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FAO Stefan Bojanowski
Retail Markets
Ofgem
9 Millbank
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Dear Stefan,

The Retail Market Review – Findings and initial proposals

Drax Power Limited ("Drax") is the operating subsidiary of Drax Group plc and the owner and operator of Drax Power Station in North Yorkshire. Drax Power Limited also owns an electricity supply business, Haven Power Limited ("Haven"), which supplies some 33,500 business customers and provides an alternative route to market for some of Drax's power output.

This response mainly covers Proposal 2, market liquidity. A separate submission will be provided by Haven containing more comprehensive comments on Ofgem's proposals for the non-domestic retail sector.

The Problem

Wholesale market liquidity continues to act as a barrier to entry for both independent suppliers and independent generators. The low levels of medium-term liquidity currently experienced in the wholesale market denies independent participants access to standard market products, stifles innovation in new product offerings and limits the market's ability to form efficient investment signals. The consequence is a market that suffers from reduced investor confidence, increased regulatory intervention and increased costs to end consumers.

There are two major, yet separate, liquidity related issues faced by market participants:

a) Contestability: the inability to gain access to particular traded products, clip sizes and shapes of volume, which small suppliers require to manage their exposure; and

b) Medium-term liquidity: the inability to gain access to volume beyond 18 months forward, which independent generators require to hedge their investment in existing plant and to signal investment in new capacity.

Without a robust forward curve beyond 18 months, there will not be a sufficient underlying level of liquidity to support entry and exit from the market. If participants are unable to enter and exit market positions as required, it is highly unlikely that there will be a significant influx of new entrants.

Financial institutions with strong credit ratings are best placed to offer innovative market making facilities that will address contestability concerns. However, a pre-requisite of such businesses offering market making services will be strong liquidity in the forward market that allows independent participants to invest, compete and grow organically.

To date, "market-led" initiatives have focused on the creation of new platforms, rather than addressing the underlying causes of low liquidity levels. A prime example is the N2EX auction platform, which has only delivered services that are currently available to market participants. The platform has failed to attract new market liquidity, having only attracted a share of pre-existing liquidity, further fragmenting the market in the process.

A major shortfall of the N2EX auction platform is the cost to participate. High collateral requirements and transaction costs have resulted in the effective exclusion of a number of independent market participants. The posting of collateral on N2EX is analogous to the letter of credit arrangements that exist in the OTC market. Letters of credit cover a wide range of offsetting transactions across energy commodities, not just power. If the presently absent medium-term liquidity were to be delivered via N2EX alone, it would come at the cost of significant additional collateral charges for independent participants, making such parties less competitive versus their vertically integrated counterparts.

Existing trading mechanisms are not to blame for the lack of contestability and low levels of market liquidity experienced two to five years forward. A liquid wholesale market can support multiple trading platforms, which in turn will create competition, encourage innovation, support increased product offerings and drive down transaction costs. The real issue is the way in which market participants interact with the traded market and the effects of such interactions on market liquidity and price signals.

<u>The Solution</u>

Whilst it is apparent that regulatory intervention is required, it is questionable how a Mandatory Auction or a Mandatory Market Maker would differ in its approach to credit, collateral and transaction costs to that of the N2EX platform. Unless these issues are addressed, it is difficult to envisage how a mandated platform would deliver greater access to market traded volume for independent participants. Hence, barriers to market entry will remain.

Independent market participants rely on the ability to trade bilaterally via the brokered OTC market (and other market platforms) to hedge their investments and manage market exposure. Vertically integrated participants are less reliant on the market as they have access to a natural hedge for a significant proportion of their generation investments. This comes in the form of a large domestic customer base. As such, it is the interaction between the large domestic supply companies and the wholesale market that must be addressed, as this is where the market power is concentrated.

The danger of mandating a particular route to market is that certain parties may be unable to participate in the regulator's chosen (mandated) platform due to the cost of participation. It would be more appropriate for the regulator to mandate the large domestic suppliers to trade a minimum volume (or market share equivalent) within the wider wholesale market. The obligation should focus on the volume <u>sold</u>, as opposed to volume offered. The choice of how volume is sold should be for the obligated parties to decide.

Self-supply restrictions on large vertically integrated parties, whether they prohibit a proportion of market share or all trades between internal business units, is not a new concept in the GB electricity market. By forcing more trades to take place via the wholesale market, the six large domestic supply companies would be required to source their power requirements on the same basis (price and terms of sale) as their small / independent counterparts.

Such a move would increase the total volume traded via the market, allow efficient price discovery, ensure price / investment signals are visible to all parties (existing and potential new entrants) and promote greater competition in both the retail and wholesale markets. The restrictions need not continue on a permanent basis; licence conditions could contain sunset clauses to relax the restrictions should overall liquidity significantly improve.

An additional benefit of a self-supply restriction approach would be the promotion of efficient plant dispatch. By ensuring the market is able to dispatch the highest efficiency (least polluting) plant before the lowest efficiency (most polluting) plant, the proposal could have a positive environmental effect in addition to its competition advantages.

Finally, accountability will be crucial if the regulator is to increase investor confidence. Obligated parties must be required to demonstrate that volumes have been traded, with the transactions being independently verified by their external auditors. This would reassure the market that obligations had been met, whilst also easing the burden of monitoring activities required by the regulator.

Answers to the specific consultation questions can be found in Appendix 1. 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
Market Development Manager
Regulation and Policy

Appendix 1: Drax response to the consultation questions

Question 1: Do stakeholders agree with our findings of the Review in relation to causes of persistent consumer harm and barriers to entry in the energy retail markets?

Drax agrees that there are substantial issues surrounding:

a) Market liquidity, particularly two to five years forward (i.e. medium-term trading); and

b) Market structure, particularly the market power held by the large domestic retail companies that benefit from a “sticky” customer base.

Each of these issues creates barriers to new independent entrants in both the supply and generation sectors.

There are further areas that require consideration, including burdensome credit requirements and the cost of participation on particular trading platforms. It was these issues that led to the muted impact of the N2EX project. These concerns also apply to the mandated routes to market suggested under Proposal 2.

Questions 2 to 7 (domestic market):

The issues that cause a lack of competition in the retail market (i.e. limited new entry), and a lack of liquidity in the wholesale market, arise due to the dominance of the large domestic suppliers with significant legacy (“sticky”) customer bases. The interaction between the large domestic supply companies and the wholesale market should be addressed prior to proposing solutions that mandate how suppliers contract with their customers.

Question 8: Do stakeholders consider that low electricity market liquidity constitutes a barrier to entry in the domestic retail supply market?

Yes. Low wholesale market liquidity constitutes a barrier to entry for both independent suppliers and independent generators. Limited tenure of trades in standard market products has a damaging effect on the development of efficient price signals, which reduces investor confidence in the GB wholesale electricity market. As a result, the development of a competitive retail sector is impaired and adequate investment in future generation capacity, which cannot be funded by the vertically integrated companies alone, is jeopardised

There are two major, yet separate, liquidity related issues that must be addressed in the wholesale electricity market:

a) Contestability: the inability to gain access to particular traded products, clip sizes and shapes of volume, which small suppliers require to manage their exposure; and

b) Medium-term liquidity: the inability to gain access to volume beyond 18 months forward, which independent generators require to hedge their investment in existing plant and to signal investment in new capacity.

Small suppliers attending the Liquidity Roundtable Event[1] signalled that the most effective way to resolve contestability issues would be to address low levels of liquidity in standard traded products. Drax agrees with this view.

The wholesale market currently supports an adequate level of liquidity across a range of standard products up to 12 months forward. Granularity of products steadily increases the closer it is to real time (delivery). The key issue is the length and depth of liquidity over the forward curve, which rapidly falls away beyond 12 months out and does not extend beyond 18 months.

[1] Facilitated by Ofgem, Navermber 2010. The event focused on liquidity issues faced by wholesale market participants.

To have any real effect, Ofgem's proposals must address the inadequate length and depth of liquidity beyond 18 months forward. A focus on increasing liquidity across the forward power curve is crucial if new entry is to be encouraged from both energy and non-energy sector traders.

Question 9: Do stakeholders consider that our two proposed interventions (the MA and the MMM) could improve the ability of the wholesale electricity market to meet independent participants' needs, and will ultimately improve the likelihood of retail supply market entry?

No. Mandating a route to market will not necessarily meet independent participants' needs. Nor is it conducive to a competitive and liquid wholesale electricity market.

It is recognised that small independent participants require access to particular products, clip sizes and shape. Whilst a market maker, for example, could be developed to deliver such products, existing platforms and contract structures could deliver the same results.

To date, "market-led" initiatives have focused on the creation of new platforms, rather than addressing the underlying causes of low liquidity levels. A prime example is the N2EX auction platform, which has only delivered services that are currently available to market participants. The platform has failed to attract new market liquidity, having only attracted a share of pre-existing liquidity, further fragmenting the market in the process.

A major shortfall of the N2EX auction platform is the cost to participate. High collateral requirements and transaction costs have resulted in the effective exclusion of a number of independent market participants. It is evident that there has been no increase in total market liquidity over the last twelve months, i.e. the delivery of new volume to the traded market. N2EX has simply cannibalised volume that was on existing platforms; this is illustrated in Figure 1 below.

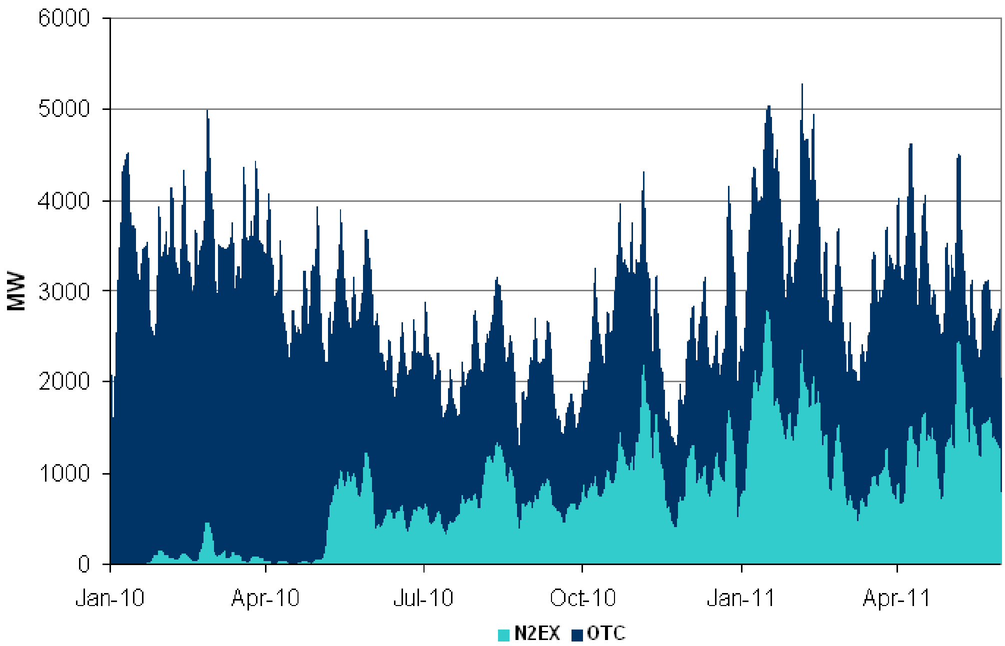

Figure 1: Comparison of baseload volume traded OTC and on the N2EX platform

The posting of collateral on N2EX is analogous to the letter of credit arrangements that exist in the OTC market. Letters of credit cover a wide range of offsetting transactions across energy commodities, not just power. If the presently absent medium-term liquidity were to be delivered via N2EX alone, it would come at the cost of significant additional collateral charges for independent participants, making such parties less competitive versus their vertically integrated counterparts.

Whilst it is apparent that regulatory intervention is required, it is questionable how a Mandatory Auction or a Mandatory Market Maker would differ in its approach to credit, collateral and transaction costs to that of the N2EX platform. Unless these issues are addressed, it is difficult to envisage how a mandated platform would deliver greater access to market traded volume for independent participants. Hence, barriers to market entry will remain.

The focus for market reform must be on increasing liquidity beyond the current forward power curve; this is crucial to encourage new entry from both energy and financial sector traders. Financial traders are attracted to markets that display high levels of liquidity, open interest and a degree of volatility.

Without a robust wholesale market where electricity suppliers and generators create sufficient liquidity to support both entry <u>and</u> exit from the market, it is unlikely that there will be a significant influx of new entrants. This will only be achieved if market structure issues are resolved by forcing the vertically integrated companies to trade greater volumes of energy across the forward curve via the wholesale market.

Ultimately, independent market participants will continue to trade via the most cost effective route to market, such as via the OTC market where credit requirements are less onerous. The danger of mandating a particular route is that certain parties may be unable to participate in the regulator's chosen (mandated) platform due to the cost of participation. This would effectively exclude a section of the industry from accessing traded volume, which in turn may lead to inefficient plant dispatch and continued barriers to entry.

Question 10: Subject to the results of our further wholesale market assessment, do stakeholders consider that both interventions could be necessary to meet the objectives stated in questions 8 and 9?

Existing trading mechanisms are not to blame for a lack of contestability and a low level of market liquidity two to five years forward. A liquid wholesale market can support multiple trading platforms, which in turn will create competition, encourage innovation, support increased product offerings and drive down transaction costs. The real issue is the way in which market participants interact with the traded market and the effects of such interactions on market liquidity and price signals.

Independent market participants rely on the ability to trade bilaterally via the brokered OTC market (or other market platforms, such as power exchanges and auctions) to hedge their investments. Vertically integrated participants are less reliant on the market as they have access to a natural hedge for a significant proportion of their generation investments in the form of a large domestic customer base. It is the interaction between the large domestic supply companies and the wholesale market that must be addressed, as this is where the market power is concentrated. This is the key to making any progress on medium-term liquidity issues.

The mandating of a particular route to market should be reconsidered. It would be more appropriate for the regulator to mandate that the large vertically integrated companies should trade a minimum volume (or market share) within the wider wholesale market, rather than mandating a particular platform where trading must take place. The route to market chosen to sell the obligated volume should be for the obligated companies to decide.

The obligation should focus on the volume <u>sold</u>, as opposed to volume offered, to the market. Certain characteristics of the obligated volume could be stipulated by the regulator, e.g. products, clip sizes and tenure of trades delivered. Overall, this approach would ensure that a full range of trading options remains available to obligated market participants, including the potential use of a market maker or an auction platform, alongside the existing brokered OTC market. The solution must encourage innovation when developing trading tools to ensure a cost effective route to market is found for all participants (in terms of cost of credit and transaction costs).

Question 11: Do stakeholders consider that there are other intervention options we should be developing?

As Ofgem note, the vertically integrated companies account for 99.5% of the domestic retail sector. It is this largely "sticky" sector of the retail market that provides a natural hedge to vertically integrated companies and renders them less reliant on wholesale market liquidity.

The key to improving liquidity across a range of products and across the forward curve is to ensure that the six large domestic supply companies source a significantly greater proportion of their demand requirements by trading via the GB wholesale electricity market.

This could be achieved by introducing self-supply restrictions on the Big Six, which is not a new concept in the GB electricity market. By forcing more trades to take place via the wholesale market, the six large domestic supply companies would be required to source their needs from the wholesale market on the same basis (price and terms of sale) as their small / independent counterparts.

Such a move would increase the total volume traded via the wholesale market, allow efficient price discovery, ensure price / investment signals are visible to all parties (existing and potential new entrants) and promote greater competition in both the retail and wholesale markets. The restrictions need not continue on a permanent basis; licence conditions could contain sunset clauses to relax the restrictions should overall liquidity significantly improve.

An additional benefit of a self-supply restriction approach would be efficient plant dispatch. By ensuring the market is able to dispatch the highest efficiency (least polluting) plant before the lowest efficiency (most polluting) plant, the proposal could have a positive environmental effect in addition to its competition advantages.

An alternative, and less extreme, approach could be to mandate a percentage of demand that each of the six large domestic suppliers must source from the traded market across a five year curve. The curve could mandate 25% of expected demand to be sourced in Year+1, through to 5% in Year+5. This approach would ensure adequate liquidity across the near and medium-term curve, providing all market participants with greater access to volume. It would also aid the development of generation investment signals over investment timescales.

It should also be noted that the lack of liquidity in the medium-term market is not only an issue for generators. Suppliers require a forward curve to price medium-term contracts with their customers. Whilst there has been concern from market participants that the Carbon Price Support mechanism[2] may make the valuation of power more difficult three to five years forward, it will not make it impossible. I&C and utility businesses will continue to require stability in power supply contracts over the forward curve.

Accountability is also crucial if the regulator is to increase investor confidence. Obligated parties should be required to demonstrate that volumes have been traded, with the transactions being independently verified by their external auditors. This would reassure the market that obligations had been met, whilst also easing the burden of monitoring activities required by the regulator. In addition, it is worth noting that the European REMIT proposals may soon require all market participants to submit details of trades to a central repository accessible by the regulator. This would provide increased access to transaction information that could also help Ofgem to enforce the obligation.

None of the above suggestions would exclude the development of a market maker to deliver greater access to a range of products, clip sizes and shapes. However, the above suggestions would provide greater incentives to financial institutions with strong credit ratings to enter the market to develop such innovative services. The pre-requisite is strong liquidity in the forward market that allows businesses to invest, compete and grow organically.

[2] The Carbon Price Support mechanism forms part of the Government's Electricity Market Reform package.

Question 12: On the basis that we could decide to take forward these interventions, do stakeholders have comments on the indicative design choices we have made, as set out in Appendix 2. In particular, views are welcome regarding our initial position on each of the following:

- ***Volume requirements***
- ***Product requirements***
- ***Frequency***
- ***Governance arrangements***
- ***Participation***
- ***Platform***

<u>Volume requirements</u>

The obligation, whether independent of a mandated route to market or via Ofgem's proposed platforms, should require the large domestic suppliers to source at least 25% of demand requirement from the traded wholesale market. The obligation could mandate a five year trading profile as follows:

- 25% of expected demand in Year+1;
- 20% of expected demand in Year+2;
- 15% of expected demand in Year+3;
- 10% of expected demand in Year+4; and
- 5% of expected demand in Year+5.

This approach would ensure an adequate level of liquidity across the short and medium-term market (i.e. near-term to five years out). This would allow all market participants, including those from the financial sector, greater access to volume and a greater ability to enter and exit the market as required. This approach would also aid the development of investment signals over investment timescales.

<u>Product requirements</u>

A range of products should be offered across the short and medium-term curve (i.e. near-term to five years out). Further along the curve, it would be reasonable to expect a concentration of trades around standard baseload, peak and off-peak products over seasons, quarters and months on a continuous basis. Within year, a greater selection of granulated products should be available, such as volume over weeks, days, EFA blocks, EFA sub-blocks and individual Settlement Periods.

<u>Frequency</u>

Ideally, all trading should take place via existing market routes on a continuous basis. If a market maker were introduced (mandatory or otherwise), this platform should offer access to a range of products on a continuous basis.

Auctions would be very disruptive, as they would mandate not just the volume, but also the timing of power trades. The proposed "monthly" frequency may be particularly disruptive, as it is likely that the timing of the power auction and timing for fuel and carbon hedging purchases would not align. A further risk is that a Mandatory Auction may discourage trading on other platforms until the cleared auction price is known. Dictating when a party trades would not be conducive to a liquid market

<u>Governance arrangements</u>

Governance arrangements must ensure that all market participants are able to influence the future structure and development of mandated platforms, not just those that have an obligation to participate.

<u>Participation</u>

In terms of the obligation, mandating participation should only apply to vertically integrated businesses. The most appropriate parties to obligate would be the large domestic supply companies, as this is where market power is concentrated.

All market participants should be able to access the volume that the obligation aims to deliver. As such, mandating a route to market would not be particularly helpful for independent participants. The volume must be available via existing trading routes that do not have onerous credit and participation costs.

Platform

It would be difficult to see how a further auction platform could resolve the liquidity issues faced by independent participants. A group of industry parties have already developed an auction platform (N2EX) with limited success. This platform has only served to further fragment liquidity and small parties have not signed up to the clearing and Day Ahead auction services provided due to the cost implications.

A continuously traded market maker may prove more useful in that it provides a new route to market, although a collective obligation on the Big Six may prove very difficult to define and monitor.

Mandating a route to market would not be particularly helpful for independent participants. It would seem more appropriate for the regulator to obligate the large vertically integrated companies to trade a minimum pre-set volume (or market share) via the wider wholesale market.

How the volume is traded should be decided by those companies that are subject to the obligation. It may be appropriate to mandate certain characteristics of the obligated volume, i.e. products offered, clip size and tenure of trades. The obligation to trade, rather than offer, would also ensure that the most innovative and cost efficient route to market (for <u>all</u> market participants) is utilised / developed. This approach would ensure that a full range of trading options remains available to market participants.

Question 13: Do stakeholders have any comments on the costs and risks of our proposal, or any alternative suggestions that you have put forward, to take action to improve wholesale electricity market liquidity?

Mandating a particular route to market, as suggested by Proposal 2, could pose a number of risks:

- Credit requirements, particularly for trades further out along the curve:
    - There could be a competitive advantage for those companies that are able to net their credit requirements, i.e. vertically integrated companies with supply and generation businesses;
- Cost to transact on / administer platforms;
- Timing of mandated auctions:
    - Auction timing and fuel / carbon hedging strategies may not align;
    - Risk that supply and demand curves may not cross;
- Total liquidity across the market:
    - Specifying when a party is to transact via a mandated platform may have a detrimental affect on liquidity via other trading routes;
    - Trading in the OTC market may become more sporadic;
- Risk in undermining the principles of NETA / BETTA.

It may be more suitable for independent market participants, and less onerous on the regulator, if an obligation were placed on the six large domestic retailers to trade a greater percentage of their expected demand via existing market arrangements, rather than mandating a specific route to market.

Questions 14 to 18 (domestic market):

The issues that cause a lack of competition in the retail market (i.e. limited new entry), and a lack of liquidity in the wholesale market, arise due to the dominance of the large domestic suppliers with significant legacy (ñstickyò) customer bases. The interaction between the large domestic supply companies and the wholesale market should be addressed prior to proposing solutions that mandate how suppliers contract with their customers.

Question 19: Do stakeholders consider that Ofgem should strengthen licence conditions to prevent unfair contracting practices in the non-domestic sector?

Drax does not support the strengthening of licence conditions. There does not appear to be a strong case for extending the current provisions of SLC 7A to the remainder of the non-domestic market. Larger businesses are aware of their obligations under contract and, in many cases, would not wish to be bound by the compulsory processes set out in SLC 7A.

Question 20: In particular, would stakeholders welcome additional licence conditions surrounding the objections procedure?

The current licence conditions and rules surrounding the objections procedure are more than sufficient. Drax would support the enforcement of these rules and a review of the practices of suppliers in the non-domestic sector with regards to objections practices.

Question 21: Would stakeholders welcome the extension of some elements of the Standards of Conduct into non-domestic supply licence conditions?

There does not appear to be a strong case for the Standards of Conduct to be incorporated into licence conditions. Whilst the Standards of Conduct may be necessary in the domestic sector, the non-domestic sector is well informed and very capable of making decisions surrounding energy purchases. Contracts are freely negotiated, often with the help of consultants.

Question 22: Do stakeholders agree with our position, at this stage, not to extend our proposals on tariff simplification into the non-domestic sector?

Yes. Tariff simplification would be a major barrier to innovation and to energy efficiency in the non-domestic sector. Such a move would disproportionally affect smaller suppliers and their ability to enter the market.

Question 23: Do stakeholders agree that Ofgem needs to look further at the role of third party intermediaries (TPIs) in the non-domestic market?

Drax has no comment on this issue.

Question 24: Do stakeholders have any comments on the costs and risks of any of our suggested policies under Proposal 4?

The financial and opportunity costs of Proposal 4 are of concern. Such costs would be reflected in the prices offered by smaller participants, ultimately impacting the consumer. Small suppliers will have a limited capacity for change; this may have an impact on the ability of small parties to provide innovative product offerings, thereby causing a detrimental impact on market competition.

Question 25: Do stakeholders agree with Ofgem's proposal to appoint a leading firm of accountants to review the transfer pricing and hedge accounting practices of the vertically integrated suppliers?
And
Question 26: Do stakeholders have views on how Ofgem could improve segmental reporting in future years?

Appointing a leading firm of accountants to review transfer pricing and accounting practices may be of benefit to Ofgem. In better understanding the practices used by such firms, Ofgem may be able to develop new reporting requirements that will enable the regulator to better monitor trading / transfer activity. However, it is currently unclear how this will promote greater disclosure of information that will help consumers and independent market participants.

If an aim of the proposal is to inspire greater market confidence, it will be crucial that the accountants understand the information that independent market participants and new entrants require from such future reporting obligations.

It is essential that independent market participants are confident that the trading / transfers of volume between vertically integrated business units occur on the same basis as trades within the wholesale market (i.e. on the same terms, at the prevailing market price, etc.). There should be no cross-subsidy between generation and supply businesses; cross-subsidies harm market competition and have an adverse affect on the costs faced by consumers.

Ultimately, the most efficient solution would be to prohibit direct self-supply between generation, supply and trading businesses within vertically integrated structures. If all trades were to take place within the traded wholesale market, transparency of investment signals would be greatly improved. This solution would ensure efficient market price formation, promote greater competition and, ultimately, drive down prices to end consumers.

Questions 27 to 28:

Drax Power Limited is not best placed to answer these questions.