



Drax Power Station • Selby • North Yorkshire • YO8 8PH • T. +44 (0)1757 618381 • F. +44 (0)1757 618504

FAO Neil Barnes
Office of Gas and Electricity Markets
9 Millbank
London
SW1P 3GE

22nd May 2009

Dear Neil,

Energy Supply Probe – proposed retail market remedies

Drax Power Limited (“Drax”) is the operating subsidiary of Drax Group plc, and the owner and operator of Drax Power Station in North Yorkshire. In March 2009, Drax acquired a small electricity supply business, Haven Power Limited (“Haven”); Haven supplies some 18,000 small and medium sized business customers and provides an alternative route to market for Drax’s power output. We are pleased to have this opportunity to respond to Ofgem’s consultation regarding proposed retail market remedies as a result of the recent Energy Supply Probe. This letter provides a generator’s perspective to the discussion in Section 6 of the consultation, Promoting Market Transparency; a separate response shall be provided by Haven.

Drax particularly welcomes Ofgem’s proposal to improve market transparency by ensuring that the financial information relating to the profits, underlying costs and revenues of the “Big 6” are reported separately for both their supply and generation businesses. Drax agrees that greater transparency regarding the relationship between the supply and generation businesses of the large, vertically integrated companies is both required and overdue.

As we mentioned in our response to the Energy Supply Probe Call for Evidence, in the early years of the privatised electricity sector, vertical integration was recognised by both the regulator and the Government as a potential source of concern and at odds to the rationale for the restructuring of the electricity market. Indeed, policy decisions were taken during this time that prevented the then two major generating companies from owning supply businesses. The ‘anti-vertical integration’ policy was later relaxed following the forced divestment of coal-fired plant owned by the same two generating companies.

However, there continued to be a licence condition that prohibited cross-subsidies between the generation and supply businesses within the vertically integrated company structures. It is our understanding that this licence condition was removed towards the start of the decade, meaning that the incentive for vertically integrated companies to keep their supply and generation businesses wholly separate (i.e. all trading taking place *within the wholesale market*) was removed. This may have led to the increase in use of internalised markets, which in turn has decreased liquidity in the wholesale market. Drax believes that Ofgem made this decision in good faith and would not have envisaged that circa 95% of the supply market would be in the hands of just six vertically integrated companies by the end of the decade. It may be an appropriate time to revisit this decision and consider the reintroduction of a non-cross-subsidy licence condition.

Drax believes that significant market liquidity issues continue to blight the wholesale electricity market. Our observations of the wholesale market have indicated that the vertically integrated companies tend to hedge their supply positions by allocating their own generation to the smaller commercial and domestic customer market. This natural hedge diminishes the need for a vertically integrated company to contract for power in the wholesale market for a large proportion of their position, other than in spot and short-term markets.

Locking out generation and/or supply volume from the contested market decreases liquidity and carries the risk that the true value of generation is never revealed; this leads to distorted market signals and the inefficient operation of the market as a whole, with the cost of such inefficiencies being passed on to the end consumer. Drax believes that a move towards greater transparency of these internalised structures would be a positive step forward for the wholesale market and, ultimately, consumers.

From the options presented in the consultation document, Drax would prefer Option 2 as it would:

1. allow the industry to understand the volume of generation that is:
 - a) transferred / traded internally; and
 - b) placed into the wholesale market;
2. place the information in a single, centralised location (i.e. via Ofgem) rather than across multiple company websites, which would ensure greater accessibility; and
3. help the industry to understand the price signals that are hidden by internalised market structures, such as those signals that:
 - a) encourage vertically integrated businesses to build new generation plant (i.e. the signals that independent generators do not currently see); and
 - b) demonstrate that all suppliers, regardless of whether they are independent or a part of a vertically integrated business, have access to the same *market* prices.

Should companies believe that they are unable to collect the pricing information required by Option 2 (as suggested in paragraph 6.13), they should at the very least be obliged to describe how they determine the prices used for internal trades / transfers and provide figures for the volume and the value of power that (a) remained internalised and (b) was placed into the wholesale market.

Ofgem must recognise that if the industry data to be released was to be aggregated, its usefulness would be severely limited. The aggregation would mean that vertically integrated companies would remain to be the only parties that are able to see the price signals that are hidden by their internalised markets; this is no different to the status quo. Disaggregation of this type of data post event is not normally regarded as sensitive; independent generators, such as Drax, International Power and British Energy (pre-merger), already publish such data.

Furthermore, the ability to view such data would allow industry parties to identify if / when companies were acting in an uncompetitive manner, along with the relationship between internalised and wholesale market prices. As the proposals stand, Ofgem would be the only party that could view data related to specific companies, which would place a huge burden on Ofgem to ensure that any uncompetitive behaviour is identified and dealt with appropriately on behalf of the industry and consumers.

Finally, Drax believes it is important that the issues surrounding liquidity are addressed by Ofgem and we welcome the comment in paragraph 1.7 of the consultation document that indicates the intention to publish a further discussion document on the subject. It is disappointing that such a discussion document has not been published to date, given that a number of industry parties, along with the regulator, are aware of the need for increased liquidity in the wholesale market.

We look forward to reviewing Ofgem's comments on the responses received as a result of this consultation. In the meantime, please do not hesitate to contact me should you wish to discuss our views.

Yours sincerely,

By email

Stuart Cotten

Regulation
Drax Power Limited