

14th April 2015

Comments on the CMA Energy Market Investigation – Updated Issues Statement

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Summary

1. We, the EPG, are very pleased that the CMA investigation is taking place because it has encouraged a much wider debate about the future of the GB energy system. Whilst, in fact, the EPG does not agree with most of what the CMA appears to have concluded so far, the process has been very beneficial, particularly with the uploading of the various working papers.
2. We are particularly pleased that the CMA has widened its investigation to 5 Theories of Harm (ToH), with the new and fifth ToH focusing on the broader regulatory framework.
3. We recognise that the CMA has to work to a particular remit set out in its Terms of Reference (ToR). So far, in our view, the CMA's interpretation of their ToR is through a too narrow economic lens which will not allow them to fully explore the underlying issues of competition at work in the current GB energy system. We hope that the combination of a 5th ToH and a broader interpretation of the ToR will enable this to happen in the next stage of their investigation.
4. The EPG argued in our original submission that the energy system is an interconnected, whole system and that it is important that the CMA considers the impact of four or five issues together rather than each issue individually, as their ToR seems to allow. By focusing, so far, on the latter, they miss the greater and more important impact on competition of the sum of the issues.
5. Overall, the document is still too focused on short term price issues. We appreciate that the CMA is constrained by its remit, but it needs to look at price and affordability issues in the context of delivering the Government's climate change and security goals in the long term. Not doing so risks trying to provide short term fixes to a problem which is inherently long term.

Introduction

6. The Energy Policy Group (EPG) input a [submission](#) to the CMA's Statement of Issues. We then gave oral evidence, the [summary](#) of which is now up on the CMA's website. We welcome the opportunity to comment on the [Updated Issues](#) paper. The [Terms of Reference](#) to the CMA Investigation sets out the problem the CMA is addressing: that 'the gas and electricity markets authority has reasonable grounds for suspecting that a feature or a combination of features of the market or markets for the supply and acquisition of energy in GB prevents, restricts or distorts competition'. And the CMA is investigating 'whether one or more issues give rise to an adverse effect on competition in the markets for the supply or acquisition of electricity and gas in GB' (para 2).
7. We sincerely apologise for missing the formal deadline for comments, and we are very grateful that the CMA is prepared to accept a late submission. Because of the time constraint, we are unable to submit detailed arguments in support of our views in this document. On the whole, our views disagree with many of the arguments that the CMA has put forward in the Updated Issues paper. We will, however, place our detailed arguments on our website (www.exeter.ac.uk/igov) and send them to the CMA when written. We do hope the CMA will have the opportunity to consider them.

CMA Findings in the Updated Issue Document

8. The CMA has published its Updated Issues Document so that the industry can understand what issues it considers are important in relation to its investigation. This document is extremely helpful and its intention is to make the investigation transparent in its findings, again very welcome. Therefore any initial findings it has published in the Updated Issues document may alter in future documents and the EPG recognises this.
9. The CMA's findings, so far and with apologies for brevity and any possible misrepresentation, are that there are minimal problems from market rule changes since NETA in 2001, which includes the move to a bilateral market (para 41); that the design of the new capacity market implemented in 2014 is broadly competitive (para 55); that there are relatively strong arguments for replacing ROCs with CfDs (para 58); that there is no evidence that the Big 6 earned excessive profits from their generation businesses or that market prices have been above a competitive level (para 72) or that firms have the ability to increase profits through co-ordinated market power (para 74); that there is no evidence of insufficient liquidity in the gas market and that liquidity is sufficient for new entrants (para 78); the CMA do not think there are significant problems with regard to transparency (para 95); and liquidity does not seem to be distorting competition or acting as a barrier to entry (para 100); and vertically integrated firms do not have the ability to foreclose generators (para 103/107) and therefore there is no real problem of VI. Overall, therefore, much of the GB energy system is in good competitive shape. It is some of these findings that the EPG finds too sanguine. We will send further detailed arguments to support our views later. One important aspect of this, as we discuss below, is the importance of understanding the impact on competition of the sum of the issues, rather than the individual impact alone.
10. The CMA does have a few concerns in a few areas, which they are keen to understand further, and these are discussed in the section below in a bit more detail. In brief, there are concerns at possible

overpayment for generators from EBSCR along with the CM payments (para 45), the impact of the CM rules on DSR (para 55); the absence of locational pricing (para 47); a lack of competition in the non-competitive CfD allocation process for renewables (no mention of nuclear) and the three pots of CfD money for renewables; and issues to do with Codes and their process which may undermine competition (para 201).

11. However, the key CMA concerns so far relate to weak competition pressure on the standard variable tariff (SVT) customers, in other words that competition may not be working effectively in certain segments of the GB retail energy markets. The CMA have three hypotheses why this may be (para 132 and following section): inactive customers (and the CMA wish to understand more about this), supplier behaviour (although the CMA does not see undue herd like behaviour by the Big 6 (para 153); and regulatory interventions (ie RMR, social and environmental policies; settlement and reconciliation etc).
12. Thus, what we end up with from the CMAs Updated Issues paper is a series of non-problems of competition; some problems related to the lack of competition where the answer is more competition; and then the biggest issue overall that of explaining why customers don't switch and why supply profits have continued to rise faster than input prices – and the initial findings seems to be insufficient competition or too much regulatory intervention, thereby making competition difficult.
13. The focus of the CMA investigation is discussed further below. However, the Updated Issues paper is very well written and the CMA is to be commended that it does set out so clearly what its initial findings are – whether issues which are probably not a problem, may be a problem, and probably are a problem.

CMA concerns which warrant further investigation

14. As said above, the CMA does have a few minimal concerns in a few areas, which they are keen to understand further.
15. One concern was the proposed changes to cash-out prices (para 45). The Updated Issues paper was published before the final Ofgem [decision](#). A great deal of discussion, much of it very [negative](#), has occurred since Ofgem's publication which the CMA will want to examine.
16. Another concern of the CMA was that there are clear arguments in principle for [locational pricing](#) for constraints and losses (para 47), and these are not as sharp as they could be within the current energy system. We would hope that the CMA examines the history of locational pricing policy in GB, so that they take a consensual, rather than a strict economic, view of their pro's and con's. Locational pricing of the transmission network has been a problematic policy area for at least 10 years, and a decision was recently [agreed](#) by Ofgem. The EPG had a small part in Ofgem's Project Transmit, reviewing [three](#) academic inputs and inputting our own [viewpoint](#).
17. The Exeter EPG concluded that the academic teams had not given sufficient attention to the possible impacts of locational pricing on investment in renewable generation. While the EPG supported in principle the idea of locational signals, either via transmission charges or energy prices, due consideration needed to be given to the particular constraints faced by intermittent renewable generators. The need to access renewable resource and stringent planning considerations requires

intermittent, such as wind generators, to locate in specific areas which are often not well-served by the electricity grid and potentially subject to high locational prices. In addition, the EPG pointed out that the delivery of the UK's renewable targets would be made more expensive if high locational prices closed down otherwise economically viable on-shore wind options that then needed to be replaced by more expensive off-shore capacity. We suggested a holistic approach to transmission charging that aimed to reduce the overall costs of delivering the UK's renewable obligations, rather than focusing narrowly on transmission costs alone.

18. We would hope that the CMA takes note of this long history. By supporting the pure competitive arguments of locational pricing as opposed to a more pragmatic discussion of the overall economy of transforming an energy system, the CMA may open up the 'old' debate yet again.
19. Similarly, the CMA is worried that the 3 pots of money within the CfDs (Para 59) for renewables – 'runs the risk that projects from one pot may be displaced by more expensive projects from another'. As the CMA recognise (para 61), innovation is an important issue, and creating space for supporting less developed technologies is important if those technologies are going to develop. While we have concerns about various aspects of the CfD process (limited budgets, high upfront costs etc), the fact that there is a recognition from Government that there should be space for encouraging newer, riskier technologies is something we support. The CMA concerns are focusing too much on short term price over long term strategic development of technologies and the system.
20. Furthermore, and again, lessons should be learnt from history. The RO which began as a non-banded technology support programme (ie one big pot of money was established against strong opposition which argued that it would simply support the cheapest technology and large companies with access to cheap funds, thereby leading to an industry made up of large companies without connection to individuals or local authorities). Everything that was argued would happen (and which was ignored at the time), did happen. The RO¹ suffered 17 or so changes to try, including by introducing technology bands (or different pots of money), to make it a workable policy, before a small scale FIT was implemented at the end of the 2000s. Technology specific pots of money is therefore a vital requirement of any renewable energy policy. There is a big economic body of literature which argues against this but the IPCC Special Report on Renewable Energy and Climate Change showed that investment for uncompetitive technologies only occurs when there is a specific support mechanism; additional R&D or non-specific carbon taxes is insufficient (SRREN, 2011; IPCC AR5, 2014). The CMA says it will think further about this issue and we hope that they will take note of the detailed discussion that has already taken place on this issue.
21. The CMA has expressed concerns about the non-competitive alternative CfD process that was used for offshore wind in 2014 (paras 60 and 64) because prices were set administratively (and have been criticised by the NAO). If the CMA is going to object to this, then it should also object to the administrative price setting for nuclear power too, particularly since the nuclear power contracts are for 35 years, as opposed to the 15 years for renewables. Currently, the CMA document makes no mention of this.

¹ Woodman B, Mitchell C (2011). Learning from experience? the development of the Renewables Obligation in England and Wales 2002-2010. *Energy Policy*, 39(7), 3914-3921.

22. We welcome the CMA looking in more detail at the CM agreements for DSR (para 55) (for example, the unequal contract lengths between supply generators (15 years) and DSR (1 year). DSR should at least be treated equally with generation, and we would argue, if possible, favoured over it because of its potential to contribute to the broader Government policy aims, possible at lower cost than building new generation. The new cash out rules also has implications for the demand side. We welcome the CMA exploring all areas of the energy system which, through exemption of the demand side, have undermined competitiveness.
23. We welcome further examination by the CMA of the extent to which regulatory intervention adds costs etc and undermines competition. A very preliminary calculation by Matthew Lockwood of comparative breakdown in Danish versus GB retail electricity prices seems to show that GB social and environmental costs are slightly higher per kWh, despite proportionally far fewer renewables etc; network costs are roughly similar; and then GB has far higher wholesale energy, supply costs and margins. What this would seem to show is not that GB has particularly high cost regulatory interventions, more that it is a rather inefficient system relative to Denmark². We urge the CMA to look at practice and costs in other countries.
24. We are very pleased that the CMA has a 5th Theory of Harm. We strongly support the further examination of Codes; the idea of introducing a timescale for decision-making (para 199); whether they favour incumbents; and how their process may undermine competition (para 201). However, the focus, as it is written in the section on the new 5th ToH, is too narrowly on Codes. We would like the CMA to look at the wider regulatory framework, as we suggested in our [submission](#) to the Statement of Interests. This would include licenses, collateral and credit requirements³, why aggregators work in other countries, and not in GB; RIIO etc. Again this all needs to be examined in the broader framework of delivering on climate and security issues in the long term.

EPG Comments on the CMA Interpretation of their Terms of Reference (ToR)

25. The CMA is a body which works to a certain remit and ToR. So far, and with all due respect, it seems that the CMA has assessed competitiveness either academically (eg running a model, as opposed to learning from a real situation or experience (for example, to see whether a centralised versus self-dispatch market is more or less efficient (para 40)); or by individual issues (ie investigating liquidity, transparency, self-dispatch, big 6 market power etc etc).
26. It seems to us, that the CMA has not so far looked at these issues from a whole system perspective (ie from a systemic point of view) and asked: does the sum of these issues add up to barriers to competition – as their [ToR](#) suggests it can. The CMA interpretation of their ToR so far appears to be choosing a narrow focus of competition rather than placing their investigation of competition into the wider context of Government policy – ie moving towards a sustainable, secure and affordable energy system. Within the Updated Documents paper, there is one exception to this (para 61) when the CMA says that it

² Matthew Lockwood, 2015, The Danish system of electricity policy making and regulation, forthcoming IGov website.

³ Cornwall Energy has undertaken a thorough 3 volume examination of collateral and credit issues for DECC in mid 2014, although no rule changes have occurred
https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/348145/Phase_1_volume_1_credit_and_collateral_in_the_GB_energy_markets.pdf

recognises that there are reasons other than support for the cheapest technology (in this case promoting innovation) when choosing a CfD design. In general, however, the CMA has not so far incorporated assessments of the value of desirable or negative spillovers from one area (ie competition) to another (ie sustainability or security of the energy system). One example of this might be, for example, how a centralised dispatch electricity market is widely thought to be more helpful to an energy system with higher proportions of zero marginal cost, variable power (which will make up the majority of electricity in the future) and DSR. Instead the CMA, chooses to highlight a NG study which shows little difference in efficiency of managing a system with either centralised or self-dispatch markets. This is an example where the CMA could learn lessons from experience, rather than from theory and/or models, and include examinations of complementary outcomes for Government policy goals.

27. Competitive, technology and fuel blind rules and incentives, as our energy system is based on, favours large, well established companies which can access corporate finance etc, and this, de facto, supports the conventional system. So far, the CMA is focused on investigating competition within this system in general - which again, de facto, maintains the current system - rather than interpreting their Terms of Reference to either investigate short term competitive decisions within the desired aim of Government policy of moving to a sustainable and secure system or (preferably) investigating the competitive aspects of the transitional needs to a low carbon energy system, which would take account of longer term issues and [new business models](#). We hope that the CMA will rethink its interpretation of its ToR.
28. With this in mind, it is very welcome that the CMA has introduced a new 5th Theory of Harm (ToH, para 192 onwards) which is looking at the broader regulatory framework, including the current system of governance. It is this ToH combined with a broader interpretation of their ToR which could enable the CMA to choose to investigate what the EPG would regard as more complex, socially relevant, competition issues.