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Dear James,

International Power's Response to Ofgem's Liquidity Proposals for the GB Wholesale Electricity Market Consultation

International Power plc (IPR) is a global independent power generation company with interests in over 32,000 MW of generation capacity in over 21 countries. This includes approximately 5000 MW of plant in the GB market where, in partnership with Mitsui & Co., it owns and operates the coal fired station at Rugeley, Deeside Power CCGT, Saltend Cogeneration Plant in Hull, First Hydro Pumped Storage Stations at Dinorwig and Ffestiniog in North Wales, Indian Queens Peaking Plant in Cornwall plus a share in Derwent Cogeneration plant. These assets represent a 7% market share, making IPR one of the country's largest independent power producers.

International Power and Mitsui also own IPM Energy Retail Limited which is a newly established electricity supplier in the GB market targeting half hourly metered medium sized Industrial and Commercial customers.

Introduction

IPR welcomes this consultation and Ofgem's focus on the current state of liquidity in the GB wholesale market. Detailed answers to the consultation questions are given in an appendix to this letter. A summary of our position is given below.

Liquidity and barriers to entry

At times the consultation paper seems to confuse the challenges faced by small suppliers with the much wider issue of poor market liquidity faced by all participants. We recognize that Ofgem's review was triggered by concerns identified under the Energy Supply Probe, and we agree that it is important to reduce barriers to entry where possible. However, this focus on the needs of small suppliers means

that there is insufficient consideration in the consultation paper on liquidity levels, the associated drivers and the needs of other players, including independent generators.

Vertical Integration

IPR has consistently highlighted that the overriding issue with respect to poor liquidity in the wholesale electricity market is the level of vertical integration. IPR does not consider that any of the proposed options will deliver a marked increase in liquidity because none of the options address the inherent market structure, i.e. there are insufficient natural buyers and sellers due to the high level of vertical integration. Some of the proposed options merely substitute for existing routes to market and may, therefore, simply fragment the current levels of trading.

Poor liquidity incentivises a vertical integration strategy, which itself can have a further detrimental impact on liquidity. We note that in recent years, the portfolios of the Big 6 players have become increasingly balanced, in terms of matching generation with customer needs. This minimizes any *imperative* to trade externally, internalizing market risks.

Notwithstanding these balanced positions, we recognise that there is, to a greater or lesser extent, some appetite to trade externally, and various commercial incentives to do so. However, our key concern is that without a fundamental imperative to trade, market liquidity has the potential to decline significantly even from current levels, in the event that other market drivers (e.g. credit, changes in strategy) change behaviour.

A liquidity assessment is necessary

We are disappointed that this latest consultation on liquidity has not developed any greater understanding of the true level of liquidity. We have seen various claims from the 'big 6' ranging of churn levels of 2 to 5 times consumption, and Ofgem quotes a figure of 2.5 over the last 3 years. In our response to the July 2009 consultation we suggested that Ofgem should independently verify the state of the market liquidity. IPR views this analysis as an essential starting point from which to address improvements to liquidity and to enable Ofgem to set out robust success criteria by which to measure whether liquidity is improving.

No improvement in liquidity

We have not seen any tangible improvement in liquidity since Ofgem commenced the review last year. We have also seen further industry consolidation between British Energy, EdF and Centrica. Looking forward, there are few signs that liquidity will improve: the majority of new generation is being built by the 'big 6' to replace existing generation despite the lack of a forward price to justify this investment.

Whilst we are pleased that the European Commission applied conditions to the British Energy/Edf merger such as the sale of generation assets and an obligation to trade, we do not believe they went far enough. Much higher priority should be given to the impact on UK market liquidity of vertical integration by the competition authorities in relation to merger control procedures.

IPR has been an active participant and supporter of the market's attempts to improve liquidity through the N2EX, however, the principal driver of liquidity is the market structure and not the availability of platforms.

Measures must avoid damaging existing liquidity

Poorly conceived ideas for mandatory auctions or supply obligations could simply fragment liquidity and damage the market. Attempts to improve liquidity should focus on preserving the flexibility offered by continuously traded markets.

Independent generators already have a strong imperative to trade

If policy measures are introduced then any measures should be applied only to the 'big 6'. Independent generators and suppliers have a very strong imperative to trade. IPR typically trades 4 times its output, but even at this level of churn we are often unable to trade the shapes and tenure to hedge our position as we would wish.

A well designed self-supply restriction should be considered

In order to address concerns over vertical integration, there is potential in developing self-supply restrictions on the large vertically-integrated players that ensure that they do have an imperative to trade externally. However, a self-supply restriction will serve only as useful protection from further deterioration in levels of liquidity and is not a 'solution' to low levels of liquidity. Further transparency over internal trades is also required.

Please do not hesitate to contact us if you have any questions on our response.

Regards,

Kevin Dibble

Head of Regulation

Appendix

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?

It is clear that there have been persistently low levels of liquidity over several years, this has damaged the competitiveness of the market and is sufficient to warrant intervention.

Currently, the scale of the problem is ill-defined. Within the responses to the July 2009 consultation, there are varying estimates of the degree of churn undertaken by the big 6 varying from 2.5 times output (E.on)[1] to 5 times output (SSE). The Liquidity Discussion document calculates the level of churn to be 2.5. This serves to highlight potential inconsistencies in the extent to which the 'big 6' trade, and perhaps what constitutes a 'trade' within each company. The internal markets operated by the 'big 6' could well distort the claimed levels of churn.

Therefore in considering appropriate interventions, the state of market liquidity needs to be independently verified. Ofgem should therefore review data on trades and volumes from all market participants (including bilateral structured deals) in order to independently establish the state of the market liquidity across different timescales. This would provide accurate data on the trading activity of the 'big 6' in order to verify the claims of high churn ratios, and distinguish between internal and external transactions. Such research will establish the need, and extent, of any future action. The results of such analysis should be published so that all market participants can make a considered assessment of market liquidity.

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

Yes. The churn level in gas does not suggest there is a lack of liquidity although it would be worth comparing how liquidity levels are measured to ensure consistency.

CHAPTER: Two

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

The initiatives seem to be mainly aimed at improving liquidity for small/independent suppliers e.g. use of trading platforms by small/independent suppliers, positive feedback from small independent suppliers. The use of trading platforms for forward products creates a margining requirement. We do not see how small suppliers can increase their use of trading platforms without the ability to post more credit – a requirement that can be met only by the supplier rather than the market. The feedback might be misleading unless credit requirements can be addressed to allow increased use of trading platforms.

No mention is made of canvassing independent generators on whether they see trading conditions improving. This should be a further success criterion.

Any success criteria must include both the volumes of standard products (such as baseload) and the ability to trade 'shape'.

[1] E.on estimated that the 'big 6' generate 230TWh and trade 573TWh

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

IPR would define success as being able to trade our required shape and term in a continuously traded market. Despite trading significant market volumes it can be difficult to trade to reflect our generation profile over longer timescales.

Question 3: When should market success be judged?

It will be difficult for Ofgem to judge success until the extent of liquidity is independently verified. IPR suggests Ofgem starts this piece of work immediately so that by mid-summer there is accurate data on trading activity.

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

Separation of the generation and retail arms of the big 6 would be the ideal solution to address the low levels of liquidity. The proposed options simply do not address the underlying issue of market structure.

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

It is not clear from the consultation whether the obligation is to trade or to offer terms.

Assuming the obligation is to offer terms then should small suppliers be unable to obtain non-discriminatory offers (allowing for credit requirements) then this issue could be addressed through competition law. If it is a question of trading shape, any guidelines need to take account of the time required to not only agree credit terms but also to price a shaped contract (which may vary on a daily basis). Since each shape might well be bespoke, setting time limits on responding to requests and pricing benchmarks might not be appropriate.

It is our view that overall market liquidity is not the main issue affecting the ability of small suppliers to transact in the market; other factors such as trading collateral arrangements are far more important. As such, any policy measures relating to liquidity are unlikely to resolve this issue.

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

The obligation to offer terms should only apply to the 'big 6' vertically integrated companies. Independent generators already have a strong incentive to trade on a competitive basis.

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

Sellers must be able to factor in their internally determined risk premium for trading with any counterparty.

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

Rather than a forced obligation to offer terms we would prefer the market structure to be such that all parties have an imperative to trade.

We are also concerned that any direct trading obligations could increase regulatory risks for market participants and actually deter new entry. They may also distort the operation of existing trading mechanisms.

Question 5: What costs would this option impose?

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?

Although preferable to a direct trading obligation IPR would still have concerns around mandating the role of a market-maker.

We do not think that the use of market makers would have a significant effect. As outlined above, the fundamental reason for poor liquidity is vertical integration. Without a basic 'need to trade' built into the market structure, we do not think that measures such as this can deliver tangible improvements.

We foresee a number of practical issues. How could a reasonable bid-offer spread be ensured when the role is an obligation? It is generally recognized that the short term markets are reasonably liquid and it is the longer term market that is the problem. Would the role therefore extend to forward products and if so how will the inevitable credit issues be addressed? Who would pay for the costs of setting up this option? Could the N2EX or the brokered market provide a platform for a market maker rather than separately establishing a market maker?

A market making obligation should not apply to independent generators as they have a very strong imperative to trade.

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

Ideally, standard (baseload and peaks) products, shaped products and overnight products.

Question 3: What volume obligation would be appropriate?

There seems little point in having a low volume due to the cost of setting up the agent and of obliging the 'big 6' to participate, a large volume would increase the risks of those required to offer prices.

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

No, participants can make markets now if they want to. We do not see the requirement for an agent, market-making could be facilitated through the existing brokered OTC market or via the N2EX platform.

Question 5: What costs would this option impose?

Setting up would be costly and there are already avenues to allow a market-making role to emerge.

It should be noted that various participants 'make markets' in power from time to time where this assists execution of their trading strategies. To our knowledge there are currently no arrangements in UK power where participants agree to make markets on a regular basis (i.e. provide a market making service). Given this position, any obligation imposed on participants to provide this service is likely to increase risk and therefore the cost of operating in the market.

CHAPTER: Six

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

No. IPR does not advocate forcing parties to trade or obliging them to trade at certain times. It is not efficient to dictate when parties must trade their output and this would increase risks for participants.

We already have the N2EX platform and believe that small suppliers could participate here even if it is only to use the clearing aspect to avoid providing credit to many parties. N2EX should be pushing to encourage small suppliers to join and Ofgem should investigate whether there are any small supplier specific barriers to participating in N2EX before progressing ideas for mandatory auctions.

We see little point in holding auctions for small volumes as this will not produce a reliable price index. Any partial auction will fragment liquidity away from the main markets and discourage trading in other arenas around the time of the auction until prices are known. This suggests that if there is to be auctioning then it needs to happen as a replacement for the current BETTA arrangements rather than alongside BETTA.

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

We do not accept that mandatory auctioning is an appropriate solution. However, for mandatory auctioning to work, all generation should be subject to the auction but this is incompatible with BETTA. The consultation does not consider this avenue.

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

The 'big 6'; independent generators already have a very strong imperative to trade.

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

There would be little point in holding auctions to address the concerns of small/independent suppliers if they did not offer the shape and clip size to meet their needs particularly outside of the prompt market. However longer dated products will introduce a margining requirement which leads us back to questioning whether it is credit that is the primary problem for small suppliers..

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

We have already commented on the reasonable level of liquidity in the shorter term which currently exists without auctions. To be beneficial, auctions should therefore address longer dated products. However, the inherent margining issues of longer term mandatory auctions may actually reduce access to the market for the non-vertically integrated players as they have no opposing position against which to offset margin calls.

Question 6: What costs would this option impose?

This is difficult to quantify. In addition to costs associated with setting up an appropriate platform, individual participants would incur implementation costs for their own systems. There are likely to be increased credit costs and potentially increased risk.

CHAPTER: Seven

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

Of the four options presented, the self supply restriction is preferred as it may serve to protect the market from further deterioration in liquidity levels. However, this is not a solution to the problem.

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

We believe that it should only apply to participants with a large share of the domestic supply market.

We agree with the view that I&C demand is largely met via the traded market and so a self supply restriction on this sector would have minimal impact that would not warrant the costs associated with implementation and monitoring.

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

We feel that the restriction should only relate to the supply of domestic customers for the reasons outlined above.

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?

No. The products required will depend on the customer types that are being supplied by each participant and each participant is likely to have different requirements so it is difficult to see how such a measure could be implemented.

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

The key issue with enforceability appears to be how you track the purpose of each wholesale transaction. The 'big 6' all state that they currently trade 2-5 times their generation and so could claim that they already purchase all of their supply requirements from the market. Without tracking where each trade ends up within the vertically integrated organisation it would be difficult to establish what proportion is self supply.

An approach that would enable the "non self-supply" volumes to be tracked would be to insist that these volumes must be purchased through the brokered market, a designated exchange and/or auction. This would make it clear that the volumes come from the market. Provided the platform was open to all, this would also ensure that the volumes purchased by the big suppliers were available to all participants. If the costs and collateral requirements associated with trading through this channel were the same for all participants this would further level the playing field for all. These costs should be kept to a minimum. Whoever operates any mandatory exchange/brokered market, steps must be taken to ensure that party is not making unreasonable profits from the requirement.

Question 6: What costs would this option impose?
The cost of this option would depend on how the restriction is implemented.

CHAPTER: Eight

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

The issue of credit does not just affect smaller companies and we support any credit-related initiatives that might increase liquidity. We also agree with Ofgem that counterparties need to be able to manage their risk exposure and that none of the approaches considered by Ofgem represent an effective and proportionate response to the problems faced by small suppliers.

CHAPTER: Nine

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

One further assessment criteria should be whether the option reduces collateral requirements in a manner that is detrimental to market stability.

Question 2: Which do you think is the best policy option or combination of options?
Our preference is for a self supply restriction once the extent of true market liquidity has been established. We do not view the other three proposals as being workable.