

6 July 2009

Michael Tilley
Office of Fair Trading
Fleetbank House
2-6 Salisbury Square
London
EC4Y 8JX

Dear Sir,

Anticipated acquisition by Centrica plc of a 20% stake in Lake Acquisitions Limited (a wholly owned subsidiary of EDFE S.A.)

Consumer Focus was created from energywatch, the National Consumer Council and Postwatch. We will champion the interests of consumers across Great Britain and postal consumers in Northern Ireland.

Consumer Focus has very significant concerns on the anticipated acquisition by Centrica of a 20% stake in British Energy (BE) because of the potentially adverse effects this may have on competition, the operation of wholesale electricity markets and ultimately the retail prices consumers pay. We have detailed our concerns and comments in this letter, but have also provided answers to the direct questions posed by the OFT in an annex at the end of our letter.

Consumer Focus believes that while this consultation exercise is focussed on the Centrica transaction of a 20% stake in BE, considerations of this acquisition should not be carried out in isolation from the general merger of EDF Energy (EDFE) and BE. The two elements of the merger are intrinsically linked. We believe that this deal will have very important implications for the nature and future development of both retail and wholesale energy markets, a view which was echoed by Scottish and Southern Energy's Chief Executive, Ian Marchant who said the deal "required the most detailed scrutiny" by the competition authorities.¹ By allowing both arrangements to proceed this would lead to a reduction in the number of major power generators from seven, which we had until recently, to five.

To this end, Consumer Focus responded to a European Commission consultation exercise on the proposed merger of British Energy and EDFE on 25 November². In our response we detailed our concerns with regard to the potentially negative outcomes for competition, consumers and the wholesale energy market. We concluded that the

¹ http://www.pennenergy.com/index/energy-issues-and-solutions/regulatory-legal/display/362997/s-articles/s-pennenergy/s-energy-products_and/s-regulatory/s-scottish-southern-raises-concern-over-edf-centrica-british-energy-deal.html

² http://www.consumerfocus.org.uk/media/viewfile.aspx?filepath=1_20090622160355_e_@@_RESComm_issionconsultationonEDFandBritishEnergyMergerNovember2008.pdf&filetype=4

merger should not be allowed to proceed without important safeguards for consumers and significant conditions placed on the deal.

We are glad that following concerns raised by stakeholders, the European Commission issued a decision which allowed for a deal to proceed only if conditions, including divestment of generation capacity and placing minimum volumes of power on the GB wholesale market, were undertaken by BE and EDFE. However, we are still awaiting the exact detail of the conditions the European Commission has made, especially in relation to the need to release power onto the wholesale market, and would call on the European Commission and EDFE to announce the exact details of any release programme, including when it will commence.

Overall, we do not believe that the stake sale to Centrica should be allowed to proceed without important safeguards for consumers and significant conditions placed on the deal. These conditions should be specifically focussed on dealing with the potential for reduced liquidity in the wholesale electricity market, thus helping to ensure that consumers are not subject to further harm.

Any deal should also be contingent upon EDFE undertaking the measures set out by the European Commission to mitigate potentially adverse effects to competition, and most importantly, laying out what exactly the details of the proposed wholesale power release programme will be. Until these arrangements have been made clear neither ourselves, nor anyone else, will be in a position to judge what the full impact of this deal will be on consumers and competition. Therefore any deal to allow Centrica to take a 20% stake in British Energy should be delayed until this is completed.

EDFE/BE merger

Following the Commission's approval of the EDFE/BE merger we are pleased to see they have taken notice of some of the concerns that have been raised by stakeholders and have given their approval on condition that measures are undertaken to allay fears of the potential damage to competition and consumers. One of the conditions set out by the Commission, the need to sell minimum volumes of power on to the wholesale market, is of particular importance to the Centrica acquisition. We detail our concerns and recommendation below.

Competition and market concentration

We do not believe the issue of increased market concentration in the UK electricity generation market is the major area of concern with regards to Centrica's planned acquisition, although this may change in future. For this reason it is important that HHI analysis is undertaken to determine changes to market concentration following the potential acquisitions. However, Centrica do not at present have a large share of the electricity generation plant in the UK.

Centrica is one of the largest physical "market makers" in the wholesale electricity market. The concern for consumers centres on the potential for Centrica to withdraw

from purchasing power on the wholesale power market and instead acquire its electricity internally from British Energy. This would represent an extremely significant reduction of liquidity in the wholesale power market.

Wholesale markets and liquidity

The functioning of the GB wholesale and retail energy markets has been the centre of three investigations in the past year by the Business and Enterprise Select Committee *Energy prices, fuel poverty and Ofgem* inquiry issued in July 2008³, Ofgem's *Energy supply probe – Initial findings report* released in early October 2008⁴, with consultations detailing proposed market remedies published subsequently in April 2009, and Ofgem's discussion paper on *Liquidity in the GB wholesale energy markets* published in June 2009⁵.

We commend these three reports for some of the insights they provide into the market and agree with many of the issues they have documented. However, we believe that it is necessary for Ofgem to undertake a full probe into the wholesale forward market to fully identify and rectify the problems stakeholders have observed.

Consumer Focus is concerned that the scale of wholesale trading activity is currently very low and dominated by marginal trades between the Big Six, thus inhibiting independent volumes from accessing the market. We are already very concerned that as matters stand the integrated suppliers base their consumer charges on marginal generation prices produced in these thin markets, reflecting these in inflated transfer prices. They then pocket the savings they make against them as upstream profits. For this reason we are very supportive of Ofgem's suggested proposals to improve market transparency by forcing vertically integrated companies to produce separate regulatory accounts. This should provide more transparency to consumers about the prices for energy they currently pay and create a more contestable market.

We are currently in the process of responding to Ofgem's investigation into liquidity in the wholesale markets and would recommend that the OFT pay special attention to the outcomes which flow from this exercise as it will be likely to have important implications for the proposed acquisition by Centrica.

As we have indicated above our main concern with Centrica acquiring a 20% stake in BE is the impact that this could have on the level of liquidity in the electricity wholesale market. At present Centrica has little electricity generation capacity and as a result is short of power to meet its customers' needs. This means that Centrica trades to a larger extent than its rivals on the wholesale market. By purchasing a stake in BE Centrica would then be in a position to acquire its power supplies internally, rather than on the wholesale market.

³ <http://www.publications.parliament.uk/pa/cm200708/cmselect/cmberr/293/293i.pdf>

⁴ <http://www.ofgem.gov.uk/Markets/RetMkts/ensuppro/Documents/1/Energy%20Supply%20Probe%20-%20Initial%20Findings%20Report.pdf>

⁵ <http://www.ofgem.gov.uk/Markets/WhlMkts/CompandEff/Documents/1/Liquidity%20in%20the%20GB%20wholesale%20energy%20markets.pdf>

While this would be a positive development for Centrica, we believe this state of affairs would not be in the best interests of Centrica's competitors, potential new entrants and consumers. We fear the outcome of this would be a more volatile and less transparent wholesale power market, which would provide less confidence to consumers that they are paying the most competitive price for their energy. Furthermore, it would deter would-be new entrants in the longer term, damaging the prospects of the development of a competitive fringe and thus leading to sub optimal outcomes for end users.

The recent exits from the small business electricity supply market of Bizz Energy and Electricity4Business are cases which underline that real damage to competitive markets is being caused by complex and volatile wholesale market regimes. These are controlled by the large players and are essentially foreclosed to smaller players. Against this background, the diminished scope for independent players to find natural counterparties will inevitably inhibit new entry and constrain the ability of existing independents to grow.

By refraining from trading in the power wholesales market, liquidity would fall further in a market which can already be described as an illiquid market. For example, in Ofgem's recent discussion document on liquidity in the GB wholesale markets, the regulator has concluded that "we [Ofgem] find that liquidity in the GB wholesale electricity market is low compared to that in many other European electricity markets, the GB gas market and other commodity markets"⁶. With a significant player exiting the wholesale power market an already illiquid market would see even fewer trades which would make the remedies that Ofgem are considering at present less likely to be effective.

Additionally, we are further concerned about the joint press release issued by EDFE and Centrica in which they claim to have agreed a deal in which "EDFE will provide Centrica with an additional 18TWh of power at market prices over five years from 2011"⁷. This key term of the proposed transaction validates our concerns that Centrica will source its power suppliers internally and withdraw to a large extent from the wholesale power market.

Our recommendation

To mitigate this probable scenario Consumer Focus believes that an extension to one of the European Commission's conditions placed upon the merger of EDFE and BE would be beneficial. The condition placed upon EDFE and BE to sell a minimum level of power volumes in the wholesale power market would allay fears that an already illiquid market would feature even fewer trades.

While we acknowledge that Ofgem is currently collecting evidence and stakeholder responses to the question of low trading activity in the wholesale market we believe

⁶ <http://www.ofgem.gov.uk/Markets/WhlMkts/CompandEff/Documents/1/Liquidity%20in%20the%20GB%20wholesale%20energy%20markets.pdf> p.4

⁷ <http://www.centrica.co.uk/index.asp?pageid=39&newsid=1783>

that if Centrica's acquisition is to be allowed to proceed it is necessary for a minimum level of power to be released on the wholesale market. While this on its own would not be sufficient to solve the problem of low liquidity in the wholesale market (indeed there is a case to review the potential extension of a power release scheme to other market participants), such a measure is necessary in the case of the Centrica, BE and EDFE deal.

Consumer Focus would however acknowledge that any measures to enable this must be thoroughly tested to ensure the possibility of secondary trades and that such a measure can be properly enforced. Whilst we recognise that it will often be the case that Centrica will purchase their power effectively from themselves on the wholesale market rather than internally, this state of affairs will still allow for more trades on the wholesale market, improving liquidity in the market. This should provide for a more transparent and less volatile power market which will benefit consumers, new entrants and competition in the long run.

Finally, it is important to define the volumes of power that should be released on to the wholesale market and what shape and length of contract should be made available. It is Consumer Focus's opinion that a large amount, in the region of 50% of power produced, should be made available for purchase on the Over-the-Counter (OTC) wholesale power market. Furthermore, a significant proportion should be made available as longer term long-dated contracts, up to three years in advance in terms of duration, in effect making power available on the forward rather than the prompt and spot market. Only by providing significant amounts of power on the forwards market will concerns about illiquidity on the far curve be rectified. Similarly clarification should be provided to what volume and length of contract will be provided by an EDFE-owned BE as demanded by the European Commission. Until the European Commission and EDFE make fully clarify these conditions, the Centrica acquisition should not be allowed to proceed.

Conclusion

Consumer Focus believes that to mitigate the concerns we and others have about a potential reduction in the liquidity of the wholesale power market following a Centrica/BE transaction, a minimum level of power generated by an EDFE and Centrica owned BE should be made available on the OTC forward power market before any transaction should be allowed to take place.

We also believe that any transaction should be allowed only on the condition that the provisions demanded by the European Commission to allow the EDFE BE merger to proceed should be implemented effectively. In particular, the condition to sell minimum volumes of electricity on the GB wholesale market must be made available at sufficient quantities on the OTC longer-dated forwards market rather than on the prompt or spot markets. Unless these conditions are made clear and implemented the Centrica acquisition should not be allowed to proceed.

I hope these comments are helpful and should you have any queries or require any clarification, then please contact Cem Suleyman on 0207 799 7932 or at cem.suleyman@consumerfocus.org.uk.

Yours faithfully,



Robert Hammond

Head of Regulated Industries

Annex

1. *Briefly describe your involvement in the UK energy industry (e.g. generator with three CCGT plants of 400, 800 and 1200 MW capacity; retailer with a customer base of 75 per cent commercial, 25 per cent residential; potential entrant looking to enter upstream/downstream gas/electricity with a focus on commercial customers etc).*

Consumer Focus was created from energywatch, the National Consumer Council and Postwatch. We champion the interests of consumers across Great Britain and postal consumers in Northern Ireland, campaigning for a fair deal for consumers. We do this through research, policy, analysis, lobbying and by working with policy makers, providers and others who can make a difference to consumers' lives. We have a special remit to represent the interests of disadvantaged and vulnerable consumers.

2. *If you are involved in the forward trading of electricity, please briefly outline your trading activities. How far into the future do you tend to contract for your major power outputs or requirements? What is your level of participation in the spot market i.e. what is the average size of trades (by volume)? What volume did you trade in the 2008 full year? Please provide a breakdown of this figure by volumes bought and sold.*

N/A.

3. *Will GB wholesale electricity prices be affected by this transaction?*
 - *If yes, which year, season(s) or time(s) of the day do you feel will be (most) affected (in terms of the delivery date of the electricity)? What type of contracts (in terms of the time period from the contract being signed to the date of delivery) will be affected? Please provide as much information as you can regarding how the merger is likely to generate these effects.*
 - *If no, please explain your reasoning in as much detail as you can.*
 - *Does it make a difference how the 'market prices' for the PPA between EDF and Centrica are set?*

Consumer Focus believes that there is a real risk that may wholesale electricity prices may increase as a result of the acquisition of BE by Centrica. This is because there is likely to be a reduction in the level of liquidity in the wholesale electricity market. We explain why we believe this will be the case in the following question.

4. *Do you anticipate the transaction having an effect on the liquidity of the GB wholesale electricity market?*
 - *If yes, which year, season(s) or times of the day do you feel will be (most) affected (in terms of the delivery date of the electricity)? What type of contracts (in terms of the time period from the contract being*

signed to the date of delivery and anticipated volumes) will be affected? If you feel liquidity will be affected, briefly outline what effects how you feel this will have. Please also provide as much information as you can about the mechanics of how any effects are likely to come about (including any anticipated changes to your own trading strategy).

- *If no, please explain your reasoning.*
- *Does it make a difference how the 'market prices' for the PPA between EDF and Centrica are set?*

Consumer Focus is concerned that the scale of wholesale trading activity is currently very low and dominated by marginal trades between the Big Six, thus inhibiting independent volumes from accessing the market. We are already very concerned that as matters stand the integrated suppliers base their consumer charges on marginal generation prices produced in these thin markets, reflecting these in inflated transfer prices. They then pocket the savings they make against them as upstream profits.

In Ofgem's recent discussion document on liquidity in the GB wholesale markets, the regulator has concluded that "we [Ofgem] find that liquidity in the GB wholesale electricity market is low compared to that in many other European electricity markets, the GB gas market and other commodity markets"⁸.

Ofgem's analysis of forward trading in the wholesale power market showed very little trading activity along the forward curve (one year out or further), especially for peak products. Furthermore, these trades are based on churn levels currently at three times underlying physical consumption (churn in the gas market is currently at nine times underlying physical consumption). Additionally, the bid-offer spreads for both peak and baseload products are high, especially when compared with the bid-offer spreads observed for gas contracts⁹.

At present Centrica has little electricity generation capacity and as a result is short of power to meet its customers' needs. This means that Centrica trades to a larger extent than its rivals on the wholesale market. By purchasing a stake in BE Centrica would then be in a position to acquire its power supplies internally, rather than on the wholesale market.

By refraining from trading in the power wholesale market, liquidity would fall further in a market which we have already described as illiquid. With a significant player exiting the wholesale power market an already illiquid market would see even fewer trades.

While this would be a positive development for Centrica, we believe this state of affairs would not be in the best interests of Centrica's competitors, potential new entrants and consumers. We fear the outcome of this would be a more volatile and less transparent wholesale power market, which would provide less confidence to consumers that they are paying the most competitive price for their energy. Furthermore, it would deter

⁸ <http://www.ofgem.gov.uk/Markets/WhlMkts/CompandEff/Documents/Liquidity%20in%20the%20GB%20wholesale%20energy%20markets.pdf> p.4

⁹ Ibid p19-23

would-be new entrants in the longer term, damaging the prospects of the development of a competitive fringe and thus leading to sub optimal outcomes for end users.

5. Do you feel that the transaction will have any effect on competition for participation in new nuclear build projects? Please explain your answer.

Consumer Focus believes there are two separate issues which the OFT should consider before making a decision.

Firstly, there is the issue of competition in the market for nuclear power stations. EDF currently employs AREVA built EPR nuclear power stations. We believe that the OFT should look into the possibility of promoting competition in nuclear vending (for example by allowing possible entry to companies such as Westinghouse).

Secondly, we are concerned that there will be insufficient competition for the nuclear build sites currently owned by BE. The OFT should investigate the possibility of allowing other participants access to these sites as high market concentration in nuclear generation could very likely lead to consumer detriment.