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By email – gbmarkets@ofgem.gov.uk

22nd April 2010

Dear Sir / Madam

Response to Liquidity Proposals for the GB wholesale electricity market

Rio Tinto Alcan welcomes Ofgem's further consideration of the issue of liquidity in the electricity market following its initial request for feedback last year. We have attached our previous response as an annex, note that this has been amended to remove previous confidential disclosures.

Rio Tinto Alcan owns and operates two integrated facilities for the production of primary aluminium, Lynemouth in Northumberland and Lochaber in Fort William. Power for use in these facilities is provided by autogeneration from coal and biomass at Lynemouth and hydro power at Lochaber. Our spill and residual purchase requirement from our autogeneration is traded through a single party trading services agreement. In addition, we also provide unique Demand Side Balancing Services direct to National Grid.

The facility at Lynemouth also consumes natural gas, which is procured through a flexible trading services contract. Our facilities also provide us with Renewables Obligation Certificates (ROCs) and create exposure to the EU Emissions Trading Scheme. We have a small team managing the commercial trading relationships in the UK energy markets, and the procurement of generation fuels for Lynemouth.

We are also involved in projects to increase the amount of renewable energy produced at sites, and investigating longer-term sources of power for our facilities. Therefore our interest is not just in creating liquidity in the current market but also to establishing enduring arrangements.

Despite our relative small size in the market, we play an active role in the industry through our membership of industry groups such as the Energy Intensive Users Group, Demand Side Working Group, Large Users Group and dialogue with National Grid and Ofgem and DNOs on specific issues of concern to our business. At the time of introduction of NETA we played an active role in working groups to inform understanding of the impact of the changes to the arrangements on smaller market participants.

Although we are encouraged by the recognition that liquidity in the electricity market requires attention and were enthused by the profile given to the initiative by Ofgem and the rest of the industry, we are somewhat deflated by the resulting proposals in that they are made with the incorrect assumption that the problem, and therefore solution, is confined to the supply side in the market.

We noted in our response (see annex) large, energy intensive users on the demand side face similar challenges to small and independent suppliers. This was recognised by Ofgem in its summary of responses (pg 60). It is therefore disappointing that the Consultation Document focuses mainly on the issues of small and independent suppliers with little reference to demand side participants. We have made these comments verbally to Ofgem at both Demand Side Working Group and Large User Group in recent days.

Furthermore, as a demand side participant with distributed generation we are equally concerned at the simplistic conclusion drawn that as 'only' 68% of generation output is attributable to the 'Big 6' (as opposed to 99% of the supply market) there is no need to consider the question of liquidity for the generation side of the market. As Ofgem has noted in its Project Discovery document, there are issues with connection and access arrangements for Distributed Generation and also with achieving fair market value for power.

The issue of credit and collateral is another area where the demand side and DG face similar issues to small and independent suppliers. Assuming that Ofgem accept that this is the case, we welcome the initiatives proposed in the Consultation document. Our initial response indicated that the 'mutualisation' provisions under the Renewables Obligation were a possible model to consider and as such we support the consideration of options to 'pool' credit and some form of mandatory credit insurance. Our support is strongly caveated that any such additional costs and burdens placed upon small participants must be in return for clear benefits.

We believe that no solution to liquidity can be effective without addressing the barrier of credit and collateral, for example, costs of credit and / collateral can severely distort the terms which large suppliers offer under 'obligations', and clearly a mandatory forward auction of power is infeasible if smaller participants are not able to participate due to credit requirements.

Although we do believe that the issue of liquidity is significant and urgent enough to require immediate action, we support the proposal to allow recent initiative the opportunity to deliver. We also agree with the proposed 'success criteria' and welcome the statement from Ofgem that improved liquidity will be measured qualitatively as well as quantitatively (i.e. through increased breadth of product offerings by exchanges and OTC, not just increased volume). We are actively reviewing participation in some of the initiatives and will be able to provide feedback to Ofgem on these later in the year.

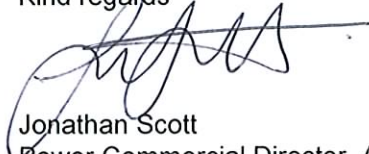
Resource constraints and time pressures prevent us from commenting in detail on the proposed solutions. However, based on preliminary analysis we give tentative support to the proposed self-supply restriction and also to mandatory auctions. We note that as stated above both would require some attention to credit and collateral barriers to entry. We agree that the area of lowest liquidity is in forward markets and as such any mandatory auctions should be for forward delivery.

To maximise access to these initiatives, participation should be facilitated via existing supply routes; for example for large users and DG registered in SVA to be able to participate via their Licensed Supplier.

Finally, we recognise the interactions between the proposals on liquidity and Project Discovery. Clearly, any potential solution to liquidity needs to be considered in the context of potentially more fundamental changes as a result of the outcome of Project Discovery. As such, we suggest that Ofgem establish a direct dialogue with smaller participants on the demand side (including those with DG) to seek to address the issues in a holistic way. In this respect, we remind Ofgem of the importance of this type of dialogue in the NETA process.

I trust that this response is of use in your consideration of the issue of market liquidity and look forward to discussing with Ofgem further in due course.

Kind regards

A handwritten signature in black ink, appearing to read 'Jonathan Scott', written over a horizontal line.

Jonathan Scott
Power Commercial Director, Alcan Aluminium UK Limited.

Annex

Rio Tinto Alcan Response to Liquidity in the GB wholesale energy markets

3rd July 2009

Rio Tinto Alcan welcomes Ofgem's consideration of the issue of Energy Market Liquidity and the opportunity to provide comments in relation to the Discussion Paper of 8th June.

Rio Tinto Alcan is a small participant in the wholesale energy market, trading its energy exposure from smelters and associated power generation in the UK. Due to restrictions on resources and time, our comments are limited to broad themes and where we can add value to specific questions posed by the document.

The issues posed by the document are significant to our participation in the energy markets and we would welcome the opportunity to discuss in further detail with Ofgem, or to participate in any further industry discussions arising from your review.

Questions

Section 2

Q1 Although we believe the gas market does have some issues in relation to liquidity, particularly in relation to demand side participation, we agree that for the purposes of this investigation attention should focus on the GB electricity market where the main issues reside.

Q2 We agree that there is insufficient liquidity in the GB electricity market

Q3 We agree that the document provides a fair demonstration of the lack of liquidity in the GB electricity market, based on publicly available and objective data.

Q4 Ofgem should be greatly concerned by the issues raised in this document, particularly with regard to ensuring continued participation of the independent generation and supply sector, encouraging new entrants, and to facilitating demand-side participation in the market. If the GB market is to meet its targets in relation to sustainability and security of supply, it is critical that barriers to participation in the wholesale market are addressed.

Section 3

Q1 We believe that vertical integration has reduced liquidity in the GB wholesale electricity market, as it has reduced the requirements of suppliers and generators to trade with each other as exposures are netted within large portfolio organisations. The evidence provided in the document in relation to the reduction in traded volumes and churn rates over the course of this decade coincides with increased vertical integration.

In addition to reducing the gross volume of 'unhedged' power, vertical integration has reduced the niche importance of independent, smaller generators and suppliers, and large energy users, who had previously been able to offer access to niche markets for standalone supply or generation companies.

Q8 Rio Tinto Alcan has experienced difficulty with managing its position in the marketplace due to the inability of the wider market to provide 'non-standard' products, shapes and volumes.

Forward Trading - We have often unsuccessfully attempted to trade for bespoke periods (e.g. annual maintenance outages), or for non-standard periods (e.g. quarters). The

forward market suffers from poor turnover on standard seasons and months; however this is exponentially more difficult in trading for non-standard periods.

Prompt Trading - Changes to our position within day must be traded in the market. Liquidity in the within-day market is sporadic, particularly for non-standard periods or volumes. This can often lead to exposure to imbalance prices as a result of being unable to forward contract.

[Confidential section removed]

Q9 We welcome the significant positive improvements made by Ofgem and National Grid to access to information in the UK gas and electricity markets. We do not see information access as a barrier to liquidity. Indeed, we note that the economies of scale and access to resources of larger players increase their ability to view, analyse and act upon information releases more promptly than smaller participants – in some instances access to information can have an impact opposite to the intention of creating a more equitable market.

Q10 The wholesale market has increased in volatility over the decade, which could suggest that this is linked with decreased liquidity. We have noticed this trend increasing since 2005, when volatility saw a stepped increase. The effect has been twofold:

Firstly, the appetite for risk amongst smaller participants has been checked by the fear of making an incorrect judgement, as the actual cost / opportunity cost of such an error has increased.

Secondly, the larger participants in the marketplace have become increasingly concerned by the impact of volatility on credit risk. This has reduced the volume of transactions in the market as a whole and also reduced the willingness of parties to trade for longer-dated periods.

Q12 As noted above we believe that the credit and collateral requirements of the broader market have increased over the past 4 years.

[Confidential section removed]

Section 4

Q1 We welcome the initiatives currently undertaken to improve price discovery and harmonisation however are sceptical to the impact they will have to significantly improve liquidity. We believe that the issues lie in more structural features of the market rather than due to the fragmentation of brokers and relatively low exchange participation.

Q4 and Q9 We believe that any measures to improve access to demand side and smaller participants should be considered together.

We welcome the suggestions put forward in the document and believe each is worthy of further discussion by the industry. As noted above, the extent of the liquidity issue in the market does suggest that a solution may need to come from structural changes to the market such as the suggestions to limit self-supply of power or even a form of unbundling rather than from incremental changes to the market arrangements such as increasing information provision.

Other suggestions worthy of detailed consideration include the socialisation of credit risk (where the Mutualisation provisions in the RO may provide a model), ensuring that governance arrangements support new entrants and small and independent participants by balancing simplicity with effectiveness, and to further encourage the participation of the demand side in the market.

As noted above, we are happy to discuss the issues raised by the consultation further with you or to participate in any wider discussions.

Yours sincerely,

Jonathan Scott