To
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DONG Energy response to Ofgem consultation on Liquidity Proposals for the GB wholesale electricity market

DONG Energy would like to thank for the opportunity to respond to this consultation. We appreciate that some of our points from our response to the previous consultation have been heeded and we look forward to the coming process. DONG Energy is the owner of more than 300 MW installed offshore wind assets in the UK, has some of the largest offshore wind projects in the UK under construction or in the pipeline, and is commissioning an 824MW CCGT plant in South Wales in 2010. Therefore the issues and challenges in the UK electricity market are of vital importance to our business and future investments.

We believe the issue of lack of liquidity and transparency in the wholesale electricity market is one of the main barriers of entry for new and independent players in the UK power market. The absence of a well-functioning wholesale power market creates a massive competitive advantage for incumbent vertically integrated companies and effectively discourages investment and competition from new players. This, in turn, is likely to adversely affect the future security of power supply in the UK and the transition to a low carbon power sector.

We consider the main impediment to liquidity growth to be a lack of price discovery. The single most important aspect of a well-functioning financial market is a credible reference price, (i.e. the observed price for prompt power), to which financial products can be linked. We see in other markets that the presence of a credible reference price creates the foundation for secondary trading, which significantly increases liquidity, and as especially secondary trading is lacking in the UK market, we believe the focus for Ofgem's efforts should be on ensuring a credible reference price. Solutions should not focus on providing the small suppliers with a specific product, or product type, but on establishing a well-functioning market with both physical and financial products, which would increase the number of companies able to provide suppliers with appropriate products.

We very much support the policy proposal of "Mandatory auctions" where an obligation is introduced to auction day-ahead power in a cleared marketplace. Such a measure would have two beneficial consequences. First, it would provide a formalised auction, in which non-integrated companies could dispose or acquire their power in a fair and transparent manner. Secondly, and more importantly, it would create a trustworthy reference price for financial products. Some of the proposals outlined in the consultation paper (for example market making arrangements) could have beneficial effects on the market liquidity, but as they do not address the root of the problem, namely the lack of a credible reference price, we do not believe they can act as stand-alone solutions.

Some players in the industry have launched a new market platform in collaboration with NordPool, namely N2EX. Until now, it has only attracted limited liquidity, and we do not consider this to be an adequate response to the lack of liquidity. The proposed obligation to trade short term power could use the N2EX platform, the existing APX platform, or even an entirely new platform, but the pertinent point is that sufficient prompt power for a reliable reference price needs to be cleared.

Arguments raised at the liquidity consultation event held by Ofgem in March 2010 such as "downstream profits are necessary in order to facilitate new capacity" are in our opinion neither valid nor substantiated and could prove detrimental to the United Kingdom's ambition of attracting new investment capital to its power sector. Cross-subsidization between different links in the value chain only strengthens the incentive to vertical integration, which would drive the liquidity even further down. The necessary incentives to build new capacity should be derived from the generation business through a realistic and transparent transfer price, not by rents derived from end customers.

Yours sincerely,

Thomas Dalsgaard

Thomas Dalsgaard
Vice President, Regulatory Affairs

CHAPTER: One

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, the lack of liquidity and thereby lack of a reliable reference price deters investment in the UK electricity market by newcomers and other IPP's, which reduces competition and jeopardizes the government's objectives concerning security of supply and the low carbon transition.

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

Yes. In our opinion, the United Kingdom gas markets are very well functioning and no intervention is needed, whereas the electricity market is dominated by non-transparent in-house deals in the vertically integrated companies.

CHAPTER: Two

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

We believe that the success criteria stated in the consultation document are very loosely defined and that the requirements for fulfilment are unclear. This might be on purpose in order to avoid that incumbents try to ensure that requirements are being fulfilled by actions in the short term that will not ensure long term solutions. On the other hand, we are worried that with these loosely defined criteria there is no real commitment to intervention and the problem thereby remains unaddressed as has been the case for some years.
Unless there are real and permanent improvements, based on a shift in behaviour from market participants, we do not see any way around government intervention.

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

As mentioned above, we believe that the only situation where intervention would not be required is if markets show true long term improvements. Therefore, we believe that if Ofgem finds the development satisfactory in the preliminary assessment in the summer 2010, there should be follow up reviews on a frequent basis (at least half yearly) to ensure the durability of the improvements.

Question 3: When should market success be judged?

In light of the need for an unprecedented level of investment in the UK energy markets over the next decade, we believe action is needed rather sooner than later. We agree with the proposed time frame where market initiatives are assessed in the summer 2010.

CHAPTER: Three

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

N/A

CHAPTER: Four

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

The main question to ask here is whether such a solution would encourage price discovery and secondary trading. The proposal focuses on creating a trade channel for structured products without creating a reference price first. There is no mentioning of prices being public, and our impression is that the proposal would thus mainly increase the market and price knowledge accessible to the big-6, where as the IPPs would remain less informed and overall at an disadvantage compared to the big-6. As far as we can see, this proposal will facilitate neither price discovery nor secondary trading, and at best would thus only solve the liquidity issues of small suppliers, while leaving the rest of the energy market exposed to the lack of liquidity.

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

N/A

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

N/A

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

An extension to cover purchases from small/independent generators would not be a suitable solution either. We do not seek merely offtakers to our energy (then we would have done a deal for either a VPP or a PPA), but a market in which we can operate.

Question 5: What costs would this option impose?

N/A

CHAPTER: Five

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?

If the market problems have been addressed through other remedies, we believe that a market maker arrangement could help increasing the liquidity; however on its own, this policy proposal is not enough. The main question is whether this will ensure a secondary trading market, and whether the proposed products will give a credible reference price or reference forward curve. Unless information regarding trades is disseminated widely, the price discovery function is likely to be insufficient order to produce a trustworthy reference price.

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

N/A

Question 3: What volume obligation would be appropriate?

If the market making agents were joined together in a common agent, and there were multiple quotes, the trustworthiness of the reference price would increase, but whether or not it would increase to a point where financial contracts would be executed using it as reference price is uncertain.

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

N/A

Question 5: What costs would this option impose?

N/A

CHAPTER: Six

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

The two suggestions here looks similar, but the implications would probably be quite different.

Forward products:
A mandatory auction of forward products will not necessarily result in a trustworthy reference price. Without this it is our expectation that secondary trading would not increase and that liquidity would never get above the mandatory level such that the issues deterring investments among non-vertically integrated players would still persist.

Day-ahead market:
Mandatory auctions of day-ahead power is by far our preferred option, as it creates the most important part of any financial contract, namely a trusted reference strike price quotation. We believe it would be conducive to secondary trading, and could very well be the needed impetus to promote liquidity in the UK electricity market, to the benefit of all levels of the supply chain.

Seen from a DONG Energy point of view, we do provide many of the products UK suppliers look for, in other markets where we have a liquid financial forward market[1]. The current UK set-up with only physical forwards creates an unsatisfactory risk profile for such products, and we do not envision offering them in the UK at present.

The required depth of such liquidity in order to be comfortable in providing these products is a key concern and we can use the two main markets in which we operate for comparison (EEX ~ 30% of volume, NordPool ~70 % of physical volume).

[1] For example, we provide smaller distributors in Germany with a structured peak/base product called a"trench contract". A trench product gives the *buyer* an up-front fixed pricing formula based on the optimal Base/Peak volume hedge of the *buyers* load shape. This is just one example of the product types that could become available to smaller distributors if a credible reference price was established. Similar specialised products will become available if the demand for them exists.

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

We believe the NordPool market right now offers the best indicator for the necessary prompt liquidity in order to have a well-functioning secondary financial market. While it may be possible to operate with less liquidity, we believe it prudent to err on the side of caution and ensure that the initial level is high enough to ensure success. A level of 50% or higher would therefore be an appropriate level in our opinion.

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

All generators.

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

It is important that no market player can trade with himself by auctioning odd tick sizes or otherwise side step the intention of the mandatory auctions. Therefore we propose standardised tick size and a mandate to Ofgem to impose self supply restrictions if avoidance of the rules is observed.

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

We believe the most effective policy option will be to introduce mandatory auctions in the day-ahead market and are more sceptical with regards to mandatory auctions on longer dated forward products.

Question 6: What costs would this option impose?

N/A

CHAPTER: Seven

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

We do not believe this to be a sensible approach if implemented on its own. It clashes with our belief in the market as the optimal approach and does not ensure secondary trading or price discovery. This policy proposal is also vulnerable to gaming behaviour or mutual agreements, which in no way helps the smaller players in the market.

We do see a case for implementing self-supply restriction in combination with manadatory auctions, as mentioned above (Chapter 6, Question 4).There could also be an argument for making internal trades public for price discovery purposes, and possibly also to ensure that similar terms are offered to IPPs and suppliers.

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

N/A

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

N/A

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?

N/A

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

N/A

Question 6: What costs would this option impose?

N/A

CHAPTER: Eight

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

N/A

CHAPTER: Nine

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

See answer to question 1, Chapter 2

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

We prefer the policy option of mandatory auctions in the day-ahead market as this will not only increase the traded volumes, but also create a reliable reference price on which financial contracts can be based. Market-making and further inter-connection with market coupling are also beneficial policy options, but we consider them to be of less importance than the prompt market auctions.