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Dear Robert,

GB wholesale electricity market liquidity: summer 2010 assessment

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 28,000 business customers and provides an alternative route to market for some of Drax’s power output.

Drax welcomes Ofgem’s latest assessment of liquidity in the GB wholesale electricity market and is encouraged that Ofgem recognises the concerns of independent market participants with regards to low levels of long-term liquidity in the wholesale market.

Low liquidity and limited term continues to have a detrimental effect on the level of new investment by new entrants and independent generators. This, in turn, is damaging to the development of price signals, hence investor confidence in the GB wholesale electricity market is reduced, jeopardising the provision of adequate future generation capacity.

The regulator will need to seriously consider actions to remedy the long-term liquidity issues that independent participants in the GB wholesale electricity market currently experience. The overall solution must:

- Address market structure issues that lead to low liquidity in the GB wholesale electricity market, i.e. remove the incentive for parties to become vertically integrated and trade internally;
- Improve short- and long-term price signals by ensuring there is a meaningful increase in generation volume traded 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. stop the optimisation of six “mini-markets” and ensure optimisation of the wider wholesale market.

Initiatives such as the development of the N2EX platform will not address the *causes* of low liquidity in the GB wholesale electricity market; the project has delivered services that are already available to market participants and has further fragmented liquidity in the process.

Drax has a number of comments on the assessment contained in the consultation document; these comments can be found in response to the three consultation questions below.

Chapter 2: Proposed metrics

Question 1: Do you agree that the proposed framework provides an adequate range of evidence for assessing market liquidity?

Drax believes that the proposed framework provides a good starting point; however, Drax would like to put forward views on a number of the metrics / specific measures detailed in the consultation document. These are set out under the relevant headings below.

3. Use of platforms which promote price transparency

Drax does not believe that it is purely exchanges that can deliver price transparency; brokers and reporting agencies are able to deliver reliable reference prices based upon completed OTC trades. Drax notes the financial coal markets and the API2 index as examples; whilst Drax would argue that the API2 index has room for improvement as a methodology, it does support a very liquid coal derivatives market. Likewise, the UK power brokers currently offer the LEBA power indices, which provide robust reference prices and is capable of supporting a UK power derivatives market.

In addition, with regards to the “specific measures” under this metric, the volume traded on a given exchange or auction platform may depend on a number of factors, including the criteria that parties are required to meet in order to participate, the products that the exchange provides access to and the way in which trades are settled (e.g. via clearing mechanisms). Measuring the percentage of total trades transacted on a given platform (or platforms) is too simplistic.

The comment noted in Table 1 of the consultation document for this metric raises an interesting issue that is not reflected in the “specific measures” column; that is, liquidity being spread across a number of platforms may not be optimal for the market, in that greater depth of liquidity on a smaller number of platforms will provide greater scope for reference price formation than shallow pools of liquidity across multiple platforms. As shown in Figure 1, the overall level of market liquidity has not increased since the launch of the N2EX platform; rather liquidity has been further fragmented and remained at a similar level to that experienced before the launch of the platform. As such, Drax continues to view the launch of the N2EX platform as a distraction from addressing the *causes* of low market liquidity.

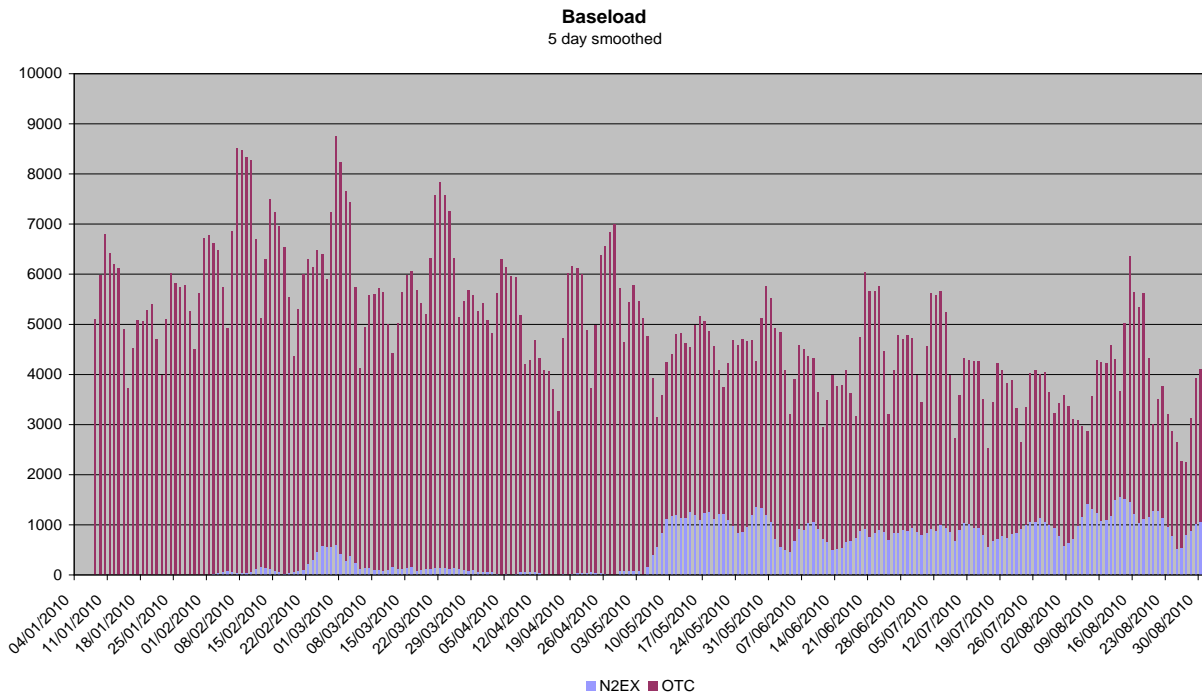


Figure 1: Total volume of N2EX and OTC trades

4. Volume of trade along the forward curve

Drax has concerns over the use of the term “volume of trades that are for 13-24 months ahead or more” for use as a specific measure of increased long-term liquidity. It would seem more appropriate to split the monitoring of liquidity into three categories:

- Short-term liquidity being trades 12 months out and less;
- Medium-term liquidity being trades 12 to 36 months out; and
- Long-term liquidity being trades 36 to 60 months out or beyond.

It should be noted that it is the trades in the final category (36 to 60 months out or beyond) that provide long-term investment signals to independent generators.

5. Availability of financial derivatives

Drax agrees that a greater availability of financial products may help long-term liquidity. However, it should be noted that the same issues that currently apply to products traded on cleared exchanges will most likely apply to financial derivatives trading on those same exchanges. The key issue is the way in which credit and settlement is handled by such exchanges.

6. Participation by banks / other financial institutions on trading platforms

It should be noted that whilst banks may have the cash that allows them to participate on trading platforms (i.e. the ability to handle clearing), independent generators and suppliers will still face collateral issues that prevent them from participating.

Further to this, the involvement of financial institutions in the GB wholesale electricity market should not be measured purely on their use of exchanges; their involvement should also be measured on their participation within the brokered market.

8. Number of counterparties active in the market providing hedging offers to small / independent suppliers

Whilst this metric focuses on the number of parties providing hedging offers to small / independent suppliers, there is a similar argument to measure the number of parties providing hedging offers to small / independent generators (i.e. retail participation). The domestic supply market is currently dominated by six large suppliers with what could be described as stable, “sticky” customer bases. Greater competition for market share in the domestic retail sector, combined with the removal of the vertical integration shield, would require such suppliers to balance their positions via the wholesale market and may create opportunities for new suppliers to enter the market.

This should also tie in with metric 9 above; the number of financial institutions that provide hedging offers to small / independent generators should be monitored.

Plus, other measurements that could be used

In addition to the above, a further metric could be the concentration of liquidity. As indicated in our comment on metric 3 above, liquidity being spread across a number of platforms may not be optimal for market participants. Greater depth of liquidity on a smaller number of platforms will provide greater scope for reference price formation than shallow pools of liquidity across multiple platforms.

Chapter 3: Preliminary assessment and targets

Question 1: Do you agree with the assessment of the metrics in this chapter?

Question 2: Do you have any comment on the level of improvement in the metrics that would make a significant difference for market participants?

Drax broadly agrees with the assessment of the metrics in Chapter 3. Drax would like to offer the comments detailed below.

1. Aggregate churn: volumes traded across all products / GB physical consumption

We agree with Ofgem's statement that there has been an improvement in the overall level of churn. Short-term liquidity has increased from the market low; however, as suggested in the consultation document, the GB market churn is below that of comparator markets and volumes in the long-term have not improved to a level that supports the market's needs.

2. Bid-offer spreads for range of standard products

Drax agrees with Ofgem's assessment that there has been a widening of the bid / offer spread for products further along the curve, with some narrowing for products closer to delivery.

3. Use of platforms which promote price transparency

Market liquidity is the key to price transparency and the use of a trading platform is unlikely to address the causes of poor liquidity. The UK brokers have been addressing methods of improving wholesale power market transparency for many years and have equipped the market with a number of solutions, many of which encompass the concepts behind 'platforms'. Currently the market benefits from robust and reliable broker indices; market participants can gain access to the live and electronic broker trading screens / platforms. The brokers and reporting agencies all issue daily market commentaries; if the market trades, market prices can be seen almost immediately. It's the lack of trading that is the issue.

Drax agrees that there is limited exchange-based trading in the GB wholesale electricity market; however, this has been the case since 2001. The UK has benefitted from a number of exchanges which have all attempted to launch their products and services into GB markets. It should be noted that when the GB wholesale electricity market had a high churn rate, exchange service offerings still struggled to elicit the market's participation. As an example, IPE, now known as ICE, with its strong brand and market leading membership / product offerings was unable gain traction within the GB wholesale electricity market. History suggests that exchange based trading is unlikely to be the catalyst to increased forward market liquidity.

Drax believes that it is equally important to measure the use of the OTC market for traded volume, with reference prices being supported / further developed by the brokers. The key issue is the volume of generation sought / contracted (as a whole) from the wholesale market by suppliers.

4. Volume of trade along the forward curve

Drax agrees with Ofgem's assessment; there has been a decline in volume of baseload products traded further out along the curve. Drax questions the perceived improvement in the trading of peak and off-peak volumes further along the curve; historically, such volume has been so poor that an actual improvement may be factually correct, but not of the substance required to support a credible case for market liquidity. The improvement in peak and off-peak volumes traded is still minimal and such trades are not taking place over the long-term (i.e. 36+ months out).

5. Availability of financial derivatives

It is important to differentiate between (a) financial products that trade OTC and are reported, and (b) the financial products that form part of the products and services offered / supported by the participating banks within the UK power market. Financial derivatives are readily available from the banking community and a number of these products reference settlement to LEBA; however, the duration of such products is limited by the underlying forward market liquidity.

There are sufficient reference prices to support the development of financial derivatives at present; however, Drax would question the context and weighting to be applied to the relevance of financial derivatives for the assessment of wholesale market liquidity. The NBP gas market is held in high regard and this market sees no significant volumes of traded financial derivatives. The financial derivative concept is perhaps a distraction from the key issues inhibiting GB wholesale electricity market liquidity

6. Participation by banks / other financial institutions on trading platforms

Banks and other financial institutions are attracted to markets which display high levels of liquidity, open interest and volatility. Without a robust market place where electricity suppliers and generators create sufficient liquidity to support the entry and exit of trading parties, it is unlikely that the UK power market will benefit from a significant influx of new entrants and financial institutions.

7. Diversity of products

Drax agrees that whilst there is a wide range of products available in the GB market, trades are concentrated in a few products. Such trades are also concentrated in short-term products, with a very limited volume of long-term trades being transacted (i.e. 36 plus months out). Short-term trading alone does not provide adequate price signals or hedging opportunities for independent generators.

8. Number of counterparties active in the market providing hedging offers to small / independent suppliers

Drax does not agree that there has been an increase in the number of entities in the market.

9. Participation by small / independent market participants on trading places

Drax agrees that credit issues provide a barrier to small / independent suppliers trading on exchanges.

10. Availability of suitable products with small clip sizes

Drax agrees that the issues surrounding the minimum clip size of products traded has not been addressed and could remain a barrier to small suppliers.

11. Feedback from a sample of small / independent suppliers, potential entrants, large energy users, and independent generators

With regards to qualitative feedback from small / independent participants, please see our comments at the beginning of this response.

Conclusion

Drax has not experienced an improvement in long-term liquidity over the last six months (i.e. since the launch of the N2EX platform) and still believes that the regulator will need to take action to remedy the long-term liquidity issues that independent market participants face in the GB wholesale electricity market. Overall, a successful resolution of liquidity issues for small / independent suppliers and generators 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.

Finally, Drax continues to believe that the timetable for assessment and remedy development should be brought forward in order to ensure that the benefits of such proposed remedies are not delayed. Drax is disappointed with the pace at which remedies are being investigated and developed; it is unfortunate that calls from independent participants to increase the pace of the liquidity work-stream appear to have gone unheard. However, we look forward to viewing both Ofgem's and industry participants' responses to this consultation.

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
Drax Power Limited