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FAO Camilla Egginton
GB Markets
Ofgem
9 Millbank
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8th May 2012

Dear Camilla,

Retail Market Review: Intervention to enhance liquidity in the GB power market

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 also owns an electricity supply business, Haven Power Limited ("Haven"), which supplies electricity to a range of business customers and provides an alternative route to market for some of Drax's power output.

Drax welcomes this opportunity to provide comments on Ofgem's latest position. Whilst we continue to believe that market intervention is required, we have significant concerns surrounding Ofgem's proposal to introduce a Mandatory Auction.

Mandatory Auction concerns

We do not believe that a wholesale market liquidity remedy lies in the delivery of generation volume. Independent generators currently provide a healthy level of competition on the offer side of the market. The main concern is the lack of bidding across the forward curve by the six large domestic retail businesses. Given the "stickiness" of domestic customers, it is only these businesses that can provide longer-tenure bidding interest in the wholesale market.

We question the robustness of reference prices a Mandatory Auction is likely to create based upon the limited volumes set out in the proposal. This is a particular concern if the reference prices were used to set the longer-dated FiT CfD index prices. We believe that using such limited volumes to set index prices for low carbon / longer-dated renewable subsidies could be detrimental to the Government's Electricity Market Reform work-stream.

It is also unclear how the credit arrangements would be expected to work. Gaining access to exchange-based platforms is difficult for independent, credit constrained market participants. This is due to the onerous collateral requirements associated with mark-to-market credit arrangements. We do not believe current market initiatives, nor the proposed Mandatory Auction, will improve the ability of independent generators and suppliers to participate on these platforms.

We recognise the difficulty in developing credit arrangements that are more amenable to cash constrained participants; overall, market integrity is paramount. However, if Ofgem's Mandatory Auction proposal does not improve the ability of independent generators and suppliers to access traded volume across the forward curve, then these parties will remain reliant on the Big Six delivering volume to the OTC market outside of the auction. A situation that is not too dissimilar to today.

Alternative solution

If Ofgem is to meet its liquidity objectives, the six large domestic retail businesses must be forced to hedge (at least partially) via the forward wholesale market. This would place their retail books on a competitive par to independent suppliers and allow independent generators to compete in meeting the hedging requirements of domestic supply.

We believe a more practical solution would be a Self-Supply Restriction or an obligation on the large domestic retail businesses to obtain a percentage of their demand requirement from the wholesale market. In the latter case, the obligation should specify a set of products and tenures to be traded, similar to the approach outlined by the Mandatory Auction proposal.

However, the route to market for the obligated parties should not be mandated. Obligated parties should be free to elect their preferred route(s) to market, be it via the OTC intermediated market, exchange-based trading, an auction and / or any other market mechanism

The obligation could be combined with a longer-dated Mandatory Market Maker, in order to ensure specific products are delivered across the forward curve. The Mandatory Market Maker could be a temporary measure, until the regulator is satisfied that liquidity has improved in forward products. This approach would ensure hedging products are available on a continuous basis, as and when they are required by market participants.

Obligated parties

Drax agrees that the chosen intervention should only impose an obligation on the Big Six. As stated by Ofgem, these six organisations account for the vast majority of power generation and domestic supply volume in GB (around 70% and 99% respectively). This volume includes a sizeable "sticky" customer hedge against generation output. In contrast, independent generators and suppliers are already heavily incentivised to hedge their investments / positions via the traded market.

Whilst we acknowledge that some independent generators have supply interests, they are much smaller in scale and specialise in the highly competitive non-residential sectors. It is only the Big Six that hold large retail positions in the domestic sector. As such, we agree that applying an obligation on independent market participants would cause a disproportionate level of costs and risks, discouraging growth in retail positions. This would work against Ofgem's aim to increase competition in the retail sector.

Answers to the specific questions raised in the consultation document can be found in Annex 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

Annex 1: A response to the specific consultation questions

Chapter 1: Our objectives for liquidity

Question 1: Do you agree with the objectives we have identified?

Yes. In order to be effective, Ofgem's chosen package of reform must ensure availability of products across the curve, allowing independent generators and suppliers to hedge their positions. The package should also establish robust reference prices and ensure that an effective near-term market is preserved.

Question 2: Do you think there are other objectives we should be considering?

No, the three overarching objectives identified by Ofgem cover the key concerns raised by independent market participants.

It is important, however, to ensure that the objectives are met over the longer-term and that liquidity continues to grow on the back of the intervention. We suggest that Ofgem includes an annual review of liquidity as part of its final proposals. The annual review would continue to monitor the outcome of Ofgem's intervention post-implementation, to ensure that the chosen approach has been successful.

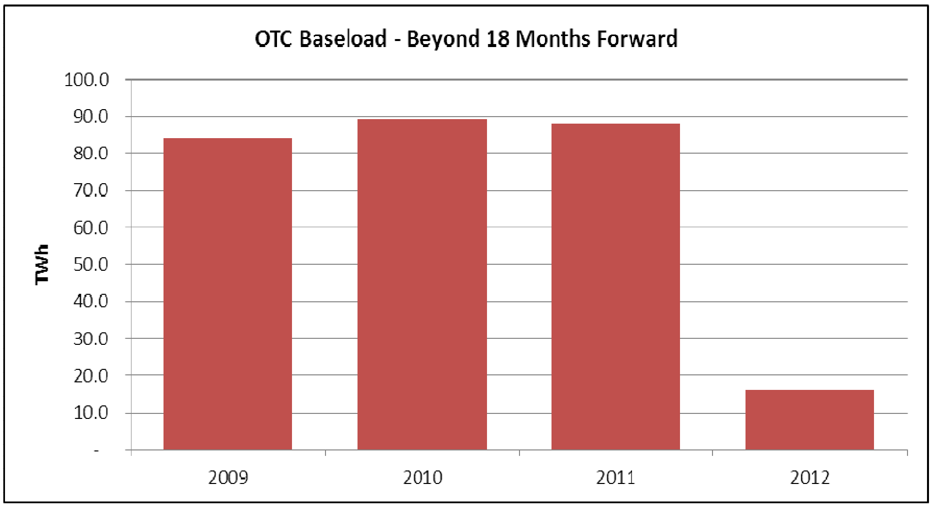
Chapter 2: Market developments

Question 3: Do you agree with our views on market developments since summer 2011?

In general, we agree with Ofgem's views on market developments. The trend appears to suggest that commercial contracting, between suppliers and end customers, is adopting a much shorter time horizon. As such, the fall in liquidity could be a feature of a change in structural demand in the market place.

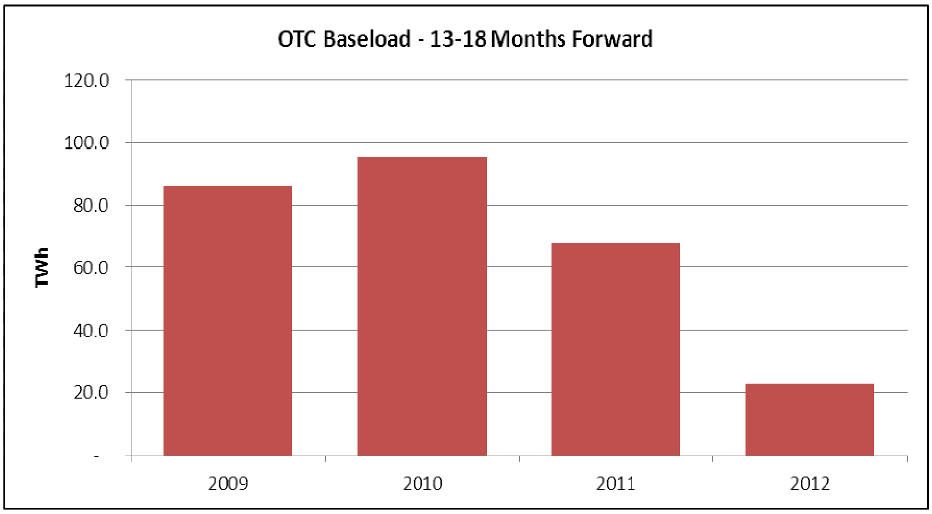
Over the course of the last year, Drax has not experienced an improvement in OTC baseload trading beyond 18 months forward. Figure 1 displays the volume traded for this product over the last three calendar years.

Figure 1: Baseload OTC volume transacted beyond 18 months forward, 2009-2011 and 2012 (Jan to Apr)



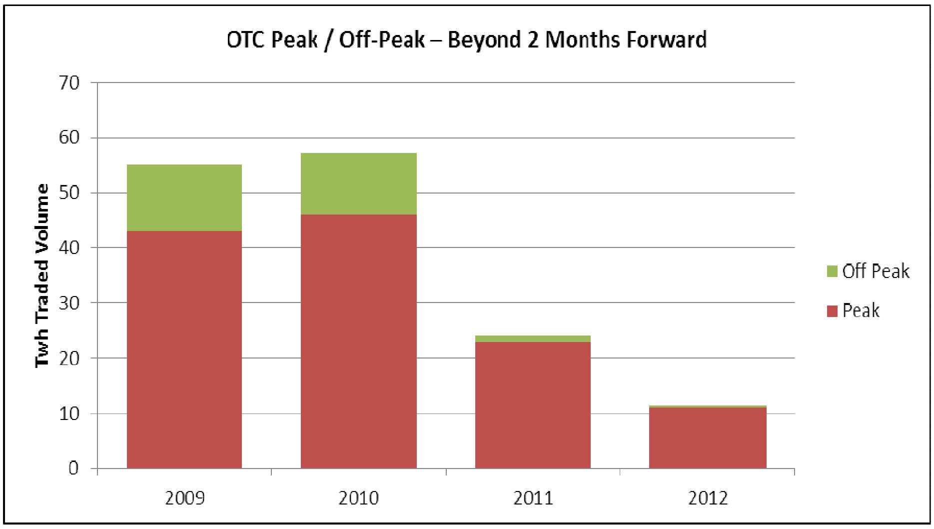
Furthermore, over the same period Drax has not experienced any improvement in OTC baseload trading between 13 and 18 months forward. The data behind Figure 2 suggests a decrease in traded volume during 2011.

Figure 2: Baseload OTC volume transacted 13-18 months forward, 2009-2011 and 2012 (Jan to Apr)



Our analysis also suggests that, when compared to 2009 and 2010, there was a large change in the trading of non-baseload forward products during 2011. Figure 3 demonstrates a sizable reduction in Peak and Off-Peak volume traded beyond two months forward.

Figure 3: Peak / Off-Peak OTC volume transacted more than two months forward, 2009-2011 and 2012 (Jan to Apr)



With regards to the near-term market, there has been a notable growth in N2EX activity over the last year. This activity is largely attributable to a number of vertically integrated businesses committing to adopt a Day Ahead "gross bidding" strategy on N2EX's auction platform.

The volume traded via N2EX, to date, has been predominantly Day Ahead and Intra Day volume. As such, this activity has increased the total volume transacted in the near-term market, but has done little to improve trading conditions across the forward curve. Whilst an N2EX Power Futures platform has been developed, there has only been a small volume of transactions placed on it to date.

The N2EX platform has not provided a solution to the shape requirement of independent suppliers. Whilst some of the Big Six have started to offer trading services to independent suppliers, these services appear to be of a bilateral nature. As such, they fail to develop greater access to small clip sizes and shaped products via a visibly traded market. Anecdotal evidence from industry forums also suggests that it is taking a long time to get the necessary paperwork ready to offer such services.

In summary, whilst there has been an increase in volume transacted in the near-term market over the last twelve months, volume transacted across the forward curve has decreased. As such, we agree that Ofgem's key priority should be to encourage greater availability of volume across the forward curve. In addition, we encourage Ofgem to continue to monitor liquidity in the near-term market, to ensure that the market develops more granularity and better availability of shape as a result of increased forward trading.

Question 4: What specific further developments would be necessary to meet our objectives?

We do not believe that a remedy to wholesale market liquidity lies in the delivery of generation volume. Independent generators currently provide a healthy level of competition on the offer side of the market. The main concern is the lack of bidding across the forward curve by the six large domestic retail businesses. Given the "stickiness" of domestic customers, it is only these businesses that can provide longer-tenure bidding interest in the wholesale market.

If Ofgem is to meet its liquidity objectives, the six large domestic retail businesses must be forced to hedge (at least partially) via the forward wholesale market. This would place their retail books on a competitive par to independent suppliers and allow independent generators to compete in meeting the hedging requirements of domestic supply. Domestic retail businesses are also better positioned to trade beyond the two year Carbon Price Support window.

Ideally, all market participants should be able to access traded volume on an equal basis. Gaining access to exchange-based platforms is difficult for independent, credit constrained market participants. This is due to the onerous collateral requirements associated with mark-to-market credit arrangements. We do not believe that current market initiatives, nor the proposed Mandatory Auction, will improve the ability of independent generators and suppliers to participate on these platforms.

We recognise the difficulty in developing credit arrangements that are more amenable to cash constrained participants; overall, market integrity is paramount. However, if Ofgem's Mandatory Auction proposal does not improve the ability of independent generators and suppliers to access the traded market, then these parties will remain reliant on the Big Six delivering volume to the OTC market outside of the auction. A situation that is not too dissimilar to today.

There is also a requirement for increased availability of small clip sizes and shaped products across the forward curve that remains unaddressed by Ofgem's Mandatory Auction proposal. Greater clarity is required on how this issue will be resolved.

Question 5: Do you agree that objectives one and two are current priorities given market developments?

Overall, we believe that objectives one and two cover the key issues identified by independent market participants. As such, we agree that these objectives should be the main focus for Ofgem.

We encourage Ofgem to continue to monitor the depth of liquidity and the ability of independent market participants to access volume and shape in the near-term market. However, we believe that development of the near-term market will be enhanced as a result of greater depth in liquidity, and more efficient price discovery, across the forward curve.

Chapter 3: Our proposal: A Mandatory Auction

Question 6: Do you agree that the MA is the appropriate mechanism to meet our immediate objectives?

No. The main issue in the wholesale market is the lack of bidding across the forward curve by the large domestic retail businesses.

If Ofgem is to meet its objectives, the six large domestic retail businesses must be forced to hedge (at least partially) via the forward wholesale market, on a competitive par to independent suppliers. Given the “stickiness” of domestic customers, it is only this sector that can provide longer-tenure bidding interest in the wholesale market.

We are concerned that the proposed obligation to sell may require generators to trade below their cost of generation. The value of trades should be a function of marginal and fixed cost recovery. The current proposal may lead to unintended consequences for wholesale market prices, thereby hampering the development of efficient price discovery along the curve.

The obligation to sell generation five seasons forward is not consistent with HMT’s implementation of the Carbon Price Support. The uncertainty of costs beyond the two year Carbon Price Support window is too onerous for thermal generators. However, the large domestic suppliers would be better positioned to trade beyond the Carbon Price Support window (e.g. with intermediaries and existing low-carbon / renewable generators), given that they are not subject to the new tax.

Due to the onerous credit arrangements generally associated with exchange-based platforms, there is a significant concern surrounding the ability of independent market participants to take part in the Mandatory Auction. If independent market participants were unable to access volume delivered to the platform, the mechanism would only serve to create a price transfer platform for the Big Six. This would not improve the availability of hedging products for those that require them most, thereby failing to meet objective one.

Whilst we acknowledge that an obligation on the Big Six to deliver volume to a Mandatory Auction could help develop forward reference prices, we would question the robustness of such reference prices if they were based upon the limited product volumes suggested by the consultation document. This would be a particular concern if they were also used to set the longer-dated FiT CfD index prices. This could be detrimental to the Government’s Electricity Market Review. As such, we do not believe the Mandatory Auction would meet objective two.

The infrequency of the proposed Mandatory Auction will only provide a snapshot of market prices once a month. As such, market participants would only be certain of being able to enter or exit positions in the proposed products during a short window. This is not consistent with the notion of a fully functioning market. There is a further danger that parties may delay trading in the OTC market until the result of the auction is known, further cannibalising the volume available to those that cannot access the auction itself.

It is troubling that the consultation document fails to assess the impact of a Mandatory Auction on the OTC market. Independent generators and suppliers have already witnessed the cannibalisation of the near-term OTC market since the introduction of the N2EX auction. Analysis on the potential risk to the already illiquid forward OTC market should be conducted prior to taking the proposal forward.

From our experience of discussions at industry meetings, including the first of Ofgem’s Liquidity Roundtable Events, it would appear that a Mandatory Auction has little support across the industry. This includes those the intervention aims to assist (independent generators and suppliers) and those that it places an obligation upon (the Big Six). This suggests that there is little market confidence in the proposal.

Question 7: Do you agree that, at the present time, the other mechanisms identified would not be appropriate for Ofgem to pursue?

No, we do not agree. The main problem does not reside in the sale of electricity to the wholesale market. The real issue is the lack of bidding across the forward curve by the large domestic retail businesses. As such, the current Mandatory Auction proposal will not deliver the desired outcome.

The intervention should take the form of an obligation on the six large domestic retail businesses to hedge via the traded market. This could be achieved as a Self-Supply Restriction or as a percentage of volume that must be traded in set products, similar to the approach taken by the Mandatory Auction proposal. However, the route to market should not be mandated. Obligated parties should be free to elect their preferred route(s) to market, be it via the OTC intermediated market, exchange-based trading, an auction and / or any other market mechanism.

In order to ensure specific products are delivered across the forward curve, the obligation could be combined with a longer-dated Mandatory Market Maker. The Mandatory Market Maker could be a temporary measure, until the regulator is satisfied that liquidity has improved in forward products. This approach would ensure hedging products are available on a continuous basis, as and when they are required by market participants.

In terms of monitoring the obligation, Ofgem has a number of tools at its disposal. The burden of proof should reside with the large domestic supply businesses, with annual reports detailing the volumes sourced from the market that are signed by company executives. BSCCo could also provide Ofgem with regular reports, based upon contract volumes submitted to the central system.

In addition, the introduction of trade repositories, an outcome of the EU's REMIT work-stream, should improve the ability of the regulator to monitor the fulfilment of obligations imposed on the large domestic retail businesses. There may also be scope for Ofgem to use aggregated trade data, submitted to the repository, for the development of robust reference prices.

Chapter 4: Proposed detailed design features

Question 8: Do you agree with the key features of the MA we set out?

Drax does not agree that a Mandatory Auction would be the correct approach to address the concerns of many independent market participants.

The main concern is the lack of bidding across the forward curve by the six large domestic retail businesses. If Ofgem is to meet its liquidity objectives, the six large domestic retail businesses must be forced to hedge (at least partially) via the forward wholesale market. This would place their retail books on a competitive par to independent suppliers and allow independent generators to compete in meeting the hedging requirements of domestic supply.

Whilst we do not support the proposal to introduce a Mandatory Auction, Drax agrees that the chosen intervention should only impose an obligation on the Big Six. As stated by Ofgem, these six organisations account for the vast majority of power generation and domestic supply volume in GB (around 70% and 99% respectively). This volume includes a sizeable "sticky" customer hedge against generation output. In contrast, independent generators and suppliers are already heavily incentivised to hedge their investments / positions via the traded market.

Whilst we acknowledge that some independent generators have supply interests, they are much smaller in scale and specialise in the highly competitive non-residential sectors. It is only the Big Six that hold large retail positions in the domestic sector. As such, we agree that applying an obligation on independent market participants would cause a disproportionate level of costs and risks, discouraging growth in retail positions. This would work against Ofgem's aim to increase competition in the retail sector.

There is a significant level of detail missing from Ofgem's Mandatory Auction. This information includes:

- How volume will be divided and delivered to each of the twelve auctions across the year;
- The level of discretion held by obligated parties on when they offer volume;
- The consequences of obligated parties failing to sell the required volume;
- The regulation of bid / offer spreads;
- The use of reserve prices;
- The cost of participation in the auction (membership and transaction fees); and
- How the credit arrangements will work.

It is clear that a key barrier to auction participation, the cost, has not been given sufficient consideration. It will be difficult for independent market participants to become directly involved in a Mandatory Auction process unless a solution is found to the onerous collateral requirements that such platforms impose.

There are further concerns over the proposed approach to the auction-based intervention:

- The frequency of the auctions (i.e. monthly) may mean that the reference prices only represent a snapshot of the market, rendering them useless between auctions;
- There is a danger that parties may delay trading in the OTC market until the result of the auction are known, further cannibalising the volume available in the OTC market and limiting access to volume for those that cannot access the auction itself;
- The robustness of the references prices would be questionable if they were based upon the limited volumes detailed in the consultation document;
- If obligated parties have discretion over the volume delivered to a given monthly auction, the volumes could be very small, which may diminish confidence in the reference prices;
- FiT CfD index prices based on limited traded volumes could be open to manipulation; and
- The ability of thermal generators to sell volume beyond two years forward, given HMT's implementation of the Carbon Price Support mechanism (a bid-side obligation on domestic supply may mitigate this problem).

Question 9: Do you consider it appropriate to have buy-side rules in place and do you have any comments on the detail of such rules?

If a Mandatory Auction approach was taken forward, we believe buy-side rules would be appropriate. The mismatch in volume on each side of the auction will produce a stronger incentive to trade and appropriately price bids and offers. However, to optimise bidding activity from the Big Six retail companies, please see our preferred approach detailed in answer to Question 7.

<u>Chapter 5: Identifying a Platform</u>

Question 10: Do you consider that there are benefits and risks to the approaches that we have not identified?

Approach one could ensure greater consistency in the delivery of auction volume from each of the obligated parties. Depending upon the decisions taken by each of the obligated parties, approach two may lead to further fragmentation of liquidity.

However, if parties were able to choose existing auction platforms to satisfy their obligation, approach two could prove more cost effective, i.e. the development of a bespoke platform may be avoided.

Question 11: Which approach do you consider is best placed to deliver our objectives at least in terms of cost and risk?

Drax does not agree that a Mandatory Auction would be the correct approach to address the concerns of many independent market participants. If a Mandatory Auction approach was taken forward, we believe approach two may provide a marginal benefit over approach one.

The use of a single auction platform may ensure that the obligated volume is consolidated and allow the regulator to maintain a greater level of oversight. However, if approach two allowed obligated parties to choose existing auction platforms to deliver volume, it may provide a more cost efficient solution by avoiding the development of a further auctioning platform.

We believe further thought should be given to how the two approaches might affect the implementation of the EU target model and, in particular, the GB Hub.

Question 12: Do you consider that both approaches are able to meet our objectives?

Drax does not agree that a Mandatory Auction would be the correct approach to address the concerns of many independent market participants. However, if a Mandatory Auction approach was taken forward, both approaches to securing service providers could meet the objectives.