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Dear Matthew, Hannah,

Secure and Promote Review: Consultation

Drax Group is a UK-based energy company with businesses spanning generation, retail and renewable heat. In recent years we have transformed Drax Power Station into the UK's single largest source of renewable power by upgrading three generation units to use compressed wood pellets in place of coal. Alongside our existing generation assets, our acquisition of four open cycle gas turbine (OCGT) development sites will allow us to build on the role we play in supporting a flexible power system that facilitates the deployment of wind and solar generation.

Our retail businesses, Haven Power and Opus Energy, are actively engaged in helping businesses with their energy needs, improving efficiency and switching to renewable products. Finally, our renewable heat business, Billington Bioenergy, supplies compressed wood pellets to off-grid homes and businesses that would otherwise continue to use fossil fuels.

This response is submitted on behalf of Drax Group. We welcome the opportunity to provide comments on Ofgem's Secure and Promote review. It is clear that all market participants will benefit from increased market liquidity, improved access to products and robust reference prices. As a business that is reliant on the traded market, we support the ongoing monitoring of liquidity and the opportunity to periodically reflect on, and adapt, the Secure and Promote regime to facilitate the future needs of market participants and consumers.

Impact on the market

As evidenced in Ofgem's analysis, the mandatory Market Maker Obligation has not materially improved liquidity across the forward curve, nor has it worked to its detriment. Access to products has remained stable, although market depth has decreased outside of the market making windows. This is largely due to liquidity migrating from the remainder of the day to the two, one-hour trading windows.

The positive impact of this concentration in trading activity is the creation of deeper pools of bids and offers, which has supported price discovery and led to more robust reference prices. These reference prices are renewing interest in financial products that can be settled against a robust physical short term market. There is evidence that financial market participants are beginning to re-enter the market, which could lead to increased market churn. This should be encouraged and given time to develop.

The negative impact of concentrated liquidity is that trading in the surrounding periods has significantly diminished. This poses a considerable challenge for physical market participants when they need to transact for purposes other than position optimisation, i.e. due to a short notice loss of physical load.

Changing business models and the future shape of market making

We note the business models of some obligated licensees are undergoing change. The recent divestment of Uniper has led to a physical separation of E.ON's thermal generation business from its retail portfolio. Further restructures, divestments and plant closures are possible amongst the remaining obligated parties over the coming years. Conceivably, these business restructures will increase the

number of trading participants in the market, which we view as a positive development. This may, however, bring into question the current design of the market maker regime.

A move to a socialised market maker model, where the costs of delivering the service are recovered from the wider market, may be a more appropriate and proportionate solution going forward. As an alternative, professional market makers (e.g. financial institutions or trading businesses that provide such services in other markets) could be commercially incentivised to sign up to trading venues and facilitate market making, similar to the scheme in place in the Nordpool market.

Short-term enhancements to the existing model

In the intervening period, there are a number of enhancements that can be made to existing arrangements to increase liquidity outside of the market maker windows and ensure appropriate protection for obligated parties. These include the lengthening of the market making windows to encourage trading over longer periods of the day, widening of near term maximum bid/offer spreads and enhancing the fast market rules. These proposals are explored further in response to the consultation questions in Appendix 1.

Please feel free to contact me, should you wish to discuss any aspect of this response.

Yours sincerely,

By email

Stuart Cotten
Group Head of Regulation and Compliance

Appendix 1: Drax Group response to the consultation questions

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.

Drax considers that current prices for forward delivery are sufficiently robust. The introduction of the market making windows has concentrated liquidity, thereby creating deeper liquidity pools during the two daily windows. This concentration of trading has supported price discovery and led to more robust reference prices, with the potential to support increased trading of financial products that can be settled against the physical market. Financial market participants are beginning to re-enter the market, which is likely to help increase churn. This activity should be encouraged and given time to develop.

Price availability outside of the market making windows has significantly diminished. Whilst we have no reason to believe prices are any less reflective of the value of underlying contracts, it is clear that the lack of market depth makes it more difficult for market participants to react to changes in market fundamentals or their own availability/capability to deliver volume.

We believe the mandatory 5% maximum bid-offer spread is set at an appropriate level. We acknowledge that the narrower, short term bid-offer spread caps may be too restrictive, particularly when the market is volatile, resulting in increased risk (costs incurred) for obligated parties.

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.

There does not appear to be any clear evidence that net product *availability* has changed – those contracts available within the market maker windows are also available outside of the windows.

We note that the years cited in the consultation document (2013 and 2016) were subject to specific market conditions. For example, given the higher gas and electricity price volatility experienced in 2016 (Fig 14 and Fig 15), we would expect to see higher levels of trading activity, irrespective of whether the windows were in place. This view is further confirmed by Fig 12, which shows that the bulk of the increase in 2016 traded volumes occurred between September and December 2016, which coincided with a sharp jump in volatility.

In regards to concerns that product availability reduces further out along the curve, we consider this to be a natural feature of the market as availability is reflective of consumers' requirements to lock in supply contracts.

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.

The near term market has good levels of liquidity and we note that trading activity has steadily increased since 2011. We believe this is due to a number of factors:

- The changing generation mix has seen a large increase in intermittent renewable generation deployment, which has led to a corresponding increase in short term optimisation actions. Higher levels of trading activity in the near term market (versus the forward curve) is expected as it is closely linked to short-term physical supply and demand fundamentals (e.g. scheduling of generation, demand and residual balancing).
- The introduction of the CfD investment instrument will lead to an increase in near term trading as generators that are allocated a CfD are incentivised to trade in line with the associated market reference price. This is required in order to realise the full value of the contract strike price.
- Market conditions have prevented thermal generators from locking in positive spreads across the forward curve, creating a greater reliance on capturing short term scarcity rents.

The key impact of the market maker windows is that *liquidity has simply concentrated* in two daily windows. The concentration of short term liquidity poses a challenge for physical asset owners,

particularly when they wish to trade for purposes other than position optimisation, i.e. due to short notice physical loss of load or forced outages.

Like any physical asset owner, Drax facilitates liquidity in the prompt market by virtue of trading around a marginal cost of production. If prices are marginal, then a small move either way could dictate that we are a buyer or a seller.

Retail participants are also experiencing reduced hedging capability outside of the liquidity windows. Retail businesses require access to market products when customers wish to lock in their energy needs, which occurs throughout the working day. Maintaining open positions until products are available via the liquidity windows increases their market exposure, thereby the cost of supply.

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.

The analysis appears to be in line with our observations. The factors identified by Ofgem to assess liquidity are appropriate and in accordance with the fundamentals of liquidity theory, for example: number of bids/offers/acceptances; types of contract; bid-offer spreads; total volume traded; and churn.

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?

In more benign periods, it has been observed that the current market making design has concentrated liquidity, with trades being conducted over the shorter liquidity windows rather than spread throughout the day. As noted above, this can pose a problem for physical asset owners where the transactions are for purposes other than position optimisation, i.e. due to short notice physical loss of load or forced outages.

In more extreme conditions, for example a substantial system stress event, obligated licensees are more likely to have their market making obligations suspended by the fast market provisions, therefore it is questionable as to whether there would (a) be sufficient active quotes available in these periods or (b) there would be high levels of liquidity due to parties (obligated and non-obligated participants) having an increased requirement to optimise their market position. We do not believe there has been a period of prolonged extreme volatility since implementation to test the market maker rules under such conditions.

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 some minor modifications should be considered.

The fast market rules are necessary to protect obligated licensees in periods of extreme market volatility. Such rules are an important feature of market making and are often incorporated into obligations on exchanges. Fast market rules should act as a pause function that enable market makers to withdraw from the market whilst the situation stabilises. Such rules should not allow obligated participants to withdraw from the market for the entire window, subject to market conditions meeting appropriate criteria to resume the market maker service.

It may be reasonable to implement a shorter withdrawal period, for example ten minutes. This would better align the market maker rules with those found in other markets, whilst remaining proportionate in light of current electricity market liquidity (examples being Nasdaq or the London Stock Exchange¹). We also note that there is no reference time associated with the 4% price move to define “fast”, for example prices increasing/decreasing by 4% in x minutes – this should be appropriately defined.

We also agree that the volume cap is a necessary protection for obligated parties. It should be noted that a participants' exposure is not lessened by this cap, in that the residual position still exists. The party may remain at risk of further market moves if they are not actively managing and reducing the position. We note that whilst the volume cap enables participants to refrain from posting bid-offer prices

¹ Nasdaq's market making agreement, appendix 5. http://www.nasdaqomx.com/digitalAssets/75/75099_mmagreementpower.pdf and London Stock Exchange's para 8.3 <https://www.lseg.com/sites/default/files/content/documents/LSE%20Derivatives%20Market%20-%20Market%20Making%20Agreement%20FINAL.pdf>

upon reaching the cap, it does not obligate them to do so. Analysis on how liquidity changes as obligated parties reach the volume cap would be beneficial.

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

We are currently unaware of any issues in relation to the SMA rules. We note, however, that there has been an increase in small suppliers opting for the Direct Market Access (DMA) route provided by some banks and utilities. This allows access to the counterparty's credit line in order for them to trade in the OTC market. The DMA provider then makes a charge per MWh to the supplier for this transaction.

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

MiFID II has been a key consideration throughout the lifecycle of Secure and Promote. However, we understand there is now clarity that any trades undertaken for liquidity support purposes are treated as "privileged transactions", thereby exempt from the RTS 21 Ancillary Activities Exemption threshold calculation.

Cash-out reform and the move to PAR1 in November 2018 will incentivise suppliers to balance their position to a greater degree of granularity to avoid extreme system imbalance prices, particularly in times of high volatility. The move to mandatory half hourly settlement may also incentivise suppliers to hedge their own bespoke shape, rather than standard baseload and peak products.

We note that the definition of a "market maker" should not include taking a directional view – this fundamentally differentiates market making trades from speculative trades.

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

Obligated licensees require certainty on (i) market rules and (ii) expected behaviours. An appropriate level of protection should be built into the rules, rather than adding the risk of short term, reactionary changes to the requirements of obligated parties.

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.

The cost of delivering the Supplier Market Access Rules is minimal. In terms of market making, Drax does not have experience in this area, although we note anecdotal evidence from existing obligated parties suggesting the cost of compliance is disproportionately high. Costs will likely vary depending on the resource and experience of obligated participants. It is unclear as to whether the figures quoted to date are an unavoidable cost of compliance (due to features of current market rules) or due to inexperience in market making. It would be useful if Ofgem were to explore this further.

There are examples of markets that have voluntary market makers, which suggests that with the right rules and protection, market makers may be able to break-even or profit from the activity. This outcome will be dependent on the level of experience in market making, the financial support afforded to the business and the business model employed (e.g. the use of proprietary trading desks).

Theoretically, a market making book has a similar risk profile to a short volatility position, in that it should be profitable during periods of low volatility, where the market maker is able to capture bid-offer spreads as each side of the market is traded. In contrast, the market making book is likely to lose money in periods of high volatility as prices move further through the bid-offer price ladder. Therefore, one period cannot be viewed in isolation.

It should be noted that the Secure and Promote market making obligation is mandatory and obligated parties have only been able to exit the regime by divesting parts of their businesses. This is a very different proposition to a voluntary scheme and should be viewed in that light when setting policy in this area.

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?

Gradually extend the windows

One solution would be to extend the market making windows. Ideally liquidity should be encouraged across the day, but an initial extension to each window may provide a pragmatic starting point. This could enable better price discovery beyond the current two hours of concentrated activity, whilst ensuring liquidity pools are not significantly diminished.

This may also help mitigate the concerns raised in para 3.14 of the consultation, namely that a significant reduction in liquidity outside the liquidity windows limits trading opportunities and may act as a disincentive for financial players to enter the market. Enabling greater access to physical products will encourage the growth of financially-settled contracts, as there will be greater confidence in the ability to physically settle contracts at a later date (please see related comments under Q12).

An extension of the trading window, accompanied by suitable fast market protections, may also lower obligated licensees' net costs. Obligated licensees would have an increased opportunity of capturing the bid-offer spread as there would be more opportunity to trade on either side of the market and close out positions before the market making window closes.

Employ professional market makers

As a greater proportion of domestic customers switch away from the traditional Big 6 suppliers, the move to a socialised market maker may be a more appropriate and proportionate solution. This could be achieved by continuing to obligate market participants to provide the service or by contracting one or more proprietary trading businesses (within or outside the sector) to deliver the service – under either approach, the cost would be recovered from the wider market (hence “socialised”).

An alternative would be to commercially incentivise professional market makers to sign up to trading venues (e.g. financial institutions or trading businesses that provide such services to other markets), similar to the scheme in place in the Nasdaq/Nordpool markets. We encourage Ofgem to explore this option to understand how this cost recovery approach is used in other markets and its appropriateness for the GB market.

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

There are some noteworthy features specific to the GB power market that hinder liquidity growth. There are also some recent developments that could create consequential improvements in power market liquidity, including changes in the initial drivers behind Secure and Promote.

Market participants

A significant number of intermediary and financial counterparties exited the physical commodity markets due to increased capital costs and the wider regulatory burden imposed by REMIT, EMIR and the impending reform to MiFID. The majority of remaining participants, and subsequent new entrants, are physical market participants whose trading activity is structured to reduce risk and progressively hedge generation assets and/or retail exposures. In doing so, they tend to trade within predefined hedging risk limits, rather than speculating on future market movements as financial institutions may be more inclined to act.

Market restructure

The business models of some obligated licensees are undergoing change. The divestment of Uniper resulted in a physical separation of E.ON's thermal generation business from its retail portfolio, resulting in the removal of the licence condition. Further restructures, divestments and plant closures amongst the remaining obligated parties will likely lead to a greater split of generation and retail portfolios over the coming years. Conceivably, these business restructures will increase the number of trading participants, which can only be a positive development. This may bring into question the current design of the market maker regime.

Market re-entry

We understand several banks are in the process of re-entering the market to trade financial power products (Power Swaps). There is growing confidence in the LEBA weighted average price as a robust index price. Whilst at an early stage, this is a positive move that should be given time to develop.