

The Retail Market Review – Findings and Initial Proposals – Consultation

Response from International Power plc

Introduction and context

International Power PLC (IPR) welcomes the opportunity to respond to this important Ofgem consultation. Following its combination with GDF SUEZ in February 2011, IPR is a large independent generator in the GB market and is also a significant supplier to the Industrial and Commercial market for both gas and electricity. We are not active in the domestic supply segment and as such we have not commented on the issues which relate solely to the domestic market. Our comments relate only to proposals 2 (market liquidity) and proposal 4 (non-domestic market).

Summary of response – Market Liquidity

- Ofgem’s proposals seem to focus on small suppliers’ market access. IPR believes Ofgem should be focussing on a general improvement in liquidity in the long term markets, where it has been most lacking.
- IPR does not support Ofgem’s proposals for mandatory auctions; this is a fundamental change to how the market operates as opposed to an initiative to increase liquidity.
- Given that the vertically integrated ‘big 6’ are net short on generation, if Ofgem is to introduce mandatory auctions, IPR believes that the ‘big 6’ should have an obligation to buy, rather than sell.
- Remedies that focus on improving trading volumes and new entry are likely to best support EMR. There has to be confidence in any index to allow to allow contracts for differences to be struck against it. “Forcing” the creation of an index in a market that is not reliably liquid can be counterproductive.
- Ofgem’s proposals do not consider or address credit. Margin exposure will be a major disincentive to forward trading through both an auction and potentially a market maker platform, and is exacerbated for longer term traded products. Whilst we support any credit related initiatives that will increase liquidity, this should not be to the detriment of market integrity.
- IPR believes that the Mandatory Market Maker (MMM) proposal is a more natural extension to current market practices which reduces the risk of liquidity fragmenting or being disrupted. However, IPR’s continuing preference is to introduce a self supply restriction, perhaps focused on on volumes in the domestic market

Summary of response – Non-domestic market

- Whilst we are conscious of Ofgem’s intent to protect customers in the smaller business sector we are concerned that there may be unintended consequences from extended intervention that may dampen competition and restrict innovative product development.
- Further protections are best limited to those customers who are taking a domestic type tariff rather than those who have entered into a bespoke contract and price.
- It would be helpful to see more publicly available information on the behaviour of suppliers in relation to objection practices, together with revised guidance from Ofgem. Subsequently if this remedy is not found to be effective then we would advocate a more rigorous application of the existing licence conditions in this area as opposed to introducing additional obligations on all suppliers.
- It is inappropriate for the regulation of TPIs to be enforced via additional obligations on suppliers. Further thought should be given to the extent to which this market sector is managed and who is the appropriate authority.

Response to questions

Proposal 2 – Market Liquidity:

General comments

IPR is reasonably content with the levels of liquidity in the short term (within month) although on occasions, it has not been possible to trade the non-standard products we would like even day ahead or within day. In the medium to long term, liquidity remains thin particularly in non-baseload products. This restricts our ability to hedge marginal generation and retail positions. For these reasons, IPR welcomes Ofgem's proposals to enhance liquidity within the Retail Market Review.

The N2EX platform was showing some potential as an alternative route to market. However, liquidity overall is not improving, and N2EX auction volumes remain volatile despite signing up most of the major energy companies. Whilst IPR is an active member of N2EX, the exchange has failed to attract new market participants, most notably amongst the independent generators and small suppliers. Over time this picture may change, delivering some positive contribution to liquidity. However, we do not see N2EX as being the sole solution to enhancing liquidity.

In general there still seems to be confusion as to Ofgem's objectives in proposing changes to market liquidity. A distinction needs to be made between market access for small suppliers (which mainly relates to the credit requirements) and general market liquidity. Ofgem's proposals seem to focus on small suppliers' market access. IPR believes Ofgem should be focussing on a general improvement in liquidity in the long term markets where it has been most lacking.

Finally, we note the linkages between market liquidity and the Electricity Market Reform (EMR) process. Increased market volumes should be beneficial to the range of market reform outcomes. Remedies that focus on improving trading volumes and new entry are therefore likely to best support EMR. "Forcing" the creation of an index in a market that is not reliably liquid can be counterproductive – a poor reference price will give no confidence to strike contracts for differences against, and liquidity is not improved.

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

International Power does not operate in the domestic retail supply market.

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?

Mandatory Auctions

IPR does not support auctions in general for the following reasons:

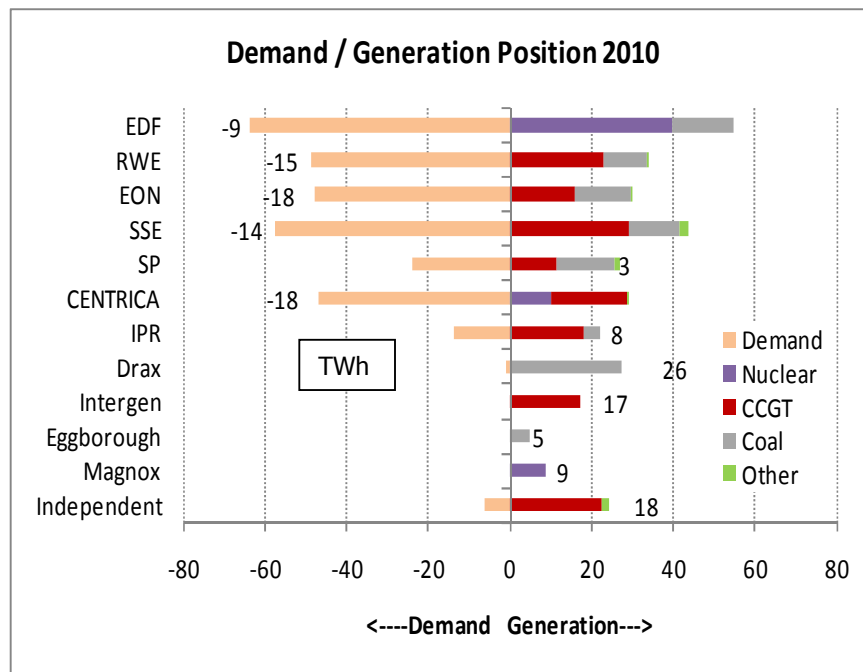
- An auction will obligate parties to trade at a specific point in time which may not align with internal trading and hedging strategies for power and also for fuel and CO2 permits.
- Margin exposure and cost will be a major disincentive to forward trading through an auction. This not only applies to small suppliers but to all participants, and is exacerbated for longer term traded products. Given that no small suppliers have as yet signed up to N2EX which offers a day ahead

auction and hence only a short period of margin exposure, we question whether small suppliers would be willing to sign up to an auction offering season and baseload products with the associated margin exposure.

- Auctions will create a trading hiatus elsewhere in the market until the auction results are known. This may frustrate the ability to trade at the most appropriate points, and disrupt the otherwise continuous operation of the market

On the specifics of the Ofgem proposal for auctions, we have the following comments:

- The proposed mandatory auction is a fundamental change to how the market operates as opposed to an initiative to increase liquidity. In the extreme, it indicates a move towards a mandatory pool market. If this approach is considered necessary, it should form part of more wide ranging market reform proposals rather than as part of a liquidity review.
- There is a high risk that rather than enhancing overall liquidity, an auction could simply fragment the market as volumes are simply moved from other routes to market to comply with the obligation. This can be expected to lead to increased costs for market participants.
- Ofgem proposes an obligation on the ‘big 6’ vertically-integrated companies to sell 10-20% of their output into the market. However, the ‘big 6’ are overall net short on generation (see graph below).



Source: International Power estimates

Given that only 7% of the I&C market and only 1% of the domestic market is supplied by companies other than the ‘big 6’, there would appear to be few buyers for this volume. Making this volume available is unlikely to bring new suppliers into the market; rather, it is likely to be sold to the other companies within the ‘big 6’. If Ofgem is to introduce mandatory auctions, IPR believes that the ‘big 6’ should have an obligation to buy, rather than sell.

Ofgem is proposing perhaps 8 products over 3-5TWh of volume per month in order to help new suppliers hedge customer shape. It also appears to see this auction model as a potential source of a reference price to support DECC’s EMR initiatives in respect of low carbon long term contracts for difference. These two objectives are not necessarily consistent with each other. If a truly robust

reference price for long term contracts is a priority then this will likely drive the direction of the market design to a narrow field of products but may not improve liquidity. Likewise a “blended” auction may not deliver sufficiently reliable reference prices. More thought is required to understand the interaction between the liquidity remedies and EMR – as it stands there does not appear to be a compelling case for the introduction of an auction.

Mandatory Market Maker

IPR believes that the Mandatory Market Maker (MMM) proposal is a more natural extension to current market practices which reduces the risk of liquidity fragmenting or being disrupted.

Ofgem proposes that the ‘big 6’ have a “collective obligation”¹ to provide a bid-offer spread for a small volume on a continuous basis, focused on the short term/prompt markets. IPR believes that this obligation could be extended to cover medium and longer term forward markets – this would remove any perceived requirement for mandating forward volumes through an auction process.

A MMM would be beneficial to independent generators, small suppliers and also to wind generators who would be able to trade in and out of a position to ameliorate generation uncertainty allowing imbalance risk to be mitigated close to gate closure. It would also provide for the opportunity to trade further out.

It is not clear from the consultation whether Ofgem is proposing exchange based clearing services to support the MMM initiative. Whilst this might help in facilitating market access to a wide range of counterparties, it does present similar credit and cost exposures to that of auctions. At least some volume should therefore be available via the normal bilateral GTMA 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?

No. The MMM could be extended such that it has the potential for 10-20% of electricity supply could be trading through this route, removing the need for auctions.

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

IPR continues to believe that a self supply restriction should be applied whereby market participants can be left to decide on the route to market and timing of trades. This avoids the need for a prescriptive approach or a dictat on where and when to trade, it removes the need for limitations on reserve prices and spreads and avoids distorting market operation. Volumes for the domestic retail market in particular (the least competitive part of the market) should be brought to market such that liquidity can be improved and price signals restored.

In addition, the segmental statements of the ‘big 6’ vertically integrated companies should be more standardised to provide comfort to customers and competitors that internal transactions are taking place at competitive prices.

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***

¹ We understand in fact that each company would have an individual obligation

- *Frequency*
- *Governance arrangements*
- *Participation*
- *Platform*

Volume requirements

The proposed volume requirements if there is to be an auction seem appropriate. If the obligation were increased, then this would signal a trend towards a mandated Pool. This would need to be the subject of an entirely separate and fundamentally different consultation.

IPR believes the MMM obligation on the ‘big 6’ should be extended from the short term market to longer term volumes negating the need for mandatory auctions.

Product requirements

The product requirements could be extended to cover EFA blocks and overnights for both the MA and MMM proposals.

Frequency

IPR agrees with the proposals for frequency.

Governance arrangements

We agree with Ofgem’s suggestion for criteria/guidelines for a bid-offer spread. Without any such limits, the extent of the spread could discourage trading. However, a prescribed spread may not be appropriate in all timescales, particularly in the prompt market when a reasonableness requirement could instead be imposed. There is a good degree of detail still required in defining the MMM obligation – for instance, clarification that traded volume should be continually replaced.

We agree that the trading arrangements should be fair and reasonable and support any credit related initiatives that might increase liquidity but this should not be to the detriment of market integrity.

Participation

Ofgem proposes that the MMM and MA obligations should apply to the ‘big 6’. IPR fully supports this proposal. For instance, were the MA to be extended and other market participants such as independent generators were forced to participate, it will simply displace volume would have been sold elsewhere in the market and at a time most suited to a company’s hedging requirements. Wider mandated participation would not enhance liquidity, it would fragment liquidity.

Furthermore independent generators, even those with some supply interests, are clearly differentiated from the ‘big 6’ companies:

- They are significantly smaller in scale (in generation and any supply interests);
- They do not operate in the domestic space (the least competitive part of the market); and
- They remain predominantly ‘long’ on generation and have a strong imperative to trade (the ‘big 6’ companies are to a large extent balanced, minimising their imperative to trade in the external market).

Any mandated remedies should therefore be targeted at the large vertically integrated companies on the basis that large scale vertical integration has the potential to limit trading activity as a result of internal trading.

Platform

Ofgem should aim to minimise the costs of participation and use existing platforms, systems and processes.

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?

The Power Trading Forum is currently evaluating how best and when to introduce calendar forward OTC contracts. These would be instead of EFA contracts and would align with continental practices as well as the N2EX futures contracts, and could potentially attract new players that are put off the GB market by having to adapt their deal capture systems to take EFA contracts. It would also ensure that power contracts are closely aligned with the quoted gas market contracts.

Proposal 4 – Non domestic market

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

Ofgem introduced SLC 7A in January 2010 to add further protection to those customers who fall under the definition of Micro Business Customer as defined in article 2(1) of the Gas and Electricity Providers (Redress Scheme) Order 2008. This definition is complex to administer for suppliers in so far as it is very difficult for a supplier to ascertain the annual turnover and staffing level of a particular customer; existing systems would not necessarily hold this type of information and therefore classification would usually default to being administered using the annual usage thresholds (55MWh electricity, 200MWh gas).

As these definitions do not relate to any recognisable industry thresholds it would be more helpful for administration purposes if any future grouping of customers was achieved on the basis of existing industry classifications. For example in gas the six-monthly read threshold could be used, this equates to an annual usage of between 73.2MWh and 298MWh and in electricity it may be sensible to extend to all Profile Classes 3 and 4. However, it is important to recognise that if any extension of SLC 7A were to be enacted by Ofgem, that the risks of any unintended consequences must be minimised. For example, any extended terms should be limited to single site contracts and should not extend to multi-site contracts where usage on certain sites may be low and would otherwise have fallen under the usage threshold.

Whilst we are not opposed to an extension of the consumer protection offered by SLC 7A, any extension must be fully justifiable and not only on the grounds of simpler administration. Ofgem must satisfy themselves that the behavioural characteristics of the extended customer group are the same as those currently in scope i.e. similar to that of domestic consumers. In practice any intervention would be better targeted at those customers who are taking a tariff offering rather than those who have entered into a bespoke contract with a bespoke price.

We are concerned that if the terms of SLC7A are extended outside of the Micro-Business definition that this may lead to a more widespread and unnecessary “regulatory creep” into the larger business sector, which we believe would be unjustified. The larger business market exhibits a higher level of engagement and contract terms in this sector are under constant scrutiny from customers, brokers and their legal advisors. Any lack of clarity or ambiguous terms here are quickly identified, indeed, it is as common for contractual changes to be suggested by, or on behalf of the customer in this sector as the supplier themselves. It is

therefore inappropriate for any undue regulatory intervention which may inhibit innovative terms or products from being developed in the more engaged element of the market.

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

Ofgem have responded to concerns highlighted in its previous supply probe in relation to the number of objections raised in the gas change of supplier process. Ofgem have introduced a formal information request to suppliers to monitor individual and collective levels of objections in the market. This monitoring process has been internalised within Ofgem and no information or observations have been made public by Ofgem to date. Clearly, there is an issue in this area however we find it difficult to comment on potential remedies at this stage without having sight of any evidence on which to substantiate any action.

We would welcome Ofgem releasing some more detailed observations and conclusions in response to its monitoring activity in this area. It is difficult for suppliers individually to assess whether there has been a marked improvement since the market monitoring began in this area and hence it is too early to recommend a course of action.

It may be that rather than additional licence obligations in this area at this stage that Ofgem issue a guidance note to suppliers in the first instance to clarify the expected behaviour in relation to the correct use of the objections procedure.

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

No, we would not welcome this type of intervention as it is unnecessary in our view. Standards of conduct in the non-domestic sector are already well policed by a combination of the competitive market generally, customers and customer agents, industry trade bodies and failing any of these by the energy ombudsman, at least for the smaller non-domestic sector.

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 we agree. There is no requirement to extend in to the non-domestic sector as the sector is primarily contracted at individual bespoke prices which are market related and reflect the prevailing wholesale price of gas or electricity. International Power only applies individual contract prices to its customers which reflect the duration and product choice of the customer, we do not apply published tariff rates to our customers except in the instance of deemed contracts where we are obliged to do so.

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

Currently the governance route and also the jurisdiction with regards to TPIs who are active in the energy sector do not seem to be assigned to any particular body. This is perhaps a feature of history and an issue which may have been overlooked when the competitive market was initially designed. The prominence of both sales agents and brokers has however been a feature of the now mature, competitive market for some years and we agree that steps need to be taken to give extra assurance now that the market has evolved to this extent.

It should be noted that the role of TPIs can be broad ranging and can probably best be segmented into two areas; firstly sales agents who act on behalf of suppliers, primarily in the domestic and SME sectors to attract customers, and secondly; energy brokers who are acting principally as an agent for the customer or a

particular group of like minded customers. This is an important distinction and many suppliers such as ourselves only employ an in house sales force or account managers and therefore do not use sales agents. It is clearly only relevant to assign responsibility for the actions of TPis only where they are acting on behalf of the supplier and hence where the supplier can exercise reasonable control.

Suppliers should not be assigned obligations in respect of those intermediaries who act on behalf of the customer as suppliers are largely passive in this process and cannot exercise reasonable control. In many cases the supplier will not have sight of the broker charges as these will be billed directly to the customer by the broker and therefore disclosure can only be achieved directly with the intermediary. In other cases the broker may ask the supplier to include their charges in the supplier quotation and as such the supplier cannot exert control in this process as the supplier is not aware of the exact details of the broker services to which the charges relate.

If obligations are to exist in this area they should be enacted directly on the affected parties and not via the supplier. This could be achieved via a number of ways ranging from a lighter touch (but monitored) code of conduct to a separate formal licensing and compliance process policed by the appropriate authority. There may be benefits from Ofgem taking the lead on determining the scope of obligations in this area due to its expertise in the energy sector and the obvious association with supplier processes and licence obligations. However this does not necessarily have to be the case as many brokers serve broader markets than simply energy; for example utility brokers would typically serve the combined energy, water and telecoms sectors.

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

We are generally supportive of the intent of the proposals as regards to the non-domestic market however, as outlined in our response to Q19 our primary concern relates to unintended consequences that may arise as a result of regulatory creep. In particular we are concerned about the application of sanctions designed for the domestic tariff market having adverse impacts on the functioning of the non-domestic market.

The non-domestic sector is a very competitive sector and has a wider diversity of suppliers , products are more tailored to individual customer requirements. This important feature of the market needs to be preserved; a heavier regulatory burden in this sector may be detrimental. The perceived risks and costs of compliance with regulations for independent suppliers where only small proportion of their customer base may be affected is disproportionately high and may deter market entry into the affected market sectors or initiate withdrawal for existing participants. This may have the effect of reducing the diversity we see currently and as such inadvertently create the levels of market concentration in the non-domestic sector that Ofgem are trying to rectify in the domestic sector.

End of Consultation Response