INTERGEN

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Dear Stefan,

The Retail Market Review – Findings and initial proposals.

InterGen is pleased to be afforded by the Ofgem the opportunity to comment on the above consultation and agrees with the findings of the Review, that "a lack of wholesale products and wholesale market liquidity combine to frustrate the trading activities of non-vertically integrated suppliers".

InterGen's response below focus primarily on the liquidity proposals set out in the Review. I would be happy to discuss further any of the points raised in our response.

Yours Sincerely,

Melissa McKerrow
Head of Public Affairs and Regulation

The Retail Market Review – Findings and Initial Proposals.

Executive Summary

InterGen welcomes the opportunity to respond to Ofgem's Retail Market Review. InterGen shares Ofgem's concerns regarding the low level of liquidity in the GB wholesale electricity market. InterGen believes that:

- The fundamental problem with the GB electricity market is its largely vertically integrated market structure and that low liquidity is one of the symptoms of this.
- Vertical integration is not compatible with a truly competitive, liquid, rational and transparent wholesale electricity market.
- A self-supply restriction should be implemented without delay. This would not only address many of the concerns regarding market liquidity but will also incentivise for non-vertically integrated companies to enter into the market (on the generation and retail sides) and finance new generation capacity.
- Ofgem's proposed introduction of a Market Making Agent would be a positive step and would increase liquidity, even though does not address the fundamental issue.
- Ofgem's proposed Mandatory Auction would further fragment liquidity and should not be pursued.
- It is appropriate for Ofgem to act quickly to address market liquidity in order that it can support the Electricity Market Reform proposals and start to encourage new entrants into the market.

About InterGen

InterGen is one of the UK's largest independent generator's, operating a portfolio of high efficiency gas-fired power stations (totalling 2,490MW) and actively trading in the prompt and forward wholesale power and gas markets. InterGen will add 1.8GW of carbon capture ready gas-fired generation to the UK by 2015, reducing the UK's carbon emissions significantly and providing essential generation flexibility, representing a further £1.2 billion of investment. Our response to this consultation is set out in light of our operating and development experience.

As InterGen is an independent generator with no supply business, we have addressed only the questions that deal with proposals to improve liquidity.

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

Yes. It is apparent from a number of discussions with small suppliers that these businesses are hard to establish because appropriate shape and tenor products cannot be acquired in the market. To work around this at least two new businesses have had to enter into electricity supply agreements with financial players, whose charges to the retail supply businesses were similar to the quoted margins of the large VI supply businesses. InterGen believes that a step change in both liquidity and in the type of products available in the market is necessary to allow new entrants in retail supply with sustainable profitability.

Low liquidity is one symptom of Great Britain's largely vertically integrated (VI) market structure in which natural buyers are not separated from natural sellers. The risk management and short term load balancing activities of the VIs are not carried out separately for generation and supply and so only relatively small net positions have to be managed, explaining the lack of highly shaped products in the market to satisfy small retailer hedging needs. While there is significant total churn in the market, this does not in itself produce a transparent price reflective of supply and demand: rational pricing can only occur when natural buyers and natural sellers are sufficiently (and preferably totally) separated.

The harm caused by low liquidity is significant. The lack liquidity and of appropriate product shapes leads to an inability to enter and exit suitable traded positions with reasonable certainty. This prevents effective risk management by single sided non-VI companies and hence acts as a significant barrier to new entry not only in supply but also in generation.

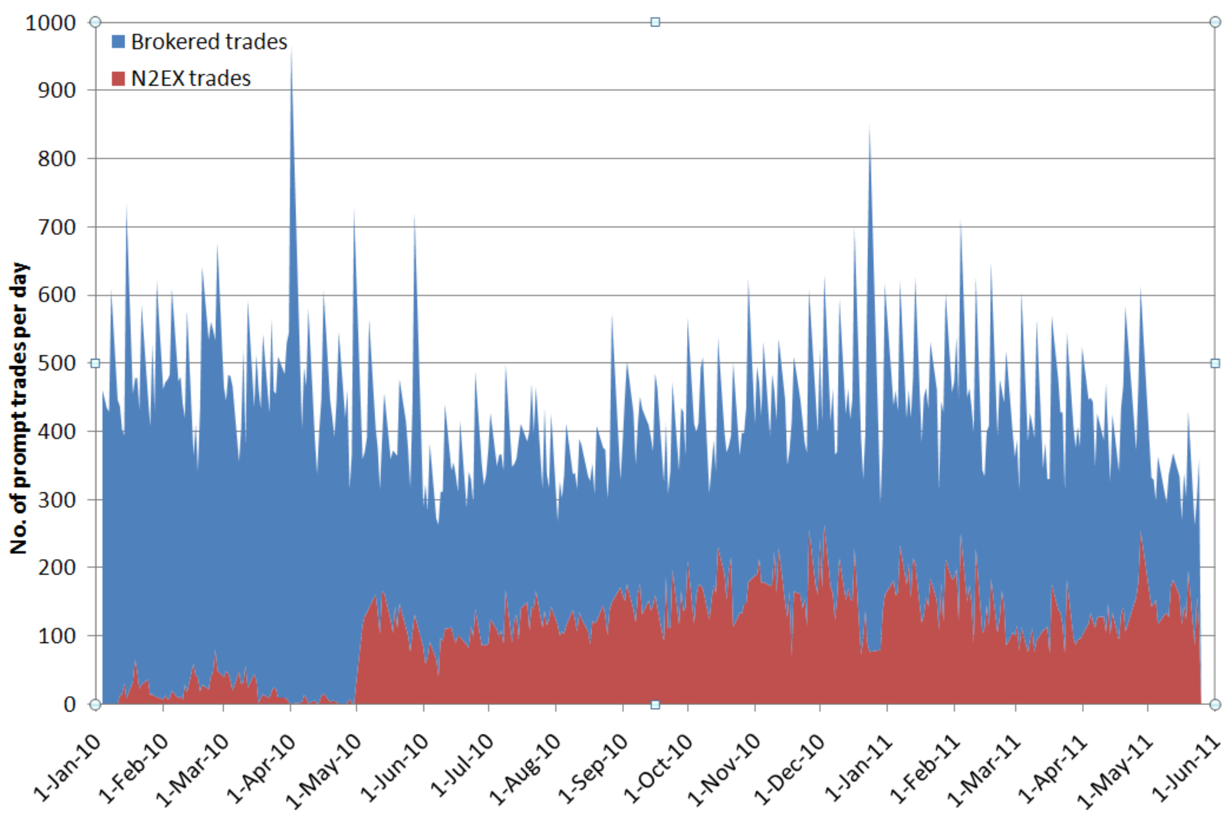
The suppression of new entry by the largely vertically integrated market structure also results in a lack of effective competition to the VI's. This must have a negative effect on consumer prices as there is little stimulus for innovation and business efficiency among the VI's, provided their risk management practices are reasonably similar. It is clear that the largest step changes in business efficiency in the electricity industry occurred after the introduction of the pool market and then again at the introduction of NETA – conspicuously both times where vertical integration in the market was limited.

Therefore InterGen supports Ofgem's view that policy intervention is urgently required. However InterGen strongly believes that the intervention needs to address the underlying VI cause and not just the specific issue of low liquidity. InterGen believes that vertical integration is not compatible with a truly competitive, liquid, rational and transparent wholesale electricity market. In this regard InterGen's position is the same as that of the Energy and Climate Change Select Committee, which in its review concluded that "Radical reform of the wholesale energy market is needed to stop the Big Six from stitching it up, but at the moment Ministers are only tinkering at the margins."

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?

Industry solution to liquidity (N2EX)

Having initially identified the existence of low liquidity, Ofgem had allowed the industry to come up with its own solution in the form of the VI's introducing the N2EX exchange and auction. N2EX, far from solving the issues of liquidity and reference pricing to attract financial players, has actually exacerbated the problem by fragmenting available liquidity rather than increasing the total. The annual fees and high credit requirements for non-investment grade players far exceed the cost of the over-the-counter ("OTC") brokers. Hence small suppliers and new entrant generators have been further deterred by the high costs (which frequently are not fundable for small players) of entering and trading in N2EX and the reduced liquidity in the rest of the market. Therefore InterGen agrees with Ofgem that further measures are needed and that ideally N2EX should be dismantled.



Mandatory Market Maker (MMM)

InterGen understands that the objective of the MMM proposal was to enable new entrant supply businesses to meet their ongoing wholesale market hedging needs and believes the proposal would have a useful positive impact on market liquidity since it would give certainty that traded positions could be entered and exited based on price. At present, it is not unusual for liquidity to dry up completely in times of high price volatility and thus simple risk mitigants such as stop losses cannot be executed because there is no market as the stop-loss price is passed. In its extreme this could lead to unlimited losses: the difference between losses from a stop loss trigger price and the *actual* executable trade price can be very large. The MMM proposal would resolve this and hence would be a very useful intervention.

One design criterion must be avoidance of further fragmentation of liquidity. The simplest way to achieve this would be for each VI player acting under the MMM arrangement to trade over the existing OTC market broker-based trading platforms. InterGen recognises that this would be difficult from a compliance monitoring standpoint, particularly given the anonymity of OTC broker screen prices, and a reasonable alternative would be establishment of a separate OTC broker platform especially for this. Deployment through an exchange would <u>not</u> be acceptable: the smaller market participants which this intervention is endeavouring to encourage have a finite credit capability incompatible with single product exchanges.

<u>Mandatory Auction (MA):</u>

InterGen understands the intent of the MA is to develop deeper liquidity in the medium to long term forward market and supports that objective.

However InterGen is not supportive of MA's for either day ahead or forward products as we do not believe they will provide a solution to market liquidity problems. Auctions concentrate trading activity around a single period in the day and would result in a hiatus in trading activity outside this period. 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, therefore 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 would 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.

There are already two DA auctions operating in the UK and their low volumes to date, compared to other European markets, suggest that there is not the natural appetite for auctions in the UK and therefore mandating one would be counterproductive. The vast majority of volume continues to trade on the brokered OTC platforms and therefore the LEBA index offers a much more representative reference price than either that of N2EX or APX. LEBA have recently extended their index reference window to cover the majority of DA volume that occurs between 07:30 and 09:00, which effectively encourages liquidity over a longer period rather than focussing it on a single time.

Furthermore, InterGen is concerned that introducing both MMM and MA could generate more unpredictable (and therefore potentially undesirable) effects than implementing simply MMM on its own. However, InterGen believes the objectives of MA could be achieved by extending MMM. It could be a requirement for the VI's to transact 10-20% of annual generation via the MMM. Combined with a self-supply restriction and accounting segregation, this would be a much improved step to breaking up VI dominance of the wholesale market.

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?

It is InterGen's view that adjustments to the MMM (described under MA in our response to Q9) could achieve both sets of required objectives: meeting the hedging needs of small suppliers and providing deeper long term forward market liquidity. Introducing only one intervention would reduce the chances of unintended and undesirable interactions and given that the two can be readily combined, InterGen does not believe a case can be made for the additional layering of the second intervention, the MA. Therefore InterGen's preference is that the volume proposed under the MA (10-20% of VI generation) is mandated to be transacted via the MMM.

Extra liquidity will be encouraged with a MMM as there will be an inherent guarantee to the small generator or supplier that they will be able to enter or exit the market at any time. This is currently possible in the NBP gas market and as a result it is one of the most liquid energy markets in Europe. Participants including ourselves will be more willing to open a power position in the knowledge that the position can be closed at a time of their choosing due to the presence of MMMs. Currently as the NBP market price moves, it does so with large traded volumes. However a similar market move in the UK power market does so with large price gaps and on thin volume meaning that stop losses are much less effective which discourages large open positions.

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

InterGen has stated in this and its previous consultation responses on liquidity that the simplest and most effective way of increasing liquidity would be to impose a self-supply restriction on the vertically integrated companies that dominate the generation and supply markets. A licence condition requiring VI companies to trade progressively increasing percentages (ultimately 100%) of their retail requirements via the wholesale market should be coupled with a regulatory requirement for the separation of accounts between their generation and retail sectors.

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 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 VI's 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 4 Aug 2009, which requested suppliers explain their retail pricing policies in light of falling wholesale prices. This explains why the VI's are developing new capacity in the UK, whist long-term price signals are 'hidden' from independent generators, who do not have price visibility beyond the current seasons. Independent generators will find it increasingly difficult to secure project finance on such poor liquidity, therefore will struggle to get development projects off the ground, which could result in the VI having dominance in the generation market (currently 80%) as they currently do in retail (99%).

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**

InterGen believes that simplest way to introduce a MMM would be to mandate the VI's to place their volume on the current OTC broker screens where the greatest number of market participants have access. Not only does this open up the volume to more participants but the broker screens do not have the joining or margining fees that prevent small generators and suppliers from signing up to an exchange. Also as you can see from our answer to Q9, the majority of prompt trades still transact away from N2EX.

As we mentioned in our response to Q10, applying the volume requirements suggested in the MA solution to the MMM would help to keep a continuous volume available to the market. The volumes bid and offered should be reflective of the period, i.e. Day Ahead to Week Ahead should be offered in 50MW clips and from Month Ahead out should be in 10MW clips. However these volumes should remain 'open', that is to say smaller volumes can be transacted, ideally in 1MW increments. This will help small suppliers who do not need to purchase such large volumes and also spark spread players who typically need to transact in 15MW clips.

Particular care needs to be given to the bid offer spread that the MMM is required to maintain. There will be little point in introducing a MMM with a spread so wide that it penalises anyone who transacts at those levels.

Although the brokered market is an anonymous market, the brokers already ‘give up’ the two counterparties in a transaction that it is placed through the N2EX exchange. Therefore it would be possible for them to give up the volumes of the MMMs to the regulator to ensure compliance with the volume requirements.

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?

InterGen would urge Ofgem to consider the risk of unintended consequences is adopting both the MA and MMM proposals. It is our view that introducing both could further fragment liquidity and would exacerbate the credit requirements and participation costs for smaller players. By making available more volume through the MMM, both in short and medium term products, liquidity will be more concentrated, financial players will be attracted as they will be able to unwind their positions, and credit requirements will be kept to a minimum.

One possible solution to the issue of credit for smaller players is the creation of a single credit entity, a central entity with which all parties lodge credit for both electricity and gas, with the potential to have less onerous terms for new entrants.

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?

InterGen is very supportive of this proposal. InterGen believes it should be extended to mandating separation of accounts for GB generation and GB supply businesses as was the case in the segmental regulatory accounts of the 1990's, providing clear insight into segment profitability and any cross-subsidies. The requirement for the VI’s to publish separate accounts for generation and retail businesses would be an essential complement to a self-supply restriction which is the critical intervention.

The publication of separate accounts would give the rest of the industry true visibility of the value of wholesale power. The lack of this price visibility currently means it is very difficult to secure investment in long-term projects as independent players will always be forced to look to the banks/bond market as balance sheets tend to be smaller than the VI players.

It should be noted that InterGen is in continual dialogue with financial institutions regarding development projects, and current feedback is that there is significant risk of investment hiatus the longer the EMR and liquidity proposal are being opined on. Therefore InterGen urges Ofgem to move swiftly on these proposals, so that investment can continue apace and EMR can progress with success.

Question 26: Do stakeholders have views on how Ofgem could improve segmental reporting in future years?

See answer to question 25.