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By e-mail: rmr@ofgem.gov.uk

Mr David Hunt
Retail Market Review Team
Ofgem
9 Millbank
London
SW1P 3GE

Dear Mr Hunt

Retail Market Review – Finding & Initial Proposals

Welsh Power does not believe that Ofgem's proposed remedies, to the ongoing lack of effective competition in the GB electricity market, are robust enough to create a truly competitive market in the medium term. We believe that a sectoral referral is the only way to address the structural changes that are required.

Introduction

Welsh Power Group (WPG) is a privately owned energy company with a strong track-record in development, in both conventional and renewable energy. In August 2009 Welsh Power submitted an application to develop Wyre Power, an 850MW CCGT (combined-cycle gas turbine) power plant near Fleetwood, Lancashire, with an investment of some £600 million. In January 2009 the Company commenced the development of a 49.9MW biomass plant at Newport Docks through its wholly owned subsidiary Nevis Power Limited. We also own and operate an OCGT, Leven Power, on a STOR contract to NGC.

Formerly, WPG owned and operated Uskmouth Power until its sale in 2009 to SSE. It also developed Severn Power, a new 850MW CCGT plant in South Wales, which it subsequently sold to DONG Energy. WPG also started its own retail business, Haven Power, in 2007, but this has subsequently been bought by Drax.

WPG has significant experience of the problems caused by the illiquid GB power:

- It is difficult to find counterparties as the big 6 have no incentive to trade with smaller players, and every incentive to discourage new entrants;
- The lack of a robust forward curve makes it difficult to value, and thus finance, new plant;
- Small players cannot buy/sell small volumes to manage their imbalance risk, increasing their costs compared to the big 6.

All of these problems have shaped the way that our business has developed. We believe that the market is fundamentally broken with illiquid markets, dominated by six large, integrated companies, and significant barriers to entry to each part of the market. While requiring that the dominant players sell output into the wholesale market, the potential for them to do this in such a way as to simply trade amongst themselves is too high a risk to take at the current time.

Effective Remedies

Ofgem has to address the fundamental problem in the market, its structure. While we agree that “strong intervention” is necessary, we do not feel that Ofgem dictating the way that companies trade, the structure of sales, etc. will result in the development of a true market. We note Ofgem is undertaking a *“further wholesale assessment”*, but do wonder what that will show that has not already been seen – the market is broken and structural reform is needed.

The problems with Ofgem’s proposed approach are:

- The design of an auction may take months, if not years, to achieve a structure where the parties needing to trade power can compete on a level playing field. All auctions also run the risks of gaming as repeated games lead to market knowledge, as was seen under the Electricity Pool system in the 1990s.
- Mandatory Market Making (MMM) also risks creating a false sense of security where there is a belief that market access is achieved, but in reality the terms are unacceptable.

Without tackling the issue of dominance the risk of abuse of dominant positions remains. Ofgem must therefore tackle the problem at source, i.e. deal with market dominance head on using structural remedies that will last. We are convinced that Ofgem’s proposals do not have a *“realistic chance of addressing the consumer harm identified”* and that a more robust solution is required. The recent Select Committee report¹ has also suggested that the dominance needs to be addressed, and the proposals that Ofgem has put forward are simply not addressing the issue, but may well allow the big 6 to hide behind the new policies, maintaining barriers to entry, for years to come.

Welsh Power feels that it, as well as many other players, have persistently made these points to Ofgem (and other authorities), but are always ignored. Ofgem has ample opportunities to try to “fix” the market, including via its reviews of cash-out prices, reviews of the retail market and market monitoring reports. We last made these points to Ofgem in April 2010, but a year on we are no further forward. Ofgem’s proposals will take at least a further year to implement and then another year to iron out problems. The market needs Ofgem to be courageous and make a Competition Commission referral. Ofgem has not managed to control the symptoms it must now treat the disease.

¹ [Electricity Market Reform – Energy and Climate Change Select Committee report](#)

Ofgem's Proposals

Firstly WPG would note that not only does the low level of liquidity create a barrier to retail competition, it also creates a barrier to new entrants wishing to build generation. The lack of a forward curve makes the financing of new projects extremely difficult. Ofgem must be mindful that low liquidity has wide reaching impacts on the development of the wholesale as well as the retail markets.

Mandatory Auctions

The new N2EX and the APX auctions are designed to help liquidity, and as Ofgem notes many markets have voluntary auctions. However, as the owners of generation at the time N2EX was developed, we opposed the scheme as we believed an auction with dominant players was a recipe for gaming. A repeating auction would mean the limited number of players would learn how to bid up prices rather than bid down prices. In a market with more players (say 20) then an auction may work well, but until the structural issues are resolved we believe Ofgem's proposal will be at best unhelpful, as transparent prices are not the same as competitive prices.

WPG would also note that the design of auctions is fundamental to their success. We have looked at the gas auctions and they suggest that auctions implemented by regulators are open to persistent rule changes. It would also take time to develop the initial rules and commission/tender for an auction platform. There are also credit issues that will need to be resolved, as well as market rules, governance, etc. We do not see that auctions would in themselves help smaller players.

Finally, given the two private exchanges offering auctions, it would be wrong for Ofgem to undermine private enterprises. It is clear from the slow progress in developing the existing exchanges that adding a further platform is unlikely to help liquidity in the existing markets. Were Ofgem's proposals to remove participants from these markets they would seem justified in complaining to Government that their business had been undermined.

These are all points we put to Ofgem last year, but none of them are addressed in Ofgem's latest document. Either Ofgem's thinking has really not developed, or they have come to the realisation, like we have, that this is simply a stalling tactic so they look like they are doing something, but the big 6 are left unchallenged.

MMM

Ofgem can require one or more parties to trade, but it is unlikely to be able to actually force trading as it is not simply the products offered, but the terms offered that will help liquidity. WPG know from experience that our trading team used to be excluded from the market due to our perceived credit worthiness (being privately owned). Credit issues alone will stop many larger companies trading with smaller new entrants. Were Ofgem to force parties to trade the big 6 would argue that prices will increase as credit risk increases.

Even if Ofgem could define a meaningful obligation, which we doubt, it would take time to put the obligation in place and then it would be months before action would be taken to address smaller players concerns when the obligation does not work (the credit requirements are too high, other costs appear, clip sizes are wrong, new systems are needed, etc). In the meantime, valuable time for a structural solution will have been wasted. We note that Ofgem's proposals are that all of the big 6 become market makers, but we are not convinced this is a practical or even desirable outcome. The more market makers the less likely they are to trade with all parties and the result will be only some products available, to some parties at different times.

WPG believes that it is possible for players to trade on the exchanges, but the costs are high and it is not clear that trading costs will be reduced by having a MMM and they will probably rise if there are a number of MMMs. Again the time taken to agree the operation of the agent, appoint one, sign contracts, etc. seems likely to take too long. At NETA go-live the change from Pool based CFDs to GTMA trading terms was done very quickly, in a matter of weeks, but to sort out all of the tax, settlement details, etc. took far longer. Ofgem's thinking on these very important details seems to be at an early stage and therefore a rapid implementation of even one MMM seems unlikely.

Ofgem should also be mindful that when there were more market players (2001) and liquidity was high, there were two on-line exchanges that acted as market makers, Enron On-line and Dynegy Direct. It would therefore appear to be better to try to attract trading houses back to the market who are more likely to offer a service people want than the incumbents, who have an incentive to keep competitors out, not encourage counterparties in. These companies would return to the market as there were a critical mass of physical players for them to deal with. We can only get more physical players into the market if the incumbents are forced to sell assets.

Other Options

WPG believes that stopping the big 6 from internal trading may result in a more immediate improvement in liquidity than regulated market access. The act of forcing trading amongst the larger players should at least create some forward price index. How they chose to do this could be left to them, but the requirement must be for the trading to be transparent and reported to Ofgem for compliance purposes.

Clearly there are resource implications for Ofgem in policing the trading and ensuring that there are no "work arounds" put in place, for example power swaps between the players. However, Ofgem's auction and MMM proposals are also heavy on regulatory resources, so the costs of the policy may not be onerous relative to the other options.

WPG would note that a Competition Commission referral may be resource intensive for a shorter period of time, but in the longer term has the additional benefit that competitive markets need relatively little, if any, direct regulatory intervention. We find it odd that Ofgem does not even access this option as a credible alternative to tinkering with market design.

Design Issues

Looking at Ofgem's policy details in Appendix 2 WPG would make the following comments:

Mandatory Auction

- The volume of power traded should be at least equal to 50% of the big 6 output in a year. 20% will simply not produce the trading churn to create a stable and reliable price index to create a robust forward curve.
- The products should be based on those products already traded on the APX. Additional to that should be smaller clips covering the usual traded periods, for example the ability to buy small amounts for weekends or balance of the month, etc.
- Monthly auctions do not allow adjustment of suppliers' portfolios in response to say a cold week, so we would suggest weekly not monthly auctions. The frequency of auctions could be revisited if the release of power to trade was creating market volume that resulted in increased liquidity. However, we suspect only compliance buying (to meet a supplier's contractual needs) will occur given other barriers to trading (credit, transaction costs, lack of counter-parties, etc.).
- It should be possible to request that the existing exchanges conduct the auctions and have a side letter with Ofgem over process, charges, etc. We do not believe having a whole new body with associated costs, governance, etc. will be helpful to smaller players.
- There should be no reserve prices for the big 6 as there may well be times in the year when the market is long and even negative prices could be economic.
- What does Ofgem have in mind when it says other parties may take part subject to "approval"? Surely the more parties that wish to participate the better. Market entry criteria must be kept to a minimum.
- The platform absolutely should not be left to the big 6 to establish. Look how long it took them to undertake the N2EX project going. They have no incentive to deliver anything like the market that smaller players want and a track record in non-delivery. A tender is fine, but WPG sees no reasons why existing platforms could not be used.
- The trading arrangements need to be reasonable, but without any firm proposals to deal with issues such as credit we cannot comment on what Ofgem has in mind.

Market Making

- Ofgem's proposals imply that the big 6 are all market making. WPG do not believe this will work. It should be one market maker with whom all parties know that they have a trading facility. The market maker may be given power by the big 6, but it cannot be that each of them is market making as we suspect not all will trade with all parties, they will have different terms, use different platforms, etc. The market maker can establish its own spreads and offer the products it knows the clients will want. If anything a bank rather than a generator will be best placed to offer this service.
- If they all market make they must do so on a common platform with open access to all players. They must use the same terms and they must have bids and offers available in a variety of volumes at all times.
- WPG does not understand what Ofgem means by "reasonable spread". The spreads in the market are vast due to the lack of liquidity. A market maker will have different spreads with different products, at different times. This highlights our concerns that Ofgem's proposals are not well thought through.
- Ofgem needs to define what "eligible" participants are. There is no sense in creating something that still leaves smaller players out of the market. How are private companies such as ours to be treated?

- A market maker must use a single platform which is easy to use and cheap to access. It would not help anyone for there to be 6 markets develop on top of those already available. Ofgem may actually cause even greater market fragmentation and worsen liquidity by spreading trades.

Conclusion

WPG welcomes Ofgem's recognition that they must tackle the lack of liquidity in the market, but the only proportionate remedy, that will deliver the desired outcome is referral of the big 6, or the whole sector, to the Competition Commission. A structural solution is what is required if the market is to be truly competitive in the longer term. We appreciate that a referral is significant work for Ofgem, and the rest of the market, but it is the only way that the big 6 can be broken up into companies who can and will effectively compete.

Ofgem has an obligation to secure effective competition. Playing with the rules is simply shifting the problem from one place to another and will not create a competitive market.

If there are any issues raised in this response that you wish to discuss further please do not hesitate to contact Lisa Waters on 020 8286 8677 or lisa@waterswye.co.uk.

Yours sincerely



Alex Lambie
Chief Executive