Consumer Focus response to ERGEG/CEER call for evidence on generation adequacy treatment in electricity

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About Consumer Focus

Consumer Focus is the independent champion for consumers across England, Wales, Scotland, and (for postal consumers) in Northern Ireland. We operate across the whole of the economy, persuading businesses and public services to put consumers at the heart of what they do.

Consumer Focus was formed on 1 October 2008 through the merger of three organisations – energywatch, Postwatch and the National Consumer Council (including the Scottish and Welsh Consumer Councils). We are a statutory organisation that works in a devolved setting, with work priorities varying across different parts of the country, by all working to common strategic goals.

Through campaigning, advocacy and research, we champion consumers' interests in private and public sectors by working to secure fairer markets, greater value for money, and improved customer service. We have a particular focus on the interests of consumers in markets that are 'designated' by Government as requiring additional consumer advocacy. Currently these include energy and postal service consumers.

Consumer Focus also has a commitment to work on behalf of vulnerable and disadvantaged consumers, and a duty to work on issues of sustainable development.

Our Response

What are the key elements for ensuring generation adequacy in the competitive electricity market in EU member states and the EU as a whole?

We agree with you over the broad points that the EU would benefit from common targets and market arrangements to facilitate generation adequacy and, more broadly, an electricity market that works in consumers' best interests. Indeed it is hard to argue in favour of the opposite.

However it is not necessarily the case that national measures will actively hinder the development of the internal market in the way that the consultation asserts. Member states can act as exemplars to others and facilitate a 'competition for ideas' that benefits the understanding and effectiveness of all national regulators. There is a risk that seeking absolute consistency across the regions may hamper, rather than help, consumer interests. Different Member States face different challenges; in the nature and scale of the renewable generation that they can support; in the age, efficiency and fuel mix of existing generation assets; and the characteristics of the existing network assets that these connect to. In addition market forces will, by definition, direct resources in ways that might hinder any such pan-EU generation strategy. ERGEG should be flexible in its approach and we prefer that the cost-effective aspect of the relevant EU directive is prioritised over concerns of co-ordination.

This is especially the case in markets where a combination of recession and energy efficiency has induced high levels of demand destruction. In that sense generation adequacy is a dynamic process that ERGEG and others can afford to be more optimistic about than they are at present; in particular we believe that there is no question of a shortage of gas situation occurring in the short- or medium-term; rather the EU will enjoy the price and supply benefits of a gas glut.

It might also be useful for stakeholders to have a better idea of what is meant by an "effective internal electricity market across Europe". This is not clear from the consultation or other documents and as such leads to a fair degree of uncertainty which in turn affects investment in generation.

Do you observe any barriers for investing in new generation capacity? If yes, please list and explain them.

High levels of **liquidity** are crucial for ensuring generation adequacy and the promotion of liquidity, through removing market arrangements that hinder it, is the correct policy response for wholesale electricity markets across the EU and elsewhere in the world as well. This is because low liquidity results in an environment where generators' investment plans cannot be confidently predicted and so generation adequacy suffers as the investment does not take place at all.

At most a closed shop of existing vertically-integrated energy companies undertake investment and consumers' interests are not fully served.

Consumer Focus has grave concerns that the wholesale electricity market in the UK, the most advanced EU state in liberalisation-terms, is far too illiquid. The core of the problem as we see it is that the large vertically integrated companies undertake very little trading in the Over The Counter (OTC) intermediated market or on an exchange (especially of long-term contracts, the contracts which because of hedging strategies ultimately determine retail prices for consumers), preferring instead to trade off-market via bilateral contracts. This hinders the development of price discovery and thus creates a cycle of low liquidity and resultant higher retail prices for consumers.

Low liquidity might not mean no generation investment; rather, it is only a liquid wholesale power market that will help provide the necessary investment price signals to *all* market participants rather than a 'closed shop' of dominant market players. This is better for competition in generation capacity and thus keeping costs to consumers down to a minimum. In the long term it also ensures that the "animal spirits" of market economics lead to a more competitive market in energy supply as non-incumbent firms are emboldened.

For example, in GB a low level of liquidity presents a very significant barrier to entry to smaller would-be suppliers as financial penalties are high if they fail to accurately predict supply at gate closure. In addition they face higher prices than would be the case in a market with proper price discovery due to increased trading; this impact is worthy of further, pan-EU, consideration.

The consultation document quite reasonably highlights that 'when a regulated price level is lower than the actual costs of generation (i.e. subsidised by some other parts of the market) the investment climate might be inappropriate'. We would broaden this observation – it also applies to markets with unregulated prices. In GB, over 70% of generation, and over 99% of retail supply, is met by the same six firms (the aforementioned 'vertical integration' by 'the big 6'). While these firms show consistent profitability in the GB market, it appears that their profit centres periodically flip (i.e. sometimes they run sustained losses on upstream production while being profitable in retail supply – and vice versa). These groups are managed to maximise overall shareholder value, and losses on one side of the market can be sustained where the other side of the market is highly profitable. But not all generators are part of vertically integrated groups. Vertical integration may therefore mean that there are circumstances where, even though prices are not regulated, generation investments look unfavourable – because the upstream sector may be loss-making. We would encourage those Member States who are in the process of liberalising their markets to learn from the GB experience – competition can bring consumer benefits, but excessive vertical integration may dilute investment signals and crowd out smaller, independent, players.

Furthermore, in GB several market generators are of the view that increased investment in thermal plant is not justified by the wholesale price signals that they (and others) can see, however the "big 6" vertically integrated firms are building and have lots planned. Hence generators, and Consumer

Focus, naturally pose the question of what do the "big 6" 'see' which others do not?

However we would not recommend, necessarily, mandating the level of generation capacity centrally or prescribing the generation mix. This could lead to accusations of "picking winners" which might not, ultimately, be in consumers' interests. Again this is a temptation which ERGEG must resist if the competitive market is to maximise consumers' welfare.

The effects of interconnection should be considered in any policy on generation adequacy. Interconnectors provide a means to inject liquidity in to wholesale markets and may facilitate for more efficient investment decisions by providing a means to flow energy from Member States with surpluses to those with deficits.

In case of additional measures for ensuring generation adequacy, what would be the key issues to take into account?

We note commonly asserted arguments (such as by Ofgem[1]) around capacity payments as a means to support new investments in Member States that currently have energy-only markets. We think that demand side responses might be beneficial; however household demand response is likely to be limited in the short term. Smart tariffs and automated energy management goods ("smart fridges" and the like) may be able to play a part but those tariffs and products have not yet hit the mass market and will not for several years.

Industrial demand response is more credible in the shorter term. Interruptible contracts are an existing feature in that sector (at least in GB) and major commercial users are likely to be more responsive to price signals than smaller non-commercial users are.

That said, it must be noted that some industrial production facilities will never wish to participate in demand side response because their 'batch' or 'continuous' nature means they cannot be safely and/or economically shut down in the middle of a production run.

Generation investment will also be greatly influenced by the current characteristics, and future development, of the transmission and distribution networks – and by the structure of charges that they apply to their users. Experience in GB suggests that areas with the greatest potential for renewable generation may be in areas where existing network assets are limited and that this has implications for system operation (for example, in the form of increased operational costs to manage constraints and intermittency). Each of the economic agents (the generator, the System Operator, the Transmission or Distribution Owner and so forth) will only see part of the overall cost/benefit picture – so it will be important for policy makers like ERGEG to develop coherent market arrangements that incentivise the best overall outcome for consumers. Although amendment to these arrangements will invariably be needed to reflect, and improve, on experience, regulators and ministries should try to avoid constant tinkering with market design as this may hinder rather than help consumer interests (for example, by discouraging investment or increasing the price of risk).

[1] In the context of its 'Project Discovery', looking at medium term security of supply.

ERGEG and others need to be careful that they do not incentivise inappropriate and expensive “solutions” to generation-related problems that do not exist. For example gas storage facilities will be constructed if the market needs deems them necessary and given that consumers will ultimately pay for such (expensive) endeavours the rhetoric of industry lobbyists on security of supply issues needs to be assessed dispassionately. Increased interconnection and the construction of LNG terminals is a more useful response.

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