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Dear Camilla

Retail Market Review: Intervention to enhance liquidity in the GB Power Market

Thank you for the opportunity to respond to your consultation of the 22nd February 2012 requesting industry views on the issues you have raised concerning liquidity in the GB Power Market. In addition we were pleased that you were able to meet with members of our Generation Division Electricity Trading Committee in order to discuss some of your concerns and listen to the wide range of member views expressed. This response has been prepared on behalf of members of Energy UK which represents a wide spectrum of interests across the Energy sector. This includes small, medium and large companies working in electricity generation, energy networks and gas and electricity supply, as well as a number of businesses that provide equipment and services to the industry.

Members are unanimous in that they are ALL supportive of a well run and liquid market however there is a division, albeit sometimes blurred, regarding the most appropriate approach going forward which is very much dependent upon the individual business model. This could be deemed the classic 'independent generator versus the integrated company' situation, together with the complexities associated with the tensions that exist between the larger more experienced players and relatively new market entrants, who are keen to expand but find themselves frustrated by the now well established company practice and UK Trading Arrangements. However to categorise the issue as such is not so straightforward given that there are both vertically integrated parties and independent generators that agree with the principle of greater liquidity and oppose the Mandatory Auction. This response will provide an overview of issues that have been identified by our membership however Ofgem should look to individual company responses for in depth detail regarding specific issues, wider concerns and responses to the consultation questions in section Appendix 1 of your 22nd February document.

Current Industry Initiatives versus a Mandated Auction

Members are supportive of market initiatives, including the introduction of the N2EX Trading Platform, and welcome additional service providers that wish to enter the market to compete for business. We are aware that there are planned enhancements by N2EX users to "gross bid" into the auction platform, which some parties believe may provide part of a market wide solution. However, N2EX on its own is not a panacea to liquidity and some members believe that intervention may be required to ensure the delivery of liquidity across the forward curve, i.e. to allow the hedging of investments and provide more efficient price discovery. The nature of such an intervention, should

this be deemed to be required, is at the heart of this debate.

You will be aware that when we discussed your proposals at our Electricity Trading Committee members were convinced that the proposal for a Mandatory Auction was unworkable in its current form. Concerns were raised both by those parties who it is suggested would be obligated and those that the intervention intends to help. We understand that independent Supply businesses have also raised similar concerns. It is clear that there is significant work to be undertaken to finesse this aspect of your proposal. This includes being absolutely sure about what the objectives are and the full scope of risks and rewards. Those who are not entirely against the Mandatory Auction approach offer at this point only cautious support, subject to significant additional detail being provided. Only after this is provided and consulted upon would members be in a position to determine the true strengths and weaknesses of the proposed intervention.

Should Ofgem determine that market developments cannot be relied on to improve liquidity, and intervention is therefore necessary, members would support a significant increase in the level of industry involvement in the development of detailed liquidity proposals, to ensure that they are as workable as possible.

We recognise that the current “outline” proposals are meant to provide the industry with a “road test” of the proposed Mandatory Auction. The aim is to help Ofgem understand what detail is currently missing, what products should be traded and why, where restrictions to trade currently exist and where trading windows naturally end? However, as indicated at Ofgem’s liquidity roundtable events, there is still a substantial level of detail missing from the proposal, particularly around how obligated parties are expected split the delivery of volume across monthly auctions, the discretion that obligated parties will have in the delivery of the volume, what will happen if the obligated parties fail to sell obligated volumes, etc. We also acknowledge that it is paramount that any improvements shouldn’t adversely impact on existing arrangements.

Included as an Appendix to this letter is a list of some of the issues members believe require further consideration and further consultation prior to any direction coming from the Authority on this issue.

Should you require any further information then please contact Barbara Vest, Head of Electricity Trading on 07736 107 020.

Yours sincerely,

David Porter OBE

Chief Executive

Response submitted by Email

APPENDIX

As outlined above in preparation for the update on the Ofgem Retail Market Review: Intervention to enhance liquidity in the GB power Market members of the Energy UK Generation Division Electricity Trading Committee raised a wide range of topics for clarification including:

Objectives

- What is the Retail Market Reform overall objective?
 - Is it to increase competition in Supply? If so is Ofgem sure that targeting generators as suggested in the consultation is the right approach? Some members believe the intervention should place an obligation on supply companies to diversify where they buy from within the market, rather than generation businesses to sell. Whilst others believe that an obligation at this stage is not appropriate as further enhancements to the N2EX platform need time to be finalised and bedded in;
 - Is the overall objective to increase competition in Supply and Generation? Members are sceptical regarding the proposed approach. Whilst all are supportive of the desire to see increased liquidity, some remain to be convinced that a Mandatory Auction is the correct solution. There was further concern that the proposals could lead to increased costs that will be faced by the end consumer, particularly if based on Financial Derivatives.

Note: Financial Derivatives discussion took place at the Ofgem Liquidity Round Table last week, however, it was of concern that there were no Financial Institution members at that meeting. Members have concerns about the additional regulatory controls that might be necessary to support the introduction of going down a financial derivative route. Impact on collateral will be significant;

- Members felt that there was too much focus on improving the lot of the small supplier and not enough focus on the needs of the independent generators.
- It is also for consideration why obligated parties should not be free to choose their route to market, be it via an auction, OTC market, a market maker, etc.

The design of the Mandatory Auction

- Does the proposed approach impact all Generation in the same way?
 - Independent generation is already heavily incentivised to deliver the majority of volume to the traded market (i.e. due to the lack of an internal hedge that is provided by “sticky” domestic customers)?
- How would the auction be run?
 - An auction would be expensive and difficult to run given that the vertically-integrated companies control 95% of the output from the industry; For example, how would the auction close? Some see this as a problem whilst others do not see it as insurmountable.
 - Selling physical and not financial product, therefore how do you back off the risk?
 - What would be the impact on the spark spread?
 - How are volumes to be split and how would Ofgem expect them to be delivered i.e. at what point do you have to sell the volumes, for example what if it all goes in the first auction? How volumes will be delivered to each of the twelve auctions across

the year; the level of discretion held by obligated parties on volume delivery; what happens if obligated parties fail to sell the required volume;

- cost of participation (membership and transaction fees);
- how credit arrangements will work;
- What exactly is the 25% that is required? There are problems in that if set on an annual basis the industry does experience a good year versus bad year production, e.g. a windy year versus a non-windy year; how will this impact expected (25%) volumes? During a year it is possible that there could be some buying/selling of plant; how is this taken into consideration?
- Some generators chose not to trade more than two years out due to the way HMT implemented the carbon price support mechanism. Further to this it has recently been demonstrated that some generators are unable to provide more than two years User Commitment to National Grid (see responses to CMP192 User Commitment).
- Is this based on offers of shape and/or volume?
- Are the proposals not just shifting volumes from one sales platform to another?

Alternative Approach

- Is the Mandatory Auction the only route being considered or are there other options in the pipeline coming from market participants? The recent Ofgem roundtable events suggested that market participants still view alternative solutions as strong contenders.
- Has the longer-dated Mandatory Market Maker route been completely ruled out? There are a number of market participants that still support this route.

Other Issues for Consideration

- There is not enough detail, particularly about the final cost and benefits to customers;
- Do we all fully understand the linkage to the emerging EMR proposals and the EU Target Model approach?

House of Lords Post Implementation Evaluations

The House of Lords stated in 2007 that regulators should be undertaking Post Implementation Evaluations, which means that Ofgem must provide detail at an early stage regarding how it will judge success, particularly around incremental benefits?

Notes

The views expressed in this consultation document may not always reflect precisely the individual views of all the members of Energy UK, but will be a consensus position.

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