Drax Power Limited

Drax Power Station • Selby • North Yorkshire • YO8 8PH • T. +44 (0)1757 618381 • F. +44 (0)1757 618504

FAO Phil Slarks
Wholesale Markets
Ofgem
9 Millbank
London
SW1P 3GE

15th February 2013

Dear Phil,

Wholesale power market liquidity: consultation on a "Secure and Promote" licence condition

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.

Disappointingly, there has been a lack of progress with regards to the availability of products that support hedging (Objective 1) and the promotion of robust reference prices along the forward curve (Objective 2) since the last update. However, we believe that there has been a positive shift in Ofgem's position since the summer 2012 update and we welcome the range of options that Ofgem has set out in the latest consultation.

In particular, we welcome Ofgem's proposal to introduce measures through licence conditions, rather than via less robust 'voluntary' code arrangements or other prospective trading initiatives. It is our strong view that the latter will not be effective and will lead to further delays in addressing this important issue. This will be to the detriment of independent suppliers and generators, and ultimately customers.

We support the obligation to trade licence condition (considered under Option B) and recommend that this is now urgently taken forward for further development by Ofgem and the industry. Provided it is targeted correctly, the obligation to trade has the potential to deliver significant progress against Objectives 1 and 2. We believe the following structure would appropriately target the intervention:

- The only retail sector that has significant firm, predictable (or "sticky") customer demand over a multiyear period is the residential sector. The obligation should therefore be placed in all supply licences, but only switched on in those licences that also have the residential supply conditions switched on;

- The six large suppliers in this sector are able to maintain an oligopolistic 99% market share due to the high barriers to entry they have secured; these barriers have effectively proven unassailable to new entrants;

- The obligation should, so far as possible, be structured to level the playing field, rather than create further market distortion:
    - Any supply business entering the residential sector should have the same licence condition switched on when they reach an appropriate customer threshold. To minimise the impact on new entrants to this sector, we suggest this should be a relatively high threshold of perhaps 1m customers;

    - Those businesses that reduce their volume of customers below the threshold should no longer be subject to the obligation;

    - The obligation should be kept under review and switched off completely when Ofgem's liquidity objectives have been met;

- As the volume is delivered by a retail sector with a large sticky customer base, it will be possible for obligated parties to deliver a range of products out to Season+4;

- The obligation to trade should not limit the route(s) to market that obligated parties may use.

This intervention will deliver volume to the traded market that is currently inaccessible to most market participants. It will provide a solid base on which the market can develop organic growth. The resultant market will allow participants to hedge their positions in the traded market, whilst the increased volume in transactions across the forward curve will help deliver robust reference prices.

Further thoughts on this proposal, and the alternatives set out in the consultation document, can be found in Annex 1 (our response to the specific consultation questions). 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 and Compliance Manager
Regulation and Policy

Annex 1: Response to the specific consultation questions

Chapter 1: Context and market developments

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

Yes, there has been a lack of progress with regards to the availability of products that support hedging (Objective 1) and the promotion of robust reference prices along the forward curve (Objective 2) since the last update.

The main focus of Ofgem's liquidity intervention should be measures that aim to increase trading along the forward curve and promote price discovery to aid the creation of robust reference prices.

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

Yes. In particular, we recognise concerns surrounding increased financial regulation in Europe, which has a strong focus on greater capital adequacy for market participation.

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

Yes. Commercial contracting trends in the SME and I&C sectors have moved significantly towards shorter dated contracts and there has been a strong shift towards the use of "flex" contracts. Customers that take flex contracts are able to access the wholesale power market at a time of their choosing, allowing them to "fix" the price for a particular period of their contract and subsequently "un-fix" and then "re-fix" the energy element of the price (as required). This type of contract provides customers with greater control over their costs and, to a greater extent, also determines how commercial suppliers interact with the wholesale market.

Chapter 2: The Secure and Promote Licence Condition

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

Yes, although the focus should shift towards promoting liquidity across the forward curve. The obligation to trade licence condition, which is explored as part of Option B, would deliver significant progress against Objectives 1 and 2. This option for intervention should be developed further by Ofgem and the industry.

Choosing Option A, which would mean "no specific intervention" is taken for Objective 2, would not adequately address low levels of liquidity across the forward curve. This is a key market failing that has been identified by both independent generators and independent suppliers throughout Ofgem's liquidity work-stream.

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

Yes. The legal structure appears appropriate.

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

Yes. We do not believe that the Mandatory Auction would provide an effective intervention. Whilst we have no objection to there being a role for auction platforms in the GB wholesale market, we believe that market participants should be free to choose their preferred route(s) to market.

Chapter 3: Securing existing developments

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?

Products

There are some minor changes to the current trading arrangements identified in the consultation document that should be promoted, such as increased product range (offered across the curve) and the addition of smaller clip sizes. These should be relatively simple to implement for those parties that do not currently offer them.

There are currently a number of market participants that will already price trades based upon a recognised market index. Increased confidence in the robustness of these products will only be achieved if liquidity is strengthened across the forward curve. We believe this is best addressed via an "obligation to trade intervention" under Objective 2.

For smaller volume counterparties, it is currently possible to transact with third parties based upon an index to the N2EX auction. It should be noted, however, that such trades will most likely incur an additional cost, i.e. to cover auction access and dealing costs.

Credit and collateral

It is essential that market participants continue to assess the financial robustness of potential counterparties. All parties should have the financial robustness to participate in the market in a way that does not pose unmanageable risk to others. Drax currently adopts a reasonable and prudent credit policy and is satisfied that this offers fair and reasonable terms to all counterparties, regardless of size or class.

Scope

Drax currently uses fair and reasonable trading terms. We will explore entering a trading relationship with any market participant that approaches us. The use of the standard GTMA and ISDA GTMA annex ensures a consistent approach to trading. These documents have been robustly tested over many years of service.

It is important to draw out the potential FSA and MiFID implications at this stage. Trading relationships should not be confused with acting as an agency. The proposals have the potential to create grey areas where the roles, and thereby obligations, of trading parties become unclear. In addition, it is important that intervention does not lead to the volumes of smaller market participants becoming fully absorbed in large vertically integrated positions, where the additional volume further enhances the ability of large parties to dominate auction price outturn.

Finally, responding to a trading request should not be confused with the establishment of a trading relationship. The latter requires due care and attention with extensive Know Your Customer (KYC) checks, which can take a considerable amount of time to conduct. This is a legal obligation and Ofgem should not be advocating any shortcuts. With respect to an established counterparty, all parties should be able to quote prices on the day for liquid products.

Further consideration

It is important to note that any requirement to provide fair pricing must reflect the economics of generation. Generators should not be placed in a position where they are expected to trade at prices below their Short Run Marginal Cost (SRMC).

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?

We do not believe that there has been a liquidity issue in the shorter dated market. In addition, we do not favour an auction as a "preferred" route to market. Market participants should be free to choose their route(s) to market for all of their volume, i.e. via brokers, exchanges, auctions and the continuous intraday market.

It should be noted that those parties with a significant level of vertical integration will be able to enter Gross Bidding agreements with exchanges. Gross Bidding agreements lower the cost of participation for those participants due to the volume they are able to deliver to both sides of the market. Other market participants, such as Drax, are not able to benefit from such arrangements.

Chapter 4: Promoting further developments

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

No. The GB electricity market has benefited from a strong near-term market for many years. The forward curve has not developed on the back of this market.

Trading along the forward curve will only develop if parties are incentivised to trade. Independent generators are highly incentivised to trade along the curve in order to hedge their asset(s). However, access to products along the curve has not developed due to there being little appetite for suppliers to hedge their positions via the wholesale market.

It is understandable that the appetite of certain market participants to participate in curve trading beyond twelve months is low. Commercial customers are generally well informed and have seen lower margins to the wholesale price, greater choice of products and better service as a result of competitive pressure. As such, commercial contracting trends have moved significantly towards shorter dated contracts and there has been a strong shift towards "flex" contracts.

Customers that take flex contracts are able to access the wholesale power market at a time of their choosing, allowing them to "fix" the price for a particular period of their contract and subsequently "un-fix" and then "re-fix" the energy element of the price (as required). This type of contract provides customers with greater control over their costs and, to a greater extent, also determines how the supplier interacts with the wholesale market.

This increasing trend within the commercial retail sectors will make it very difficult for commercial retailers to participate in the "secure and promote" licence condition. The commercial retail markets are innovative and highly competitive. It is crucial that any intervention does not create additional barriers to competition in the SME and I&C sectors.

The residential supply sector is the only retail market that has significant, firm (or "sticky") customer demand over a multiyear period. Whilst the six large suppliers argue that residential customers are free to move, market data gathered as part of Ofgem's Retail Market Review has evidenced low levels of customer migration in this sector. Furthermore, the residential retail sector has the highest barriers to entry and economies of scale, further protecting those companies with consolidated residential portfolios from outside competition.

As such, the residential supply sector, with its "sticky" customer base, is the only supply sector that is able to support the "secure and promote" licence condition.

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

Yes. Ofgem should intervene to ensure that the "sticky" residential customer base is brought to market. The increased volume across the forward curve will help develop price discovery, hence the ability to develop reference prices. This measure will also help to break down barriers to entry in the least competitive retail sector and, due to its targeted nature, ensure that the intervention can be monitored and enforced.

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?

Market making

Whilst we are not adverse to the use of market makers as part of an overall package of measures to improve liquidity, there are a number of design issues that must be addressed prior to pursuing this approach.

Whilst market making may create a potential new route to market, and may promote greater transparency across the forward curve, it is less clear how this approach will develop robust and enduring reference prices unless it encourages parties from *both* sides of the wholesale market to trade. A market maker effectively provides a route to market for those parties that are already incentivised to trade across the forward curve. Its role in incentivising those parties that are currently disengaged with the market to transact via the market may be less pronounced. This needs further analysis. It is important that the chosen interventions address the root cause of market illiquidity.

Obligation to trade

We believe that the "obligation to trade" has the potential to deliver significant progress against Objectives 1 and 2. Firstly, the delivery of volume across the forward curve will allow market participants to hedge their positions in the traded market. Secondly, the increased delivery of volume, which will result in participation from *both* sides of the market, will help deliver price discovery, thereby robust reference prices.

The obligation should be appropriately targeted with the aim of delivering volume that is currently inaccessible to most market participants. The obligation should therefore be placed in all supply licences, but only switched on in those licences that also have the residential supply conditions switched on.

The obligation should, so far as possible, be structured to level the playing field, rather than create further market distortion. Any supply business entering the residential sector should have the same licence condition switched on when they reach an appropriate customer threshold. To minimise the impact on new entrants to this sector, we suggest this should be a relatively high threshold of perhaps 1m customers. Those businesses that reduce their volume of customers below the threshold should no longer be subject to the obligation. In addition, the obligation should be kept under review and switched off completely when Ofgem's liquidity objectives have been met.

The residential supply sector is the only retail market that has significant firm, predictable (or "sticky") customer demand over a multiyear period is the residential sector. Whilst the six large suppliers have argued that residential customers are free to move, market data gathered as part of Ofgem's Retail Market Review has evidenced low levels of customer migration in this sector.

Furthermore, these businesses have inherited high barriers to entry in terms of the economies of scale they have secured, e.g. the systems required to run a residential retail business and the millions of customers that do not engage in switching supplier. These barriers have allowed the six large suppliers to maintain an oligopolistic 99% market share of residential supply. It is the inertia of this market that provides a huge competitive advantage over new entrants (of any size) and is effectively proving unassailable.

As mention in answer to Question 9, this is not the case in the innovative and highly competitive SME and I&C sectors. Commercial customers are generally well informed and have seen lower margins to the wholesale price, greater choice of products and better service as a result of competitive pressure. It is crucial that the intervention does not create additional barriers to competition in these sectors.

Finally, as the obligation to trade does not limit the route(s) to market or involve small trading windows, the risk of distressed buying and selling to meet compliance requirements is greatly reduced. This allows licensees the freedom to better use the most economic route(s) to market for their business, unlike under the mandatory auction proposal.

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

Whilst we are not adverse to the concept of market making as part of an overall package of measures, there are a number of design issues that must be addressed prior to pursuing this approach.

We believe further consideration is needed before proceeding with a proposal where the regulator forces market participants to market make. If this approach were adopted, market participants may be placed in a position where they have to speculate on market price. Some market participants develop a trading facility solely to hedge their exposure to the market and are not able to enter speculative trades. This approach underpins their FSA and MiFID exempted status.

The creation of multiple market makers, as set out in Ofgem's proposal, may have advantages, but could also have some further disadvantages. Whilst multiple market makers could well increase choice and develop competition, this approach may have a greater cost impact on those that wish to transact with market makers, particularly if they were required to enter trading agreements with multiple platforms. Whether this cost impact outweighs the benefits of choice and competition (which itself may drive down costs) needs further analysis.

An alternative approach could be to have a central market maker that is funded by obligated parties, but provided by a third party. This central market maker role may be more suited to a financial institution, as these entities are currently financially regulated and have sophisticated trading capabilities. The main questions surrounding this approach concern the funding of the model:

- Would the market maker be covered for taking open positions in the market, e.g. would obligated parties effectively write a blank cheque to cover the risk of losses?

- If not, and the market maker is to propose an upfront charge for providing the service, how large will the risk premium be to provide this service in an illiquid market?

- If the costs are to be built into the market makers charging model, then is it right for those that rely on the presence of a market maker (i.e. due to a lack of natural buyers) to pay the entire bill?

Further analysis is required to understand the cost implications of each market maker approach on (a) obligated parties and (b) those that are expected to use the services of market makers. In addition, a better understanding is required on the willingness of financial institutions to perform the role.

Chapter 5: Update on the Mandatory Auction

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 do not believe that the Mandatory Auction would be an effective intervention. Whilst we have no objection to there being a role for auction platforms in the GB wholesale market, we believe that market participants should be free to choose their preferred route(s) to market.

Should the MA option be progressed, we do not believe that it is appropriate to have multiple MA platforms. A single platform will centralise costs, ensure consistency of approach and negate the need for an MA hub. The use of multiple MA platforms would be an unnecessarily complex solution.