

Camilla Egginton
GB Markets
Ofgem
9 Millbank
London, SW1P 3GE

DONG Energy A/S
Nesa Allé 1
2820 Gentofte
Denmark

Tel +45 99 55 11 11
Fax +45 99 55 00 01

www.dongenergy.com
Company no. 36 21 37 28

Consultation on “Intervention to enhance liquidity in the GB power market”

8 May 2012

DONG Energy is pleased to be afforded by Ofgem the opportunity to comment on the abovementioned consultation on a possible intervention to enhance liquidity in the GB wholesale power market.

Our ref.

jakfo@dongenergy.dk
Tel +45 99 55 91 66

Executive summary

DONG Energy believes that:

- A **self-supply restriction** with a separation of the trading department of supply and generation would solve the fundamental market structure problem, incentivise vertically integrated companies to trade openly and solve the liquidity problem.
- Alternatively Ofgem could demand a minimum of **50% gross bidding on the day ahead auction** by the vertically integrated companies and require **market making on the curve** in order to develop financial hedging products.
- The GB electricity market arrangement that was designed for liquid traded markets has unintentionally led to a trend of significant vertical integration.
- The large portion of self-supply and internal trades leaves no incentive to trade and is the main cause of lack of transparent price discovery to the consumers, suppliers and generators and low liquidity in the open market.
- Low wholesale market liquidity has during many years acted as a barrier to entry for suppliers and generators and to effective competition.
- The recent initiatives taken to trade in the day ahead auction, while being a positive development, seem uncoordinated, too fragile and slow moving to create a robust day ahead price that can successfully be used for financial forward hedging products.
- Ofgem’s proposed Mandatory Auction, while not solving the problems for independent generators, has the positive effect of bringing some trades and volume out in the open market. However, it seems too narrow in its scope, insufficient in frequency (monthly) and very complex to design to have significant impact.

About DONG Energy

DONG Energy is one of the leading energy groups in Northern Europe. We are headquartered in Denmark. Our business is based on procuring, producing, distributing and trading in energy and related products in Northern Europe. We have approximately 6,000 employees and generated DKK 57 billion (£ 6.2 billion) in revenue in 2011.

In the United Kingdom DONG Energy is one of the most active offshore wind investors and operators with a total capacity of approximately 5 GW, including four offshore wind farms in operation, a stake in further four sites currently under construction and a strong pipeline of future projects. In thermal generation, DONG Energy is operating the highly efficient CCGT power station Severn in South Wales.

This spring we established DONG Energy Sales UK with an annual supply of around 2.5 billion cubic metres of natural gas after acquiring the gas supply business Shell Gas Direct.

Developments of the GB electricity market arrangement and structure are very important to DONG Energy both in terms of present generation capacity, but certainly also for our significant future investment programme.

DONG Energy would be pleased to discuss any of the issues raised in the consultation response and look forward to engaging with Ofgem. Should you have any questions relating to our response, please contact either Danielle Lane on 020 7811 5200 or Jakob Forman on +45 99 55 91 66.

Yours sincerely

Jan Ingwersen
Vice President
Infrastructure and Regulatory Affairs
DONG Energy

Intervention to enhance liquidity in the GB power market

Lack of liquidity in the market

In general, DONG Energy supports the case for an intervention in the wholesale market. Being an independent generator trading in the market with a gas fired power plant and a portfolio of wind power generation we have for years been struggling with the lack of liquidity in the GB electricity markets. Specially we see a very thin forward market with hardly any reliable quoted prices beyond a year ahead. Hedging possibilities are still far from optimal in the GB market. Further the intraday market should also be monitored closely as trading the volumes rising from wind forecasting errors are causing significant challenges that would only grow as more wind enters the system.

Ofgem has during the past years been monitoring the functioning of the market and clearly showed that the present market structure does not by itself deliver the necessary transparency, liquidity and robust reference prices needed for managing volume and price risks for new entrants and independent generators and suppliers. In comparison with many other European markets liquidity levels remain low in the GB market, bid-offer spreads high, churn rate low, and specially the lack of transparency lead to a high risk environment, not least for non-integrated companies.

While welcoming the continuous monitoring of the market liquidity, we are in the consultation document missing an analysis of the potential causes of low liquidity e.g. by looking at the fundamental market structure.

Causes of an inefficient market

The situation in the GB market is that the market arrangement has unintentionally led to a trend of vertical integration. Six vertically integrated companies have more than 97 % of the supply business and ca. 70 % of generation. Now the degree of vertical integration in a market is a key driver of traded volumes, since vertically integrated players may offset demand with their own generation and only trade the net long or short position in the market. In GB, the underlying requirement for trading has fallen significantly as vertical integration has increased. Due to a large extend of internal trades the majority of physical demand is never traded in the open market with transparent pricing and therefore the churn remains low. This is also evidenced in the consultation document, as the churn rate has stayed low since 2003 with only small deviations.

Consequences of low liquidity

The lack of price discovery in the market in turn prevents a trustworthy reference price from developing. This uncertainty whether prices quoted in the market truly reflect the underlying prices being paid for a particular product means that price risk management becomes difficult. Further, competition is disturbed by the

asymmetric access to information as vertically integrated companies clearly have an advantage over independent generators and suppliers as they have much better price discovery due to their position in the market and knowledge of internal transfer prices.

Our ref.

A consequence of not having trustworthy and robust prices is that it is difficult to settle financial hedging products and hence non-physical players that could provide liquidity will not enter.

Fragile improvement in the day ahead market

The recent initiative by a number of the “Big 6” to trade more volumes on the N2EX day ahead auction show some willingness to trade openly. We do support this and think it is a good development, but given that this initiative is only supported by some companies it seems very fragile and these companies could pull out anytime they want. This might happen if others are not joining or if Ofgem relax their focus on liquidity in near term markets. This uncertainty poses a large risk to other market players, who should supposedly start to rely on the day ahead price.

To our knowledge the gross bidding agreements used on N2EX are only covering 30% of the individual vertically integrated companies generated volumes. This means that a lot of self-supply and internal trades without price discovery will still take place. Our experience with trading on the day ahead auction is that there is still volatility, because volumes are not sufficient to underpin a robust market.

It is therefore too early days to say that the near term markets are working well or to say if a robust reference price would emerge from the present level of trading.

If the development on the day ahead market is not sustained or mandated the risk is that it could take a long time until a trustworthy reference price has developed. This will conflict with the demand in the EMR for having robust reference prices in the near term. Delays in a robust day ahead market would also postpone the much needed development of financial products that grows on the back of a robust day ahead price.

Most likely the fundamental problem with the lack of price discovery for large parts of the physical traded volumes will still constitute a real problem for the development of robust reference prices.

Selecting a mechanism for liquidity intervention

Generally, we support the objectives put forward by Ofgem of availability of products which support hedging, robust reference price generation along the curve and effective near-term markets. We are, however, concerned that Ofgem’s approach of not looking at the causes of low liquidity and looking at the different markets and objectives separately will lead to a suboptimal solution.

It would be best to focus on all power markets together as they are interlinked in price formation, risk management and market expectations. Taking a holistic approach like the one being discussed in the Cash Out Review would be beneficial.

Our ref.

We welcome that Ofgem recognise the need for at least a proportion of the Big-6's production to be openly marketed, but the Mandatory Auction that would be offering a range of physical forward products on a monthly basis is not our preferred solution. We need to hedge positions on a continuous basis and not only once a month and if the MA cannot deliver a narrowing of the bid-offer spreads there is no added value.

Further it will in our opinion not solve the underlying problem of

- 1) not having full price transparency and access to information in the market, including on internal price discovery and,
- 2) low incentive for the vertically integrated companies to trade in the market.

From the recent Ofgem stakeholder events 18 April and 2 May there were raised a number of concerns with the MA regarding implementation, beneficiaries, products, functionality, interaction with the present market, platforms and governance. Many stakeholders raised questions on why the self-supply restriction (SSR) has not been considered more carefully and there were in DONG Energy's assessment a general disagreement with the "Outline Impact Assessment" made in the consultation document that a SSR cannot deliver on the three objectives put forward by Ofgem. We share many of the issues raised by other stakeholders. If the MA is the only solution implemented, we remain concerned that the ability of independent generators to compete is not sufficiently addressed.

The above problematic situation raises the question if the self-supply restriction would appropriately and efficiently enhance transparency and liquidity and thereby facilitate more competitive markets.

Making a well-functioning wholesale market

We think that a self-supply restriction (SSR) will address the root causes of lack of liquidity. There are two fundamental steps that should be taken to raise liquidity and reach at a more competitive market to the benefit of consumers and the whole industry.

First of all full price transparency should be enforced on all trades, also those taking place between generation and supply businesses of vertically integrated companies.

In parallel, we would propose a requirement to trade all volumes in the open market through a SSR. However, the obligated parties must not be allowed to discharge this obligation by simply trading volumes in excess of their physical

positions, which the consultation document rightly states as a problem. Rather, there should be a complete separation of the trading of generation and supply, so that whenever the position of either is revised, that volume must be traded in the open market. In practice, this could take the form of “Chinese walls” within the trading department of generation and supply.

Our ref.

An alternative or combined solution to incentivise open and transparent trading will be to require the vertically integrated companies to do full or at least minimum 50% gross bidding on the day ahead auction. This will create the volumes needed to create a robust reference price and make financial products attractive, while most likely enhancing liquidity from intermediaries and financial players. Another benefit of this approach where volumes are concentrated on the day ahead stage would be maximising the efficiency gains for GB consumers of the EU target model and market coupling.

In Denmark, DONG Energy is a vertically integrated company where “Chinese walls” have been established between the generation and the supply side and each side acts independently in the market. This together with a gross bidding agreement for DONG Energy is in effect a restriction on self-supply. Such a separation of generation and supply has also made it easier to live up to the REMIT regulation in taking actions against trading on insider information and creating transparency.

Meeting the design principles and objectives

We do not agree with the consultation document that a SSR does not meet the three objectives set out and that it cannot be implemented in an effective way. Separation of generation and supply has already been implemented in Nordpool and it works for DONG Energy. Also it fits the design principle that Ofgem has listed.

Aligns with what currently works well in the market

SSR aligns very well with what currently works well in the GB market. Obligated parties can decide their own route to market using existing platforms and trade channels. Gross bidding is already tested on the N2EX day ahead auction, so including this aspect would work well.

Does not impose unreasonable costs

Compared to the costs imposed by a MA and taking into account that all vertically integrated companies need to comply with REMIT the cost of implementing a SSR does not seem unreasonable. The costs might even be smaller with a SSR than the MA given the complexity of the MA design as it stands.

Allow GB to evolve towards becoming an integrated part of the European market

Having more trades in the open market on exchange platforms compared to bilateral trades does align very well with the EU target model and a SSR does not pose any conflicts with this development.

Takes account of EMR and EU legislative developments

Our ref.

When it comes to EMR and EU legislative developments as a design criteria, we do believe that a SSR accompanied with a degree of gross bidding of a minimum of 50% would create a robust day ahead price, while market makers on key financial futures products could create robust reference prices one year or more ahead.

Ofgem is raising concerns that a SSR would not necessarily create a robust reference price, but this could be obtained by ensuring either a mandatory or voluntary market maker arrangement on the financial products developed on the back of the day ahead auction. It should also be noted that a SSR will create a significant demand for the vertically integrated companies to seek hedging and trading in forward products in the market instead as now via self-supply and internal trades.

No matter what mechanism will be put forward it is important that the intervention is not stalled. The liquidity problem and inefficiencies in the GB wholesale market should be handled as soon as possible.

We would be pleased to discuss our experiences with exchange based trading, hedging in financial product, working with separation of generation and supply businesses or any other part of this response.

DONG Energy responses to the questions raised in the consultation

Our ref.

CHAPTER: One

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

We agree that the market ultimately should provide competition in generation and supply leading to cost efficient and fair prices to consumers and investment in new generation to encourage security of supply. In the present GB context a final objective would also be creation of reference prices for the EMR mechanisms suggested.

A well-functioning market arrangement should provide cost efficient allocation and drive prices down by having real competition on a continuous basis. In doing this liquidity is one of the parameters needed in order to have a transparent price formation and a competitive market where society and consumers are certain that they pay a fair and cost efficient price for electricity.

We agree that liquidity has to exist in different segments of the market, but there should be focus on getting the incentives structure right and view the wholesale electricity market holistically. To decide on the remedy to put in place it would be good to take a step backwards and analyse why the market has not delivered these overall objectives, which normal competitive markets do. One of the barriers to entry is as discussed in the consultation document lack of liquidity. The consultation document, however, stops short of addressing the key issue of why there is a lack of liquidity.

As pointed out earlier, as vertical integration has increased the underlying need for trading has fallen significantly. Transparency is crucial in order to have investments come forward and in allowing consumers to realise, trust and accept the prices they pay.

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

We find that there is very little focus on the objective of having equal and appropriate access to information. In a perfect competitive market all participants would ideally have full access to prices and qualities of the products on that market.

Having access in a transparent way to information on all trades, including those trades that take place between the generation and supply businesses of all incumbents would be key to developing robust reference prices.

For the GB wholesale electricity market consumers, suppliers and producers should have full price transparency and access to information in the market, which includes reporting requirements on internal trades. At the moment there is a clear asymmetric access to information which do not benefit independents and consumers.

Our ref.

CHAPTER: Two

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

We largely agree with the view made by Ofgem on Objective 1 and 2. When it comes to the near term markets we believe that Objective 3 is not analysed in depth.

We have welcomed the positive steps taken by certain companies on the N2EX Day Ahead auction, but it is too early days to conclude that the trend of more volumes will continue. It is not all relevant parties who have been backing the exchange based trading in the day ahead auction and the volumes are not at the moment supporting a robust reference price.

We have experienced volatility and that there is often not sufficient depth of the day ahead auction. Another indication that the day ahead market is not being effective yet is that there has been a tendency of the OTC market and the day ahead auction not being in line, which still shows uncertainty in the market. Specially for wind generation it is important to have enough depth in the market to be able to trade shaped profiles.

To improve the above mentioned problems the volumes would in our assessment need to go up significantly. If the objective of an effective day ahead auction with a robust reference price should be reached the share of physical traded volumes should at least approach the levels of a market like the German.

The lack of coordination and backing among the Big 6 of the exchange based day ahead trading have also delayed and potentially stalled the further development.

While it is recognised in the consultation document that the recent improvements in the day ahead market may disappear this uncertainty poses a large risk to new entrants and new investments to the market. It would be hard to base a business case on the observation that “the market appears to be moving” in the right direction.

It is our opinion that there needs to be much stronger backing of the day ahead market before a robust reference price develops and before financial hedging will take off. Therefore it would still be appropriate if Ofgem continue with an intervention to make sure that the day ahead market development continues until it can be said to be robust and trustworthy.

Our ref.

We would like to see a monitoring of the development in the intraday market. Having a well-functioning intraday market would be very important to the future generation mix, when a large share of intermittent generation will need to readjust positions according to changes in forecasting.

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

It would be necessary to look closely at the causes of lack of liquidity. Please refer to our analysis and suggested solution above.

Further it would be appropriate for market players to know, what are the minimum requirements that should be achieved in the market within a year for Ofgem not to carry on with further intervention.

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

We believe that all three objectives should stay in focus. As stated earlier the development in the day ahead market is very immature and it does not take a lot for the big participants to pull out or decrease their commitment before the market dries up again.

There should also be more focus on the intraday market, which is very important to wind power producers. This market would only become more important as wind integration will rapidly speed up. In other markets with higher wind penetration like the German and in the Nordpool area measures have been taken to enhance liquidity.

CHAPTER: Three

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

We think there would be better ways of making the markets work. One way is to make sure the vertically integrated companies have the incentives to trade openly. Mechanisms like SSR with gross bidding and market making would more effectively improve liquidity and still give the vertically integrated companies freedom to trade when they want.

There might be some positive impact from the MA, but we do in general not believe it is the appropriate mechanism. It is hard to know exactly how the market would develop with a MA with a range of product from front month to +3 years, because we have no experience with such a prescriptive mechanism.

Our ref.

Further, in our assessment the MA seems to be very complex and costly to operationalize, execute and monitor – a view that was shared among a number of participants in the liquidity workshops held by Ofgem 18 April and 2 May.

If the aim of the MA is to also support hedging needs of independent generators, it is not very well targeted.

Should Ofgem consider to proceed with the introduction of the MA, we will recommend that it is seen as one among other mechanisms needed to reach the outlined objectives for both supply and generation.

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

As stated earlier, we think that the appropriate solution should bring volumes to the open market with price transparency that everybody would benefit from. This could best be done with a SSR mandating generation volumes and supply volumes to be traded in the market. It should though be a SSR with “Chinese walls” between generation and supply.

A SSR does not mandate a single route to market, which does not necessarily lead to a single reference price. However when imposed on the Big 6 it will be significant volumes that would now be on the market and not in six separate market inside these companies. It is therefore very likely that a reference price would evolve. On the other hand it would make sense to kick start the exchange based trading by for a period of time to mandate the bigger incumbents to trade a large share of their generation and supply volumes on the day ahead market and to either mandatory or voluntarily to make them market make key financial futures products until the market is up and running. It could be done through gross bidding arrangements like the ones already established on the N2EX.

In this sense a self-supply restriction with some simple requirements attached to it would align with what works well in the market. As for introducing market making this is a well proven mechanism in other markets.

CHAPTER: Four

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

In general, we believe the key features as highlighted are good. It should, however, be noted that the MA mechanism as suggested is a very new thing to wholesale markets and not much experience can be drawn upon.

Participation

Our ref.

We agree with the participation and the rationale. It is appropriate that those companies with significant positions in both generation and supply markets take responsibility in making the markets work for everybody.

Products & volume

It is important to make sure that there is sufficient volume compared to the number of products, so the auction will not dry up on certain products. There might be a need for a flexible arrangement to adjust the volumes and products to account for how much and what is really needed to meet the objective that the MA is trying to solve.

Frequency

Ideally, auctions should be done more frequently than monthly. Hedging does not only take place on a monthly basis and there is a risk of having liquidity concentrated on these infrequent times.

Governance and safeguards

With such a new mechanism aiming to achieve very important objectives for the wholesale electricity market it is important that Ofgem has a key role to play in making the MA a success.

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?

Yes, we find it very appropriate to have buy-side rules as both buy and sales sides of the market need to be there in order to make sure trades are done and that the price formation is real and fair.

CHAPTER: Five

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

We think it is important to have one platform for the MA. This would be less costly, more easily accessible and would make sure liquidity is not spread around the market.

In the energy sector we do have regulated monopolies in many areas. Having one power exchange creates transparency and easy access to a very complex market.

In most other European power markets there is only one exchange and this facilitates transparency, competition, volumes, financial products and liquidity rather than the opposite.

Having competition among providers of trading services should not be an end goal in itself as long as a potential monopoly situation is regulated.

Our ref.

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

We think the Ofgem led approach (approach one) is the best one. There is a much better chance of other market participants to be engaged and Ofgem has the clear objective of making it work whereas obligated parties do have mixed interests.

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

There would be a real risk of conflicts of interest and delays in letting the parties obligated by the MA design the mechanism. It could then turn out overly complex and the time to implement it could be very long.

The experience with the industry led process of solving the liquidity issue has been that it was very long, with lack of transparency and results were very modest.