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CALON energy
passionate about power

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19 September 2017

Dear Matthew and Hannah,

Secure and Promote Review: Consultation

Calon Energy operates 2.1GW of flexible gas-fired generation assets at Baglan Bay, Sutton Bridge and Severn Power, as well as pursuing new build options at our Willington site. The company deploys international investment capital, and is keen to participate in the continued development of a sustainable, secure and economically-efficient electricity sector. As a headcount-light organisation we manage the bulk of our operations through contracts with suppliers - including a route-to-market, wholesale market access agreement with a bank.

In answering this consultation it is worth noting what creates a successful market and what design principles a market should have and assess whether the S&P policy upholds these concepts:

Successful markets a) bring sufficient buyers and sellers together to b) determine price and a volume at which they are prepared to transact and c) provide feedback for future decisions.

We hold the following principles for the design of markets:

- Inclusivity – promotion and incentivising wide and active participation
- Transparency – making methodologies, inputs and outcomes accessible and visible
- Fairness – creating mechanisms that are not able to be gamed and are non-discriminatory
- Reliability/sustainability - providing outcomes that are acceptable for both participants and society as a whole
- Frictionless - minimise transaction costs to ensure the gains of trade are going to the principal participants which in turn should increase participation

With this in mind please find our response to the questions below.

Response to 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.

Prices for forward delivery are robust inside the market making windows, as mandated spreads appear to achieve the objective of providing regular price transparency. However, with the windows providing a focal point, liquidity outside of the windows tends to be less.

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.

The windows promote greater availability of mandated products but not necessarily non-mandated products. The market is fast changing towards more flexible generation and renewables that are creating a landscape where shape risk is considerable, especially for businesses that are not vertically integrated. So whilst the provision of base and peak products enable efficient hedging of commodity risk, it does not facilitate effective hedging of shape risk in forward time horizons.

A periodic tender process throughout the year for shape products may help facilitate hedging of shape risk if they cannot be included in the windows.

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.

Whilst there are usually no apparent constraints in liquidity for EFA Block OTC Day Ahead products, frequent paradoxical rejection in the N2EX auction is a cause of concern and brings into question if this is a credible index and reliable hedging medium. This risk and uncertainty means the DA auction is viewed as a 'last resort'.

A multistage auction might be more conducive to optimizing our assets and providing greatest liquidity in both whole profiles and hourly shape. The first stage would consist of whole profiles i.e. baseload, peaks, extended peaks, off-peaks and overnights, before proceeding to the second stage for finer granularity products i.e. EFA block and hourly profiles.

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.

Although the evidence provided is not sufficient to verify that the policy has increased liquidity per se, we believe that prices of some mandated products have become more transparent through the policy.

Bid-offer spreads are only reported at the end of the afternoon (market making window) in the analysis. This could be widened to monitor spreads across the whole of the trading day.

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?

During times of market volatility the windows will most likely serve to promote liquidity as market makers inject liquidity by providing volumes and potentially balancing consequential positions.

When prices do not vary significantly day on day then market participants might be more willing to enter the market as they have greater confidence in the price levels of products, thereby diluting market makers' influence on liquidity.

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

The volume cap rule would appear more effective in managing participants risk as markets are rarely volatile enough to trigger the fast market rule.

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

NA

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

Regulatory intervention tends to reduce investor confidence, so further significant modification of a policy that appears to be working should be avoided in our view for now. That said, the ultimate goal should be to develop wholesale markets that are sufficiently liquid so that the S&P policy can be lifted. We believe that this would provide signals to investors that they should have confidence that the market is working and risks can be efficiently and effectively managed.

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

We believe the license condition is working, and would require more guidance and information to answer this question as the references to flexibility and certain market conditions are too ambiguous.

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.

More transparency around the costs incurred to licensees would help identify and substantiate any concerns over it, as the consultation document indicates that ongoing costs were significantly below forecasted.

If current market makers are concerned over cost, then we suggest regulating the activity and compensating market makers for the service provided and putting the service out to tender which will also encourage others to come forward, as well as allow for increased flexibility. Otherwise socializing the cost across all market participants seems sensible, akin to BSUoS.

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?

There are other factors, such as underwriting credit, that should be focused upon and more innovative solutions like periodic tenders/auctions for shaped products.

Furthermore, the disparity between an increasingly fragmented supply market whilst the generation side remains relatively concentrated indicates greater structural changes could increase liquidity. Lastly, suppliers should focus more attention to their energy and credit risk management which would make them trade more frequently.

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

NA

Yours Sincerely,

Phil Robinson
Head of Commercial
Calon Energy