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Camilla Egginton
GB Markets
Ofgem
9 Millbank
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Our Ref: GS-000464

10 May 2012

Dear Camilla Egginton,

Re: Intervention to enhance liquidity in the GB power market

Introduction

RES is one of the world's leading renewable energy developers working across the globe to develop, construct and operate projects that contribute to our goal of a sustainable future. We have a portfolio of low-carbon energy technologies and a range of services which together can meet demand from the industrial, public and commercial sectors on whatever scale.

RES has been an established presence at the forefront of the wind energy industry for over three decades. Our core activity is the development, design, construction, financing and operation of wind farm projects worldwide. With a portfolio of more than 5GW constructed and several thousand megawatts under construction and in development, RES continues to play a leading role in what is now the world's fastest growing energy sector. RES is also involved in the offshore wind and wave and tidal sector.

RES welcome the opportunity to respond to Ofgem's consultation on the Retail Market Review: Intervention to enhance liquidity in the GB power market and we hope you take our comments into consideration. Key points to note in our response are:

1. The needs of independent generators are not being met by Ofgem's objectives, assessments and proposals in this consultation. The consultation focuses on small suppliers and does not fully consider the liquidity requirements of other market participants. As an independent generator we believe our issues with liquidity lie outside the scope of this proposal and still need to be considered and addressed. At present the vertically integrated nature of the market and lack of liquidity means we require Power Purchase Agreements (PPAs) with one of the Big Six suppliers in order to secure project finance for our developments. It is vital that the wholesale market is made highly liquid so that independent aggregators and traders can be attracted into the market to compete with the traditional PPA providers.

2. RES believe monitoring and evaluating the number of aggregators active and the type of trading activity in the market is a key feature of a good quality wholesale power market and should be considered in more detail by Ofgem. There are currently insufficient numbers of aggregators in the market because of liquidity issues in the near-term and longer-term markets.

3. RES believe additional action is needed by Ofgem for the market to meet the objective of new aggregators entering into the market, the near-term market needs to be the most liquid market and this will foster liquidity further along the curve. Whilst liquidity in the near-term market can be said to be improving but it is only after the threat of regulatory intervention, and could be easily withdrawn again. This insecurity, coupled with historical experience is likely to deter new entrants.

4. With the potential move towards more marginal cost based cash-out arrangements. Liquidity in the near-term market becomes far more important to minimise the risks of punitive balancing costs on generators with a smaller portfolio of assets.

5. The timescales being discussed are too long given the timescales needed to see real improvement before the introduction of the Electricity Market Reform (EMR). For the Contract for Difference Feed-in Tariff (CfD FiT) proposals within the EMR to work effectively it is crucial that investment incentives paid to low-carbon generators are linked to a robust wholesale market reference price. This is the only way to ensure the correct market signals exist and generators can benchmark their investments off a robust reference price. However, we believe it is being left too late to establish robust reference prices before the introduction of CfD FiTs in April 2014.

6. Some form of invention is necessary urgently before any further market difficulty arises from liquidity constraints. We understand and agree with Ofgem's desire for a market led solution, however, this has not happened to date and we believe it is unlikely to do so as quickly as is needed. DECC has repeatedly stated that it is relying of Ofgem to resolve liquidity problems in the GB market to ensure successful implementation of the EMR and the current reform proposals will not achieve this.

Overall we are concerned by the apparent lack of analysis that is presented in this consultation. There needs to be robust analysis undertaken by Ofgem into the impact on the GB power market of all the potential mechanism to support liquidity. Without this analysis it is difficult for us fully evaluate the proposals put forward in this consultation.

<u>Consultation Questions</u>

CHAPTER: One – Objectives for Liquidity
Question 1: Do you agree with the objectives we have identified?

RES believe it is critical that liquidity in the GB power market is sufficient to underpin competitive generation and supply markets. For that reason the needs of independent generators must be adequately considered. Section 1.6 of the consultation states: "it is also important for consumers that the wholesale market supports sufficient investment in generation, since this is important for security of supply." Ofgem identify an outcome of an effective wholesale market to be "investment in generation". This outcome should be broken down to also include the level of investment in generation by independent generators and new market entrants.

Please see further details in our responses to the questions below particularly question two which outlines in detail why we believe the needs of independent generators have not been adequately considered in this consultation. Therefore, the needs of independent generators are not being met by Ofgem's objectives, assessments and proposals in this consultation.

Question 2: Do you think there are other objectives we should be considering?

RES believe monitoring and evaluating the number of aggregators active in the market is a key feature of a good quality wholesale power market and should be considered in more detail by Ofgem. There are currently insufficient numbers of aggregators in the market because of liquidity issues in the near-term and longer-term markets. We believe aggregators are unwilling to enter into the market by for example buying a season ahead product when there is so much uncertainty about whether they could sell the power at all and at what price closer to delivery. This is due to the limited number of suppliers for aggregators to sell their power to. Small suppliers do not often have a credit rating or trade sufficient volumes. Furthermore, there will be additional volatility in the day-ahead market going forward if the increasing trading volumes remain the reserve of a few large vertically integrated players. Along with an increasing role of independent renewable generation in the near-term market (onshore and offshore wind).

At present and even because of the liquidity review itself the power market is just too uncertain and complex to encourage aggregators to participate. In the example of the liquid Nordpool market which contains a number of specialist aggregators: “volumes traded in the Nord Pool Elspot day-ahead auction market around 70% of demand”. This is interesting given the MA will only trade around 4% of total UK demand. Also there are many more counterparties and suppliers in the Nordpool than in the UK.

The consultation focuses on small suppliers and does not fully consider the liquidity requirements of other market participants. As an independent generator we believe our issues with liquidity lie outside the scope of this proposal and still need to be considered and addressed. At present the vertically integrated nature of the market and lack of liquidity means we require Power Purchase Agreements (PPAs) with one of the Big Six suppliers in order to secure project finance for our developments. It is vital that the wholesale market is made highly liquid so that independent aggregators and traders can be attracted into the market to compete with the traditional PPA providers. At present PPA terms typically include discounts on the wholesale electricity price and ROC value. With the removal of the obligation on suppliers to procure renewable electricity as put forward as part of the EMR proposals, this will reduce suppliers’ interest in offering PPAs to renewable generators. We fear that without new entrants and aggregators coming into the market PPA terms will deteriorate and greater discounts will be applied. It is therefore vital that the wholesale market is made highly liquid so that the new entrants and aggregators are attracted into the market and to avoid a deterioration in PPAs terms and higher costs being passed onto the consumer to maintain the same level of renewable build out.

CHAPTER: Two – Market Developments
Question 3: Do you agree with our views on market developments since summer 2011?

RES broadly agree with Ofgem’s review of developments. Further out products are not liquid and liquidity review itself is affecting trading and causing additional liquidity constraints. Moreover, Ofgem should continue using multiple quantitative and qualitative measures to monitor liquidity.

Question 4: What specific further developments would be necessary to meet our objectives?

As discussed above we believe there should be additional objectives of the number of aggregators active in the market and the ability for new renewable electricity projects to be able to secure a Power Purchase Agreements (PPAs) within a fully competitive market, with actors beyond the current incumbents.

Furthermore, RES believe additional action is needed by Ofgem for the market to meet objective three, the near-term market needs to be the most liquid market of all to bring about more liquidity further along the curve. The timescales being discussed are too long given the timescales needed to see real improvement before the introduction of the EMR. For the CfD FiT proposals within the EMR to work it is crucial that investment incentives paid to low-carbon generators are linked to a robust wholesale market reference price. This is the only way to ensure the correct market signals exist and generators can benchmark their investments off a robust reference price. However, we believe it is being left too late to establish robust reference prices before the introduction of CfD FiTs in April 2014. Although Ofgem are of the belief that the market appears to be moving towards achieving objective three and has been done so in part by welcome moves by SSE and E.ON to sell their power through the day-ahead auction. There is limited confidence that this will remain, unless it becomes more widely replicated across the market and with a limited number of market participants there is a risk of greater volatility in the market, which will ultimately increase the cost to consumers.

If no action is taken at this stage to meeting objective three it is essential that Ofgem keep a watching brief on developments in this area.

Question 5: Do you agree that objectives one and two are current priorities given market developments?

Meeting objectives one and two are crucial to provide market development. However, please see comments to question four above regarding the importance of actions which are needed to meet objective three.

CHAPTER: Three – Mandatory Auction Proposal
Question 6: Do you agree that the MA is the appropriate mechanism to meet our immediate objectives?

Some form of invention is necessary urgently before any further market difficulty arises from liquidity constraints. We understand and agree with Ofgem's desire for a market led solution, however, this has not happened to date and we believe it is unlikely to do so as quickly as is needed. DECC is relying of Ofgem to resolve liquidity problems in the GB market to ensure successful implementation of the EMR as discussed above.

The Mandatory Auction could be viewed as the appropriate mechanism to meet the needs of small suppliers because it will bring in the products to meet small suppliers requirements. However, for the Mandatory Auction proposal to be robustly deemed an appropriate mechanism, auction theory needs to be worked through and published. Calculations of which Big Six suppliers are long or short or which have more baseload than peak needs to be produced by Ofgem and published. This will enable the market to really see what will happen by these auctions and reduce market uncertainty. Proposals and consequences need to be made available and open to review by the market. Otherwise it will lead to much uncertainty and instability than already present in the market. Furthermore, publishing this information may in fact reassure the market that Ofgem's proposals will be successful.

However, the Mandatory Auction proposals as they stand at present will not meet the needs of all market participants, notably independent generators. The Mandatory Auction may support the growth of independent suppliers. However, this is unproven and it will take time for them to grow to a size which will allow them to offer PPA's. There are also concerns that the Mandatory Auction will just move liquidity away from other existing platforms or OTC trades and not introduce any more liquidity into the market overall. The Mandatory Auction will also not improve GB power liquidity in time for the commencement of CfD FiTs in April 2014. This is particularly true if supply licensees appeal Ofgem's decision to introduce the Mandatory Auction.

Furthermore, the Mandatory Auction proposal equates to a temporary fix not a long term solution. The Mandatory Auction proposals may work for small suppliers and enable them to grow but what will happen when the current small suppliers grow and need more volume than that available through the Mandatory Auction to continue growing. How long Ofgem envisage the Mandatory Auction continuing for and what will happen to the market when it stops needs to be considered. We believe it cannot be viewed as a long-term viable solution.

Question 7: Do you agree that, at the present time, the other mechanisms identified would not be appropriate for Ofgem to pursue?

At present continual development of the chosen mechanism is needed. This is necessary as assessment and implementation of an intervention mechanism is time consuming. It is preferable to be ready with a solution that is not implemented than to halt progress now and recommence at a later date. Even if none of the proposed mechanisms are ever implemented, the threat of implementation should be maintained to continue the market led developments that are currently being seen.

There are other mechanisms which could also improve liquidity and should be considered by Ofgem as assisting the liquidity work rather than a liquidity solution. Another mechanism which could potentially improve liquidity and should be pursued by Ofgem along with the current work on liquidity is the work stream needed for GB to comply with the EU Target Model. Market coupling offers potential for liquidity improvements but it needs to be looked into in more detail and will take time for it to develop. The proposed "BG Hub" will improve access to at least near term products. Although, RES would like to stress it would not be appropriate for Ofgem to wait for this to be introduced.

We believe that Mandatory Market Making (MMM) could have been a good solution for providing the liquidity that was required in the near-term market. With the potential move towards more marginal cost based cash-out arrangements. Liquidity in the near-term market becomes far more important to minimise the risks of punitive balancing costs on generators with a smaller portfolio of assets. Cash- out reform should also be considered by Ofgem as part of the liquidity work stream.

CHAPTER: Four – Proposed Detailed Design Features
Question 8: Do you agree with the key features of the MA we set out?

To outline the detail necessary to respond effectively to this question, we have chosen to breakdown our response into the key features of the Mandatory Auction:

- **Obligation Definition** – Ofgem need to reconsider how the annual generation required by obligated parties to sell into the Mandatory Auction is defined. Section 4.27 of the consultation states that an obligated party's annual obligation: "would include output from generation plant which is not owned by the obligated party, but which has been reallocated to the production account of the party or their affiliates due to a tolling agreement". However, we are concerned by defining the volume required for the auction in this way as it will further disincentive the Big Six from offering PPA's. Particularly to renewable variable forms of generation such as wind. Therefore, we would like to propose that the definition of annual generation does not include renewable forms of generation. Along with the removal of the obligation on suppliers to procure renewable electricity as put forward as part of the EMR proposals, this will reduce suppliers' interest in offering PPAs to renewable generators even further.

- **Volume** – The volumes proposed for the season ahead in the Mandatory Auction is less than that which is currently traded through the NFPA auctions which small suppliers use as a good platform to buy power. The NFPA auction also represents a premium power product as the green power comes with ROC, LECS and REGOs. However, this auction has not improved liquidity sufficiently and introduced aggregators into the market so the success of the Mandatory Auction could also be limited.

  Our calculations indicate that 4% of total annual demand will pass through the Mandatory Auction as roughly 100TWh a year is generated by non-Big Six generators. The direction of where this 100TWh currently goes needs to be addressed. This volume in all likelihood goes to the Big Six through long term contracts. An additional positive outcome of the MA proposal would be the breaking of these contracts to bring more liquidity into the market. Also from our calculations about 6% of demand was supplied by small suppliers.

- **Products** – The products outlined in the consultation seem broadly appropriate and should meet the needs of most small suppliers. However, it would benefit all small suppliers, particularly the smallest if the Mandatory Auction was a one stop shop for all their power requirements. This would be possible if the Mandatory Auction included a near-term auction as well. This may also lead to more aggregators in the market.

- **Credit** – A fundamental consideration of the platform chosen is the credit requirements for participants and more detail than that presented in the consultation is needed. The credit requirements for the Mandatory Auction need to be outlined as this is one of the significant drivers of the illiquid market. The consultation states there will be credit and collateral requirements but Ofgem will "seek to ensure that the Mandatory Auction is as accessible as possible for independent market participants." The Mandatory Auction needs to be accessible otherwise it will be redundant. However, controls do need to be in place to protect all participants. The credit requirements for the Mandatory Auction will impact the ability of small players to purchase the further out seasons (up to 3 years ahead). So it could be that only the Big Six participants purchase the longer dated products or perhaps aggregators come into this area, if the prices are robust.

- **Frequency** – Auctions taking place only once a month could lead to stagnation in the market before each auction and volatility afterwards. Also, only holding auctions once a month leaves very little movement of when to trade. The obligated parties could potentially game the market. If it is a continuously traded market they would not be so able to do that. Furthermore, if the Mandatory Auction takes place only once a month if it happens to coincide with a price spike it will not help small suppliers.

- **Flexibility** – It is essential that market participants are able to access the products they need through the Mandatory Auction therefore, the Mandatory Auction should be designed to enable flexibility for new products to be added when needed.

- **Safeguards (buy-side rules)** – Please see our comments to question nine below.

Question 9: Do you consider it appropriate to have buy-side rules in place and do you have any comments on the detail of such rules?

This is a particular area of the Mandatory Auction proposals in which it is difficult for us to evaluate effectively given the lack of analysis presented in the consultation. To support this proposal the market analysis of how the buy-side rules will work in practice needs to be fully considered and presented by Ofgem. At present it is difficult to see the impacts Ofgem expect the buy-side rules to have on the Mandatory Auction. The inclusion of buy-side rules will lead to a distorted market. However, we cannot accurately assess whether this distorted market will be a high cost market which will exclude small suppliers or an artificially low cost market which will unsustainably support the growth of small suppliers away from the real market. Either eventuality will not support the growth of small suppliers in the long term. As started in our response to question six we do not believe the Mandatory Auction proposal is as a long-term viable solution.

Furthermore, there is potential the obligated parties could over sell one month and over buy the next or vice versa to keep a balanced cycle or positions. This could lead cyclical price distortions in the auctions. This trading may appear to improve churn but it will not support the growth on independent suppliers and generators.

The buy-side rules could also increase volatility in the market. Given the obligated parties will have to auction plus or minus 5% of their obligation, they will have to sell or buy this power back after the auction which could lead to volatility directly afterwards. If prices suddenly spike or drop it is more risky for smaller participants.

The penalty for breaching the buy-side rules needs to be sufficiently defined in order to act as a real deterrent. This should be the same as a supply licensee breaching any of the Supply Licence Conditions, up to ten percent of turnover.

CHAPTER: Five – Identifying a Platform

Question 10: Do you consider that there are benefits and risks to the approaches that we have not identified?

Overall it is difficult to respond effectively to this question without knowing the full details of the structure the Mandatory Auction will take. Ofgem have covered the main benefits and risks to the approaches of identifying a platform.

Question 11: Which approach do you consider is best placed to deliver our objectives at least in terms of cost and risk?

Again, it is difficult to answer this question without knowing the full details of the structure the Mandatory Auction will take. It makes sense to use an existing platform which works well for small suppliers and expand upon this, for example the NFPA power auctions offer payment on delivery contracts and 50% of all purchases on the NFPA power auctions goes to small suppliers. Furthermore, the NFPA power auction provides a valuable route to market for independent generators. It would also not be sensible for a new platform to be introduced.

Additionally, it would also not be preferable to split the Mandatory Auction across more than one platform. If more than one platform is chosen it would prove an administrative nightmare and would result in splitting of volume and therefore prices. Whichever approach taken the tender for the platform needs to be fully governed.

The platform chosen must be fully and easily accessible to aggregators. The aggregators will enhance liquidity by offering new products to small suppliers and offering a route to market for independent generators.

Question 12: Do you consider that both approaches are able to meet our objectives?

Both approaches could meet the objectives but in accordance with our response to question eleven above the platform criteria should be: no new platform, a single platform only and be accessible to aggregators.

Conclusion

RES are grateful for the opportunity to comment and look forward to your response along with your minded-to position which will include your final proposals in Summer 2012. We hope you take our comments on board and welcome any further contact in relation to this response.

Yours sincerely,

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