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19 September 2017

Dear Matthew/Hannah,

Secure and Promote Review: Consultation

InterGen welcomes the opportunity to respond to the above consultation as part of Ofgem's scheduled review of the Secure and Promote licence condition. We believe that the introduction of market making and obligating large vertically integrated utilities to make specified products available has had a positive impact on overall liquidity, created robust reference prices, and the opportunity for smaller parties to manage risk and hedge forward positions. Although improved in the last three or so years, we consider that the relatively low level of liquidity is reflective of the current level of competition in the electricity wholesale market, which falls short of providing a level playing field due to a high degree of vertical integration. Secure and Promote is a central measure to alleviate this market distortion.

Moreover, ongoing reform to electricity cash out is yet to complete its phased implementation. InterGen feel that this key component of market pricing and resultant liquidity must be allowed to embed and mature so its impacts are fully observed and understood before undertaking any significant change to Secure and Promote.

Background

InterGen remains the only genuinely independent generator active in the GB market with a track record of developing, constructing and operating large scale thermal power generation projects. We have been active in the market since the 1990s and therefore bring a unique perspective to issues regarding the GB wholesale electricity market.

InterGen is owned by two major international investors, representing two key classes of investment which the Government is seeking to attract to UK infrastructure investment, namely, pension funds (Ontario Teachers' Pension Plan) and strategic investors from the People's Republic of China (China Huaneng/Yudean). We are one of the UK's largest independent generators, operating a portfolio of three flexible gas-fired power stations totalling 2,490MW; an investment of some £2.1bn. These stations are located at Rocksavage (Cheshire), Spalding (Lincolnshire) and Coryton (Essex).

Additionally, in December 2016, at the T-4 auction, InterGen won a fifteen-year capacity market agreement to construct a 300MW OCGT, an expansion of the existing Spalding site. InterGen is also ready to build new CCGT projects at sites in Spalding (Spalding Energy Expansion) and Essex (Gateway Energy). These new CCGT stations, which are shovel-ready, will cost around £800million each to construct and create around 3,000 jobs over their three year build programmes.

Response

At the time of its implementation, InterGen strongly supported the Secure and Promote licence condition. After almost three and a half years in place, we have seen an improvement of product availability, more robust prices, and greater opportunity to hedge in the prompt and on the curve. As a result, we remain fully supportive and would urge Ofgem to maintain the obligation. Although we believe that extended windows, if combined with a 100% level of compliance, would increase liquidity further, the current framework does provide the market with pricing signals which are vital to smaller, independent companies. InterGen's internal trade data[1] shows that we execute 51% of all trades in mandated products within the two one-hour liquidity windows, 82% of this volume is with obligated parties and 18% with non-obligated parties. Outside the windows, the remaining 49% of trades are executed with the share of mandated products traded with obligated parties increasing to 87%. In our experience, volume of trading is not restricted (or concentrated) to the liquidity windows. Rather, the windows generate robust reference prices that inform trade throughout the day.

Furthermore, the obligated parties still dominate in electricity with over 80%[2] of the domestic electricity supply market. The natural hedge that vertically integrated businesses enjoy mean that they have little incentive to hedge via the traded markets. Since this hides the true value of generation from the market, barriers to entry are created, particularly for small and independent generators that depend on hedging their investments on the wholesale market. This in turn has a negative impact on competition, liquidity, and therefore the prices that consumers ultimately pay. We believe that intervention is justified to correct this kind of market distortion and any radical departure from current arrangements might have unforeseen consequences that set the market backwards. With full marginal cash out pricing due in November 2018 expected to improve the incentives for hedging and increase liquidity, radical modifications of Secure and Promote should be avoided to allow ongoing work to bed in and time to prove its effectiveness.

We have outlined detailed responses to the consultation questions in appendix 1, attached below.

Please do not hesitate to get in touch if you have any questions or would like further discussion on any of the points raised above or in appendix 1.

Yours sincerely,

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[1] 1 September 2016 - 2 May 2017, all mandated products, % by volume.
[2] https://www.ofgem.gov.uk/data-portal/retail-market-indicators

Appendix 1: Responses to questions in *Secure and Promote: Consultation*

Question 1: Please comment on whether you think prices for forward delivery are robust. Please refer to prices in and out of the market making windows and comment on the current mandated bid-offer spreads.

We believe that the robustness of prices has increased with the implementation of the Secure and Promote licence condition. The prescribed limits on the spread between bid and offer prices provides the market with robust price references that are important both in and out of the market making windows. This is an essential by-product of the Market Making Obligation (MMO) as prior to its implementation many curve products would not even have a spread or trade for weeks on end. The MMO is indispensable for this price discovery. As Ofgem's own analysis suggest, the overall narrowing of the bid offer spreads is evidence of that. Overall it may appear as if liquidity is concentrated in the two hours where parties have licence condition to make markets. Our own experience is that we execute 51% of all our electricity trades in the mandated products within the market making windows[3]. However, the price signals revealed during the windows provide market confidence in robust reference pricing and are therefore important for liquidity throughout the day.

InterGen, an operator of gas fired assets in the UK, hedge spark-spread whereby we transact power, gas and carbon together. As such, the windows act to tighten the spreads on power products to create a reference throughout the rest of the day when the gas and carbon products align for us to execute the three components of the clean spark-spread.

Question 2: Please comment on whether the windows promote greater availability of products needed to hedge. Please provide evidence you may have on the availability of products outside the windows.

Yes, we believe that the market making windows promote greater availability of products needed to hedge – this is particularly true of the products in Seasons +3 and +4 where without the Secure and Promote conditions it is questionable whether there would be any spreads to trade. This is a result of the natural hedge created by vertical integration, which removes the incentive to hedge via the traded markets. Whilst vertical integration remains a feature of the GB power market it is imperative that the Secure and Promote obligations remain. In its investigation into the wholesale energy market in 2016[4], the CMA concluded: "*Ofgem's S&P licence conditions serve to further dampen concerns about the impact of vertical integration on liquidity, because they ensure the availability of the products that were most widely used for hedging by the Six Large Energy Firms*".

The CMA also linked competition directly to liquidity, *"if liquidity is poor, independent suppliers or generators may be less able to hedge their demand or output, increasing their risk or causing them to pay a premium to reduce risk. This disadvantage may in turn affect competition in retail markets or generation."* This is echoed by Ofgem[5], *"improved liquidity can work to provide a level playing field for*

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[3] 1 September 2016 – 2 May 2017.

[4] https://assets.publishing.service.gov.uk/media/5773de34e5274a0da3000113/final-report-energy-market-investigation.pdf

[5] https://www.ofgem.gov.uk/electricity/wholesale-market/liquidity

independent companies so they can compete in the market on the same terms as vertically integrated companies".

For InterGen, the obligation on Peak products is invaluable. The baseload product is frequently 'out of the money' for us to hedge but the Peak product can offer a route to market that is 'in the money'[6]. There is no rational economic incentive for an independent operator of physical assets to hedge out products at below the costs of operating their assets – they have no retail customer base to provide a natural hedge. The same will apply for operators of other forms of generation and DSR – liquidity comes when products are in the money for these assets.

Although spreads are not as tight and markets not as deep in volume outside of the windows, the prices revealed during the windows provide a robust reference that increase market confidence in trade of forward delivery products. InterGen are able to benefit from these reference prices, particularly in the Peak products on the curve that, prior to Secure and Promote, were very difficult to hedge due to the lack of a robust reference price and motivated buyers of the product.

Question 3: What are your views on how liquid the near-term market is? Please refer to any factors that you consider have contributed to the liquidity of the near-term market.

Overall, the Day-Ahead power market has a good level of liquidity in core products on the wholesale market. When combined with the Day-Ahead auction, InterGen, as an independent generator managing 1.5GW of merchant assets, is able to participate without being constrained by volume.

However, beyond Day-Ahead, liquidity falls away steeply as you move further ahead of delivery and away from Baseload to Peak and other products. Consequently, the near-term markets are not the area of greatest concern. The MMO is most effective and important through its application to Seasons +2, +3 and +4 and in particular in the Peak product. Without the MMO obligation across these seasons, InterGen would anticipate a regression to the trading inactivity that typified the curve prior to the introduction of Secure and Promote.

Question 4: What are your views on our high-level analysis of the state of liquidity? Are there any factors not identified that we need to consider to assess liquidity or Secure and Promote? Please provide quantitative or qualitative evidence where relevant.

We believe that Ofgem's assessment of the current state of liquidity and Secure and Promote is robust and we agree with its findings. In addition to the factors outlined in the consultation document, we would encourage Ofgem to also consider these additional points:

- Full recognition of the potential negative impact of vertically integrated utilities is imperative, including consideration of previously independent businesses becoming integrated and therefore in a position to potentially withhold capacity from the market;
- Whilst we strongly urge Ofgem to maintain the licence condition and justify potential modifications with evidence based, quantitative where possible, assessment, it is also

[6] In the money – when power is hedged in combination with gas and carbon the product represents a profitable trade against operating the physical assets in our portfolio to deliver the electricity.

important to recognise changing market conditions. With renewable generation becoming increasingly important, the demand for certain hedging products will change. The unpredictable nature of renewables and availability of subsidies means that these generators have no incentive to hedge further out than the Day-Ahead. In addition, a more diverse fuel mix may bring about a need for a review of the suite of mandated products to better suit market needs. For example, tighter Peak spreads, 'Super Peak' or extended Peak products could encourage greater liquidity in the forward markets;

- Going forward, it could be considered that access to the mandated products could be provided by a central market making body/bodies selected via a tendering process. This would alleviate the administrative burden of the MMO from the parties currently obligated. Parties with affiliations with supply side entities should maintain the cost burden of providing the MMO (S&P was introduced to prevent volume not being transacted on the wholesale markets due to customer bases providing an internal demand for generation);
- Participation in the wholesale power market is very credit intensive. The credit requirements to hedge in material volume further out along the curve can often outweigh the benefit of hedging risk. This would seem perverse and in need of redress;
- Electricity Cash-Out reform is yet to be fully implemented. This phased market reform must be allowed to embed and mature before a companion market intervention (S&P) is restructured. They are closely linked and interdependent; and
- Persistent review and reform by Ofgem in areas such as Gas and Electricity Transmission Charging mean that there is considerable regulatory risk associated with hedging in advance of delivery. Frequent regulatory intervention will deter liquidity and force it into the near-term.

Question 5: What are your views on the impact of the market making obligation on liquidity in different market conditions, including in benign times and in times of price volatility?

Volatility and liquidity are inextricably linked. As Ofgem's own analysis of Secure and Promote demonstrates, liquidity was lowest in times of low market volatility (summer 2015) and highest at times of highest market volatility (Q4 2016). Progression to fully marginal cash-out in November 2018 should heighten prompt volatility and sharpen incentives for all market participants to hedge. In an efficient market, the prompt volatility would feed through to the curve and encourage hedging volumes. This is because volatility creates 'organic' liquidity as incentives to hedge are sharpened for all market participants, whereas periods of low volatility creates less incentive to hedge. During these benign times there is still however a requirement to hedge and therefore the MMO is instrumental to provide reference prices and maintain liquidity levels. Additionally, although liquidity tend to naturally increase during volatile market conditions, the requirement for the MMO during these times remain so to ensure availability of robust prices every day. The MMO supports liquidity in all market conditions and therefore to remove or water down the obligation in some way when volatility increases would have a negative impact on liquidity across the mandated products throughout the day.

Question 6: What are your views on the fast market and volume cap rules, in particular on reducing risk for licensees when needed?

We believe that the current rules and trigger of 4% variance in bid offer spreads is sensible and have shown to protect licensees in significant market volatility. It is our view that any potential costs of obligated parties should be minimised where possible, without having a negative impact on liquidity. As a result, any potential changes to the fast market and volume cap rules must follow an evidence based assessment providing all market participants with the confidence that Ofgem's objective of increased liquidity remains the key priority. Obligated parties have previously expressed a view that extended market making windows with reduced level of compliance would significantly reduce their costs. In principle we do not object to this proposal although we would urge Ofgem to perform a thorough analysis before introducing modifications. If longer windows are introduced, we would encourage Ofgem to maintain a high level of compliance, introduce measures that discourage potential distortive behaviour, and consider increasing the volume cap to ensure that market depth remains when there may be a reduced number of market makers posting bids and offers at any one time.

Question 7: What are your views on how the SMA part of the licence condition has helped smaller suppliers to access the wholesale market?

No comment.

Question 8: What in your view are the additional relevant external policy factors we should consider in our assessment of Secure and Promote?

Competition on equal terms is key for an efficient market, regardless of the products or services exchanged. A high degree of vertical integration in the electricity market negatively impacts competition and therefore prices available for consumers. Although the dominance of the obligated parties in the domestic supply market is reducing, it is still significant – 83% in Q1 2017. Add to this the number of non-obligated generators acquiring an electricity retail businesses and the matter is made worse. Should consumers not see substantial benefits from a high level of vertical integration in the GB energy industry then it is the responsibility of the Regulator to ensure that sufficient competition and access to market is facilitated to enable consumer gains.

It is also important to consider that the Electricity Cash-Out reform is yet to be fully implemented. This phased market reform must be allowed to embed and mature before a companion market intervention (S&P) is restructured. They are closely linked and interdependent.

In addition, persistent review and reform by Ofgem in areas such as Gas and Electricity Transmission Charging mean that there is considerable regulatory risk associated with hedging in advance of delivery. Frequent regulatory intervention will deter liquidity and force it into the near-term.

Question 9: What are your views on amending the licence condition to allow flexibility during certain market conditions?

Amending the licence condition to take account of market conditions is in theory a sensible approach to reduce costs without significantly impacting liquidity. In reality, however, the parameters used to monitor the market conditions (volatility) will either be lagging or have to be implemented on a real time basis. Lagging would cause issues at different points of the year for obligated parties – where the market conditions change and costs increase, alternatively impact liquidity negatively by not having tight enough spreads. Conversely, trying to implement in real time would be very difficult and may require continual change such that it makes the implementation of the obligation more complex and costly. Therefore, allowing flexibility during certain market conditions could potentially increase costs, negatively impact liquidity, and make the obligation more complex to implement and manage. This would have a negative impact on, obligated parties, general participants and consumers alike.

Introducing flexibility to compliance levels away from 100% would add further administrative and monitoring burden on the obligated parties and Ofgem to ensure that compliance was observed – which we understand is not always the case at the moment with the obligation conditions being very clear.

InterGen's view is that the licence condition should be stable and not subject to continual amendment. It is important to ensure that parameter changes or adjustments to the structure of the licence condition are only made after robust assessment over an appropriate period of time. The licence conditions should be made a statutory part of the licence for an integrated utility with the threat of meaningful sanctions enforced for any material breach.

Question 10: What are your views on the costs and benefits of complying with the policy either as an obligated licensee or as a general participant? Please provide evidence and detailed costs/ benefits per annum.

From discussions with obligated parties we understand that the costs incurred as a result of the Secure and Promote licence condition is believed to be greater than Ofgem's initial assessment. As a general participant we are not able to comment on this but would encourage Ofgem to perform a robust assessment of any costs submitted so to ensure consistency and validity. It would also be helpful if Ofgem, where possible, could quantify and make available information on realised benefits.

The only way to fully and truly assess the 'opportunity' costs incurred is to breakdown the full trade list of every obligated party to separate out exactly which transactions are due to the obligation and which are outwith. The figures suggested by the obligated parties as costs incurred are high and, in the absence of supporting evidence, debatable.

Question 11: How can liquidity be improved without the costs of the policy increasing significantly? Alternatively, how can costs of the policy be reduced without significantly reducing liquidity?

We believe that any proposed changes should be assessed using the current obligations as the benchmark and although the costs should be a consideration, it should be second to the objective of increasing liquidity.

Question 12: Is there any other relevant stakeholder feedback we haven't captured that we should consider?

As the market changes we expect that the range of products that need to be traded will change. Ofgem should therefore be considering what products will be used more in the future and how liquid markets can be created to allow these products to be traded at a robust price.