

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

Submission by International Power Plc

(I) About International Power Plc

International Power plc is a leading independent power generation company with active interests in closely linked businesses such as LNG terminals and water desalination. Following the combination with GDF SUEZ Energy Europe and International, International Power plc has strong positions in all of its major regional markets (Latin America, North America, the Middle East, Turkey and Africa, UK-Europe, Asia and Australia). In total, it has 66 GW gross capacity in operation and committed projects for a further 22 GW gross new capacity.

In the UK-Europe region, International Power plc has interests in 13.2 GW capacity in operation and a further 1.3 GW under construction. This includes over 7.3 GW of plant in the UK market made up of a mixed portfolio of conventional plant – coal, gas, CHP, a large OCGT , and the UK's foremost pumped-storage facility. Several of these assets are owned and operated in partnership with Mitsui & Co. Ltd. IPR's assets represent just under 9% of the UK's installed capacity, making IPR the country's largest independent power producer.

IPR in the UK-Europe region operates about 1100 MW of wind power. The company is keen to develop its renewable portfolio further and is developing a range of projects in the UK as part of this strategy. The company also has a significant Industrial and Commercial retail supply business, and a gas supply business in the UK.

(II) Summary of key points

- **It is important to distinguish liquidity objectives from those relating to small supplier market access where we believe credit is the major obstacle to greater participation. As with Ofgem's Consultation, this response focuses on ways to improve liquidity.**
- **IPR does not believe that the mandatory auction initiative will enhance liquidity, it will just move liquidity from other places and reduce the ability to trade on a continuous basis to hedge positions.**
- **To enhance liquidity, more participants need to be attracted into the market. Given the economies of scale and the credit requirements needed to participate, these new participants are unlikely to be pure suppliers (unless backed by a substantial credit worthy entity). In the current climate of low spark spreads, lack of clarity over the detail and timing of EMR proposals and financial constraints, the market might deter new independent generators from entering the market.**
- **Financial players are therefore needed to enhance liquidity, necessitating a robust, liquid reference price against which financial products out into the forward markets can be traded. The N2EX platform is developing product offerings and is moving in this direction. The introduction of**

Mandatory Auctions is likely to distract from this progress. IPR believes it should be allowed time to mature as this kind of initiative is more likely to increase liquidity than mandatory auctions.

CHAPTER: One

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

1. IPR agrees the objectives are appropriate but does not consider the solutions facilitate these objectives. IPR would prefer to see current market led developments to enhance liquidity given the time to succeed as we believe that these can deliver on all three objectives.
2. IPR believes that low liquidity is not the only barrier to greater participation from small suppliers. The requirement to post exchange collateral under the proposed mandatory auction may limit participation by small suppliers in the auction. We do not believe auctions are the solution to enabling suppliers to enter the market and grow, as unless those supply business are backed by a larger entity, the credit requirements will continue to be the key barrier to entry.

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

3. IPR believes that credit is, and will remain the main issue for small suppliers whatever the solution. A further objective should be that whatever liquidity interventions are adopted, the credit arrangements remain robust.

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

Churn

4. We note from Ofgem's analysis that overall churn sits at around 3, and has reduced from a recent high of 4 in 2009. In general, IPR believes that churn is a rather blunt metric to assess liquidity. Nevertheless, whilst it is disappointing that the overall level of churn has reduced, the contextual reasons need to be considered. Currently baseload spark spreads are around £1-2/MWh, and low churn levels would be expected, particularly when transaction costs are taken into account.
5. The regulatory uncertainty (Carbon Floor, EMR etc.) may be deterring non-physical players and therefore be a contributory factor.
6. A further possible reason for the more general low level of churn could be because of the strong correlation of power with gas. This has reduced need for participants to trade power as they can hedge any exposure through gas. There are some clear substitution effects here.
7. Given all of this, it is perhaps not that surprising that churn levels have fallen rather than grown.

Objective 1 – availability of a range of products to support hedging

8. IPR considers that Ofgem needs to allow more time for the N2EX platform to develop. N2EX took a long time to establish and has now been running for two years. After a slow start, it has seen a rapid increase in volumes and is heading in the direction of providing a range of products to support longer term hedging. There are now 38 parties trading the physical market, 13 trading financial

futures (including RWE and EdF who have signed up as market makers) and 10 parties clearing UK power futures. Four of the 'big 6' have now signed up for gross bidding in the day ahead auction. Introducing a mandatory auction could have negative impacts on further growth in the volume traded and in the number of participants in N2EX, potentially undermining the progress made to date.

9. Whilst in specifying a platform, Ofgem could improve on the above set up time, the mandatory auction platform is not going to be up and running in a short period. If mandatory auctions do not enhance liquidity and take time to introduce, it seems logical to allow the market to develop organically to get to the same end goal.

Objective 2 – development of robust reference prices

10. There is a significant question mark over the ability of the MA to deliver a reliable index, firstly because it is likely that much of the volume will be bought and sold by the Big 6, and secondly because the buy side rules will restrict how the Big 6 participate which could result in some unexpected auction outturn prices. It is unclear to us how much volume in addition to the obligated volume will appear in the MA as this will be dependent on the credit terms offered and whether participants view the MA as an effective way to manage their exposures. We believe that the market should focus around a single reference price taken from the day ahead auction.
11. We also question whether it is necessary to mandate auctions to provide the longer term reference prices required for baseload CfD FiTs. In many commodity markets reference prices are taken as the closing settlement price on an exchange, a price from an industry publication or the volume weighted average of trades done within a certain time window. If a reference market is specified for a type of CfD FiT, trading will naturally move to that reference market.
12. In any case, in the absence of greater clarity on CfD FiT design at this stage there is a significant risk that any reference prices resulting from Mandatory Auctions may not be compatible for CfD purposes.

Objective 3 – Effective near term market

13. IPR agrees with Ofgem that liquidity in the near term market is sufficient. We agree that any changes to cashout could have implications for near term liquidity that could be either positive (the threat of higher prices encourages over contracting by suppliers) or negative (the risk of higher imbalance costs means generators are more conservative in the trading particularly in the short term).

European Target Model

14. At the moment, the European Target Model is focusing on market coupling through a coordinated day ahead auction. Liquidity interventions should aim to support this. It is not clear how Mandatory Auctions are in any way consistent with this requirement.

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

15. IPR continues to believe that Ofgem's objectives can be met through development of the N2EX auction and financial futures platforms.

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

16. IPR agrees that we do need to develop an industry approved reference price for forward periods and would also like to see more liquidity in more products but we do not view the MA as the best approach to delivering this.

17. IPR does not believe that increased availability of term products and robust reference prices on their own they will encourage smaller suppliers into the market (unless backed by a substantial credit worthy entity). Please see Q6 for further detail.

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

18. No. IPR does not consider that MA is at all appropriate. Firstly, we do not believe it will create a more liquid market as it is likely that liquidity will simply move to the auction from elsewhere. The existing physical market participants already state that they trade their output multiple times and so we feel that in order to enhance liquidity more players need to be attracted into the market. We do not believe mandatory auctions will achieve this as they are targeted at those already active in the market and the added complexity and costs that they bring may actually put off potential new market participants.

19. Secondly, the proposal would not appear to suit the needs of small independent suppliers. We note that credit is barely touched on in the consultation other than a mention that small suppliers will be able to do all their trading in one place reducing credit requirements. To trade on an auction platform, small suppliers will need to post margin. This requirement is likely to be at least as onerous as current bilateral credit requirements.

20. In addition, by focusing all trading on a platform, when credit is exhausted, trading ceases. At least with bilateral credit, a supplier can trade with more than one counterparty. In addition, the MA will only allow trading once a month and this is very unlikely to match with the requirements of any supply or indeed generation business meaning that participants would still need to set up the capability to trade in the continuous market.

21. Thirdly, IPR believes that a MA could be very costly to set up and implement particularly if a new central platform is specified rather than building on an existing platform. The platform is also likely to be classed as an exchange so will have to hold regulatory capital.

22. IPR's preference is to allow the current day ahead auction to grow organically so that it leads to a robust day ahead index against which longer term financial products can be traded. The closing

prices on these financial products used by the exchange for daily settlement could then become the robust reference price that we are looking for.

23. If Ofgem believes that they do need to mandate certain volumes of certain products to be traded, then IPR feels it would be better to mandate activity in the continuously traded market. We acknowledge that this could present challenges in terms of whether this is compliant with market regulations and in setting rules to ensure all participants have access to volume, but this would at least be working to support liquidity in a single market mechanism rather than risking fragmenting activity.

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

24. IPR considers that Ofgem is prematurely ruling out its earlier alternative proposal of a Mandatory Market Maker (MMM). Unlike the MA, the MMM would allow continuous bilateral trading which has been one of the cornerstones of the NETA arrangements. Ofgem has rejected the MMM for now because of the requirement to regulate bid-offer spreads. IPR does not see this as that onerous a requirement. Simple spread limits could be applied – the two voluntary market makers in the N2EX are limited to spreads of £1/MWh.
25. Alternatively, a tender process could be held to select a market maker who could be a physical player or a financial player. Potential market makers could specify the spread they will set, where the tighter the spread, the higher the risk for the market maker and the greater the cost they would charge the industry to provide the service. Given that the proposed MA is a monthly process, the risks (and therefore costs) associated with the MMM could be capped by the obligation only applying for a set time period each month.

CHAPTER: Four

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

Participation

26. Whilst IPR does not support mandatory auctions, if they are to be introduced, IPR agrees with Ofgem that they should only apply to the big 6 for the following reasons:
- they provide a well defined group avoiding the need for an arbitrary definition for inclusion;
 - they operate in the domestic retail sector where ‘sticky’ customers provide a sizeable hedge¹ against generation output and against power market volatility;
 - their inclusion is consistent with the background to these liquidity measures and the rationale previously presented by Ofgem under the Liquidity and Retail Market Reviews (i.e. potential concerns over foreclosure of volumes by the big 6 and trading access to big 6 volumes for small suppliers.); and
 - extending participation beyond this group would cause disproportionate costs and could discourage growth in retail competition.

¹ 60% of domestic customers have not changed their supplier - source Ofgem RMR research conducted by Ipsos MORI (2011)

Products

27. If the auctions are to be adopted then the proposed products seems reasonable.
28. Whilst Ofgem proposes mandating up to Season +5, there may well be a reluctance to buy longer dated products due to the margining requirements. The lack of certainty over the carbon floor price (which is only known 2 years in advance) will increase the risk of trading beyond season +4. For this reason, we suggest limiting the obligation out to Season +4 and increasing the requirement in the front two seasons.

Volume

29. In the context of the overall traded market, mandating the big 6 to trade 25% of their generation output would seem insufficient if it represents 5% of the overall traded market. Whilst we are not advocating a larger volume as we do not support the proposal in principle, we question the point of mandating such a small overall volume. The costs of setting up such an auction are likely to be highly disproportionate to the benefits
30. The proposed volume does not seem sufficient to provide robust reference markets for CfD FiTs – basing the baseload reference price on a small volume of generation (10.6 TWh for Seasons 1+2) is equivalent to the output of a station slightly larger than Sizewell B. Even with the additional volume as suggested above, it would still not be sufficient to give robust reference prices.

Frequency

31. Monthly auctions seem appropriate. Given the volumes are small, we doubt it will lead to a trading hiatus. However, the fact that the auction will only trade once a month does appear to present an issue in terms of participants using this to meet all of their needs; trading requirements very rarely comply with such a rigid timescale. This is a further reason that we feel Ofgem should support initiatives focused on increasing liquidity in the continuously traded market.

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?

32. We do consider it appropriate to have buy-side rules but do have concerns as to how these may impact on the auction outturn level and the stability of prices. The uncertainties regarding how the auction algorithm will work and how the buy side rules may impact outturn prices puts at risk the aim of establishing a robust reference price. A reference price based on a continuously traded market does not have these risks.

CHAPTER: Five

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

33. We see little benefit in terms of enhancing liquidity in adopting approach 2 (allowing parties to make arrangements with their chosen platform providers). If auctions are to be introduced, they

should occur in one place. This will minimise the set up costs for the non-obligated parties, reduce the need to set up credit arrangements with multiple platforms and ensure that as much volume as possible is included in setting the single auction outturn price.

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

34. Approach 1 for the reasons listed in Q10.

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

35. No. Approach 2 in particular is unlikely to enhance liquidity as the multiple platforms would create increased complexity and increased costs for all and so would be more likely to deter any new liquidity.

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