James Grigor
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Ofgem
9 Millbank
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23rd April 2010

Dear Mr Grigor,

Liquidity Proposals for the GB wholesale electricity market

InterGen is the UK's largest and most successful new entrant, having invested £1.4 billion in the UK since 1995. InterGen owns and operates three highly efficient gas fired power stations in the UK totalling 2,490MW and actively trades in the prompt and forward wholesale power markets. InterGen is currently pursuing a number of development opportunities in the UK including the construction of two further 900MW CCGTs, representing a £1 billion investment.

InterGen considers that the significantly illiquid GB wholesale electricity market threatens the future of independent development projects. InterGen believes that a progressive programme to fully separate the activity of retail supply from that of generation is required in order to increase liquidity, restore long-term price signals and maintain and promote competitiveness in the GB generation and retail supply markets.

We would be happy to meet with you to discuss further any of the issues raised in our response.

Yours sincerely,

Chris Ridgway

InterGen's response to Ofgem's consultation paper "Liquidity Proposals for the GB wholesale electricity market"

Executive summary

InterGen is the UK's largest and most successful new entrant, having invested £1.4 billion in the UK since 1995. InterGen owns and operates three highly efficient gas fired power stations in the UK totalling 2,490MW and actively trades in the prompt and forward wholesale power markets. InterGen is currently pursuing a number of development opportunities in the UK including the construction of two further 900MW CCGTs, representing a £1 billion investment. Our response to this consultation is set out in light of that experience.

InterGen shares Ofgem's concerns regarding the low level of liquidity in the GB wholesale electricity market. InterGen believes that:

- Low liquidity is one of the symptoms of GB's largely vertically integrated market structure.
- Vertical integration is not compatible with a truly competitive, liquid, rational and transparent wholesale electricity market.
- A self-supply restriction, implemented without delay, will not only address many of the concerns regarding market liquidity but will also reduce the ability for vertically integrated companies to cross-subsidise new generation capacity with profits from their retail businesses.
- The introduction of a Market Making Agent using existing trading platforms should assist in increasing liquidity, though does not address the underlying issue.
- Current market initiatives, principally the N2EX clearing service and day-ahead auction, are unlikely to improve market liquidity but may actually serve to fragment the prompt market.
- It is appropriate for Ofgem to act quickly to address market liquidity rather than wait until the end of the year to assess if action is required.

Our responses to the specific questions asked in the consultation paper are below. These build on our previous response to Ofgem's June 2009 discussion paper "Liquidity in GB wholesale energy markets".

CHAPTER: One – Defining the problem

Question 1.1: Do you agree that the harm caused by low levels of liquidity is sufficient to merit policy intervention, if such low levels persist?

Yes. Low liquidity is one symptom of Great Britain's largely vertically integrated (VI) market structure in which natural buyers are no longer separate from natural sellers. The harm caused by low liquidity is significant as it prevents effective risk management by non-VI companies and hence acts as a barrier to new entry in both supply and generation.

Another symptom of this VI structure is the ability for VI companies to cross-subsidise the construction of new power generation capacity with profits from their retail sector, such that forward wholesale market prices are not necessarily at a level which reflects the anticipated supply-demand balance. This in turn dissuades non-VI companies from building potentially cheaper new generation capacity.

It is InterGen's view that these symptoms of a VI market structure result in a lack of effective competition which, over the long-term, is poor for the consumer. Therefore policy intervention is required to address the underlying VI cause and not just the specific issue of low liquidity.

Question 1.2: Do you agree that the focus should be on electricity markets?

Yes, it is our view that there is sufficient liquidity in the GB gas market and so it is appropriate for Ofgem to focus on the electricity market.

CHAPTER: Two – Success criteria for market initiatives

Question 2.1: Do you think our high level success criteria are appropriate?

Broadly yes, although we would propose that:

- The word "suppliers" is expanded to "suppliers and generators" in criteria 3 and 4 so that the market test is not one-sided;
- A further criterion is included: sufficient number of active market participants. Whilst additional liquidity is good in itself, the true test of an effective market is that new players are participating.

Question 2.2: Do you have views on how these can be quantified and the appropriate target level of performance?

Churn rate is the simplest measure of traded volumes. As indicated in the Ofgem June 2009 paper on liquidity the current churn rate is around three for electricity compared to around nine for gas. An appropriate target may be to demonstrate progress towards the current gas churn rate over a period of three years.

However, more important for a smaller player is the availability of tradable products with sufficiently small clip sizes and a tight market spread for forward periods. Compiling and reporting the trends in such statistics could become an activity of the regulator or an obligation on trading facilitators such as brokers and exchanges or a market making agent.

Question 2.3: When should market success be judged?

It seems sensible to review the market liquidity measures on a six monthly basis going forwards. The initial two assessments (we propose Q2 2010 and Q4 2010) would be critical in determining whether any meaningful progress is being made without further intervention by Ofgem in early 2011. Subsequent reviews would then assess whether sufficient momentum towards a liquid market has been maintained.

CHAPTER: Three – Overview of the possible remedies

Question 3.1: Are there any other policy options, beyond those set out in chapters 4-8, which merit attention?

InterGen believes that vertical integration is not compatible with a truly competitive, liquid, rational and transparent wholesale electricity market. Accordingly, InterGen advocates a package of measures incorporating a self-supply licence condition requiring VI companies to trade progressively increasing percentages (ultimately 100%) of their retail requirements via the wholesale market, coupled with a regulatory requirement for the separation of accounts between their generation and retail sectors.

Other options will merely treat the symptoms of a VI market structure rather than tackle the underlying cause.

CHAPTER: Four – Direct Trading Obligation

Question 4.1: Is a direct trading obligation an appropriate solution to the problems related to wholesale market liquidity?

InterGen believes it would be extremely difficult to force generators to transact with all small supply companies. Prior to trading, counterparties typically undertake a "Know Your Customer" process involving substantial background checks and research on each other. They must also prepare a master agreement and appropriate credit arrangements according to the type of trading they wish to undertake and their appetite for risk. It is unlikely that a standard framework for master agreements and collateral requirements could satisfy this due diligence process for all parties.

As stated in the consultation paper, there are significant design issues associated with this option. Implementing and monitoring such an obligation would be onerous, particularly in relation to the likely benefits. InterGen believes that it would be preferable to implement the market making agent approach using existing trading platforms and relationships. A direct trading obligation should be a last resort.

Question 4.2: Which licensees should be subject to the obligation?

Question 4.3: What requirements should be put in place relating to products, pricing, collateral and other conditions of trade?

Question 4.4: Is it appropriate to extend the obligation to cover generation purchases?

Question 4.5: What costs would this option impose?

As InterGen is not supportive of a direct trading obligation we have not answered questions 4.2 through 4.5.

CHAPTER: Five – Market Making Agent

Question 5.1: Is a market making arrangement of the kind set out in this chapter an appropriate solution to the problems related to wholesale market liquidity?

InterGen believes a market making arrangement could be an appropriate means of increasing market liquidity. However such an arrangement needs to make use of the existing broker-based trading platforms as well as (or rather than) an exchange. Smaller market participants with low credit ratings have a finite credit capability and are generally unwilling to transact products beyond the near-term on an exchange due to the risk of being unable to post sufficient variation margin in the event of large price movements. In addition, use of the existing trading platforms would prevent fragmentation of the market.

Question 5.2: What products should be made available through a market maker?

To improve longer-term liquidity, it is suggested that there should be a requirement to provide bids and offers on seasonal (i.e. six month) products out to three years. Medium-term liquidity could be improved by requiring bids and offers on, say, the front two quarters and front three months.

In the absence of a standardised profile requirement for suppliers, it is proposed that there is an obligation to provide prices for baseload, peak and overnight (i.e. EFA 1 and 2) shapes.

Question 5.3: What volume obligation would be appropriate?

Rather than propose a minimum energy volume for each of the Big 6 to transact over a period of time, it is suggested that they are obliged to maintain bid and offer prices for a minimum clip size (which may vary by product) within an agreed spread (e.g. £1/MWh or 2% of the offer price) on all of the agreed products between specific times of the day (e.g. 09:00 to 16:00).

In order to facilitate the requirements of small suppliers, it should be possible for them to transact for partial volumes of the best bid or offer clip size in whole MWs. This should also reduce the credit support required.

Question 5.4: Would the establishment of a "Market Making Agent" facilitate the introduction of market making?

Subject to the comments above, InterGen supports the establishment of a Market Making Agent along the lines proposed in paragraphs 5.17 to 5.19.

Market participants other than the Big 6 should also be able to notify bid and / or offer prices to the Market Making Agent on a voluntary basis.

Question 5.5: What costs would this option impose?

As well as the tasks described in this chapter, the Agent should also undertake a compliance monitoring and reporting role to ensure volume and price obligations are complied with. However,

the activities of the Market Making Agent are relatively limited and therefore the overall costs should remain low.

CHAPTER: Six – Mandatory auctions

Question 6.1: Are mandatory auctions an appropriate solution to the problems related to wholesale market liquidity?

InterGen is not supportive of mandatory auctions for either day ahead or forward products as a solution to market liquidity problems. Auctions tend to concentrate trading activity around a single period in the day and are likely to result in a hiatus in trading activity outside this period. However, gas-fired generators such as InterGen generally hedge by ensuring that when they sell power, they purchase the gas required to generate that power at the same time, locking in both revenues and costs. In an auction process, there is a delay between placing offers or bids and discovering whether or not they have been accepted. During this time, the price of gas may have moved substantially. A continuous market allows power sales and gas purchases in a more dynamic manner throughout the whole day.

Auctions (such as the UK EU Allowance auctions) can distort the continuous market prices as large volumes are transferred between participants at a single moment and all those participants who have failed to buy or sell their allowances discover this simultaneously.

A day-ahead auction seems more likely to fragment the current day-ahead market (where liquidity is generally accepted to be adequate) rather than increase liquidity overall. Furthermore, it seems unlikely that a reference price from the auction will be accepted as a basis for financial trading any more than the reference prices currently provided by LEBA.

Question 6.2: How should the volume of generation subject to a mandatory auction be set?

Question 6.3: Who should be obliged to offer into the auction?

Question 6.4: What design features should be incorporated into the auction process and rules?

Question 6.5: Should the mandatory auction apply to day-ahead volumes and/or to longer dated forward products?

Question 6.6: What costs would this option impose?

As InterGen is not supportive of mandatory auctions we have not answered questions 6.2 through 6.6.

CHAPTER: Seven – Self-supply restriction

Question 7.1: Is a self-supply restriction an appropriate solution to the problems related to wholesale market liquidity?

InterGen is strongly supportive of moves to separate the activities of generation and supply. The other solutions proposed in the consultation paper merely tackle the symptoms of an increasingly vertically integrated industry structure whereas a self-supply restriction goes some way towards addressing the underlying cause. Because the Big 6 large VI companies have now become relatively

well balanced in terms of their generation capacity and customer demand, their requirements to transact have reduced over time. Furthermore, they have largely immunised themselves from the impact of wholesale market prices. This permits the Big 6 to cross-subsidise the construction of new generation capacity with profits from their retail arms, as was stated by a number of them in their responses to Alistair Buchanan's letter of 4th Aug 2009, which requested suppliers explain their retail pricing policies in light of falling wholesale prices.

InterGen believes that a truly liquid, competitive, rational and transparent electricity market will only emerge once a distinct separation between generation and supply businesses is achieved. In the absence of the break-up of VI companies, the most effective means of achieving this is a progressively increasing self-supply restriction. This should be backed up by reporting requirements which separate the GB generation and GB supply financial statements within the accounts of VI companies.

Question 7.2: Who would be covered by the self-supply restriction?

InterGen believes that all companies with supply and generation interests should be subject to the same self-supply restriction.

Question 7.3: How should the extent of a self-supply restriction be set? Should it relate only to the supply to domestic customers?

InterGen believes that the self-supply restriction should apply to all customer demand (albeit phased in from a starting level of, say, 50%) with all transactions between generation and supply companies conducted in the visible wholesale market. This is the simplest and least discriminatory approach. However, it should be permissible for the generation and supply arms of the same company to transact on platforms where the price and volume of that transaction is visible and available to other market participants.

It is a critical requirement that the arrangement cannot be bypassed by long-term contracts-for-difference between the generation and supply arms of the VI companies. One possibility is to require the disclosure of details for all such long-term deals to the regulator or for a new market in standardised long-term products, accessible to all.

Question 7.4: 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?

In order to facilitate the requirements of small suppliers, it needs to be possible for them to transact on existing trading platforms for partial volumes of the best bid or offer clip size in whole MWs.

Given a separation between generation and supply businesses, it seems likely that a market for a typical supplier's profile requirement would develop. However, if not, it may be appropriate to introduce a market making arrangement in addition.

Question 7.5: How could the previous problems related to enforceability be overcome?

The final half-hourly traded position between generators using their Production accounts and suppliers using their Consumption accounts is notified to the ECVAA ahead of Gate Closure. Although the notified position is, in general, the aggregated volume by counterparty per Settlement

Period, it can be used to give an indication of the extent to which individual parties are trading internally and with external parties.

Alternatively the regulator could require from all generators and all supply businesses a breakdown of traded volumes by counterparty, which would show the exact volume of self-supply and allow its percentage to be monitored over time.

Question 7.6: What costs would this option impose?

InterGen agrees that the main costs are as outlined in paragraph 7.21.

CHAPTER: Eight – Collateral requirements

Question 8.1: Do you think that any of the possible approaches outlined in this chapter have merit and should be pursued further?

As an independent power producer with a business model of project-financed, non-recourse assets there are a number of key points which we need to ensure are addressed in any central market proposals for collateral requirements:

- Our collateral requirements have to be capped as a result of the letter of credit support provided as part of the financing package. Accordingly, any forced collateral posting (i.e. variation margining) must be limited.
- Collateral requirements cannot be solely determined purely by reference to a credit rating i.e. creditworthiness.
- Single commodity market exposure (i.e. non-netted power and gas exposure) is of high risk for any party with a finite collateral support package, especially given the high volatility of the market.

On the basis of the requirements above and in light of the proposed solutions, InterGen's preference would be for a form of credit insurance (subject to proposed levels), although some form of pooled credit arrangement may work, again dependent upon the proposed cap levels. However, it would appear that finding a flexible resolution to the predefined credit terms will be very difficult given the requirement that creditworthiness should not simply be measured on net worth or credit rating.

InterGen has employed a number of innovative solutions in agreeing credit terms with counterparties and would not be supportive of a forced clearing approach.

CHAPTER: Nine – Conclusions and next steps

Question 9.1: Do you agree with the proposed assessment criteria?

Broadly yes, although we would expand the first criterion to include the ability for small or prospective new entrant independent generators to manage their wholesale market risks.

Question 9.2: Which do you think is the best policy option or combination of options?

InterGen believes that vertical integration is not compatible with a truly competitive, liquid, rational and transparent wholesale electricity market. Of the four proposals presented in Ofgem's paper, InterGen believes that a robustly implemented self-supply restriction will not only address many of

the concerns regarding market liquidity, but also reduce the ability for VI companies to cross-subsidise new generation capacity with profits from their retail businesses. Accordingly, we believe such a measure should be introduced without delay, progressing from an initial level to a 100% restriction.

InterGen believes that the introduction of a Market Making Agent using existing trading platforms should assist in increasing liquidity, and would be complementary to a self-supply restriction (though in itself it does not address the underlying issue).

InterGen does not believe the current market initiatives, principally the N2EX clearing service and day-ahead auction, will have much success in improving market liquidity and are more likely to fragment liquidity in the prompt market. The services introduced so far, and the spot / prompt exchange still to be launched, have been available to market participants for some time but have had very limited take-up. The cost of entry to the new exchange and the ongoing transaction costs are high relative to existing routes to market and no small-scale generators or suppliers have joined to date. Furthermore, whilst an exchange for longer-term products is planned this is unlikely to be utilised by those market participants who are credit constrained (generally smaller players and new entrants) due to the potential requirement to post collateral for margin calls. Accordingly, InterGen believes it appropriate for Ofgem to act quickly to address market liquidity rather than wait until the end of the year to assess if action is required.