



FAO James Grigor
GB Markets
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16th April 2010

Dear James,

Liquidity Proposals for the GB wholesale electricity market

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 an electricity supply business, Haven Power Limited ("Haven"); Haven supplies some 25,000 business customers and provides an alternative route to market for some of Drax's power output.

Drax welcomes Ofgem's consultation regarding liquidity proposals for the GB wholesale electricity market. A full response to the questions raised by the paper can be found in Appendix 1; however, Drax would like to put forward the following high-level views:

- There are two notable weaknesses in the GB wholesale electricity market that have a detrimental effect on the level of new investment by new entrants and independent generators; these are low liquidity and limited term;
- Liquidity related issues have a detrimental effect on the development of price signals, thereby reducing confidence in the market;
- Drax does not believe that trading mechanisms are to blame for such low liquidity, more the way in which vertically integrated parties interact with the traded wholesale electricity market;
- Vertically integrated supply businesses do not test the market for volume, meaning they may not contract with the most cost effective source of generation; their associated generation businesses build new assets to hedge future supply business demand without testing the market, even if existing plant or investment from new entrants could fulfil supplier requirement more cost effectively;
- The failure of Ofgem to act now will mean that investment decisions, which will shape the UK's generation mix for the next twenty or more years, will be taken based upon incomplete price signals;
- The N2EX project has not addressed the *causes* of low liquidity in the GB electricity market prior to developing the new platform; the project has not established alternative market tools for trading power, it has delivered services that are already available to market participants, further fragmenting liquidity;
- Drax believes that the combined action of introducing a market maker along with self-supply restrictions should ensure that small suppliers have access to the products, shapes and clip sizes that they require, whilst simultaneously increasing the volume of trades that take place via the wholesale market, increasing liquidity in both the prompt and over the long-term curve;
- Such action would produce a *meaningful* increase in liquidity, as it would:

- Address market structure issues that lead to low liquidity in the GB wholesale electricity market, i.e. it would remove the incentive for parties to become vertically integrated and trade internally;
 - Improve short- and long-term price signals due to the added volume of generation being traded via the market (ideally, 100% of trades should take place via the wholesale market);
 - Provide a long-term market in which price (thereby investment) signals become visible;
 - Ensure *all* parties can evaluate the true value of generation, thereby making the market more competitive and lowering the cost and barriers to new entry; and
 - Ensure that generation is provided by the most efficient and the most cost effective plant, i.e. it would stop the optimisation of six “mini-markets” and ensure optimisation of the wider wholesale market;
- The timetable for policy decisions should be brought forward in order to ensure that the benefits of the proposed remedies are not delayed; the further development of policy interventions and the final assessment should take place as soon as reasonably practicable.

We look forward to viewing both Ofgem's and industry participants' responses to this discussion paper. In the meantime, if you would like to discuss any of the views expressed in this response, please feel free to contact me.

Yours sincerely,

By email

Stuart Cotten

Regulation
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Appendix 1: Drax Response to Discussion Paper Questions

Chapter 1: Defining the Problem

Question 1: Do you agree that the harm caused by low levels of liquidity is sufficient to merit policy intervention, if such low levels persist?

Yes. As stated in our recent response to Project Discovery, there are two notable weaknesses in the GB wholesale electricity market that have a detrimental effect on the level of new investment by new entrants and independent generators; these are low liquidity and limited term. These issues, in turn, have a detrimental effect on the development of price signals and confidence in the market.

The level of liquidity in the GB wholesale electricity market, along with the volume of long-term market trading (i.e. greater than two to three years ahead), are extremely important issues that warrant market reform. Wholesale market liquidity and term has diminished considerably since self-supply restrictions were removed from licence conditions in 2004. As suggested in the consultation document, there are currently six large supply businesses that hold 99% of the domestic retail market with very stable market shares; in addition, each of these suppliers has an associated generation business that supplies a substantial portion of their generation needs. The vertically integrated nature of these businesses provides a natural hedge, meaning there is less of a need for the supply businesses to hedge via the traded markets; this has a substantial effect on new entrants and / or independent generators, who will seek to hedge their investment via the illiquid wholesale market.

Essentially, the current market arrangements encourage vertical integration and reduced liquidity. A lack of liquidity forces independent businesses to use vertically integrated solutions, which has been demonstrated more recently by independent generators that have bought small supply businesses to provide them with a new route to market (i.e. directly via the retail market). However, more worryingly, greater consolidation is occurring between the generating interests of the "Big 6", where parties have joined forces to create three significant nuclear investment partnerships.

As trades take place internally to company structures, price signals that would otherwise facilitate new investment do not form part of the market price. This means that the true value of generation is effectively hidden from the wider market. Supply businesses do not test the market for volume, meaning they may not contract with the most cost effective source of generation; associated generation businesses build new assets to hedge future supply business demand without testing the market, even if existing plant or investment from new entrants could fulfil supplier requirement more cost effectively. Ultimately, this is most detrimental to consumers as the least cost solution may not prevail.

The lack of longer-term market trading is due to the lack of impetus on the large vertically integrated companies to trade within the wholesale market beyond two to three years forward. Greater liquidity across the current market curve, and further initiatives to increase trading beyond the current two to three year barrier, would drastically increase the strength of price signals in the wholesale market. Ultimately, to deliver efficient capital allocation and the lowest cost to consumers, investment decisions must be made across the market rather than internalised within the major vertically integrated companies; to allow this to happen, there must be clear price signals within the wholesale market.

The low levels of liquidity and the reluctance of the vertically integrated companies to trade meaningful volumes across the wholesale market curve is concerning, particularly during a period of time when major investment decisions are taking place that will shape the UK's generation mix for the next twenty or more years. With this in mind, Drax believes that action is required now and that the current timetable for policy decisions, outlined by Ofgem, should be brought forward.

Question 2: Do you agree that the focus should be on electricity markets?

Yes. It is the GB wholesale electricity market that suffers from limited liquidity and term; therefore, measures for reform should focus on this market.

Chapter 2: Success Criteria for Market Initiatives

Question 1: Do you think our high level success criteria are appropriate?

Question 2: Do you have views on how these can be quantified and the appropriate target level of performance?

Drax recognises that market mechanisms may need to be modified to provide small suppliers with the help they require to secure access to particular products, clip sizes and shape; for that purpose, it is essential that Ofgem develop appropriate success criteria to ensure that the market delivers the needs of such parties, either as a result of the introduction of market solutions or after some form of market intervention from the regulator.

However, with regards to overall levels of liquidity, particularly long-term liquidity at the far end of the curve, Drax does not believe that it is trading mechanisms that are to blame; it is the way in which vertically integrated parties interact with the traded wholesale electricity market, and the consequential effects of such interactions on market liquidity and price signals, that must be addressed. Early action should be taken to ensure that the six large supply companies source a significantly greater volume of their demand requirement from the GB wholesale electricity market; a Competition Commission referral may be required to determine the most appropriate remedy.

The regulator must continue to monitor levels of liquidity to ensure that appropriate levels are maintained in the long-term. The criteria set out by Ofgem appear reasonable to deliver a consistent approach to such monitoring.

Question 3: When should market success be judged?

Drax believes that when judging market success, it is necessary to look back at levels of liquidity since the removal of the previous self-supply licence conditions. As mentioned above, wholesale market arrangements, in their current form, encourage vertical integration which, in turn, encourages the optimisation of six “mini-markets” rather than optimisation of the wider wholesale market. The current arrangements work to the benefit of those businesses that can bypass the traded market and keep price / investment signals internalised; there must be greater price transparency (in the long-term) if efficient investment is to be facilitated by market signals and new entrants are to gain project finance.

The N2EX project, developed by the industry, aimed to address market liquidity concerns and, after a number of years in the making, has delivered a new auctioning platform. Whilst Drax believes exploring a market solution was an important step, the project has not delivered a viable solution and has turned in to little more than a smoke screen for failings in market structure. The project has not addressed the *causes* of low liquidity in the GB electricity market prior to developing the new N2EX platform. The fact is that the industry, which is dominated by six large vertically integrated companies, is not in a sufficiently independent position to address such liquidity issues, nor does it have the powers to introduce the required remedies to fix such failings; this task can only be conducted by the regulator.

The N2EX project has not established alternative market tools for trading power, it has delivered services that are already available to market participants, such as the 24-hour continuous cleared market place, the daily cleared auction and the cleared prompt market that are provided by APX, along with the cleared forward markets that are supported by ICE and LCH.Clearnet. In addition to the UK power market already benefiting from the services provided / proposed by the N2EX project, the market is also serviced by brokerage firms, who provide dedicated voice services, purpose built trading platforms and robust power indices.

The N2EX project has essentially delivered a new platform and clearing service that will compete for business from existing market tools providing the same services; if anything, this further fragments liquidity by redistributing volume across a greater number of platforms, rather than (a) consolidating liquidity or (b) increasing liquidity, as claimed by a number of market participants. The market must be very careful in making any claims that the N2EX solution will increase power market liquidity or any assertion that power market liquidity issues are purely related to the trading mechanisms themselves.

Whilst such tools provide platforms on which market participants can trade, they do not resolve the key issue: the volume of power trades that are withheld from the wholesale market due to the internalised market structures of the vertically integrated players. An increase in market liquidity will only be achieved if the six large suppliers that command 99% of the domestic retail market purchase a greater percentage of their demand requirement from the wholesale market. Such market reform is necessary to increase market liquidity across the curve, ensure investment signals are visible to all market participants and encourage greater competition and new entry.

Furthermore, Drax continues to question the assumption that a cleared marketplace (forced or otherwise) would enhance liquidity for market participants. Whilst cleared exchanges and clearing services may benefit traders, vertically integrated businesses and non-physical entities, it is not a given that the increased use of clearing services would improve market accessibility for independent generators and suppliers; in fact, it could be argued that the opposite is true. The increased use of clearing has the potential to make the wholesale market less competitive and to raise barriers to new entry, as independent participants could be required to secure higher levels of credit (in relative terms) than their vertically integrated counterparts. This is due to the fact that vertically integrated companies are able to benefit from the ability to net generation and retail trading positions, whilst independent participants face potentially huge margin calls on their positions, as evidenced by the power price movements in 2008.

In summary, whilst the N2EX project may aim to help deliver small volumes of specific products to small suppliers in the short-term market, it does not increase trading by the six large suppliers in the long-term market; it is the latter that will increase liquidity in long-term trading and provide the necessary investment signals for new entrants and independent generators to invest in generation equipment. The large suppliers have had plenty of time to increase their long-term trading positions in the wholesale market and have failed to do so.

Action must be taken now as decisions on investments that will secure the UK's energy supply over the next couple of decades are required now; investment decisions for plant connecting around 2015 will be made in the next 18 months. The failure of Ofgem to act now to improve market investment signals by ensuring *all* market participants have access to the same market signals means that investment decisions that will shape the UK's generation mix for the next twenty or more years will be taken based upon incomplete price signals.

The timetable for policy decisions should be brought forward in order to ensure that the benefits of the proposed remedies are not delayed; the further development of policy interventions and the final assessment should take place as soon as reasonably practicable.

Chapter 3: Overview of the Possible Remedies

Question 1: Are there any other policy options, beyond those set out in chapters 4-8, which merit attention?

Drax believes that a combination of remedies will be required to address the issues that are being experienced by both independent suppliers and independent generators. Whereas the options identified by Ofgem largely address the perspective of independent suppliers (ensuring short-term products are available in appropriate clip sizes), there are less options highlighted to address greater liquidity and greater term trading across the wholesale market curve.

The main issue, relatively speaking, is that there are limited parties with which to trade generation output, i.e. just six huge suppliers that are predominantly hedged by their associated generation businesses. The issue lies in encouraging these huge suppliers with largely 'sticky' domestic customer bases to trade within the wholesale market, rather than trading within internal company structures; remedies to remove the huge reliance on internal hedging would help to increase liquidity, provide greater forward volume and ensure investment signals are more visible to *all* potential investors, not just those that have a vertically integrated presence.

Drax considers that a further option could be obligations in the licences of large suppliers to trade a set percentage of their demand requirement via the wholesale market, similar to those obligations set out in Project Discovery Policy Package B. Such obligations would force large suppliers to trade a set

percentage of their requirement three to five years forward; such a market 'hedge' could be developed as a sliding scale that diminishes over future years, in a similar style to the hedging strategies of independent generators.

As suppliers would purchase their requirement across the curve (i.e. over the long- and short-term), the obligations would help to stabilise their purchase price (averaged over a longer period of time) and ensure that the volume sourced by market comes from the cheapest and most efficient plant. Simultaneously, price signals would be visible within the wholesale market, which would encourage investment in the most efficient generation solutions. This would, in turn, ensure that the investment decisions taken optimise the wider wholesale market, rather than purely optimising a number of "mini-markets" that exist within company structures.

A further solution could be to impose an obligation on large vertically integrated parties to publish the terms, volume and price data of internal trades on a central repository (the party name would be known to Ofgem, but remain anonymous to the wider industry). This would allow other industry parties to contest the validity of a given trade (i.e. when compared to market prices and terms), allow relevant parties to include such trades in market indices and ensure that internal trades are transparent and reflected in the composition of forward prices. Ultimately, the obligation should allow the vertically integrated companies to prove that they had tested the market to ensure other market participants could not provide the same volume at a better price. Furthermore, obligations should be placed on large vertically integrated companies to demonstrate that major generation investment decisions have been 'market tested', to ensure that other parties could not provide a more efficient investment solution.

Such measures to ensure clarity of investment signals and greater optimisation of the market (i.e. where the most efficient and cost effective solutions prevail) would work to the benefit of end consumers.

Chapter 4: Direct Trading Obligation

Question 1: Is a direct trading obligation an appropriate solution to the problems related to wholesale market liquidity?

Drax believes that whilst a Direct Trading Obligation may help small suppliers to gain access to particular products, shapes and sizes of clips, it would not address the more fundamental market structure issues that have caused diminished liquidity across the GB wholesale electricity market curve. This proposal is purely about certain entities (i.e. small suppliers) gaining access to particular products, rather than creating a more liquid wholesale market.

With regards to the structure of the Direct Trading Obligations, it is difficult to assess the potential impact of such trades without greater detail on how the obligations would work and the types of products that they aim to encourage. Drax agrees with Ofgem's initial concern regarding the transparency of this solution; as trades would take place directly between small suppliers and those that have the obligations, there would need to be a mechanism that allows greater transparency of such trades to ensure that price (thereby investment) signals are not hidden and that the regulator would be able to monitor compliance.

Given that this potential solution would not bring about greater liquidity in the wholesale market, due to its primary aim being to provide specific products for small suppliers, it would need to be combined with further measures that would aim to address overall levels of liquidity, particularly over the long-term curve. Ensuring adequate liquidity is available across the curve, from the within-day market to the forward market, must be a key focus for reform.

Question 2: Which licensees should be subject to the obligation?

Drax believes that the obligation should be targeted at the large vertically integrated companies, i.e. those that hold a large market share in the domestic retail market and have a significant hedge provided by their generation business.

Question 3: What requirements should be put in place relating to products, pricing, collateral and other conditions of trade?

The products offered to small participants would need to be workable for all parties and take into account the internal resource requirement of companies offering the products. For many market participants, small suppliers tend to fall outside of the credit status required to initiate trading relationships; if a Direct Trading Obligation were imposed, the increased credit risk and cost for market participants affected by the measures would need to be taken into account.

Question 4: Is it appropriate to extend the obligation to cover generation purchases?

In terms of a suggested extension to this potential solution to encourage large suppliers to purchase volume from small generators, it must be recognised that this only goes a small way to addressing a much larger issue. There are currently six large supply businesses that hold 99% of the domestic retail market with very stable market shares; in addition, each of these suppliers has an associated generation business that supplies a large percentage of their generation needs. The vertically integrated nature of these businesses provides a natural hedge, meaning there is less of a need for these businesses to hedge via the traded markets; this has a substantial effect on new entrants and / or independent generators, who will seek to hedge their investment by trading with the large suppliers via the wholesale market.

The ability to contract in the forward market is very important for new entrants and independent generators, as such parties do not have a supply business to provide a natural hedge for their generation investment. Currently, there is a very limited need for the major suppliers to contract via the wholesale market due to the natural hedge referred to above. Rather than focusing purely on the generation businesses of the Big 6 to provide greater volume to the market, there must be more thought on remedies that encourage the large supply businesses of the Big 6 to purchase greater volume from the wholesale market, i.e. across the curve from all sizes of generation business (not just small generators).

Question 5: What costs would this option impose?

There would be significant issues for generators dealing directly with small suppliers. The first is with regards to credit and the fact that many small suppliers do not meet the ratings required for generators to be able to transact with them. The second issue regards the size of the trades, which tend to be very small, and the shape of the trades, which vary. Each of these issues has an associated cost and complexity for generators. The cost of dealing with requests would also depend upon the frequency and total volume of requests from small suppliers; it may be more costly for those with less resource, as such requests may remove resource from normal day to day operations.

Drax believes that there are better solutions available (such as the Market Making Agent option) that could help small suppliers with their requirements at a lesser cost to industry resource.

Chapter 5: Market Making Agent

Question 1: Is a market making arrangement of the kind set out in this chapter an appropriate solution to the problems related to wholesale market liquidity?

Again, whilst a Market Making Agent may help small suppliers to gain access to particular products, shapes and sizes of clips, it would not address the more fundamental market structure issues that have caused diminished liquidity across the GB wholesale electricity market curve. However, this solution may have advantages over the Direct Trading Obligation proposal, given that a Market Making Agent may have a better credit rating than a small supplier (particularly if the services were provided by an independent financial institution) and there would be the advantage of the Market Making Agent being able to aggregate positions, which would act as a bridge between the products required by small suppliers and those supplied by generators. The Market Making Agent could also report aggregated data, providing transparency of trades and ensuring that price signals reach the wider market; the agent could also monitor the achievement of obligations and provide regular reports to the regulator.

Drax believes that the Market Making Agent should either be completely independent of the Big 6 (say, a financial institution) or should have an obligation to ensure that there are adequate Chinese walls between the interests of the large vertically integrated companies and the market maker's business. It should be noted that this solution (as with the Direct Trading Obligation) would not increase liquidity over the long-term curve by encouraging the large suppliers to trade via the wholesale market; this issue would still need to be addressed by further measures. Again, ensuring adequate liquidity is available across the curve, from the within-day market to the forward market, must be a key focus for reform.

Question 2: What products should be made available through a market maker?

Question 3: What volume obligation would be appropriate?

Ultimately, this will depend upon the number of small suppliers making use of the market maker and the total volume required to be sourced via a market maker. Furthermore, there must be obligations on the market maker to control the costs of such services.

Question 4: Would the establishment of a "Market Making Agent" facilitate the introduction of market making?

This would depend upon the finer detail of the Market Making Agent model and the platform chosen to accommodate the trades. Ultimately, the platform would need to allow the small clip sizes required by those that the model aims to help and would need to have collateral arrangements that would not work to the detriment of the small suppliers. If the N2EX platform was chosen to accommodate the market maker, the collateral requirements of the associated clearing function may prove too costly for participants (both small suppliers and independent generators), particularly if the market maker function were to attempt to address medium- to long-term liquidity issues (see answer to Chapter 2 Question 3).

Question 5: What costs would this option impose?

Whilst it is expected that there would be a cost associated with setting up a Market Making Agent, the cost of this solution would be shared by those providing the service; therefore, this model would help promote competition by ensuring that individual businesses are not affected by the costs associated with individual resource availability. In addition, if the market maker (as a single entity) were to have a better credit rating than the small suppliers, this would help to facilitate trading between those that have a licence condition obligation and the chosen Market Making Agent (potentially lowering the cost of credit).

Drax believes that this option would be best suited to help address the issues that small suppliers face in accessing the products, clip sizes and shapes that they require. This proposal could be combined with further remedies to address the overall level of liquidity in the GB wholesale electricity market.

Chapter 6: Mandatory Auctions

Question 1: Are mandatory auctions an appropriate solution to the problems related to wholesale market liquidity?

Question 2: How should the volume of generation subject to a mandatory auction be set?

Question 3: Who should be obliged to offer into the auction?

Question 4: What design features should be incorporated into the auction process and rules?

As mentioned earlier in this response, the largest issue in the GB wholesale electricity market is that there is a limited need for the six large suppliers to trade volume over the long-term, as these suppliers are predominantly hedged by their associated generation businesses. These huge suppliers, with their largely 'sticky' domestic customer bases, must be encouraged to trade a greater percentage of their demand requirement within the wholesale market, rather than trading within internal company structures; remedies to remove the huge reliance on internal hedging would help to increase liquidity, provide greater forward volume availability and ensure investment signals are more visible to *all* potential investors, not just those that have a vertically integrated presence.

The consultation document suggests that 68% of generation output came from the Big 6 during 2009, whereas the same companies were responsible for 99% of domestic supply. This would suggest that there is greater diversity in ownership of generation sources than there is in the supply of electricity to end consumers. The 32% of generation output that was provided by companies outside of the Big 6 needs a more adequate route of access to retail demand, i.e. greater trading with suppliers via the wholesale market.

Given that domestic supply is dominated by just six suppliers, it would seem more fitting to place obligations on the dominant supply businesses to source power from the wholesale market, particularly over the long-term where independent generators experience minimal liquidity. Independent generators have only one option, which is to sell their output via the wholesale market. On this basis, it is not the generators' lack of will to sell output that is the problem; it is the suppliers' lack of will to purchase volume via the wholesale market.

Drax believes that there should be an obligation on large suppliers that have 'sticky' customer bases (such as those in the domestic retail sector) to source a set percentage of their future supply requirements via the GB wholesale electricity market. Whilst it could be argued that suppliers do not know how many customers they will have in future years (due to the ability of customers to switch supplier), it is fair to say that such retailers experience extremely stable market shares with no single supplier displaying intentions to grow larger than the rest (this has been observed over a number of years). This suggests that retail businesses are able to forecast requirement in future years; such obligations could work on a sliding scale basis, in a similar hedging profile to those used by independent generators to hedge their generation assets.

However, whether mandatory auctions are the most appropriate method for imposing such obligations is questionable. Further detail would be required regarding the auctioning platform, and the requirements that would be placed on participants to be able to trade on the platform, in order to establish how feasible a mandatory auction solution would be. For example, if the N2EX platform were chosen to facilitate mandatory auctions, the platform may impose unreasonable collateral requirements on independent suppliers and generators, particularly if it were used for long-term trading. See answer to Questions 6 below.

Question 5: Should the mandatory auction apply to day-ahead volumes and/or to longer dated forward products?

Whilst Drax is a keen advocate for greater long-term liquidity in the GB wholesale electricity market, the use of mandatory auctions may not be the most appropriate or the most cost effective solution to facilitate long-term trading. Independent generators are willing to enter into long-term trades now; the issue is that the large supply businesses of the Big 6 are not willing to enter into long-term trades via the wholesale market. The solution must encourage or obligate suppliers to enter into trades across the curve (over the short- and long-term) via a range of trading options. Forcing long-term liquidity onto a single trading platform, such as the N2EX platform, would hugely increase the cost of collateral for independent participants and sustain high barriers to entry. See answer to Questions 6 below.

Question 6: What costs would this option impose?

This would depend upon (a) the chosen platform and (b) the businesses that are to be obligated to offer volume in the auctioning process. As stated in our previous response, whilst cleared exchanges and clearing services may benefit traders, vertically integrated businesses and non-physical entities, it is not a given that the increased use of clearing services would improve market accessibility for independent generators and retailers; in fact, it could be argued that the opposite is true.

The increased use of clearing has the potential to make the wholesale market less competitive and to raise barriers to new entry, as independent participants could be required to secure higher levels of credit (relatively speaking) than their vertically integrated counterparts. This is due to the fact that vertically integrated companies will benefit from the ability to net their generation and retail trading positions, whilst independent participants face potentially huge margin calls.

This is a particular concern for Drax with regards to the N2EX platform in general.

Chapter 7: Self-Supply Restriction

Question 1: Is a self-supply restriction an appropriate solution to the problems related to wholesale market liquidity?

Yes. As previously mentioned, there is a need to ensure that the supply companies of the Big 6 trade within the GB wholesale electricity market; these suppliers are predominantly hedged by their associated generation businesses at present and have very limited need to transact with independent generators.

Self-supply restrictions would ensure that such suppliers trade via the wholesale market rather than trading within internal company structures; remedies to remove the huge reliance on internal hedging would help to increase liquidity, provide greater forward volume and ensure investment signals are more visible to *all* potential investors, not just those that have a vertically integrated presence.

Further to this, if the market is going to attract non-energy sector traders to re-enter the market (i.e. financial institutions that take more speculative positions and, in turn, provide greater market liquidity), then there needs to be greater volume brought to market by the physical parties across and beyond the current curve.

Drax believes that this proposal would produce a *meaningful* increase in liquidity, as it would:

- Address market structure issues that lead to low liquidity in the GB wholesale electricity market, i.e. it would remove the incentive for parties to become vertically integrated and trade internally;
- Improve short- and long-term price signals due to the added volume of generation being traded via the market (ideally, 100% of trades should take place via the wholesale market);
- Provide a long-term market in which price (thereby investment) signals become visible;
- Ensure *all* parties can evaluate the true value of generation, thereby making the market more competitive and lowering the cost and barriers to new entry; and
- Ensure that generation is provided by the most efficient and the most cost effective plant, i.e. it would stop the optimisation of six “mini-markets” and ensure optimisation of the wider wholesale market.

Drax recognises that there would still be a need for additional action to help small suppliers with their needs for access to particular products, clip sizes and shape.

Question 2: Who would be covered by the self-supply restriction?

Question 3: How should the extent of a self-supply restriction be set? Should it relate only to the supply to domestic customers?

A restriction that relates to the supply of domestic customers appears to be a reasonable option, given that this is the least competitive area of the retail market. The domestic retail market has the most ‘sticky’ customer base and is currently dominated by the Big 6; these companies account for 99% of the market, with the majority of them having very similar and stable market shares.

Self-supply restrictions would ensure that *all* parties compete on equal terms, as each party would source their power requirements from the GB wholesale electricity market. This would provide greater market confidence for new entrants as all trades would take place via the wholesale market on similar terms. As such, price (thereby investment) signals would be visible to *all* market participants; allowing all potential investors access to the same investment signals will ensure greater competition in the generation market.

Question 4: Should a self-supply restriction be accompanied by measures to ensure that small participants have access to the products they need? If so, which products?

Drax recognises that there would still be a need for additional action to help small suppliers with their needs for access to particular products, clip sizes and shape. Drax would suggest that self-supply restrictions are accompanied by the introduction of a Market Making Agent.

Question 5: How could the previous problems related to enforceability be overcome?

Question 6: What costs would this option impose?

The main issue is that the large suppliers must come to market to buy volume, which means that all parties have the ability to trade with a supplier on the same terms as the vertically integrated party's associated generation business. There may need to be restrictions on the ability of OTC trades between a given company's generation and retail businesses, in order to ensure that "market avoidance" does not occur, even if trades look to be completed via the market. However, vertically integrated parties that effectively trade with themselves via exchanges, where such trades are not transacted *knowingly*, should not be a problem so long as all parties were able to access the traded product.

The exchanges should be able to provide data to Ofgem for the purposes of monitoring transactions between parties; Ofgem would be able to periodically check, or obligate exchanges to report, trades that take place between two businesses that share the same parent, in order to monitor the extent to which self-supply takes place via the market. Ofgem could make use of trade repositories to gain greater access to information on trades transacted.

Chapter 8: Collateral Requirements

Question 1: Do you think that any of the possible approaches outlined in this chapter have merit and should be pursued further?

Ofgem must be careful when considering imposing specific credit arrangements on some or all parties, as such arrangements could enforce too little or too much credit, which would either place the industry at greater risk of party default and / or increase the cost to participants and, consequentially, end consumers. A range of credit options currently exist within the market, with diversity in products providing options to market participants that complement their business models and trading operations.

With regards to forced clearing, such moves may serve to benefit traders, vertically integrated businesses and non-physical entities, rather than independent retailers and generators. As mentioned earlier in this response, the increased use of clearing has the potential to make the wholesale market less competitive and to raise barriers to new entry, as independent participants could be required to secure higher levels of credit (in relative terms) than their vertically integrated counterparts.

Chapter 9: Conclusions and Next Steps

Question 1: Do you agree with the proposed assessment criteria?

Question 2: Which do you think is the best policy option or combination of options?

Drax believes that the two main issues Ofgem must address are:

1. Limited liquidity in the GB wholesale electricity market, particularly long-term trading (i.e. three to five years forward); and
2. The inability of small suppliers to gain access to particular products, clip sizes and shapes.

As mentioned earlier in this response, Drax recognises that market mechanisms may need to be modified to provide small suppliers with the help they require to secure access to particular products, clip sizes and shape; for that purpose, it is essential that Ofgem develop appropriate success criteria to ensure that the

market delivers the needs of such parties, either as a result of introducing market solutions or after market intervention.

However, with regard to overall levels of liquidity, particularly long-term liquidity, Drax does not believe that trading mechanisms are to blame; more the way in which vertically integrated parties interact with the traded wholesale electricity market and the effects of such interactions on market liquidity and price signals. Early action should be taken to ensure that the six large supply companies source a significantly greater volume of their demand requirement from the GB wholesale electricity market; a Competition Commission referral may be required to determine the most appropriate remedy.

On this basis, Drax believes a combination of options would be required. Self-supply restrictions would force more trades to take place via the wholesale market, rather than via internal trades / transfers; this would ensure that the six large supply companies source their needs from the wholesale market on the same basis (price and terms of sale) as their independent counterparts. Such a move would increase liquidity, ensure price / investment signals are visible to all parties (existing and potential new entrants) and, ultimately, promote greater competition in both the retail and wholesale markets. In addition, the introduction of a Market Making Agent would ensure that small suppliers could gain access to the products, clip sizes and shapes that they require in order to compete and grow organically.

A successful intervention by Ofgem should result in the following:

- Small suppliers being able to satisfy their trading requirements on a similar basis to their larger counterparts;
- Large suppliers increasing the volume of generation they source via the GB wholesale electricity market;
- Competition between the six large supply companies noticeably increasing, with such businesses competing for market share;
- The volume of power traded across the curve increasing, particularly in the long-term (i.e. three to five years forward); and
- Optimisation of trading across, and investment in, the wider GB wholesale electricity market, rather than the optimisation of six "mini-markets" within company structures; this should lead to the most efficient investment decisions for the end consumer.