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Consultation on “Wholesale power market liquidity: consultation on a ‘Secure and Promote’ licence condition”

15 February 2013

DONG Energy is pleased to provide a response to the abovementioned consultation on an intervention to enhance liquidity in the power market.

Our ref.

In general, DONG Energy supports the case for an intervention in the wholesale market. We fully agree with the ‘Rationale for intervention’ put forward by DECC in the “Energy Bill 2012 Impact Assessment: Liquidity Measures”.

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Key Messages :

- The development of the wholesale electricity market has led to a significant vertical integration, with a large portion of self-supply and internal trades and limited incentives to trade openly. A result has been a low market liquidity, and consequently a lack of transparent price discovery to consumers, suppliers and generators.
- DONG Energy has supported the efforts of Ofgem to improve the wholesale market to become well-functioning and liquid, enabling continuous trading to support normal hedging behaviour on both the generation and supply side of the market. It is our belief that the present market situation calls for some concrete interventions and we have put forward our views on potential intervention options.
- DONG Energy thinks that a robust liquid short term market (especially the day-ahead market) is the basic platform and prerequisite for the development of a well-functioning longer term market.
- DONG Energy’s preferred intervention option is a **self-supply restriction** with a separation of the trading department of supply and generation as this would effectively relieve the fundamental market structure problem – including the lack of liquidity - by incentivising vertically integrated companies to trade on open and transparent platforms.
- DONG Energy could also support Ofgem’s proposal of ‘Secure and Promote’ license condition which could potentially create a more liquid

and well-functioning market if vertically integrated companies are mandated to make **50% gross bidding on the day ahead auction** and provide for **market making on the curve** in order to develop financial hedging products.

Our ref.

- DONG Energy does, however, find it highly uncertain if the 'obligation to trade' presented as an alternative approach will have significant impact on the market or if it will support a continuous traded market, unless the obligated volumes would be very high and thereby come closer to a real self-supply restriction.
- DONG Energy believes that barriers of entry for new players in the market would be lower if more exchange based trading with transparent price discovery and clear credit requirements would be facilitated.
- DONG Energy sees a strong need for securing liquid and robust near term markets as wind power production is volatile and requires short term optimisation. Therefore we believe that the intraday market should also be monitored closely in the on-going liquidity work by Ofgem.

Developments of the GB electricity market arrangement and structure are very important to DONG Energy both in terms of present generation capacity (offshore wind and gas), but certainly also for our significant future offshore wind 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
DONG Energy

DONG Energy responses to the questions raised in the consultation

CHAPTER: One

Question 1: Do you agree with our assessment of market developments?

Being an independent generator trading in the market with a gas fired power plant and a portfolio of wind power generation we have significant difficulties in establishing our preferred hedging profile without excessive costs attached to it. This leaves us with investments where we have more value at risk than in a well-functioning market. Hedging possibilities are still far from optimal in the GB market.

The direct impact is that the hurdle rate for doing investments in the GB market is higher than otherwise and so is the cost of new entry for generation capacity. In the end the consumers pay the costs which will most likely be visible in the prices on capacity in the anticipated capacity market.

Near-term market:

There has during 2012 been a positive development on the day-ahead auction with more volumes coming through since the introduction of gross bidding. Together with the spot and prompt market this is giving better possibilities to optimise in the near-term markets.

DONG Energy believes that a robust near term market is necessary to create a building block for continuous trading along the curve.

In order to create a long term trustworthy day ahead reference price this development should be secured via mandatory gross bidding agreements as also suggested in the 'Secure and Promote' proposal.

We would still urge Ofgem to include in their public reporting a monitoring of the intraday market to make sure all segments of the market is covered in their assessment of a well-functioning GB wholesale market.

Forward market:

We do agree with the Ofgem assessment in terms of the market not experiencing any depth in the trading along the curve.

The wide bid-offer spreads are still a significant barrier and makes hedging along the curve very risky and costly. The latest figures we have seen for spreads on Nasdaq/Nordpool forwards show that they are considerable lower than the figures shown by Ofgem for the GB market.

Financial trading along the curve has unfortunately not been taking off, which is also documented by the numbers on volume in the consultation document.

Our ref.

Question 2: Do you agree with our description of the policy and regulatory context affecting liquidity?

We do not find that the policy and regulatory context described change the fundamental market structure problem leading to low liquidity. This context does therefore not change the measures needed to create a well-functioning market. On the concrete policy issues we have the following remarks.

Electricity Market Reform

While the different parts of the Electricity Market Reform is still being designed there will continue to be a high degree of regulatory uncertainty that could dampen risk taking on the trading side.

Financial Regulation

We do not expect that REMIT would have a very large impacts on the appetite to trade. The regulation of market integrity and transparency included in REMIT has to a large extend already been working in the Nordpool area and this has not worked against a liquid wholesale power market. More transparency and certainty against insider trading will make the GB market more attractive for new comers.

Regarding the MiFID/MiFIR regulation – which is not finalized yet - this would most likely push for standardised products to be traded on energy exchanges. When this materialises there is a good opportunity for more trading and better liquidity.

On the other hand there might be some considerations on increased costs due to a heavier regulatory burden, which could decrease the appetite to trade.

European Target Model

Getting more alignment between markets and a harmonisation on cross-border trade would facilitate and sustain liquidity in the GB market. The development with the BritNed interconnector has shown that as capacities on interconnectors will be allocated to power exchanges this will strengthen trade on these open and transparent platforms.

Summing up

We do support the case for an intervention given that Ofgem has for several years documented that there is a need for a stronger support to the market to develop a more liquid wholesale market.

Question 3: Are there other factors that we have not identified that may be posing a barrier to improvements in liquidity?

Our ref.

Ofgem has little focus on how the market structure with a trend of vertical integration have impacted liquidity. The incentives and underlying requirement for trading has fallen significantly as vertical integration has increased.

Causes of an inefficient market

Compared to the Nordic and the German markets where there are many retail companies supplying consumers, the situation in the GB market is that few vertically integrated companies have significant control over the market.

The market arrangement primarily based on bilateral trading has unintentionally led to a trend of vertical integration. Few vertically integrated companies are dominating domestic supply business and have 70 % of generation.

While vertical integration might be seen as the most rational behaviour given the market arrangement, the degree of vertical integration in a market is impacting negatively the 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.

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

We believe that getting more exchange based trading is the way forward to get sufficient transparency for generators and consumers.

In our view the problem of small suppliers not having access to forward hedging could be solved if the GB market would be more transparent and with clear price discovery so aggregator, financial players and intermediaries could enter and

develop the needed products for smaller suppliers. In this development a robust near term market is important as a building block for getting more trade along the curve.

Our ref.

If credit and collateral is a key issue this emphasises the need to create an enabling environment for aggregators. In the Nordpool area small suppliers are acting on the exchange either directly or via trading companies and aggregators.

CHAPTER: Two

Question 4: Do you agree that the Secure and Promote model presented in this document could help to meet our objectives?

The Secure and Promote does have good elements in it and we support building on the industry developments in the direction of more exchange based trading.

Leaving the developing of a well-functioning market solely to industry initiatives has, however, shown not to work. The experience with the industry led process of solving the liquidity issue has been that it is very long, with lack of transparency and results are very modest. Years have gone without any significant change and it could take many years for liquidity to improve using a 'wait and see' approach. With a clear incentives not to change their trading behaviour it cannot be expected that significant improvements will come from the large vertically integrated companies.

Without looking at the root causes of lack of liquidity the 'Secure and Promote' approach run the risk of only deliver small steps forward. Please refer to our analysis and suggested solution above.

If a self-supply restriction is not considered, we strongly urge Ofgem to take Option B and introduce a market maker to meet objective 2.

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

There should also be more focus on the intraday market, which is very important to wind power producers and will become increasingly important. Transparent monitoring in the Ofgem liquidity updates and other Ofgem market monitoring reports should be a minimum.

Question 5: Does our proposed structure for Secure and Promote seem appropriate?

Our ref.

Nature of the obligation:

Looking isolated at the 'Secure and Promote' the proposed structure seem appropriate.

Obligated parties:

We do agree that the license conditions should apply to the six large vertically integrated suppliers. These parties would be able to meet the obligation more cheaply and easily than other parties.

In other markets it is in a similar way the biggest players who are expected to facilitate well-functioning markets.

Further the six large vertically integrated suppliers are enjoying a large competitive advantage in the present market structure due to their ability to self-supply and thereby not being exposed to the price risks and inability to hedge in the forward market.

Legal structure:

We find that it is important that Ofgem keep focus on enforcement. Voluntary initiatives have shown to be too weak so far.

Question 6: Do you think that the proposed Secure and Promote model would be a more effective intervention than the Mandatory Auction?

If the Secure and Promote model contains a market maker obligation, we do think that this package will be more suited to facilitate a liquid market than the Mandatory Auction.

We believe, however, that the most effective intervention is a self-supply restriction is the most effective intervention and will outline the reasons why below.

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 segments of the power markets (intraday, spot, day ahead, prompt, forward) together as they are interlinked in price formation, risk management and market expectations. Taking a holistic approach would be beneficial.

We welcome that Ofgem has now introduced a 'secure and promote' approach instead of the Mandatory Auction approach, which did not offer continuous trading.

Our ref.

We are, however, still concerned that Ofgem will not address 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.

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. We support Ofgem in their view that a requirement to trade a volume equal to a percentage (eg. 100%) of the generation on the market does not constitute a self-supply restriction and would not have material impact on the market as it is today. Such requirement does not necessarily create one reference price but can be fulfilled by more widespread trading activities.

Rather, there should be an effective separation of the trading of generation and supply, so that whenever the position of either is revised, that volumes must be traded in the open market. In practice, this could take the form of "Chinese walls" between generation and supply. Such a separation of generation and supply will also make it easier to live up to the REMIT regulation in taking actions against trading on insider information and creating transparency.

An alternative solution to incentivise open and transparent trading and mitigate the problem of a weak forward market, is to require the vertically integrated companies to do a high portion or minimum 50% gross bidding of their generation volume on the day ahead auction and combine it with a requirement to do market making on the forward curve. This will create the pooling of volumes needed to create a robust day ahead reference price and make financial forward products attractive.

Given that the large vertically integrated companies have 70% of the total generation volume a requirement to do gross bidding of 50% of this share would ensure that the day ahead market is supplied with a minimum of 35% of the total generation.

Our ref.

The experience in other markets is that a certain critical mass in the day ahead market is necessary for the financial forward market to take off. For comparison the German day ahead auction attracts 47% of total consumption and the Nordpool day ahead auction attracts 78% of total consumption.

This solution is aligned with Ofgem's 'Secure and Promote' option B, but stress the importance of promoting a strong day ahead market in order to kick-start financial trading.

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.

Meeting the design principles and objectives

Unlike Ofgem, DONG Energy finds that a SSR does meet the three objectives set out and that it can be implemented in an effective way. We do also find that SSR 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

Disproportionate costs imposed on the big VIs is often mentioned as a reason for not going down this route. However, on Nordpool the larger companies have on a voluntary basis years back made the separation of generation and supply arms.

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

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% of generation volumes 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.

Our ref.

Ofgem is raising concerns that a SSR would not necessarily create a robust reference price, but this could be obtained by ensuring a 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.

A SSR does not mandate a single route to market. In this respect Ofgem is raising concerns that a SSR would not necessarily create a robust reference price. However when imposed on the six vertically integrated companies it will be significant volumes that would now be on the market and not in six separate markets inside these companies. It is therefore inevitably 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 require them to market make key financial futures products until the market is up and running.

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.

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.

CHAPTER: Three

Question 7: Do you have any views on the requirements we have set out for trading commitments – in particular those points listed under “outstanding design challenges” on page 25?

In general the trading requirements set out in the trading commitments seem appropriate.

We do support that licensees should offer fair and reasonable terms when negotiating trading agreements. As a company we are, however, not in the same position as small suppliers that could be very dependent on these agreements.

Our ref.

On the other hand we do find that even small suppliers via aggregators more cost efficient could find a route to market if exchange based trading is given better conditions. An exchange would be able to lower their fees once it can harvest economies of scale.

The credit and collateral issue is not being debated in the Nordpool area where trading companies and aggregators pave the way for smaller suppliers to get access to hedging products on the exchange.

As stated earlier, we think that the appropriate solution to create a level playing field for independent suppliers and generators 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.

Question 8: Do you have any views on our proposed approach to securing existing developments in relation to day-ahead auctions – in particular those points listed under “outstanding design challenges” on page 28?

If the development on the day ahead market is not mandated there is a real risk 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 could grow 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.

Impact:

We do believe that the gross bidding agreements is a significant step forward in order to get a reference price at the day ahead stage. Looking only a few years back there was no robust reference price on the day ahead market.

Companies can now start using the day ahead price in the N2Ex auction as a reference price in different types of contracts and even as the basis of internal transfer prices.

It is therefore very important that the day ahead auction can remain trustworthy in the future.

Our ref.

Platforms:

We do understand Ofgem's general assessment that more platforms leading to competition among them could overall decrease the costs for market players. However, if small suppliers and generators need to access a number of bilateral contracts, a number of brokers and a number of exchange platforms the entry costs can run very high.

Limiting the number of exchanges could support economies of scale and thereby drive down costs, so the assessment is not straight forward.

Volume:

We would suggest that the gross bidding agreements should contain 50% of generation volumes of VIs or at least 30% of supply volumes of VIs.

Experiences from Nordpool suggest that the higher the percentage of trades on the day ahead auction compared to actual physical volumes the higher the traded volumes of financial forward products.

The large VIs do only have 70% share of the generation market. If the 30% gross bidding is measured against the generation volumes there is a risk that the volumes would be too low for financial trading to organically to grow from day ahead.

CHAPTER: Four

Question 9: Will trading along the curve naturally develop from the near-term market?

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.

Trading along the curve might develop naturally, but it depends on the large vertically integrated companies (VIs). If they benefit from not taking part of this development it is not likely to happen naturally.

Rational behaviour suggests that the VIs do have a competitive advantage in self-supplying and not in trading on open and transparent platforms.

The development of the Nordpool exchange was based on a change in market behaviour of the largest participants to do 100% gross bidding on the day ahead auction and combine this with hedging in financial forwards/futures. Also this was

a de facto self-supply restriction separating the generation and retail side in order to provide for price discovery.

Our ref.

So, as long as the VIs do not take significant steps to facilitate a well-functioning market it will not happen by itself. Hence the need for intervention to kick-start a positive development.

Question 10: Should Ofgem intervene to ensure that robust reference prices along the curve develop?

As mentioned earlier 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.

We agree with DECC in their assessment that there is a 'market failure' whereby the market is stuck at a low liquidity equilibrium. Therefore we strongly support an Ofgem intervention.

Question 11: Is market-making the most appropriate intervention option to promote robust reference prices along the curve? What is your view on the trading obligation option that is outlined on page 34?

We find *market-making* the most appropriate intervention to promote robust reference prices along the curve.

It is in line with the objective of a liquid and well-functioning power market enabling market participants to continuously move in and out of short and longer term positions as market and business rationale dictates

A continuously traded market would maximise competition and attract financial players and aggregators that would in turn create more liquidity and trustworthy financial hedging options. Trading companies and aggregators would then in turn be the most cost efficient way of smaller suppliers to get access to hedging products.

A *Trading Obligation* like the one outlined in the consultation documents could have merits, but only if obligated volumes were very high. If volumes are e.g. only set at 100% of the generation volumes of large vertically integrated companies this would not make any behavioural changes and leave the market in the same condition as today. Further it needs to be designed in a way that enhances to the largest extent a continuous traded market. DONG Energy does on this ground not prefer an intervention in the form of a Trading Obligation.

Question 12: Do you have any view on the design of the market making intervention outlined in this document – in particular those points listed under “outstanding design challenges” on page 33?

Our ref.

Bid-offer spreads

We find that Ofgem has taken a very sensible approach by aligning the bid-offer spreads to existing market maker arrangements and also monitoring the volumes that are traded over the course of a year. This should make sure that the spreads in the market maker agreement facilitates trading and availability of cost efficient hedging products.

Costs

We agree with the consultation document that the costs of a market maker approach is proportionate and that these would be outweighed by the large benefits to wholesale market actors and thereby also in the end to the consumers.

MiFID II

We believe that carrying out market making within the energy sector should be exempted from the MiFID II regulation and we would urge Ofgem to work towards this objective.

If market making arrangements in the energy sector are not exempted for in MiFID II, we think the market maker approach could still be explored.

CHAPTER: Five

Question 13: Do you have any views on the MA design issues discussed in this chapter? & Question 14: Do you believe that a hub approach to pool liquidity across multiple MA platforms is a viable option?

We welcome the competition among platforms which will emerge in the tender process where Ofgem can select the best and most cost efficient platforms. However, a presence on multiple platforms might increase the costs and complexity for smaller players and might as well risk spreading the market liquidity thin. In order to reduce costs and to focus the market liquidity, we would prefer a limited number of platforms and auctions.