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Dear Phil,

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Wholesale power market liquidity: final proposal for a 'Secure and Promote' licence condition

DONG Energy welcomes the opportunity to respond to the above consultation and would like to present the following key messages.

Key Messages :

- DONG Energy supports the 'Secure and Promote' licence condition as a necessary intervention to enhance liquidity and a more well-functioning wholesale market. Further, we agree to the approach and evaluation made in the Draft Impact Assessment that better liquidity, transparency and competition will lead to significant benefits to consumers.

- Monitoring of the market by Ofgem has for several years documented the liquidity problem and the lack of progress calls for implementation of the licence condition as soon as possible.

- The proposed market making obligation strikes a good balance between costs and benefits given that market making is a well-known and cost-efficient tool to facilitate liquidity.

- In designing the market making obligation it is essential that it makes a real impact by having tight bid offer spreads so all market participants can enter and exit the market without excessive price risks.

- The biggest companies enjoying a privileged position with the present market structure should face the obligation and costs of facilitating a liquid market for the benefit of competition and consumers.

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- DONG Energy finds that Ofgem should lead the work on improving liquidity as voluntary industry initiatives have shown too inefficient and time-consuming to address the liquidity problem.

Below are our response to the specific questions raised in the consultation together with our response to the Draft Impact Assessment.

DONG Energy would be happy to meet to discuss any points raised in our response. In case of concrete questions please contact Jakob Forman on +45 99 55 91 66.

Yours sincerely,

Danielle Lane
Head of Regulatory Affairs UK
DONG Energy

DONG Energy responses to the questions raised in the consultation

Chapter one

Question 1: Do you agree with our updated assessment of the wholesale market?

We agree to the fact that the updated assessment along with several years of market monitoring by Ofgem has shown that liquidity has not developed by itself. The case for an intervention has now been documented for several years.

The wide bid-offer spreads in the forward market are still a significant barrier to efficient competition and makes hedging along the curve both risky and costly. The bid offer spreads shown for the GB market by Ofgem are considerable higher than what we experience in e.g. the Nasdaq/Nordpool financial forwards market.

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 supply companies and generation capacity. In the end the consumers pay this extra cost which will most likely be visible in the prices on capacity in the forthcoming capacity market.

Question 2: Do you agree with our conclusion that we should intervene in the market in the form of the 'Secure and Promote' licence condition set out in this document?

Yes, we do agree that the 'Secure and Promote' licence condition should be implemented as soon as possible to address the inefficient market conditions.

Chapter two

Question 3: Do you agree with our proposed legal approach to S&P?

Yes, we find it very appropriate and a well-balanced approach.

Question 4: Do you agree with our proposals for who should face the obligations under S&P?

Yes, we do believe that the biggest companies enjoying a privileged position with the present market structure should face the obligation and the costs of facilitating a liquid market for the benefit of competition and consumers.

While Ofgem has chosen not to opt for a self-supply restriction with 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, it is reasonable that the big vertically integrated companies with their minimal incentive to trade on open and transparent platforms should contribute to a more efficient market. These parties would be able to meet the obligation more cheaply and easily than other parties.
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 in the same way to the price risks and inability to hedge in the forward market.
In other markets it is in a similar way the biggest players who are expected to facilitate well-functioning markets.

Chapter three

Question 5: Do you have any views on our final proposals for the Supplier Market Access rules, particularly those aspects listed under 'key outstanding design questions'?

No specific comments.

Question 6: Are there any further areas that these rules should cover?

No specific comments.

Chapter four

Question 7: Do you have any comments on our proposed detailed design for the market making obligation, particularly those listed under 'key outstanding design questions'?

In general, we believe that the market maker mechanism would benefit from having six market makers. This would force the market makers to be sharp on providing correct price levels and spreads. Further it would ease the cost of

each market maker as they could share and minimise the risks of being hit when third parties are buying or selling a given product.
If there is only one market maker this might lead to a situation of controlling price movements and the market.

Platform:
While we do agree on the need for a criteria on accessibility for a significant number of market participants, we find that this could initially be a barrier to relatively new trading platforms like exchange based platforms. These platforms hold many of the merits needed to create a vibrant and liquid market in terms of transparency, full price discovery, clear use of urgent market messages, limiting the need for multiple trading agreements and efficient use of collateral.

In a number of cases other market players than those holding a supply or generation licence form the basis for a well-functioning market. Aggregators without a generation or supply licence could act as energy traders offering to handle trading and hedging needs of smaller generators or suppliers. Banks and financial players could offer similar services to the market.

There could be a phase in approach of the criteria that 10 generation or supply licensees must be set up to trade through an eligible platform. One way could be for the first year to set the level to ten trading members of the platform, while specifying that at least seven of these should hold either a generation or supply license. The other three could be aggregators, banks or financial players helping to spur liquidity. Then after one year of being a host platform for a market maker at least 10 generation or supply licensees must be set up to trade through that particular platform.

This approach would allow for some evolution of new trading platforms and not fix the present market structure of primarily bilateral trading which benefits incumbents the most.

Bid offer spreads:
Having a tight bid offer spread is the most important feature of the market making obligation.

Setting the bid offer spreads too wide do not pose a real opportunity to trade as a high risk environment would limit the trading activity along the curve. A market making obligation with wide spreads would simply frustrate the aim of the market making and create no changes to the market today.

In order to attract financial players, aggregators and new comers to the market narrow spreads would be necessary in order for new market traders to be able to unwind positions and face manageable risks.

The proposed minimum spreads strike a good balance between the need for a real trading option, what we see in other markets and the cost of carrying out the market making.

Products:
We do recognise that the announcement of the carbon price floor only two years in advance causes a risk on the market makers. This does, however, not prevent the market makers from offering the peak season +4 product, which should be included in the market maker obligation.

Question 8: Do the detailed elements of the proposed market making obligation appropriately balance costs and risk for the licensees?

Yes, we find that there is a good balance in the proposal.

As the Draft Impact Assessment (DIA) clearly shows a relatively small competitive pressure could create large benefits in terms of better deals for consumers.

There will be a risk in being a market maker taking a view on the market at any time, however, there is normally also a remuneration of market makers through reduction of trading fees. The base case of the DIA does not take this remuneration to market makers into account, which seems rather conservative.

There is significant evidence that market makers operating on the basis of getting trading fee reductions work in other markets, so it would most likely also work in the GB market.

Furthermore, some of the proposed obligated parties are already acting as market makers on the Nasdaq power exchange for GB Power Futures. It is therefore difficult to argue that something that can happen voluntarily in the GB and in other markets would be prohibitively costly to the obligated parties.

Question 9: Do you believe that an industry-run tender process could more successfully deliver our proposals for a market maker? If so, do you have views on how we can solve the practical challenges we have identified?

No, we believe that Ofgem needs to take the lead on improving liquidity as experience has shown that voluntary industry initiatives are not effective and very slow in progressing.

The practical challenges and the risks in an industry-run tender process seem to be very big.

The risk of getting a half way solution with significant time delay seems relatively high. Further such solution would be very resource intensive in terms of involvement from smaller players. There is therefore a significant risk that the biggest companies with most resources can provide a biased solution in what could be called a result of an industry process.

Chapter five

Question 10: Do you agree with our analysis of the costs, risks and benefits of intervening in the near-term market?

No, we continue to believe that there would be a significant benefit in creating long term trust in a market that has not been transparent and without the necessary price discovery. The cost of having a licence obligation that is already in effect via gross bidding agreements would be minimal.

Question 11: Do you agree that we should not intervene in near-term markets at this stage?

No, we do believe that the risk surrounding the voluntary initiatives have shown to be high and unpredictable. This layer of risks for new and smaller players should be removed by making a license obligation for the biggest vertically integrated players to trade at least 30% of their supply business volumes in the day ahead market.

DONG Energy response to the 'Draft Impact Assessment' – Questions 1-5

In general, DONG Energy agrees to the approach and evaluation presented in the Draft Impact Assessment (DIA).

We agree that one of the key impacts is on competition and having a level playing field for all generators and suppliers in the market. This will in the end give a much better deal for consumers.

The lack of liquidity and 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.

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.

The approach taken on evaluating the costs of the intervention seems sensible and with the different scenarios (low case, best case and high case) it is shown that even with uncertainties there is a large gain to be achieved from increased competition. This is fully in line with the assessment done by DONG Energy.