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FAO Phil Slarks
Wholesale Markets
Ofgem
9 Millbank
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14th August 2013

Dear Phil,

Wholesale power market liquidity: final proposals for 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.

We welcome this opportunity to respond to the latest consultation on proposals to address wholesale power market liquidity concerns. Our response to the questions raised in the consultation can be found in Annex 1 to this letter.

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 consultation questions

Chapter 1: The rationale for our intervention

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

Yes.

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?

We agree intervention is required, although we do not entirely agree with the proposed approach.

Supplier Market Access rules (Schedule A)

Whilst we welcome aspects of the Supplier Market Access rules, we also have a number of concerns.

We agree that Schedule A should seek to secure fair trading terms for small market participants, such as timely engagement and increased transparency of the contracting process. The proposed approach to these matters appears sensible, as the suggested framework aims to ensure (a) larger market participants understand what is considered acceptable behaviour and (b) smaller participants understand when they are being treated unfairly and how they can ensure their complaints are dealt with appropriately. We support this element of the proposal.

An area of concern is where Schedule A is used to create (in effect) a mini market making obligation. Discussion with Ofgem has confirmed that obligated parties would be mandated to offer and trade volume under the licence condition, regardless of product availability. For example, in a situation where the obligated party has no volume to sell and cannot access the required volume via the wholesale market, the licence condition still requires the obligated party to trade, thereby forcing them to enter into an open position that cannot be hedged. We consider this element of the proposal to be unreasonable.

Drax's business has been structured to reduce risk. The business seeks to progressively hedge a generation asset, Drax Power Station, by selling its output via the traded electricity market. Drax only trades volume that it has available to sell within its prevailing hedging envelope. As it stands, the Supplier Market Access schedule would force obligated parties to enter into open positions, which would increase their exposure to market risk.

The objective of the licence condition should be to level the playing field, rather than provide "special treatment" for a particular class of participant. This should have the effect of ensuring trading requests from all market participants are treated in the same way as those from our own supply business, Haven Power Limited. Ensuring equivalent access is more likely to encourage effective competition. As such, Schedule A should focus on access to trading partners, timeliness of engagement and ensuring equal access to available volume, rather than the creation of a further market making arrangement.

Market Making obligation (Schedule B)

With regards to the introduction of a market making obligation, we agree that the proposal has the potential to increase accessibility to Baseload and Peak products along the forward curve. This is due to the proposal mandating the posting of bid/offer prices on a number of products that do not regularly trade in today's market. The aim of the market making obligation should be to promote a continuous forward market; this is a key function of a market maker.

The success of the market making approach will depend upon the routes to market utilised, e.g. OTC vs. exchange, physical vs. financial, etc. We encourage Ofgem to avoid picking a preferred platform for market making, i.e. keep all routes to market open. The use of multiple routes to market will deliver maximum accessibility to products across the forward curve and encourage the market to utilise the most efficient approach.

We continue to contend, however, that a market making obligation will not directly increase market liquidity as it does not mandate the delivery of *additional* volume. The opposite is true for the Obligation to Trade approach (outlined in the previous consultation). If appropriately constructed and applied to the large domestic supply businesses, the Obligation to Trade would deliver volume above that currently traded, i.e. volume that is currently inaccessible to independent market participants. This approach would better meet Ofgem's liquidity objectives.

Reporting requirements (Schedule C) and the near-term market

We generally support the approach outlined by Ofgem. We agree that no intervention is required in the near-term market. The near-term market does not present a liquidity risk to market participants and is strong enough to support reference pricing.

Whilst the obligation in Schedule C places an additional reporting burden on those market participants captured by the licence condition, we believe that continued monitoring of near-term liquidity is sensible. Ofgem should ensure that the adopted reporting processes are efficient, utilising existing reporting routes (e.g. REMIT transaction reporting data) where possible.

Chapter 2: The legal structure of S&P

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

Codifying the obligation

We agree that individual businesses should be able to decide which part of their group structure is best able to fulfil the obligations. This ensures that implementation can take place in a timely manner and make use of existing business structures, which will ultimately reduce the cost of implementation.

We also agree that the Secure and Promote obligations should be placed in the licence condition itself, rather than a separate document. This provides obligated parties with a greater degree of certainty, particularly in regard to potential future modification to the schedules.

How the licence condition is applied to obligated parties requires some additional thought. In particular, the action required when the generation asset that holds the licence is closed or sold.

Enduring monitoring and enforcement

The use of existing powers to monitor and enforce the licence condition is a sensible approach. We agree that Ofgem has a role to play in investigating complaints made against obligated parties. We request, however, that the regulator is transparent on its approach to investigations relating to the licence condition from the outset. Given that elements of the obligation involve a commercial negotiation between two parties (thereby the process is subjective), Ofgem should consider steps to mitigate reputational risk to companies that are subject to investigations whilst the facts are established.

Changes to licensees

We agree that the licensees subject to the condition should be periodically reviewed. The condition should apply to all licensees that meet the criteria for applying the obligation. It is critical that Ofgem establishes robust criteria from the outset to ensure the condition is applied equitably.

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

As stated in previous consultation responses, the obligations should be placed on those parties that are not required to actively participate in the forward market due to the internal hedge provided by their large domestic supply businesses.

The domestic retail sector, with its largely "sticky" customer base, is the only supply sector that has certainty of demand requirement across the forward curve. However, this volume is currently inaccessible

to independent market participants. As such, it is this sector that should be targeted by any element of the Secure and Promote licence condition that mandates trading.

Drax already has a strong incentive to trade across the forward curve, as it relies on the wholesale market to hedge its generation asset, Drax Power Station. There is no reason to incentivise, or obligate, Drax to trade in the wholesale market; we must already do this.

Supplier Market Access rules (Schedule A)

Fair market access and trading terms:

Drax agrees with the principle of fair market access and trading terms. We currently trade with a number of small suppliers and welcome all credible counterparties to establish trading relationships, regardless of size.

We agree that all counterparties should expect their requests to establish trading relationships to be dealt with in a reasonable and timely manner. We currently support the trading of clip sizes less than 1MW via our supply business, Haven Power Limited. In addition, the business adopts a reasonable and prudent credit policy. As such, we are satisfied that the approach we currently take offers fair and reasonable terms to all potential counterparties.

We believe that Drax already meets the majority of requirements contained in Schedule A relating to fair market access. The key changes that Drax will be required to implement in order to comply with this element of the licence condition is (a) the publishing of specified information on our website and (b) a process that ensures compliance with the strict timelines set out in the consultation. Drax has initiated a work-stream to meet these elements of the proposal.

Should Ofgem consider it necessary to apply this element of Schedule A to Drax's generation licence, then it should be fairly straight forward to deliver. We do, however, have some concerns over the prescribed timelines for responses to requests; we cover this in answer to Question 5.

Obligation to trade clip sizes as small as 0.5MW:

Drax is currently able to support the trading of clip sizes less than 1MW and offers the same products to both Haven Power Limited and its other trading counterparties. However, it is important to note that the availability of products depends on Drax's hedging position / availability of volume in the traded market.

Drax's business has been structured to reduce risk. The business seeks to progressively hedge a generation asset, Drax Power Station, by selling its output via the traded electricity market. Where we have volume to sell or we are able to back-out the trade via the market, then we will seek to fulfil trading requests from our trading counterparties. This is true regardless of whether the counterparty is a small supplier or a larger market participant.

When we do not have volume to sell *and* we cannot back-out a trade request via the market, then we will not undertake the transaction. Under these circumstances, the same rule applies to all of our trading counterparties including our own supply business, Haven Power Limited.

Schedule A, as it currently stands, would require a change to our risk management strategy in order to fulfil trade requests. The requirement to trade beyond the limit of our progressive hedging profile would force the business to enter trades regardless of product availability or the ability to back-out such trades (thereby our risk exposure) via the market.

Drax cannot support a proposal that will force the business to trade with another market participant regardless of product availability. As noted above, the only function of our trading facility is to hedge the company's exposure to the market; this underpins our risk management policy and MiFID-exemption status.

The objective of the licence condition should be to level the playing field, rather than provide "special treatment" for a particular class of participant. The outcome of the Supplier Market Access rules should be to ensure that small suppliers are treated in the same way as any other trading counterparty, including

our own supply business, Haven Power Limited. Equivalent access supports effective competition; preferential treatment does not.

As such, Schedule A should focus on access to trading partners, timeliness of engagement and ensuring equal access to available volume, rather than the creation of, what is effectively, a further market making arrangement.

Should this element of Schedule A be taken forward, then Ofgem must be certain that there is a clear distinction between trades undertaken to comply with the licence condition that result in an open market position (i.e. trades initiated by another party) and trades that are considered “speculative” (i.e. positions opened in the belief of a favourable future market movement). If there is no distinction, or a distinction cannot be maintained under future changes to energy and financial market regulation, then the licence condition could have a fundamental impact on those obligated parties that are not financially regulated.

Market Making obligation (Schedule B)

We agree with the list of obligated parties under Schedule B, although the licence condition should be applied to the domestic supply businesses held by these companies. It is the “sticky” customer base held by these businesses that substantially reduces the hedging requirement of the Big Six along the forward curve. This will also mitigate the risk of the licence condition falling away due to generation asset sales / closures.

Reporting requirements (Schedule C) and the near-term market

If, in the context of monitoring liquidity, Ofgem believe it would be helpful for Drax to provide the data specified in the final proposals, then we are happy to contribute.

Whilst the obligation in Schedule C places an additional reporting burden on those market participants captured by the licence condition, it is sensible for Ofgem to continue monitoring liquidity in the traded market. We request, however, that Ofgem ensures reporting processes remain efficient, utilising existing reporting routes (e.g. REMIT transaction reporting data) where possible.

Chapter 3: Detailed design of the Supplier Market Access rules

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’?

A1 – Transparency

Drax supports the publication of contact information and a list of required items to be sent alongside trading relationship requests. We feel that this will facilitate the process by ensuring an agreed starting point for both parties.

A2 – Scope

Drax currently trades with a number of small suppliers and welcomes all credible counterparties, regardless of size. However, the obligation to trade with small suppliers upon request is in contradiction of Drax’s position as a hedging business. This is covered in detail in our answer to Question 4.

A3 – Response to Trading Requests

Drax welcomes requests to enter trading agreements from all credible counterparties. We agree that all counterparties, regardless of size, should expect their requests to be dealt with in a reasonable and timely manner. It is important to note, however, that the establishment of a trading relationship requires due care and attention.

There are legal requirements, such as the Know Your Customer (KYC) process, and risk management processes, such as assessing credit requirements, that must be followed to ensure that Drax (and the

market as a whole) remains legally and commercially protected. These processes involve a number of sections within the business, each having their own specific area of expertise.

Whilst it is possible (and reasonable) to acknowledge a trading request and to undertake an initial high-level check of the information provided within two business days, it may not be possible to advise if further information will be required prior to completing a detailed assessment of the information provided. For example, where Enhanced Due Diligence is required for a given counterparty, this could delay the process by a number of weeks.

Such delays tend to be outside the control of Drax, e.g. due to the involvement of third party service providers or, in some cases, the response time of the counterparty requesting the relationship when further information is required. As such, it is not reasonable to include delays that are outside the control of an obligated party as part of the 15 day written response period. However, it is reasonable to expect obligated parties to keep the counterparty informed of delays and provide estimated timescales to resolve the issues encountered.

It should also be noted that the processing of requests to trade is performed by a small number of people within Drax. There is limited capability to manage multiple simultaneous requests (regardless of the size of the counterparties), particularly during periods of annual leave or illness.

A4 – Credit and Collateral

Drax already adopts a reasonable and prudent credit policy and is satisfied that this offers fair and reasonable terms to all potential counterparties.

A5/A6 – Clip Size/Product Range

Drax is currently able to support the trading of clip sizes less than 1MW and is able to offer the same products as it would to other counterparties, including its supply business, Haven Power Limited. It is important to note that the availability of products depends on Drax's hedging position or availability of volume in the traded market.

As detailed in answer to Question 4, Drax cannot support a proposal that will force the business to trade with another market participant regardless of product availability. The only function of our trading facility is to hedge the company's exposure to the market; this underpins our risk management policy and MiFID-exemption status.

At present, small clip sizes (i.e. <5MW) are unavailable in the traded market. In addition, liquidity is limited in a number of longer-term products. Whilst it is recognised that the remit of the market making obligation (Schedule B) is to address product accessibility, it will not guarantee liquidity when required, i.e. when a trade request is received from a small supplier. Nor will it deliver access to small clip sizes (at least in its current form).

To facilitate requests to trade under Schedule A, it is therefore suggested that:

- a) Clip sizes under the Supplier Market Access rules should be better aligned with those available under the market maker obligation (i.e. the latter should provide for clip sizes <5MW); and
- b) The time limit for responses to trading requests should be linked to the availability of prices provided as a result of the market making obligation.

For the latter (assuming a trading window approach is adopted), obligated parties should be required to respond to a trading request either within 3 hours of the request or prior to the end of the next trading window, whichever is the later.

A7 – Fair Pricing

It should be recognised that whilst prices (bids or offers) for a particular product may be visible on a trading screen, these prices may not be accessible to Drax. This can be for a variety of reasons, such as Drax not having a trading relationship with the given party or agreed credit limits having been reached.

In addition, bids/offers posted on trading screens are for 5-10MW clip sizes (at present), thereby may not correspond to the volume required by a small supplier. Thus establishing a “fair price” for products is not as simple as taking the price available on a screen. It must be recognised that a “fair price” may include a risk premium to cover the trading risks associated with mismatching clip sizes.

The introduction of the market making obligation should facilitate the availability of products; however, the risk associated with trading small clip sizes will remain unless there is better alignment under the Supplier Market Access rules and the market making obligation.

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

The establishment of a trading relationship is a complex process and it is Drax’s experience that small suppliers may underestimate these complexities. Whilst Drax is able to provide a level of support to small suppliers throughout this process, we feel that small suppliers should have a good understanding of their responsibilities and obligations before requesting a trading agreement. We therefore ask Ofgem to consider highlighting these and to provide details of sources of further information.

Drax would also welcome clarification on the process for complaints/disputes and how these will be managed by Ofgem. In particular: what Ofgem envisages their role to be in the course of any dispute and at what point they will become involved; how “fair prices” will be determined when considering risk premiums; and what constitutes a “timely manner” when complications occur.

Chapter 4: Detailed design of the market making obligation

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’?

B1 – Nominating a third party

We agree with the position outlined by Ofgem. The introduction of several market makers will bring about a number of benefits, including price competition and greater choice of service providers. This will drive efficiency benefits, which are less characteristic in monopolistic service provision. It will also help those with constrained credit resource to access market making services via multiple routes.

We agree that there are practical challenges in adopting a tendered approach. A key concern being the time required to tender and implement the service. We address this further in answer to Question 9.

B2 – Platforms

We agree with the position outlined by Ofgem. Obligated parties should be able to choose their route to market.

Free choice of platform, coupled with the introduction of multiple market makers, may result in bids and offers being posted via a variety of trading routes (brokered OTC and exchange, physical and financial venues, etc.). Access to volume via multiple market routes would allow greater access to all types of market participant (large or small, energy businesses or financial institutions, etc.).

B3 – Products

We agree with the products listed in the consultation document.

B4 – Availability

We agree with Ofgem’s proposal that obligated parties should post prices within the predefined bid-offer spread limits for more than 50% of market opening time in each calendar month.

We note that a number of parties caught by the market making obligation have called for the use of trading windows. The trading window approach may provide the benefit of knowing when products will be available in a given day. They may also assist in the development of reference prices, due to trade data collection being targeted at high liquidity trading periods and the data collector having to collect and analyse data over a shorter number of periods.

However, we also note the potential for trading windows to pool liquidity, thereby dampening liquidity in other periods of the day. In addition, the cumulative opening time across the trading windows is likely to result in the posting of prices within the predefined bid-offer spread limits being less than 50% of market opening time in each calendar month.

We are not opposed to the idea of trading windows, although thought is required on the positioning and length of trading windows across a given month if the proposal is to be implemented to its fullest effect and within the spirit of Ofgem's liquidity objectives. To achieve this, trading windows should only be adopted if they:

1. Occur each working day of a given calendar month;
2. There are at least two windows per day (one in the morning and one in the afternoon); and
3. Each window remains open for at least one hour.

In the latest consultation document, Ofgem note that one concern with the Mandatory Auction approach is that the proposal would not deliver continuous opportunities to trade. Should a trading window approach be adopted as part of the market making proposal, the same issue may be encountered. It should be noted that the compromise approach outlined above (a one hour window, twice a day) would result in obligated parties posting prices within the predetermined bid-offer spread limits for less than 25% of market opening time in each calendar month.

B5 – Bid-offer spreads

The spreads specified appear overly tight. At the time of writing this response, the mandated Season+1 Baseload spread would be ~15p. Consideration should be given to the size of mandated spreads should market prices move (e.g. fall). The consequence could be that spreads are mandated to tighten to extremely small values. We do not believe that this is the intention of the intervention.

We agree that the tightness of spreads should vary along the forward curve to reflect market risk.

B6 – Obligation to trade

We agree with the position outlined in the consultation document. This is a key role of a market maker.

B7 – Trade Size

The use of 5MW and 10MW clip sizes appears reasonable. However, additional clip sizes below 5MW are also required, such as 1MW clips (or maybe as low as 0.5MW clips). It is these clip sizes that smaller market participants have requested. As such, there should be greater correlation of clip sizes between the market making obligation and the Supplier Market Access rules. This is required if the market is to evolve to support the needs of small suppliers.

Fast Market Rules

Fast Market rules will be required as part of the final market making solution. The proposal must contain a mechanism that protects obligated parties against large, unpredictable movements in the market. Our preferred option would be to relax the bid/offer spread rule in situations where the market becomes particularly volatile, rather than completely removing volume from the market. The spread limit could be completely relaxed for a set period of time, ensuring obligated parties remain in the market but enabling them to manage the increased risk by adjusting their prices.

An alternative option could be to apply a temporary increase to the spread limit (set by Ofgem ahead of time). However, in this case, it may be difficult to develop robust analysis that determines an appropriate temporary spread limit for all conceivable situations.

Volume reloading times

There has been industry discussion over what happens once a bid/offer has been lifted. Some parties have indicated that there should be a “maximum reload time” to replace the lifted bid/offer. Others have suggested that volume should be continually available. We believe that the intention of the market making obligation is to promote a continuous market, i.e. volume should be replaced instantaneously. Ofgem should provide clarity on its preferred approach to bid/offer replacement and how this links to the objectives of the market maker approach.

Volume cap

Whilst a volume cap appears a sensible suggestion, it will only be practical if it appropriately balances the risks faced by market participants alongside the objective of the market maker proposal, i.e. to encourage a continuous market with increased access to bids/offers along the forward curve.

Consideration must be given to how a cap would be applied, i.e. monthly, daily, per trading window, etc. A cap that applies across multiple trading periods/windows may limit the development of robust reference prices, as some reference periods would suffer from a constraint in liquidity. Equally, a cap that can be reached in a very small number of trades may result in trading periods/windows being much shorter than intended, as liquidity concentrates at the start of the period.

Consideration should be given to the appropriate balance of risk mitigation tools between a volume cap, fast market rules and volume reload times. It is important to ensure that obligated parties are able to manage their risk; however, the rules should not overly constrain the activities of market makers, effectively rendering the intervention useless.

Phased implementation

There has been discussion amongst industry participants regarding the phasing-in of the market making obligation. We believe that there should be a single implementation date in order to realise the benefits of the market maker approach as soon as reasonably practical.

However, we would be reasonably comfortable with a phasing approach provided the following two criteria are met:

1. All phases are implemented within 6 months of the licence condition being applied: whilst we understand a phasing approach may help to minimise risk for the obligated parties, it should not be used to unduly delay the implementation of the licence condition (in full); and
2. Both phases should include the delivery of Baseload and Peak products: access to Peak products with appropriately set spreads has been a key feature of discussion on liquidity; as such, Peak products should feature in all implementation phases.

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

In its current form, the risks may be too high for obligated participants. Further consideration is required on the tightness of spreads and the introduction of Fast Market rules, as addressed in our answer to Question 7.

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?

We agree that there are practical challenges in adopting the tendered approach. One such challenge is the required lead time to scope, tender and implement the service. It is highly unlikely that a tendered market making approach will be implemented by the end of Q1 2014. This will result in the realisation of benefits being delayed.

Should a tender approach be adopted, Ofgem should maintain a reasonable level of involvement to ensure the process runs smoothly and is completed in a timely manner. At the very least, the original proposal (the introduction of six individual market makers) should be implemented until such time that the tender process results in the appointment of a provider and commencement of the service.

A particular concern with this approach is that the aim will be to produce a single market maker, rather than several competing services. The presence of several market makers will bring about a number of benefits, including price competition and greater choice of service providers. This will drive efficiency benefits, which are less characteristic in monopolistic service provision, and help those with constrained credit resource to access market maker services via multiple routes. In addition, the presence of multiple market makers may result in bids/offers being posted via a variety of trading routes (e.g. brokered OTC vs. exchange, physical vs. financial, etc.).

Chapter 5: Near-term markets

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

Yes.

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

Yes. The near-term market does not present a liquidity risk to market participants and is strong enough to support reference prices.