10 banks where consumers can't switch doesn't obviously mean it will be more competitive than having five banks where consumers [can't] switch and where you don't have ease of entry.*"

EMR

The DECC EMR consultation closed on 9th March. A White Paper is expected later in 2011 according to the Government's recently published Carbon Plan.

The Government has today announced in the budget a floor price for carbon in the power sector from 1 April 2013 to target a price for carbon of £30 per tonne of carbon dioxide in 2020. The floor will start at around £16 per tonne of carbon dioxide and the carbon price support rates for 2013-14 will be equivalent to £4.94 per tonne – please see discussion of this announcement inside the front cover.

As we said in our note on EMR, the key question for future investment in new generation capacity in the UK is whether the proposed market reforms will produce a regime that is better suited to attracting capital in the amounts necessary to meet the Government's aims of security of supply, decarbonisation and affordability. Among other things, we suggested that the EMR proposals were such that the Big 6 needed to play a pivotal role in delivering this investment in low carbon generation, as architect engineers who develop projects and then recycle construction equity and/or through providing market facing PPAs to hedge some of the risks that seem to be retained by independent generators under the market reform proposals. ***Does the Ofgem consultation therefore help or hinder this?***

Enhancing electricity wholesale market liquidity

Our note on EMR highlighted the importance of liquidity to the effective operation of the proposed market reforms and Ofgem's new proposals in relation to enhancing electricity wholesale market liquidity adopt two of the four possible approaches highlighted in our earlier paper as options under consideration by Ofgem – mandatory auctions of generation and market-making arrangements. Ofgem emphasises that its assessment of the wider wholesale market is ongoing. Attached at Annex 1 is a copy of the summary Ofgem proposals in relation to electricity wholesale market liquidity. Our immediate observations on these proposals are:

Mandatory Auctions

The Big 6 would be required to put up for auction a volume of electricity equal to 10-20% of GB electricity supply.

– Ofgem proposes that the platform for Mandatory Auctions would be selected by competitive tender (including the possibility of a new entrant in addition to the established exchanges). The proposed arrangements would represent a step change in on-exchange market-traded volumes and will presumably be the dominant platform for UK traded power, with implications for other price discovery routes and future market coupling.

– A key question is whether the Ofgem proposal will facilitate the development of appropriate reference prices across the necessary market segments to enable liquid markets in the products to be traded (which are not yet specified).

– We have previously noted that it is key to the CfD (which is DECC's preferred option for implementing the 'Feed-in tariffs' that are intended to be at the heart of EMR) that low carbon generators are able to capture/hedge against the reference price which underpins their CfD. It is not obvious to us that market prices arising from the Mandatory Auction process will be the appropriate reference price for the CfD as the auction process may perhaps be more focussed on a price that would appeal for purchases by an independent supplier (rather than for sales by an independent generator). There is no suggestion that it should be; however if the Mandatory Auction process impedes the development of markets on other exchanges it is unclear how this reference price can be set.

– The development and ambit of the platform or platforms for the Mandatory Auction arrangements are also fundamental to the question of whether the additional liquidity will provide the requisite route to market for independent low carbon generators (thereby avoiding the perceived need for their developments to be supported by PPAs offered by the Big 6). Again, we are not convinced that this will be case unless the Mandatory Auction process, taken together with the Mandatory Market Making obligation gives such independent generators a clear and dependable way to sell their power and manage imbalance risk within acceptable price ranges (including volatility of pricing).

– The Mandatory Auction process is therefore not inconsistent with the EMR proposals but equally is not obviously facilitative (in the sense of curing some of the potential problems with the proposed EMR structure). The focus on price discovery will not support the EMR objectives unless the fruits of the various market reform proposals are coherent and facilitate the ability of independent low carbon generators to access the CfD reference price through the Mandatory Auction platform.

– Ofgem envisages that the auctions will be overseen by an independent trustee who will, in addition to this broad monitoring function, be required to ensure that reserve prices are set at reasonable levels. The Big 6 will be allowed to participate on the buy-side, subject to approval, presumably from Ofgem. It seems that Ofgem are concerned that the auctions could result in tactical bidding behaviour by the Big 6 to prevent independent suppliers from being able to obtain wholesale power at economic prices. This suggests that licence conditions may need to be formulated in a purposive manner so as to reduce the opportunity for such behaviour.

– It seems to us that complicated purposive style rules may also be required in relation to the Mandatory Auctions to take into account timing issues and the characteristics of different types of generation (particularly intermittent generation and interconnector capacity) including allocation amongst the Big 6 and whether the minimum percentage requirement is applied on an asset or group basis. Further rules will presumably also be necessary to take into account "virtual power station" style contracts which can provide companies with quasi-ownership positions, capacity which is contracted into the capacity mechanism to be developed as part of EMR and, depending on their terms, "white-label" energy supply arrangements. The development of these rules will be critical to the success of Ofgem's intervention and EMR.

– The possible requirements for posting collateral in relation to the Mandatory Auction arrangements may be significant impediment to the participation of smaller players.

Mandatory Market Making

The Big 6 would be required to continuously provide bid and offer prices for power, with an aggregate obligation in the order of 20 – 50 MW.

– In relation to the Mandatory Market Making obligation we note that Ofgem envisages that this is the offering of a bid and offer price (with a capped spread) for a narrow range of widely traded products (eg baseload and peak). The intent is that smaller market participants should be able to obtain such products on an ongoing and transparent basis. The aggregate obligation across the Big 6 is limited to 20-50MW (albeit on a continuous basis). This may offer small independent generators and suppliers a more practical ability to balance their positions pre-gate closure, but clearly the volume limits will constrain its applicability to wider issues of intermittent generation or increased single loss load factor. Credit and collateral arrangements will also need to be understood.

– However the Mandatory Market Making obligation also has important implications for ongoing price transparency in the relevant markets. This will further supplement the forensic accounting proposals in relation to the terms on which the generation and supply businesses of the Big 6 contract for power internally.

Transparency of financial reporting in vertically integrated companies

– The 2008 Supply Probe required separate reporting of financial information for generation and supply activities. However, Ofgem is still concerned that transparency is currently limited by differences in the way individual companies report their wholesale energy costs. It is consulting on a proposal to commission a leading accounting firm to review the transfer pricing and hedge accounting practices of the vertically integrated players.

– The Mandatory Auction of output will be designed to minimise the risk of oligopolistic behaviour; this will not only have a price discovery element (to provide comfort that vertical integration is not acting to the detriment of consumers), but should also exert a downward influence on wholesale prices. Improved transparency of financial reporting can be seen as the complement to the proposed wholesale liquidity interventions, as together they would seem to operate to facilitate the transparent application of market prices to self-supplied power within the Big 6.

The Ofgem proposals do not therefore change the conclusion that the Big 6 are fundamental to the successful development of future low carbon generation assets in the UK. It remains to be seen whether the Ofgem intervention is perceived to contradict the goal of EMR to produce a market where "the economics of low carbon will stack up like nowhere else in the world", at least from the perspective of the Big 6. The irony of all of this is that the consumer may not benefit. Without having determined the level of subsidy which will emerge from EMR, the lack of possible competition for construction equity and market facing PPAs in the future in relation to low carbon generation developments, may mean that any downward pressure on retail prices as a result of Ofgem's intervention is offset by the socialisation (presumably to the consumer and not the general tax base) of the subsidy element contained in the fixed leg payment under the CfD.

The Ofgem proposals are open for consultation until 1 June 2011.

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ANNEX 1: *Quick reference guide to Mandatory Auction and Mandatory Market Making proposals*

Mandatory Auction (MA) design features

DESIGN ASPECT	PROPOSAL
Volumes	Require Big 6 to collectively provide a prescribed volume of electricity into each auction round. Collective annual volume obligation to be either: 10 per cent; 15 per cent; or 20 per cent; of total electricity supplied in GB over a given year.
Products	Require Big 6 to collectively offer a range of products into each auction round. These would include: Near term products; Products for delivery further out; Baseload products; Peak products; Potentially a smaller number of shaped products (eg standard domestic load profile) Small clip sizes would be supported.
Frequency	Monthly auction rounds, with guaranteed availability of prescribed products and volumes in each round.
Governance	Independent trustee to be appointed to ensure that the MA is run in accordance with Ofgem's desired objectives. Auction rules to be set out clearly and transparently.
Reserve Price	Mandatory sellers to be allowed to set reserve prices for the mandated products, provided reserve prices are not set at levels which frustrate the objectives of the auction. Role for independent trustee in securing reasonable reserve prices.
Participation	Big 6 mandated to sell. Other participants may sell into the MA, subject to approval. All market participants, including Big 6, may participate on the buy side, subject to approval.
Platform	To be selected by competitive tender, or established by parties in accordance with Ofgem's objectives. Accessibility to all participants must be fair and reasonable.
Trading arrangements	Ofgem wishes to see fair and reasonable trading arrangements (including those regarding credit and collateral arrangements) that do not frustrate the objectives of the MA.

Mandatory Market Making (MMM) design features

DESIGN ASPECT	PROPOSAL
Volumes	Require each of the Big 6 to provide a bid and offer price for a small volume of power, across a narrow range of frequently traded products. Ofgem believes the collective market making obligation on the Big Six should be in the order of 20-50MW in total. These volumes should be available for the market to buy and sell on a continuous basis.
Products	Require Big 6 to submit a bid and offer price for a narrow range of widely traded products (eg baseload and peak). These products should be available for the market to buy and sell on a continuous basis. Small clip sizes would be supported.
Frequency	Continuous market making by Big 6 required.
Bid Offer Spreads	Big Six will be permitted a maximum bid offer spread for the prescribed products, to ensure that the objectives of MMM are not frustrated. The maximum permissible bid offer spread should be reasonable and broadly reflect the spreads observed elsewhere in the wholesale market. This could be relaxed under volatile market conditions.
Participation	Big 6 mandated to post bid and offer prices. All eligible market participants, including Big 6, may participate on the buy side, subject to approval.
Platform	Ofgem would support, and may require, the Big 6 to post their continuous bids and offers on a common platform, to increase transparency and accessibility to market participants.
Trading arrangements	Ofgem wishes to see fair and reasonable accessibility and trading arrangements that do not frustrate the objectives of the MMM.

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