International
ESBI Energy Innovation

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Dear Phil,

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

ESBI welcomes the opportunity to provide views on Ofgem's proposed 'Secure and Promote' (S&P) licence condition to address some of the underlying issues affecting wholesale market liquidity. As an independent owner and operator of generation assets, we are only too aware of the lack of meaningful liquidity in the market and the problems this brings to independent market participants. Whilst liquidity in the prompt and day-ahead markets is satisfactory, there remains a fundamental lack of liquidity further along the delivery curve and we would urge Ofgem to concentrate its efforts on delivering improvements in this area. Of the proposals within the consultation, we believe the 'obligation to trade' has the scope to deliver most improvements and should therefore be developed further by Ofgem.

This response provides a brief introduction to ESBI, followed by a summary of our views on the issues raised in the consultation. We then provide responses to the specific questions raised by Ofgem in its consultation.

**ESB International**

ESB International (ESBI) brings together our worldwide generation, engineering and related services businesses.

ESBI has been a developer and operator of independent Combined Cycle Gas Turbine (CCGT) generation projects in the GB market for almost 20 years. We own, operate and trade Corby power station and developed the 850MW plant at Marchwood, which was commissioned late in 2009. We are also constructing our latest 860MW development at Carrington which is intended to become operational in 2015. Additionally, we own and operate the 406MW Coolkeeragh plant in Northern Ireland. We are also developing further large-scale CCGT projects at other locations across GB, in particular our 1500MW project at Knottingley, West Yorkshire.

In addition to increasing our conventional generation fleet, we continue to grow our position in the UK wind market. Our operational and development portfolio will be around 165MW, comprising of: the 24MW West Durham Wind Farm in Northern England; the 20MW Hunters Hill; the 23 MW Carrickatane: and 15MW Crockagarron projects in Northern Ireland. Additionally, we recently completed commissioning of England's largest onshore wind farm, at 66MW, at Fullabrook in Devon and are constructing our 38MW Mynydd y Betws Wind Farm in South Wales. We are also active in the ocean energy sector.

With increases in physical interconnection, in particular the commissioning of the East-West interconnector later this year, coupled with the further development of the regional market, our operations in Ireland will become increasingly linked with the GB market.

**Summary of views**

As we have stated in previous responses to Ofgem, ESBI continues to believe that an open and competitive retail market must be underpinned by a competitive, liquid wholesale market that supports the participation of both independent generation and supply and the diversity it provides. We remain concerned that Ofgem's focus is on providing regulatory intervention to primarily encourage and support new entrant supply companies to the retail market. We strongly believe that a more competitive generation market, with improved and robust price discovery, can deliver significant benefits for consumers and should therefore be treated as an equal priority to stimulating greater retail competition.

There continues to be progress on supplementing liquidity in the day-ahead and prompt markets. Whilst this is welcome, we would argue that this is providing additional liquidity in markets that already have reasonable levels of liquidity. We note, and support, Ofgem's analysis of liquidity further along the curve which shows liquidity and churn reducing over recent periods. As such, we strongly support Ofgem's continued view that mandated intervention is required. We are concerned that whilst Ofgem has identified wholesale market liquidity as a fundamental issue for a number of years, there has been no action to date. We would therefore urge that interventions be made at the earliest opportunity to support independent generation and supply participation and the development of robust reference prices.

The GB energy markets face a period of significant challenges over the coming years. Government, through its Electricity Market Reform (EMR), has proposed a suite of measures to address the challenges of decarbonisation whilst ensuring security of supply, all at a cost that consumers can afford. These measures may help achieve those policy goals but they are predicated on a competitive, liquid wholesale market. The policy measures being introduced through EMR will require robust market-based reference prices. The contracts for difference (CfD) to support low carbon generation and capacity payments to provide security of supply will each require reference prices at different points along the curve, from day-ahead through to (possibly) several seasons in the future. We urge Ofgem to ensure that any market intervention will deliver the liquidity required to provide robust reference prices that are able to be derived within the challenging timescales required from the EMR process. Uncertainty and a lack of robust reference prices is creating an investment hiatus at a time when investment should be accelerating and we would seek that Ofgem does not exacerbate this hiatus in delivering its proposals.

The S&P model proposed in Ofgem's consultation could consolidate the progress made to date in the day-ahead and prompt markets and stimulate the much needed liquidity further along the curve. In order to achieve this we believe option B of the S&P model should be adopted and that the most effective and efficient route to achieving Ofgem's objective 2 would be through a trading obligation along the lines of that discussed in the consultation.

**Responses to specific questions**

Below are ESBI's responses to the questions raised in Ofgem's consultation.

*Q1. Do you agree with our assessment of market developments?*

Yes, the assessment provided by Ofgem reflects our view of the levels of liquidity and churn currently in the market. We strongly agree that liquidity further along the curve (in those areas most valued by independent generators) is particularly thin and should be addressed as a priority.

*Q2. Do you agree with our description of the policy and regulatory context affecting liquidity?*

We broadly agree with the regulatory issues that may be influencing current levels of liquidity.

*Q.3. Are there factors that we have not identified that may be posing a barrier to improvements in liquidity?*

We would also add uncertainty around the introduction and level of the forthcoming carbon price support mechanism (CPS) to the list. Unfortunately, the CPS is likely to create a natural barrier to liquidity beyond two years as the inherent uncertainty around the level of the tax will make hedging and subsequent churn difficult.

*Q.4. Do you agree that the Secure and Promote model presented in this document could help meet our objectives?*

We agree that licence conditions enshrining the principles proposed under the S&P are the most appropriate route to meeting Ofgem's objectives. In order for independent players to take comfort that the changes will lead to the intended improvements, any obligations must be enshrined in licences with associated penalties for non-compliance, as opposed to (for example) voluntary codes.

*Q.5. Does our proposed structure for Secure and Promote seem appropriate?*

As discussed in response to later questions, we do not believe that liquidity will develop along the curve without specific intervention to promote objective 2. As such, option B for the structure of the S&P, would be best placed to develop robust reference process along the curve and presents the best balance between intervention, and the likely creation of unintended distortions to participants' behaviour and the market.

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

Option B of the S&P proposal would provide a more effective intervention than the Mandatory Auction (MA).

Specifically, we believe the S&P model would be more effective at creating robust liquidity without the likely distortions that would be seen under the MA. We think that the MA, as proposed, would likely drive liquidity to the specific periods that the MA platform(s) would open, further reducing any liquidity that may exist outside of those windows. In addition, it may also hinder any appetite to develop new products further down the line. We consider that the S&P with a trading obligation has better scope to develop enduring liquidity and robust market reference prices without these distortions than previous proposals.

*Q.7. Do you have any views on the requirements we have set out for trading commitments – in particular those listed under "outstanding design challenges" on page 25?*

As stated previously, we strongly believe that a competitive, liquid wholesale market that supports independent generation would bring significant benefits to consumers. We are therefore concerned that Ofgem remains focused on improving liquidity for the benefit of independent supply companies. We would argue that the barriers to market entry and participation experienced by independent generation are as great as those experienced by smaller suppliers (if not greater as independent generators bring significant step changes to volume - often 800MW and more - whereas suppliers build volume over time). As such, we strongly believe that the scope described in figure 10 is too narrow in its focus and should be extended to include all trading agreements, irrespective of counterparty. This would not only encourage independent generation and supply companies but also financial players which will bring yet further liquidity.

We welcome Ofgem's recognition of the issues that independent players experience with regards the provision of credit and collateral. Any intervention to encourage liquidity will have to consider the credit implications for those wishing to avail of the benefits that Ofgem seeks to promote through its interventions. We accept that credit and collateral are required to ensure appropriate allocations of risk within the market and welcome Ofgem's consideration of the issue in the trading commitment proposal. In advance of players that could provide more innovative credit solutions to smaller participants, such as financial institutions, we would welcome more transparent calculations of counterparty risk and associated credit requirements. However, we do not think the model suggested by Ofgem (using independent assessment agencies and bespoke calculations) is appropriate. We would rather see obligations placed on the large VIs to make credit calculations more transparent and consistent between counterparties. In addition, robust reference prices should allow licensees to more efficiently price this risk/collateral, giving increased benefits to independent suppliers and generators alike

*Q.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 welcome Ofgem's intentions in relation to this aspect of the S&P proposals. The licence condition would provide a useful regulatory backstop against losing the improvements that have been seen in the day-ahead auctions. That said, we would be concerned if such a condition led, in some way, to additional cost that may otherwise not have been created. We therefore seek for Ofgem to ensure appropriate cost benefit is undertaken on this element of the proposals in particular.

*Q.9. Will trading along the curve naturally develop from the near-term market?*

Whilst there have been further positive developments in the prompt markets since Ofgem's last consultation, these have unfortunately not developed in to improvements in liquidity further along the curve. Indeed, Ofgem has identified that liquidity has reduced in some parts of the curve. Whilst there are external factors (such as the current uncertainty around legislative changes to the market under EMR) that may have impacted liquidity, we would have hoped to have seen at least some organic development on the back of improvements in the prompt markets. This, however, has not been the case and supports our conclusion that trading will not develop along the curve from the liquid near-term market without targeted intervention.

*Q.10. Should Ofgem intervene to ensure that robust reference prices along the curve develop?*

ESBI is strongly of the view that Ofgem must intervene to ensure the development of robust reference prices along the curve. As stated above, developments in liquidity in the near-term markets cannot be relied upon to develop liquidity and, subsequently, robust prices along the curve.

*Q.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?*

Mandated market-making may some merits but we are of the view that there are a number of drawbacks that mean it is not the most appropriate intervention to stimulate effective liquidity along the curve. These are discussed in further detail in response to the following question.

We believe the trading obligation described in the consultation provides a much more effective intervention option and has the scope to drive robust improvements in liquidity in areas of the curve that are currently illiquid and most needed by independent generators.

The obligated volume should be sufficient that Ofgem is satisfied that it would deliver tangible improvements to the levels of liquidity seen today and could be similar volumes to that specified in Ofgem's previous proposals for the MA, if those are the volumes that Ofgem's analysis shows to be required to deliver discernibly better liquidity. We believe the products specified within the market-making proposals provide a useful starting point and could be built on to deliver an effective basis for the trading obligation.

We do not believe the trading obligation would result in distressed behaviour in the market. The mandated volumes are unlikely to be sufficiently large to materially change the hedging behaviour that the large VI companies undertake (albeit in a more transparent, accessible manner). Notwithstanding, the likelihood of distressed behaviour could be reduced to some extent by adjusting the period over which the obligation must be satisfied (eg a longer period may provide more opportunity to spread out the obligation or conversely smaller volumes obligated within short periods may provide similar results). In addition, we strongly believe that the additional liquidity that such an obligation would bring, would also encourage new market participants, in particular financial players. As a result, the natural competitive behaviour described in the consultation, whereby market participants arbitrage away inefficient outcomes, would invariably occur, further mitigating the risk of distressed behaviour from mandated companies.

*Q.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?*

We are of the view that the market-making proposals are an improvement on the previous MA design. However, we believe market-making should be a natural evolution of the market, whereby players (in particular financial players) start to provide market-making services as a result of the improved levels of liquidity in the market. These types of services could be more flexible and innovative than a regulated set of arrangements (for example around credit) with possible benefits for independent players.

We have a number of concerns and areas around which we would welcome additional information on the proposals in Ofgem's consultation.

The range of products that are specified appears reasonable and represents those most required by market participants for hedging purposes. We agree that it is impractical to mandate liquidity beyond season+4 in baseload products given the natural barrier created by the forthcoming carbon price support tax. Further, the limited market requirement for peak products beyond season+3 also makes it inefficient to mandate trade in these beyond this point. We note and agree that products could be financial or physical.

Ofgem should give additional thought to whether there is value in requiring obligated parties to have to post smaller volumes but across 100% of market opening times. We believe this would remove distortions and ensure liquidity is allowed to occur when it is required, as opposed to being driven to particular periods, as would happen under the proposed model. We would expect little activity outside the mandated trading window in the proposal outlined in figure 12.

Our key concern centres on the role that Ofgem will have to take in regulating bid-offer spreads for the market-making proposal. We note Ofgem has endeavoured to limit the influence it would have but we feel the requirements specified in figure 12 remain insufficiently defined and therefore does not provide a sound basis for an enduring solution. We believe that this lack of definition could result in Ofgem having to step-in at a future date and begin specifically regulating the bid-offer spread. We believe this is an outcome that neither industry nor Ofgem seeks. We strongly believe that the trading obligation discussed above removes much of this risk and is a much more efficient model.

*Q.13. Do you have any views on the MA design issues discussed in this chapter?*

We do not have any additional comments to those we have previously submitted to Ofgem in this and previous responses.

*Q.14. Do you believe that a hub approach to pool liquidity across multiple MA platforms is a viable option?*

We are concerned about Ofgem's references to a hub such as GB hub being used to improve liquidity. The GB hub concept will bring together trading and price data from the two current day-ahead trading platforms, as well as system flow and constraint data, to use in the market coupling algorithm. The GB hub is therefore a theoretical price, rather than being a traded platform. As such, we are somewhat confused as to how a hub could be developed to consolidate market-making platforms and act as a single point of trade for market participants. We would welcome Ofgem's further thinking on this point.

I hope you find these comments of value. Should you wish to discuss any of the points we raise further, please do not hesitate to contact me.

Yours sincerely,

Michael Dodd
GB Regulation Manager

By e-mail