Eggborough
Power Ltd

To: gb.markets@ofgem.gov.uk

Phil Slarks
Wholesale Markets
Ofgem
9 Millbank
London
SW1P 3GE

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Dear Mr Slarks

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

Eggborough Power Limited

Eggborough Power Limited (EPL) is an independent generator which owns and operates Eggborough Power Station (EPS), a 2,000 MW coal-fired power station situated in the Aire Valley in North Yorkshire. EPS was previously owned and operated by British Energy (and latterly EDF) to provide flexible and reliable mid merit support to the "baseload" nuclear portfolio. EPL is now owned by substantial private shareholders and is operating as an essentially merchant power plant in the wholesale market. EPL provides flexible generating capacity to today's challenging electricity market.

EPL's business relies on being able to trade its output. We are therefore extremely supportive of Ofgem taking action to create a market where all parties can manage their businesses in transparent, liquid and competitive markets. EPL would therefore urge Ofgem, whichever model it chooses to adopt, to take action in a timely manner.

Introduction

Self-supply Restriction

Before responding to the questions, EPL would like to reiterate its support for a self-supply restriction (SSR) applied to the Big 6 VIUs. This would be a prohibition on the Big 6 from selling any of their metered generation output direct to their licenced supply businesses, rather than the proportions proposed by the 'secure and promote' policy option. Enforcement of either option can be audited by requiring the companies to show that 100% of their generation metered volume (as recorded in the BSC systems) has been traded (and therefore notified via energy contract notification) to third parties. Anything above their metered generation volume they can 'trade' with their own supply businesses.

A SSR has the advantage over the 'secure and promote' policy of requiring 100% of the output from the Big 6 to come into the market. However, given the delays in implementing this policy, combined with the needs of EMR, we feel it may be appropriate to mandate the trading of certain types of products at least initially, in particular peaks and extended peaks where liquidity is most weak. While EPL

Eggborough Power Ltd | Eggborough Power Station | Goole | East Yorkshire | DN14 0BS
t: +44 (0) 1977 782500 f: +44 (0) 1977 782501 w: www.eggboroughpower.co.uk
Registered Office: Eggborough Power Station | Goole | East Yorkshire | DN14 0BS | Registered in England and Wales No. 3782700

believes the products under a licence condition can be defined today, it may be more difficult to alter the products traded as the market develop and new requirements arise. We recognise that the SSR may not deliver the range of products that we all want to see develop along the curve, but we believe the obligation will prompt the Big 6 to start to sell further out in time and this will provide a spring board for market development without being overly prescriptive.

EPL recognises that the liquidity proposals all raise the issue of cross trading; where the generation business sells to the related supply business arm by simultaneously placing and accepting a trade on a platform. This will difficult to control, without micro regulation, in auctions, exchanges or other screen based systems. Looking at other forms of separation, such as Rough from British Gas, it would appear fundamental to the success of a SSR that physical separation of trading on the energy account of supply businesses and generation businesses is needed. That does not mean the parties cannot trade with each other, but where different divisions are operating in the same market they do so at arm's length. This would create some compliance costs, but EPL does not feel that these would be substantial.

Enforcing an SSR restriction in this manner would also prevent opaque transfer prices being offered between the generation and supply businesses in the VIUs. Both parts of the business can then take part in auctions, exchanges, etc. without the concerns surrounding market manipulation. Having both sides of the VIUs in the same auction will also add to liquidity, allowing third parties to enter a liquid market. This should also allow more transparent accounting of VIUs and provide a clearer line of sight between wholesale costs e.g. power, gas, coal, emissions costs and retail prices charged to end consumers.

An SSR solution could be supplemented by the development of a Market Maker (MM) in the market. The benefit of the MM over an auction is that it can make energy available 100% of the time via a transparent, screen based service. Ofgem could ask for expressions of interests from parties wishing to be the MM to test if there is an appetite for such a role in the market.

Ofgem's Questions

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

EPL agrees that the outline of the market status given by Ofgem reflects the reality of developments at the current time. However, improvements in liquidity have been focussed very much on the prompt, which we agree does not address the wider issues in the market; the ability to hedge or provision of investment signals. Without analysis of the data behind this improvement it is difficult to judge which market changes are increasing the liquidity and where the majority of the liquidity resides.

EPL believes that Ofgem needs to do further analysis to examine whether the improvements seen are really the actions of the Big 6 VIUs or simply increasing churn around the products sold by independent generators such as ourselves. The use of data provided to ACER under REMIT should give Ofgem significant detail of the trading been done to date. If they can share that with other parties - with participants names removed - it may be easier to formulate the right policy to target the problems.

Specifically, EPL would support a detailed analysis of all trade data (OTC & all exchanges) by period, instrument and product, to be reported to Ofgem quarterly. We believe Ofgem, working together with other regulators e.g. FSA could convince the London Electricity Brokers Association (LEBA) to allow the release of this data for specific use in this initiative. Thjs data would show trades as well as all posted bid & offers (which could help with monitoring a market making initiative

EPL believes that much of the improvement may have been driven by Ofgem's work to date and the risk of interventionist measures. Therefore, evidence based monitoring and oversight by Ofgem will ensure that market participants keep market liquidity as a priority We also note the arrival in the market of at least one new supplier. While the improvements are to be welcomed, EPL agree with Ofgem that they still need to take further actions if their liquidity goals are to be met.

Question 2: Do you agree with our description of the policy and regulatory context affecting liquidity?
EPL recognise that the climate for trading is undoubtedly challenging, but believe this is being used as an excuse for inaction and lack of improvement. Liquidity in other energy markets, such as NBP gas, has remained good despite the economic background. Ofgem's graph on bid-offer spreads illustrates the ongoing problems in the power market.

EPL notes that some players have argued that there has been a flight from GB power to gas, but we have seen no evidence to support that. Furthermore, it is not a solution to the lack of liquidity in the power market to go and trade gas instead. For smaller suppliers, coal fired generators, etc. the cost of taking positions in the gas market as a means to hedge power risk is not economic, nor desirable. It is a significant barrier to market entry if you want to be a power supplier and are being forced to also become a gas trader. EPL believes that if the relationship between gas and power breaks down there will be significant problems for those players using the gas market to manage their risks.

Question 3: Are there other factors that we have not identified that may be posing a barrier to improvements in liquidity?
One of the greatest issues impacting trading remains the lack of credit available to many players. This is a function of some of the factors Ofgem identifies, and not an issue that can be easily overcome. EPL believes that we could free up more credit in the power market were we to reduce the central credit requirements and socialise some of the risks associated with market participant failure. The credit lodged by energy companies with monopolies, for example to cover system charges and under the central code arrangements, is onerous. Following the demise of Enron, and Ofgem's credit review, the arrangements were adjusted to make sure that the central credit arrangements covered 100% (or more) of the credit risk. EPL believes that the time has come to review that approach.
DECC's recent work on Energy Supply Administration Cost Recovery Mechanism[1] suggested that the cost recovery associated with the 'worst case scenario' could increase household energy bills by between £7 and £32 per annum (based on 2010 prices), over a five year payback period. EPL believes that this figure is in fact far too high, as the current arrangements aim to stop the company defaulting from buying 'imbalance' energy and it is reasonable to assume the customers will still pay their bills. However, the scale of the estimate suggests that the costs of spreading some credit risk across all parties and the consumers is low when compared to the benefit they will enjoy from effective competition in the wholesale market. Freeing up some of this central credit could be achieved

[1] DECC, Consultation on Energy Supply Administration Cost Recovery Mechanism, 8 January 2013

by simply making the credit arrangements less onerous or putting in place some form of central credit insurance.

Question 4: Do you agree that the Secure and Promote model presented in this document could help to meet our objectives?
EPL believes that the proposed licence requirement could provide a reasonable balance between forcing the larger parties to bring energy to the market and giving the market the flexibility to choose which products it trades. As we noted previously, there are risks in forcing parties to trade specific products rather than allowing the market to develop around the products that best meets the industry's needs. Our main concern is that the volume of energy may not be big enough to create liquidity, hence our preference for a full SSR.

However, given the slow progress to date, EPL supports Ofgem's Option B over no change, with some specified trading required in order to ensure that a robust reference price is developed. The structure of EMR, with the need to reference CfD FITS to a reliable index makes this project time critical. EPL believes, even if Ofgem acts this year, it will take some time for an index to develop that is robust enough for developers to have confidence in. With the first capacity mechanism auctions potentially occurring in 2014 and the first CfD FITS being signed at the same time, creating a forward curve that allows parties to enter and exit positions without fear of manipulation is now extremely urgent.

In terms of the obligated parties, EPL agrees that the condition should only apply to the Big 6 VIUs. While we can see a case for application to all, the concept of regulating trading in a free market is one we should all feel less than comfortable with. This should therefore be seen as a limited measure that is being introduced only as needed. EPL feels that it would create yet another barrier to entry to place the condition in all licences, with inward investors having considerable concerns over regulatory risks that they may not always fully understand. There is already a precedent in having different clauses in different licences and we see no reason not to ring fence this obligation on to the largest, vertically integrated players.

Question 5: Does our proposed structure for Secure and Promote seem appropriate?
EPL expects that the Big 6 will not accept the proposals as they stand as there is little clarity over the regulatory framework, which will represent regulatory risk. The more detail Ofgem can put into the licence conditions the better and, while some flexibility is needed, we have sympathy with the view that the regulatory risk is lessened via a licence obligation that forms of guidance.

The proposed 'requirements document' should be limited to allowing some change in the products that are sold, but possibly with boundaries around how much the obligation can alter. The governance of the document must also specify that the market will be consulted before any changes in the obligations are made. Ofgem should also not force all trading through specific platforms, but give the obligated parties some commercial freedom. That said, the Big 6 should notify Ofgem (and the wider market) on which platforms they do intend to operate.

Question 6: Do you think the proposed Secure and Promote model would be a more effective intervention than the Mandatory Auction?
EPL has always had concerns about the MA idea. By leaving the market to develop products to meet business needs the 'secure and promote' licence condition will enhance the current liquidity and give flexibility over future developments. [For smaller suppliers and companies like EPL the ability to trade

peaks and extended peaks is vital, but these can be specified under the details of the products to be sold. What will be difficult is striking the right balance between mandated products and those the parties are free to choose to trade

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?

Generally we agree with Ofgem's definitions of 'fair and reasonable terms'. It is particularly important that the responses to trading requests are made within a reasonable timeframe, such as 20 working days. There should also be a clause about offering terms that are not unduly discriminatory between parties, i.e. they should give two parties with the same creditworthiness similar terms.

Requiring the parties to price against an index is also difficult when there is no robust index to use at the current time. After some consideration, EPL is of the view that if subject to such an obligation the Big 6 VIUs may themselves put greater volume in one part of the market to create that index, as it will give them more comfort. EPL therefore supports this proposal.

Ofgem needs to be careful about the wording of some of the requirements. For example, the Big 6 need the obligation to sell, but may also need to buy energy back. Trades on either side of the market add to liquidity and should be welcomed. The Big 6 should also not just see this obligation as relating to the way they do business with the smaller suppliers, but should be required to offer terms to all parties who approach them. To foreclose the market to other generators, who sometimes need to buy as well as sell energy, or new market traders would not be helpful. EPL therefore recommends that the scope of the obligation applies to the way the parties interact with the whole market, which should only be reinforcing a requirement to behave in the way one would expect parties in competitive markets to transact.

EPL has commented on credit issues above. While we are of the view that there is little that Ofgem can do in relation to the bilateral trading in the market, we do feel that the central credit requirements could be reviewed.

In terms of products, the clip size looks reasonable. EPL has done some work analysing the market depth of products and we think suppliers and IPPs like ourselves need to see traded. As noted above, unlike Ofgem, we cannot tell who is trading which products and think further work in this area may mean the measure could become more targeted. In general we believe that the market needs to be able to hedge at least 4 seasons out, both base load and peak products. However, we would like to see obligations related to trading at least some volume in:

- Base Load products in all periods beyond the "balance-of the-month"
- Significant Base Load volumes sold in Seasons 1 to 4
- Peak Load products in all periods beyond the "balance-of the-month"
- Extended Peak products in all periods beyond "balance of the month"
- Peaks and Extended Peaks from the front month, covering the first 2 seasons

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?

EPL does not believe it is necessary to specify how the parties sell the volumes suggested, what is more important is the actual products themselves. While selling via and auction would create a transparent reference price, the idea of creating trading hubs, etc. will be costly and take time. EPL believes that once greater volumes or energy are coming to the market, liquidity is likely to focus on certain platforms for certain products. Parties will naturally want to trade where the market is most robust, so there should be no specific need to dictate where sales occur. Were Ofgem to find in say 1 year that trading was still occurring over a whole raft of platforms it could consider creating some hub, but we do not believe that waiting now to build such a regime would be helpful.

EPL does agree that, if liquidity starts to reduce in the day ahead market, Ofgem should mandate a certain volume be released into that market. It is important to secure the improvements made to liquidity to date while simultaneously improving the liquidity further along the curve.

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

EPL recognises that there are some barriers to trading too far out, such as the carbon floor tax, credit and EU ETS, but generally we believe liquidity should develop. Ofgem may want to help prompt the market by requiring a certain volume of the energy to be sold, is placed into the market in say front month, seasons+2 to season+4, base load and peaks. EPL would prefer it if initially the products released to the market are specified, at least to a degree, but if not a requirement on the Big 6 to report how they sold and to whom may allow Ofgem to monitor if its intervention is working.

As well as products, EPL believes it may be beneficial to obligate that at least some volume is traded at specific times; in trading windows. This would require, for example, that the 6 VIUS have to offer say month ahead volumes at 3pm each day. This concentration of liquidity does help suppliers and other generators wanting to trade a specific product know when it will be most actively traded, and thus taking or getting out of a position should be easier at that time. Such windows, while not mandated, are common in other markets.

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

As noted above, EPL would support an obligation on the Big 6 VIUs to sell a range of forward market products (for example, front month to season+4, peak and extended peak). The figure of 5% of the annual volume to be sold in each month may spread the liquidity too thinly. However, were the sales to be coordinated (say in the first week of each month), given the current state of the market, it would be likely to represent an improvement on where we are.

As well as Ofgem monitoring the volumes sold, it may be helpful to monitor who the counter parties are to see if there is any market entry as a result of the measures. Ofgem will want to ensure that the independent suppliers are seeing better market access, but this will probably be facilitated by third parties (such as banks) entering the market and selling better 'shaped' products to suppliers. As the licensee would have to report to Ofgem on the volumes traded at the end of each month it would not be onerous to add counterparty names[2]. Ofgem should find a way to publish reports on the way parties are trading to add transparency to the market and help shape future policy developments, for example altering trading requirements to specific products being demanded by smaller players, but with little liquidity.

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[2] EPL believes that Ofgem should either use the data collected by ACER or ask parties providing data to ACER to also provide copies to Ofgem for the purpose of fulfilling their regulatory duties.

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?
Offering the position of Market Maker (MM) to a third party could enhance liquidity, though we are unclear why Ofgem would necessarily have to procure the service. There are risks that no party will want to market make in the absence of a liquid market in which to manage their own risks; so a MM may have to follow the implementation of the 'secure and promote' condition. EPL believes that Ofgem should ask for expressions of interest (based on the description outline on page 32) and, if a party is willing to undertake the role, work with them to create a MM agreement that will help smaller players take advantage of such a service.

EPL believes it may be helpful to mandate all of the Big 6 VIUs to undertake this role to support or attract a professional market maker. VIUs have sophisticated trading and risk management functions and market making may be an advantage to some of them for price discovery and the valuation of their own businesses. A larger number of market makers will add volume that may also be helpful to one of the big 6 VIUs at any point in time to hedge their own risk as well as other market players.

Ofgem's document appears to imply that it considers the 'secure and promote' condition, requiring forward energy sales, similar to market making. EPL does not believe it is similar as the Big 6 may choose to make all of their volume available over a few days in a month or year. The MM would have to have bids and offers available all of the time. We feel that the two measures are complementary and would urge Ofgem to further examine the MM in light of any willing parties coming forward to offer to be a MM.

Back at NETA go-live both Enron and Dynegy offered MM platforms[3] where counterparties could go. These were set up freely by the companies concerned and did seem to add to liquidity. EPL believes with a liquid market (and the knowledge that the big VIUs are supporting the market), other players e.g. financial players, would again be willing to offer this service. There is no reason that such MMs would need specific regulation, but if "approved" by Ofgem may need to comply with a set of contract terms, etc. following consultation with the market players.

To limit the obligation, the 6 VIUs could be mandated to make a market every day in a window of 15 minutes in certain products and in a set volume. This would allow other participants to enter the market in that window and trade. The timing of the windows would need consideration, but while power tends to trade in the morning, given the products it trades, with longer dated products, such as month ahead, trading could be later in the day. It would be possible to link times between markets, such as month ahead gas and power.

An obligation to trade will create more trades and more liquidity but, without formal business separation, would need strict monitoring to ensure that dominant participants did not use the obligation to distort forward prices following any major position taking and/or ahead of any announcement or asset transaction.

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?

[3] Enron On Line and Dynegy Direct

Bid-Offer Spreads – In the gas market the spread is in the region of 0.2-0.6%, whereas in power spreads in excess of 1% are more common. It would appear to be unreasonable to ask a MM to offer spreads significantly lower than they may face in the rest of the market, but it may be possible to reduce the 'target spread' over a number of years. EPL would propose that Ofgem asks for a spread of between 0.5-1.25% as a starting point.

Costs – in looking for an MM Ofgem can ask them what reasonable costs they would offer the service for.

MIFID II – It would appear that MMs may be excluded from the MIFID requirements, but until the regulations are all finalised this does create regulatory uncertainty. EPL would suggest that Ofgem moves forward more quickly with its 'secure and promote' conditions, while working on the MM so that the design of an MM role can be finalised once the EU regulations are in some final form. Ofgem should not see the Directive as an insurmountable hurdle as there may be parties, even with more rigorous financial obligations, still willing to undertake the role of MM. EPL believes it would therefore be prudent for Ofgem to pursue an invitation for expressions of interests, which may or may not be subject to wider regulatory conditions.

As noted above, it may be helpful to introduce a daily window where trades of a specific product(s) executed, thus concentrating liquidity into this period, making them more likely to facilitate setting reference prices which are useful hedging tools.. This proposal can be used in any of the models Ofgem has suggested, such as auctions and SSR. For the market makers, they would operate in this window as well and attract other market participants as they will know that volume will be available to trade. While mandating when people trade may seem excessive, such trading windows are common in other markets such as the GB's gas market.

Question 13: Do you have any views on the MA design issues discussed in this chapter?
The lack of the detail on what would be auctioned, in what time frame and which platform make it difficult to provide detailed comments on this MA arrangements at this stage. Generally we have not been supportive of the MA proposal as we are not in favour of mandating the way people trade, but a voluntary MM entering the market would want to design products for which they believe there is demand. As noted above, there seems to be no harm in looking to see if any parties are interested in undertaking the role.

Question 14: Do you believe that a hub approach to pool liquidity across multiple MA platforms is a viable option?
EPL does not believe this is a viable option due to the time and cost involved in creating such a hub. What the market needs is timely action to improve liquidity not further delays while significant IT projects are undertaken.

Summary
In summary EPL would like to see a full SSR on the Big 6 VIUs to bring far greater volumes of energy to the market. A second best solution for us would be the "secure and promote" condition implemented, but with some specification of the products to be sold. Whichever route Ofgem goes down, it is vital that the Big 6 VIUs are forced to trade more "shape" so that suppliers and IPPs can more easily access market prices for peak and extended peak power. In parallel, Ofgem should look for expressions of interest to become the MM in the market.

If you or your colleagues would like to discuss any of these issues further please do not hesitate to contact me.

Yours sincerely

Michelle Dixon
Commercial Director