INTERGEN

Phil Slarks
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Ofgem
9 Millbank
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Dear Phil,

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

InterGen welcomes the opportunity to respond to the above consultation. A liquid and transparent wholesale market is essential to the success of EMR; to build a robust market reference price, encourage new build generation capacity and support independent generators and suppliers, whose participation will ensure that consumers benefit from highly competitive and efficient energy markets.

InterGen would be happy to meet to discuss further any points raised in our response.

Yours sincerely,

Stuart Middleton
Public Affairs and Regulation Manager

1 Executive Summary

1.1 InterGen has been an integral part of the UK generation fleet since 1998 and currently has 2.5GW of capacity in operation. We are committed to investing in the UK and are planning to add 1.8GW of carbon capture ready gas-fired generation (CCGTs) during this decade, reducing the UK's carbon emissions significantly and providing essential generation flexibility.

1.2 A liquid and transparent wholesale market is essential to the success of EMR; to build a robust market reference price, encourage new build generation capacity and support independent generators and suppliers, whose participation will ensure that consumers benefit from highly competitive and efficient energy markets.

1.3 However wholesale market liquidity has decreased over the last few years to the extent that regulatory intervention is now required. InterGen would urge Ofgem to ensure that these proposals are implemented in accordance with the timescales stated in the consultation in order to deliver a real and sustained improvement in market access and market liquidity.

1.4 Improved long-term market liquidity not only allows independent generators to trade more efficiently but has the ultimate result of bringing down costs for all participants and therefore the consumer due to increased competition in generation and supply.

1.5 InterGen believes that in order to generate robust reference prices along the curve and increase the availability of products that support hedging, the implementation of a Market Making Obligation (MMO) is required. InterGen continues to believe that the near term market is operating efficiently and does not require intervention at this time

1.6 The MMO combined with the Supplier Market Access Rules (SMA) will allow independent generators and small suppliers access to forward products essential for hedging and risk mitigation. The MMO, if designed with trading windows, will also create a robust and reliable reference price, essential for the success of the CfD FiT for low carbon generation.

2 About InterGen

2.1 InterGen is owned by Ontario Teachers' Pension Fund (one of the world's largest pension fund investors in infrastructure projects) and China Huaneng Group (the world's second largest power generator).

2.2 InterGen is one of the UK's largest independent generators, operating a portfolio of high efficiency gas-fired power stations (totalling 2,490MW; an investment of some £2.1bn in today's money) and actively trades in the prompt and forward wholesale power, carbon and gas markets.

2.3 InterGen requires a liquid forward wholesale power market to be able to hedge our existing assets effectively. Currently the shape required is only available in the prompt market which leads to cash flow volatility and uncertainty for our shareholders thereby discouraging them from longer term investments in our existing assets and new development projects.

2.4 These development projects include the new Spalding Energy Expansion and Gateway Energy Centre CCGT power stations which, if built, will create around 1,200 direct jobs during construction and long term skilled jobs thereafter.

3 Questions

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

3.1 InterGen agrees that there has been some progress towards Ofgem's objectives (mainly in the near-term) but believes there are still significant issues in relation to liquidity on the curve.

3.2 Poor liquidity on the curve has been seen to be self-reinforcing as the lack of liquidity has led many banks to exit the UK power market (Goldman Sachs, RBS, etc.) causing liquidity to fall further. We consider that this negative cycle has reached a point where active intervention from Ofgem is necessary and long overdue to ensure that participants have access to products required for hedging.

3.3 In their final proposals, Ofgem states three liquidity objectives and InterGen agrees that these should be the focus of the obligations and help to determine the measures of success.

3.4 **Objective 1: Availability of products that support hedging**

3.4.1 For an independent generator, the availability of products has continued to decline over several years. In particular, it is very difficult to hedge peaks beyond the front month or season and for baseload only the front two months and seasons trade with any regularity. The table in Figure 1 shows the market prices and number of trades for the 13 obligated products taken as a snapshot on the 12th July. What is clear from the data is that where the market spreads meet the suggested Ofgem spreads, trading occurs and where they don't, it doesn't. As Ofgem will appreciate from their visit to InterGen in early January 2013, this is not an unusual picture of market activity.

	Bid	Offer	Trades	Market %age	Ofgem % age	Meets?
M+1	46.60	46.70	41	0.2	0.3	
M+1 pks	53.73	54.20	40	0.9	0.7	
M+2	46.60	46.70	13	0.2	0.3	
M+2 pks	54.10	54.75	0	1.2	0.7	
Q+1	52.50	52.90	1	0.8	0.3	
Q+1 pks	58.75	62.00	0	5.4	0.7	
S+1	54.70	54.85	9	0.3	0.3	
S+1 pks	62.50	62.90	6	0.6	0.7	
S+2	49.00	49.10	7	0.2	0.3	
S+2 pks	55.60	56.25	1	1.2	0.7	
S+3	55.40	55.65	9	0.5	0.5	
S+3 pks	63.25	64.00	0	1.2	1.0	
S+4	52.25	52.45	2	0.4	0.5	

Fig. 1 Snapshot of OTC market prices and trades in proposed obligated products from 12/07/13 at 13:50

3.4.2 This inability to hedge has led to volatile cash flows, hindering further investment as a consequence.

3.4.3 As the percentage of renewables increases in the market, baseload products become less effective as a hedging tool for independent CCGT generators and it is essential that peak products are more readily accessible.

3.4.4 The voluntary measures taken by the large utilities to assist small suppliers are helpful but for any improvement in Objective 1 to be measurable, an obligation is required to standardise terms of market access for small suppliers.

3.5 Objective 2: Robust reference prices along the curve

3.5.1 InterGen agrees with Ofgem that the bid-offer spread gives an indication of price robustness, but we believe that actual trades provide a better measure. However we agree that forcing trades to occur may distort the market price and that if spreads are sufficiently tight, trading will naturally occur within those spreads. Clearly for an improvement in liquidity to occur, spreads will need to be tighter than are currently observed in the market.

3.5.2 Concentrating the spreads into 'trading windows' is more conducive to determining an accurate reference price as the volume weighted average price of trades across the windows will be easy to report against and less open to gaming.

3.5.3 The financial forwards market has been around for a number of years without gaining much industry support. If these products were going to evolve naturally over time, there would have been some visible improvements by now. It is likely that a major reason for this is the credit costs, particularly for a player that is naturally imbalanced (for example always a buyer or always a seller). This is because a naturally imbalanced player cannot benefit from netting a position, whereas a more balanced player may have a much larger total traded volume but is only required to post collateral to cover the net position.

3.6 Objective 3: Effective near-term market

3.6.1 InterGen has always found the near term markets to be sufficiently liquid, and acknowledges that the introduction of the auction has improved access for those players wishing to trade a half hourly Day Ahead (DA) shape (though that does not suit all participants). We believe that the prompt market has and continues to operate effectively and does not require intervention.

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?

3.7 Yes. The two interventions described in the Secure and Promote licence condition will address the principal factors that are currently preventing independent players from participating in the market, dampening the positive effects of competition in the sector.

3.8 The SMA rules will allow independent suppliers to receive a guaranteed level of service from the obligated parties' credit and origination department, something that we believe can sometimes be the greatest barrier in signing new trading agreements.

3.9 The MMO will ensure that independent generators will have guaranteed access to key products at a tight enough spread and with enough depth that they can effectively hedge their generation from existing assets should they chose to do so.

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

3.10 Yes. InterGen believes that the market has had many years to voluntarily increase liquidity and has failed to make significant progress. Whilst some measures have been introduced to guarantee prompt market volumes, nothing has so far been developed for the curve. Further, it has been evident that the liquidity in the prompt has not naturally spread onto the curve as some parties had suggested would occur.

3.11 We therefore think it is appropriate for Ofgem to intervene in the form of a licence condition. A licence condition is clear, measurable and enforceable. Further, if the intervention is not working or having unintended consequences on obligated parties then it can be adjusted over time to ensure the market develops efficiently.

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

3.12 InterGen agrees that obligation should be placed on those parties who are large enough to provide additional liquidity. In the case of the MMO, we believe that it is correctly directed at those parties that are, as a result of their position in the market, required to purchase for their customers as well as sell from their generation. It is not appropriate for these measures to be placed on parties coming from only one side of the market and are dependent on price alone to dictate whether they need to hedge in the market.

3.13 It should not however be underestimated the administrative burden as well as the additional financial risk that these proposals place upon obligated parties. The SMA will likely require an additional dedicated person to administer requests from small suppliers as well as the increased burden on credit and origination teams. In smaller companies, these 'teams' may only consist of one person so they have proportionately a much more significant impact than on the larger companies.

3.14 We feel it important for Ofgem to monitor how these interventions are being met by the obligated parties to ensure that not only that the measures are effective in meeting the objectives state by Ofgem but that the costs of obligation are broadly consistent with those forecast in the draft impact assessment.

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'?

3.15 As previously mentioned an obligated party will likely dedicate at least one additional member of staff to administer the SMA scheme to ensure that deadlines are met and to coordinate the responses with other internal departments. To that end we do not believe that a 2 day limit for an initial response is achievable. If that first response was purely an acknowledgement that a request had been received then this could be done automatically. However ensuring that all the required data has been received from the small supplier will take time and 2 days does not take into account any allowance for annual leave/absence etc.

3.16 We would propose that the first step is dropped and instead obligate a formal response within the 15 days. Alternatively if Ofgem feel that it is important to keep the first step, this should be extended to 6 business days as our experience with small suppliers shows that it may take several attempts to gather all the information required to fully consider a request to trade.

3.17 InterGen agrees with the scope of the obligation however we are concerned with the credit and collateral requirements particularly around the longer dated products. We believe that by restricting the obligated products to the front 2 seasons it may be easier for the obligated parties to provide credit terms acceptable to the small suppliers. Suppliers large enough to have good credit can access seasons 3 and 4 through the MMO.

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

3.18 It is not clear what the procedures are when a small supplier feels that either the credit terms or the pricing supplied by an obligated party is 'unfair'. InterGen believes that Ofgem should be required to be an arbiter in such a matter. This is because there needs to be some kind of recourse to prevent an obligated party attempting to circumvent their licence condition by stalling the process. Equally there needs to be some protection for obligated parties from small suppliers who cry foul when they do not like the credit terms they are offered even if they correctly reflect the additional risk.

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'?

3.19 InterGen believes that if implemented correctly, the MMO could be an important step to solve the liquidity problem faced by independent generators and suppliers in accessing the wholesale market.

3.20 **Timing** – InterGen would prefer the approach put forward by Ofgem, i.e. all products are available from go-live. However, we can see the rationale for splitting the release into 2 phases to minimise unforeseen risks to the obligated parties. This will also ensure that any lessons learned during this implementation phase can be applied in Phase 2. In this case we would envisage that the baseload and peak markets out to Season +2, i.e. those covered by the tighter bid offer spread rules, would be offered in Phase 1 consistent with the timetable proposed by Ofgem. We would then propose that the Seasons +3 & +4 products be introduced in Phase 2 in H2 2014.

3.21 **Nomination of a third party** – We believe that as the obligated parties have the freedom of platforms to post their prices there should remain six obligated parties in order to ensure that as many participants as possible have access to the spreads. Therefore we do not believe that a third party provider should be able to represent more than one obligated party. If a single platform was obligated, then we can understand the rationale for reducing 6 market makers to 3.

3.22 **Platforms** – We would prefer that the MMO be obligated via the Trayport screens as the vast majority of trading is Over The Counter but can see the need for allowing obligated parties the flexibility to make a cleared offering. However, if all six obligated parties decide to post spreads on a cleared market where an immaterial volume is traded then Ofgem should retain some powers to move those spreads to more representative market places in short order. InterGen believes that in order to qualify, a platform must have more than 10 licensees that actively trade in substantial volumes. This will prevent market making 'in a vacuum' on a platform that is inaccessible to other market participants.

3.23 **Products** – We agree with the product list that Ofgem proposes. We are aware that some parties are pushing for more shape to be obligated and whilst we would like to see as large a product list as possible, we believe that this would add unmanageable risks to the obligated parties. Once there is a robust market for baseload and peak products, additional shape e.g. EFA 5 and EFA 6 may develop naturally.

3.24 **Availability** – InterGen firmly believes that two trading windows each day would be more effective than the 50% of the market opening time in any given month. Two windows per day not only concentrates the liquidity into short periods, making it easy to determine reference prices, but it is also easier for the obligated parties to demonstrate compliance. Two windows will allow participants wanting to access the markets a guaranteed time each day in which they know that volume will be posted. Having two windows instead of one also allows some form of continuous trading alongside the gas market. We would suggest having a window from 10:30 – 11:30 to coincide with the clearing of the North West Europe DA auction and a second from 15:30 – 16:30 to coincide with the gas index window.

3.25 **Bid-offer spreads** – Under a phased approach we support a relaxation of the bid offer spreads in Phase 1. Under Phase 1 we would propose a relaxation of the 0.3% baseload spread to 0.4% and the 0.7% peak spread to 0.8%. However once Phase 2 is effective and the Season +3 and +4 products introduced then the Phase 1 spreads should revert back to 0.3% and 0.7% respectively. The Phase 2 spreads should be retained at 0.5% and 1% as stated in Secure and Promote.

3.26 **Trade size** – Obligated parties should post their prices in clips of 5 or 10MW. Any larger volume trades should not count towards their obligation.

3.27 **Additional Safeguards** – To protect the obligated parties from undue risks a series of additional safeguards could be introduced.

- To reduce the risks posed by unusual volatility a **fast market rule** should be introduced. These are well established in other market places and measure the volatility in the period directly before the trading window. If the volatility increases substantially (by a pre-defined percentage) during the window, then the obligated party can remove their spread for a period of 5 minutes.
- In addition, if the obligated party is hit or lifted in the **same direction 6 times** consecutively per product, they can then remove the bid **or** offer until they are traded in the opposite direction thus reducing their exposure. This measure resets at the end of each window, ensuring that there is available volume in both windows.
- Finally a **reload rule** of five minutes, i.e. once a bid has been hit there is no obligation to repost that bid for 5 minutes, could be introduced.

3.28 These safeguards and the fact that the spreads need only be posted for a quarter of the trading day remove the need for any kind of volume cap.

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

3.29 We believe that the phased approach with relaxed spreads and products and additional safeguards strikes a good balance between costs and risk. Phase 1 can be introduced at a much lower overall cost to the obligated parties and when Ofgem is satisfied that it is working as intended then it can progress to Phase 2 which is where most of the cost, risk and uncertainty lies.

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 any views on how we can solve the practical challenges we have identified?

3.30 We do not believe that an industry run tender process is practical in the timescales Ofgem propose. From our experience of the prompt cleared market introduction, the tender process can take several years and there is no guarantee that there will be a third party interested in bidding to provide the service.

3.31 The obligated parties can lead a tender process for a third party provider only once the MMO is underway. This will allow the obligated parties to avoid any additional burdens placed upon them as a result of the possible removal of exemptions under MiFID II. It will also allow third parties to see the MMO in action which will make them more likely to bid for the service. However it should be the obligated parties who are responsible for any transfer of obligation from themselves to a third party and for satisfying Ofgem that the tender process meets the needs of Secure and Promote.

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

3.32 InterGen believes that the near-term market has been and continues to be sufficiently liquid. Therefore the imposition of any mandatory measures and associated costs in this area would be unnecessary and risk unintended consequences.

3.33 We believe that it is not appropriate to obligate trading via one method or one platform as there are a number of different robust solutions in place that satisfy a wide range of participants.

3.34 Market coupling will add more competition in the DA auction market and the volume of physical trades OTC remains strong. The likely increase in trading along the curve as a result of the MMO will only strengthen the prompt market.

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

3.35 InterGen agrees that there should be no intervention in the near-term markets.