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ExxonMobil
*Gas & Power
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Jonathan Brierley
Director Energy Market Strategy and Futures
Department of Energy and Climate Change
3 Whitehall Place
London
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10 March 2011

Dear Mr Brierley

Consultation on Electricity Market Reform (EMR)

Thank you for the opportunity to comment on the Government's proposal to reform the electricity market to meet the Government's objectives to supply reliable, low-carbon and affordable energy.

This letter forms part of our response and is sent on behalf of a number of ExxonMobil entities active in the United Kingdom. The interests of these entities include the oil refining interests of Esso Petroleum Company, Limited, the oil and gas exploration, production and natural gas processing activities of Mobil North Sea LLC, the oil and gas exploration, production and natural gas processing activities operated by others on behalf of Esso Exploration and Production UK Limited and the chemical manufacturing activities of ExxonMobil Chemical Limited.

Our contribution to the UK economy is significant. We provide direct jobs for over 9,200 employees and contractors. Within the supply chain, over 9,000 companies provide goods and services to those ExxonMobil entities active in the UK. These suppliers benefited from our £3.3 billion UK operating and capital expenditure last year. In total our direct and indirect tax contribution to the UK economy was over £5 billion in 2009, equivalent to approximately 1% of total government tax revenue.

ExxonMobil has a major business presence in the UK. We have invested some £31 billion in the UK offshore oil and gas industry since first exploration in 1984.

- We are the third largest producer in the North Sea.
- We contribute around 25-30% of the physical gas first sold on the GB market.
- Our refinery at Fawley on Southampton Water is the largest in the country.
- We market Esso and Mobil-branded products to around 1 million UK customers a day through a network of nearly 900 service stations.

Below we summarise key points from our review of the documents associated with the EMR consultation. However, we would draw your attention to the first attachment to this letter which is a copy of the response that we have already sent to HM Treasury in relation to their separate (but related) consultation on carbon price support. The further attachment to this response contains comments on consultation questions raised in relation to the other three elements of EMR (FITs, Capacity Mechanism, EPS).

- We agree with the Government's assessment that the current market will unlikely deliver the levels of low carbon investment needed to achieve UK binding environmental targets. However, we also see significant risk in attempting to achieve these targets through the proposed EMR.

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- We believe that the Government's affordability objective may be compromised as consumer costs rise due to loss of liquidity in the wholesale markets (including gas). The multiple interventions represented by the EMR proposals will increase complexity in the sector, provide a significant threat to future wholesale gas market liquidity and are unlikely to solve current concerns about power market liquidity. We see some risk that certain elements of EMR (FITs) could result in even less physical generation being sold into the wholesale power market than is sold currently.
- We see the possibility that Government can substantially increase the rate of low carbon investment through its carbon price support mechanism and this may offer the simplest, most transparent route to restoring investor confidence by ensuring a level playing without which market failure risk increases.
- We support initiatives in Government to reduce overlapping policies and contain the growth of regulations affecting business. Complexity in policy and regulation increases both the difficulty of attracting new market entrants/investors and of retaining those already present.
- We believe investors take a long-term view. It takes many years to develop a major energy project to the point where a financial investment decision can be made. The more policy certainty Government can provide the more likely investment will be. The various support mechanisms of EMR may indeed reduce revenue (price) risk, but we believe the investment community could also see EMR as representing an increase in policy risk. As Government itself notes, technology, grid access, construction, planning or long term availability risks may be the ultimate determinant of the success of any individual project.

For these reasons ExxonMobil continues to argue for the minimum possible level of intervention. We support the Government introducing one of the mechanisms at the outset and considering further changes later if necessary after seeing how the chosen mechanism operates and after all the possible consequences have been fully explored.

Of the four mechanisms reviewed, that of carbon price support is preferred. However, there is one aspect of the carbon price support proposal that is of concern; the removal of the exemption for CHP. With CHP, we produce electricity to power our operations while also capturing heat to make steam to transform raw materials into consumer products. This operation provides a more efficient power source than purchasing from a local utility, in some cases up to 50 per cent more energy efficient. We believe that the policy proposals outlined in the consultation will create the perverse effect that the use of CHP, a clean and efficient power source, will be disincentivized. ExxonMobil would recommend that the Treasury and Department of Energy and Climate Change consider providing an exemption to carbon price support for gas used to generate heat as part of a CHP operation.

We thank you once again for the opportunity to comment on this consultation and would welcome a dialogue on the issues raised in our response as you continue to develop these proposals.

Yours sincerely,



Copied to

Richard Sargeant (DECC)
Robert Pollock (HM Treasury)
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Encl.

DECC Consultation on Electricity Market Reform
ExxonMobil Response

Current Market Arrangements

1. Do you agree with the Government's assessment of the ability of the current market to support the investment in low-carbon generation needed to meet environmental targets?

We agree with the Government's assessment that the current market will unlikely deliver the levels of low carbon investment needed to achieve UK binding environmental targets.

We would question the Government's assessment of how investors make decisions as the consultation appears to suggest that investors are more driven by the short-term rather than taking a long term view and therefore make poor decisions. We believe investors do take a long-term view and that it takes many years to develop a project to the point of a final investment decision. The more certainty government can provide in the regulatory environment, the more robust the investment climate.

We are very concerned about the multiple, complex and overlapping mechanisms proposed in the consultation; investors may consider that a complex or overlapping scheme of rules increases the risk of further changes during the period of the investment. The proposals in the consultation will potentially put the investor in a position of constantly reassessing versus a moving target. Furthermore the proposed measures do not address any of the non-price risks that investors face in relation to technology, construction, planning and public acceptance.

2. Do you agree with the Government's assessment of the future risks to the UK's security of electricity supplies?

We would agree that the risks to UK power security are probably higher in the medium term as European Directives (LCPD, IED) force substantial fossil fuel plant retirements whilst replacement power is intended to be sourced substantially from new low carbon generating technologies.

The uncertainty surrounding the availability and reliability of future low carbon projects also creates risk for those investors considering provision of backup capacity or capacity flexibility.

In its own analysis the Government points to the causes of future investment risk as being those of policy uncertainty on the one hand along with poor price signals in the wholesale power market caused by lack of liquidity and transparency on the other hand. We agree that these are the underlying causes that need to be addressed and believe that they would be better dealt with through an evolutionary approach to changes in market design.

Options for Decarbonisation

Carbon Price Support

This is the subject of a separate HM Treasury / HMRC consultation. Readers of this consultation with specific comments on the carbon price support mechanism should cover these in a separate submission to the HM Treasury / HMRC consultation.

Please refer to our submission to H M Treasury (attached)

Feed-in Tariffs (limited responses only)

3. Do you agree with the Government's assessment of the pros and cons of each of the models of feed-in tariff (FIT)?

A FIT of any prescription introduces additional complexity and overlap in regulations, increases the risk of unintended distortions of the electricity market and presents the opportunity for investor exploitation of the rules and some potential for legal claims from disadvantaged generators. These effects could be avoided if low carbon investment were to be incentivised by the carbon price support mechanism alone.

To the extent that Government may continue to see some form of FIT as a necessary tool, then we would agree that any scheme must be carefully designed to avoid further deterioration in the liquidity of the UK wholesale power market; in our view an important criterion of the design is that FIT beneficiaries are provided with a strong incentive to participate in the wholesale market and to offer despatch flexibility to the maximum extent possible for the benefit of overall system optimisation.

We are concerned that generators who would benefit from a long term CfD FIT will see little incremental value from actively participating in the wholesale market; as the number of generators accepting CfD's grows, price signals formed in the wholesale market will become less reliable and the possibility of market collapse from reducing liquidity increases.

As the Government notes (i) there are design issues with its preferred CfD FIT scheme (ii) transition rules are required to move from the current Renewables Obligation to the FIT scheme and (iii) the applicability or otherwise of European State Aid rules have to be clarified. Investor uncertainty remains as long as these matters remain unresolved.

Of the FIT models presented in the consultation it would seem to us that the Premium FIT model is the simplest and offers least impact on market liquidity whilst the Fixed FIT is not appropriate.

5. What do you see as the advantages and disadvantages of transferring different risks from the generator or the supplier to the Government? In particular, what are the implications of removing the (long-term) electricity price risk from generators under the CfD model?

Unless the Government can be sure that it has access to the same information as potential investors, transferring risk from generators to the Government (and therefore consumers) will lead to stronger returns for investors funded by consumer price increases. Any potential gains to consumers through a lower cost of capital (assuming these are passed on to the consumer at all) could be outweighed by the long-term price set under any FIT model, with a risk that the support level is set too high.

8. What impact do you think the different models of FITs will have on the availability of finance for low-carbon electricity generation investments from both new investors and existing the investor base?

Direct financial help (from consumers) will of course improve the prospects for investments of a certain risk profile; projects that are exposed heavily to technology, construction, planning, operability risks may see much less benefit from a scheme that provides only revenue support.

10. How important do you think greater liquidity in the wholesale market is to the effective operation of the FIT with CfD model? What reference price or index should be used?

Wholesale market liquidity is key to a functioning market, investor confidence, and the effective operation of the CfD FIT. It would seem that the wholesale power market may be characterised by

an ever reducing quantity of physical power first sold on that market. To the extent that there is less physical power first sold into the market and fewer participating generators, there will be less churn and total trade together resulting in less reliable price formation.

We are concerned that the introduction of FITs seems to have precedence over Ofgem's task of re-designing the market for enhanced liquidity. We believe that Ofgem's options for improving market liquidity should be reviewed as an integral part of the EMR activity.

11. Should the FIT be paid on availability or output?

In reviewing the documents to address this question it was not at all clear to us how to interpret "availability" in the context of FITs payment. We can see that investors might prefer to see tariffs paid on the basis of capacity available to generate so that a more continuous revenue stream is available to finance a loan. However we believe that more work is required to define what availability to generate means for intermittent sources. Does it mean that the capacity of a wind farm will be treated as available to generate even when the wind is not blowing?

FITs paid on output would seem preferable as they implicitly include incentives for operational availability and generation efficiency.

Emissions Performance Standards

12. Do you agree with the Government's assessment of the impact of an emission performance standard on the decarbonisation of the electricity sector and on security of supply risk?

As with FITs we are unconvinced that EPS is a necessary or desirable scheme.

Emissions performance standards (EPS) are typically used in those sectors where emissions are otherwise not very responsive to a carbon price signal because of market limitations (e.g. building efficiency). EPS are sometimes also used to drive significant – but not least-cost – emissions reductions in sectors (e.g. in transport through use of biofuels and vehicle efficiency standards).

Current legislation requires new coal and gas fired power to be consented on a Carbon Capture Ready (CCR) basis and together with EU ETS and the proposed UK carbon price support these represent clear and sufficient incentives for carbon emissions reduction.

EPS is not necessary now and could still be considered at a later stage.

14. Do you agree that the EPS should be aimed at new plant, and 'grandfathered' at the point of consent? How should the Government determine the economic life of a power station for the purposes of grandfathering?

EPS is being considered only as a backstop to prevent new fully unabated coal plant should other mechanisms fail in that respect.

If a statutory right to set an EPS were to be included we believe Government should at least allow itself the flexibility to avoid setting of levels until the need or conditions for it become clear. We would agree that should an EPS be introduced it should be aimed at new plant only and not existing plant. Economic life should be determined by competitive market forces.

Options for Market Efficiency and Security of Supply

19. Do you agree with our assessment of the pros and cons of introducing a capacity mechanism?

A well functioning market with as few forced mechanisms as possible would provide certainty for investment without introduction of a capacity mechanism.

In our view, incremental changes to wholesale market design for improved market liquidity and clarity of price signals, together with an otherwise stable and simple policy environment should provide sufficient investor confidence to provide additional flexible capacity at least cost.

Analysis of Packages

26. Do you agree with the Government's preferred package of options (carbon price support, feed-in tariff (CfD or premium), emission performance standard, peak capacity tender)? Why?

The Government has proposed introducing a carbon price floor to drive intended behaviour and should avoid altogether, or at least delay the use of, any of the other mechanisms until the price floor has had time to take effect.

The number, level of overlap and complexity of the EMR proposals presents real risk of unintended consequences not only in the wholesale power market, but also in the wholesale gas market.

In the attached Gas Perspectives document we illustrate how future UK energy markets might appear to gas marketers and external investors. We hope that the Government will be persuaded to consider the possible consequences of its EMR proposals on the wholesale gas market and allow its final decisions on EMR to be informed by that work.

Implementation Issues

30. What do you think are the main implementation risks for the Government's preferred package? Are these risks different for the other packages being considered?

ExxonMobil believes that some of the main implementation risks of the preferred package include:

- The overlapping and complex regulation: the potential this creates for unintended consequences, such as the additional price increases for consumers that may result, including, for example, through potential exploitation of detailed rules.
- The probability of further delays to investment as detailed design issues of FITs and capacity mechanisms are worked through.
- The risk that FITs become a mechanism for picking winners and losers in the market, ending with support for weaker operators or less efficient technologies whilst smart investment is driven out of the market.
- The effects of the package on Ofgem's ability to identify and implement design changes required to improve liquidity in the wholesale power market. Ofgem's work appears disconnected from EMR when an integrated approach would make more sense to us.

31. Do you have views on the role that auctions or tenders can play in setting the price for a feed-in tariff, compared to administratively determined support levels?

We believe that all of the proposed methods of setting FIT support levels, including auctions or tenders, contain significant flaws:

Typically a successful auction relies on multiple competing parties offering/bidding for the same product or service. The auction would in theory identify the most efficient projects although of course there can be no guarantee that auctions will always reveal the most efficient projects and some projects may be unsuccessful for reasons entirely to do with (for example) lack of time to prepare for the auctions or gaming by other participants. In the case of new nuclear we can imagine there might be questions as to whether there is sufficient competition in this sector to justify use of auctions.

This approach also re-introduces much of the long-term price uncertainty that the Government is seeking to remove through the introduction of FITs, as potential investors must commit significant time and resources to participating in an auction round before they can form a long term view of a project's viability. As the Government rightly points out, auctions introduce significant gaming risks, and the NFFO illustrates some of the issues with this approach.

A tender process exposes the Government (and therefore the consumer) to the full asymmetry of information between investors and the Government. Under this scenario, the consumer risks simply paying the lowest bid, regardless of whether all bids were excessively high to start with.

The least problematic option would seem to be that the Government sets support levels based on analysis of the fundamentals of each technology. The obvious risk of this approach is that it requires the Government to have access to a detailed and up to date understanding of a range of key data that is relevant to making accurate assessments of each project's economics.

These are some of the reasons why we believe that a less complex approach would be preferable, with carbon price support introduced as the sole intervention and with higher priority being given to implementing incremental market design changes for improved liquidity and interoperability with continental Europe.

32. What changes do you think would be necessary to the institutional arrangements in the electricity sector to support these market reforms?

We believe that Ofgem's work to find ways of improving liquidity in the wholesale power market should be given greater emphasis and discussed as an integral part of the proposed electricity market reforms rather than in parallel with it. Any reduction in the complexity of current electricity market regulations would help attract new market entrants and investors, as well as reducing the overheads of current players. Relatively simple changes such as aligning the UK electricity market settlement calendar with that of continental Europe would do much to reduce barriers to trade in the UK electricity market and should be a further area of focus.

33. Do you have a view on how market distortion and any other unintended consequences of a FIT or a targeted capacity mechanism can be minimised?

In our view, unintended consequences and market distortions can best be avoided by limiting intervention to introduction of a suitable form of carbon price support, whilst continuing the important work on incremental market design measures aimed at improving wholesale market liquidity and clarity of price signals.

