To all stakeholders

Promoting choice and value for all gas and electricity customers

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Dear Stakeholder

Retail Market Review: GB Wholesale market liquidity update

The aim of the liquidity project is to enable independent suppliers and generators to access the wholesale market products and price signals they need to compete effectively. From the outset, we have been clear that industry-led initiatives could deliver the improvements needed to meet this goal.

In our February 2012 consultation document[1] we split this overall goal into three key objectives for the wholesale market. In order to effectively support competition, the wholesale market must deliver:

- Availability of products that support hedging
- Robust reference prices
- An effective near-term market.

We issued a challenge to industry to meet these objectives. We also set out detailed proposals for a form of Mandatory Auction (MA), for Ofgem to implement in the event that the market does not develop and our objectives are not met. Our intention was to subject the emerging design to a 'roadtest'. In line with this, we have now concluded a productive period of stakeholder engagement.

This letter is an update for stakeholders. It reflects how industry has responded to our challenge and the results of the MA roadtest. It also sets out our next steps. Our overall message is that we have seen positive industry-led developments which could signify progress towards our objectives. However, further progress is needed, so we will continue to develop the detailed design of the MA at this stage. We will also continue to monitor market developments – and seek market participants' views on these developments – and our final decision on intervention will reflect these.

There have been positive responses to our challenge; but more is needed

We are encouraged that industry participants are beginning to respond to the challenge we set, and note efforts being made by the large vertically integrated suppliers to improve product availability and the transparency of their trading. We highlight some key actions being taken at annex one. These actions represent important steps towards meeting our objectives. Table 1 summarises progress. In particular we think that the efforts being made to improve trading with small suppliers[2] could make a difference to our first objective.

[1] Retail Market Review: Intervention to enhance liquidity in the GB power market: http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=84&refer=Markets/RetMkts/rmr
[2] By making clear commitments

Further, we recognise that there are plans to improve futures trading along the curve and that while these have not yet fully developed, they could help to secure objective two.

However, market developments have not yet driven significant change to our liquidity metrics – we present key figures at annex two. By way of headlines: churn in 2012 is still in decline and trading in longer-dated physical products has not increased. Further, while there have been increased volumes traded in financial products, the volumes remain uncertain and are small compared to the rest of the market.

Objectives	What we are looking for[3]	Market developments
Objective 1: availability of products which support hedging	• Market participants able to access a range of longer-dated physical products • Reasonable and transparent trading terms	✓ Several large suppliers have published commitments to trade with independent suppliers; SSE's have been well-received[4], otherwise feedback from independents is limited × No increase in trading of longer-dated physical products
Objective 2: robust reference prices	• Robust prices in longer-dated products • Narrow bid-offer spreads along the curve	× Bid-offer spreads along the curve have widened for most products ✓ Futures trading has increased, although volumes remain low/uncertain; non-specific plans by some of the large suppliers to further increase futures volumes traded ✓ Emerging plans to develop week-ahead trading
Objective 3: effective near-term market	• Significant trading in day-ahead volumes • Reasonable and transparent trading terms • Independents able to meet shaping requirements	✓ All of the large VI suppliers have now set up gross-bidding arrangements on N2EX ✓ Stakeholders broadly in agreement that gross-bidding is a positive development[5] ✓ Generally the intra-day market offerings[6] are deemed sufficient at present[7] ✓ GB market coupling via the 'virtual hub' should also enhance near-term liquidity

Table 1: Market developments and the status of our objectives

As can be seen from table one, our objectives one and two are currently only partially addressed by industry initiatives and further progress is required in a number of areas.

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[3] As set out in our February consultation document
[4] Based on ad hoc feedback from independent suppliers
[5] Please note that we would like to explore this further – and welcome views
[6] Which includes brokers as well as two exchange platforms – N2EX and APX
[7] Though we recognise concerns from some market participants that intra-day liquidity may be put under increasing pressure as more renewable generation is developed.

We would like to understand the impact developments are having, and any limitations

Below we set out specific issues we would like to discuss with market participants, particularly independent players, in relation to our objectives. These are intended to facilitate an ongoing conversation to help us understand the progress of developments and the impact they are having, and to explore how existing industry commitments could be enhanced. We are keen to meet with any market participant with views on these issues. We will also consider opportunities for further group discussions with market participants.

Objective one

We recognise the role that bilateral trading arrangements can play in helping independent suppliers meet their hedging needs. However we remain concerned that reliance on high-level and voluntary trading commitments may not meet independents' enduring needs. While these commitments could play a role, we think it is important that they are specific[8] and enduring. We are also concerned that indicators of trading along the curve continue to suggest a lack of trading in longer-dated products, and especially peak products. Until we can be certain that independents are able to access key products, we will continue to develop our intervention proposal. Under the MA, core products would be transparently and reliably auctioned in each round (eg every month).

We would like to explore how far bilateral trading commitments are meeting the needs of independent suppliers.

Objective two

To date, the steps being taken to increase longer-dated trading and improve the robustness of reference prices along the curve are non-specific (eg general plans to increase futures trading) or potentially limited in scope (eg plans to improve week-ahead trading[9]). We are especially concerned that none of the commitments are specific about when they will be implemented. While we appreciate that the policy environment (for example uncertainty regarding the Carbon Floor Price) increases the risk of trading more than two years ahead of delivery, we remain of the view that greater progress is required even for products within this time period. Robust reference prices are also important to the successful implementation of the Government's Contract for Difference (CfD) mechanism which is intended to support investment in low-carbon generation.

The MA proposal we set out in February was designed to reliably produce robust prices for key products[10] along the curve. To meet our objective, we need to see more developed and specific plans to bolster longer-dated trading and improve price robustness. We accept that there is no consensus on what constitutes a 'key product' or on how far the curve can be stretched. We want to understand what is feasible, and by when.

With regards to objective one and two, we would also like to explore the role that futures trading has in helping independent suppliers and generators meet their needs. We are also keen to understand the role that these products can play in encouraging the participation of financial players in the market.

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[8] For example, setting out clear approaches to pricing and credit and collateral

[9] Though we recognise that this could, in time, bolster liquidity along the curve.

[10] As provisionally set out in our consultation document and anticipated to be subject to further discussion by a Working Group in the event that the MA is taken forward.

Objective three

We agree with the majority of respondents that, in line with our February assessment, commitments to trade greater volumes on the near-term market are helping to meet this objective. We also note that as the GB market is integrated with Europe at the day-ahead stage[11] following the implementation of the GB 'virtual hub[12]' we could see further improvements in near-term liquidity. However, we will continue to keep this objective under review and will consider whether improvements to near-term liquidity could bolster liquidity along the curve.

Crucially, across all of our objectives, where we have seen progress we need to be confident that this will be sustained.

We are refining the MA design following the 'road-test'

The majority of respondents to our consultation considered that action is required to improve liquidity in the GB power market. We summarise responses to the consultation and capture some key themes from two well-attended roundtable events at annex three.

Disagreement remains over the best course of action and the market continues to evolve. However until progress towards our objectives is significant and sustained, we still think that it is appropriate to develop the MA. Several independent market participants agree that in making sure that key products are transparently sold on an accessible platform, the MA could secure our objectives. However, we recognise that such support is qualified with a desire to see further detail.

Table 2 highlights some key challenges that have been raised during the road-test process and indicates how we are addressing them.

MA design aspect	Key challenge	Ongoing work
Buy-side rules	• Will these prevent gaming? • Will they impact product access?	• Further work to design the rules with auction design experts • Initial testing of outcomes
Platform	• Should Ofgem procure a platform to host the MA? • Will establishing the MA be costly and time-consuming?	• Consideration of platform options for the MA • Information gathering from platform providers
Credit and collateral	• Will credit and collateral costs be prohibitive?	• Consideration of how this interacts with platform provider decisions
Overall cost	• Will the costs for obligated parties be prohibitive? • Will this lead to increased industry-wide costs?	• Impact Assessment to be provided with any detailed proposals[13]

Table 2: Results of the 'road-test'; MA design challenges

[11] And ultimately at the intraday stage

[12] See annex one – National Grid Interconnector Limited has successfully tendered for a provider to combine liquidity on current GB exchanges (at present N2EX and APX) in order to form a single day-ahead reference price for coupling.

[13] Though note that the design of buy-side rules set out in the February consultation document was intended to limit cost and risk to obligated parties through allowing buy-back of their own volume. We will explore the design of these rules and the impact on cost further in advance of any detailed proposal.

Next steps

We note that: (i) the MA is flexible[14] and (ii) no decision to introduce the MA has yet been made. Whether, and how, the MA is introduced depends on how compelling we consider market developments to be in meeting our objectives.

Ahead of the autumn, we will continue to develop our detailed MA proposals (in particular focussing on the areas set out in the table above) and to monitor market developments. We will also explore ways of making sure that, where industry commitments are helping to meet our objectives, they are secured and, if necessary, strengthened, for example through licence conditions. As a key part of our work, we will seek to discuss market developments and the issues outlined in this letter with market participants.

This will be a critical period and we intend to reach a decision on if, and how, to proceed ahead of winter 2012.

Yours sincerely,

Rachel Fletcher
Partner – GB Markets

[14] The arrangements set out in our February document were designed to allow products and volumes to be adjusted to reflect market developments.

ANNEX ONE: Highlighted industry-led developments

Objective	Action / development	Taken by	Date effective
Objective 1: Availability of products which support hedging	• At tender stage to provide an incubation service to a small supplier	• EDF Energy	• Ongoing
	• Published commitments to trade with independent suppliers • Wrote to small suppliers in February 2012 regarding trading commitments[15], a number of relationships have been established	• EDF Energy[16], SSE[17] • ScottishPower	• March 2011, April 2012 • Ongoing
	• Developed a product linked to day-ahead market for industrial and commercial (I&C) customers	• RWE Npower	• January 2012
Objective 2: Robust reference prices along the curve	• Developing proposals to bring a week-ahead product to the market • Renewing interest in week-ahead contracts; agreeing liquidity provider agreements	• EDF Energy • APX-ENDEX	• Ongoing • Ongoing
	• Plans to increase futures trading • Set up to trade futures	• SSE • ScottishPower, Centrica, EDF Energy, E.ON, RWE Npower	• Ongoing • Ongoing
Objective 3: Effective near-term market	• Signed up to gross-bidding on N2EX; commitment to trade at least 30% of GB power generation volume through the day-ahead auction	• RWE Npower • Centrica • EDF Energy • ScottishPower • E.ON	• May 2012 • TBD • April 2012 • March 2012 • January 2012
	• Signed up to gross-bidding for up to 100% of generated output	• SSE	• October 2011
	• Provider of a 'virtual hub' to produce a single GB day-ahead price for market coupling has been identified. Once active, this will allow participants on any GB exchange (eg N2EX or APX) to access a greater pool of liquidity. • Due to introduce more flexible order types on the day-ahead auction • UK spot reference price data now openly available	• National Grid Interconnector Limited (NGIL) and N2EX • APX-ENDEX • APX-ENDEX	• End 2012 • To align with market coupling • January 2012

[15] http://www.scottishpower.com/uploads/ScottishPowerSixCommitments.pdf
[16] http://www.edfenergy.com/about-us/energy-generation/PDF-Documents/liquiditycommitMarch11.pdf
[17] http://www.sse.com/uploadedFiles/Controls/Lists/Energy_policy/Building_trust/OurSmallSupplierTradingCommitment.pdf

ANNEX TWO: Update on key liquidity metrics

This annex updates the liquidity metrics that form part of the evidence base used to assess progress towards our wholesale market objectives. This builds on our most recent published analysis, included in the February 2012 liquidity consultation document. All metrics are updated to the end of June 2012.

Churn

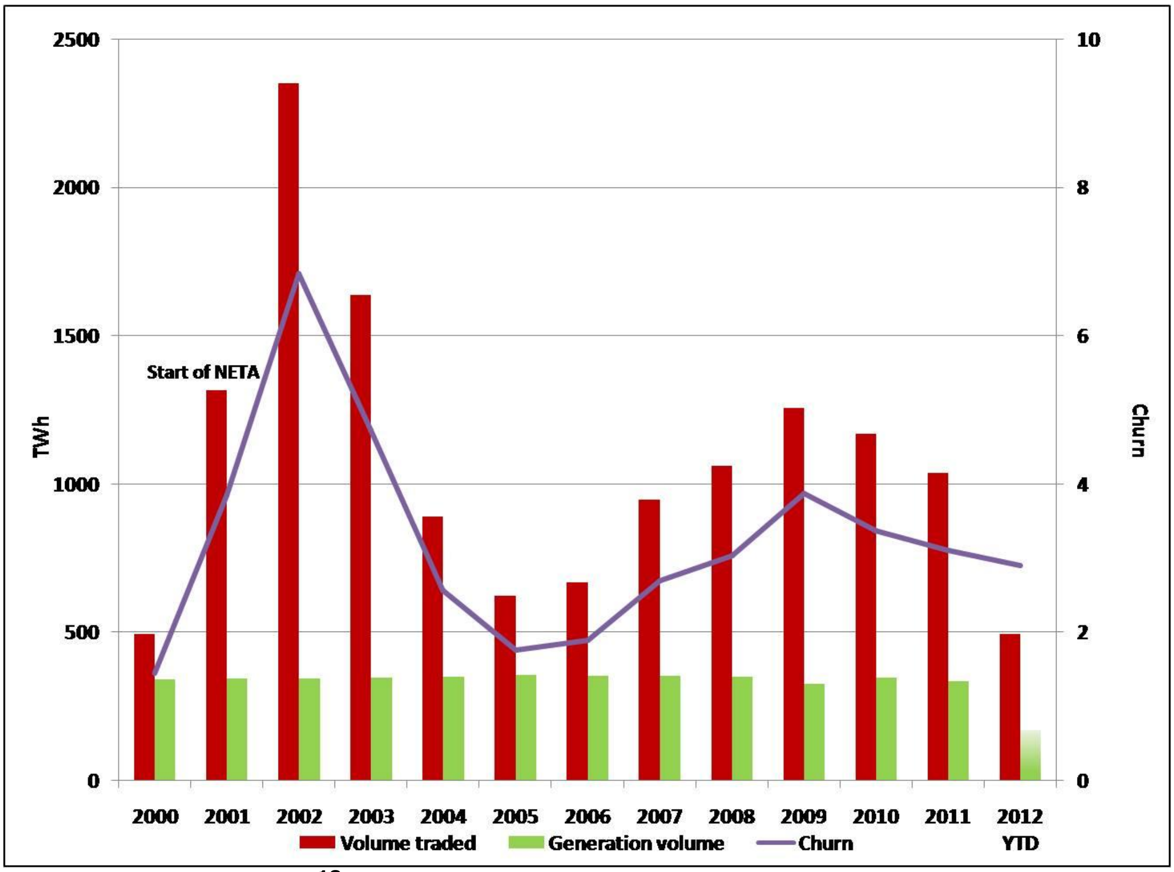

Figure 1 - Annual churn[18]

Churn is defined as the number of times a unit of generation is traded before it is delivered to the final customer and consequently is an indicator of the overall level of liquidity in a market. Churn in the GB power market first half of 2012 was 2.9, continuing the downward trend seen since 2009 (see figure 1).

OTC trading in longer-dated products

Market participants require products that enable them to hedge against the risk of future movements in the wholesale price. In the GB market, this is most commonly done through OTC trading in physically-settled forward products.

Our updated analysis suggests that OTC trading in longer-dated products declined slightly in the first half of 2012 (see figure 2). OTC products traded more than 13 months ahead of delivery fell from 18% to 16% of the market across all product types (although there was a slight increase in the proportion of trading in longer-dated peak products).

[18] To calculate churn it has been necessary to use a projection of GB electricity generation for May and June 2012.

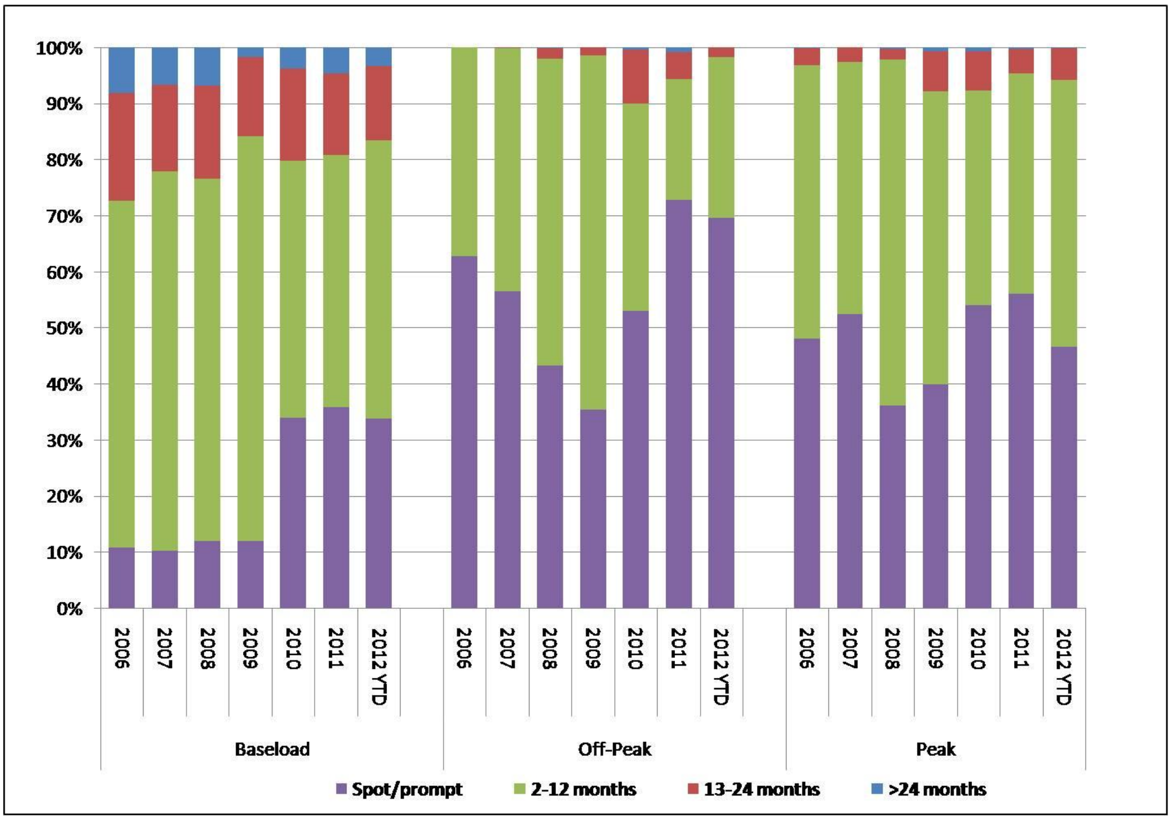

Figure 2 - OTC products traded by period ahead of delivery

Bid-offer spreads

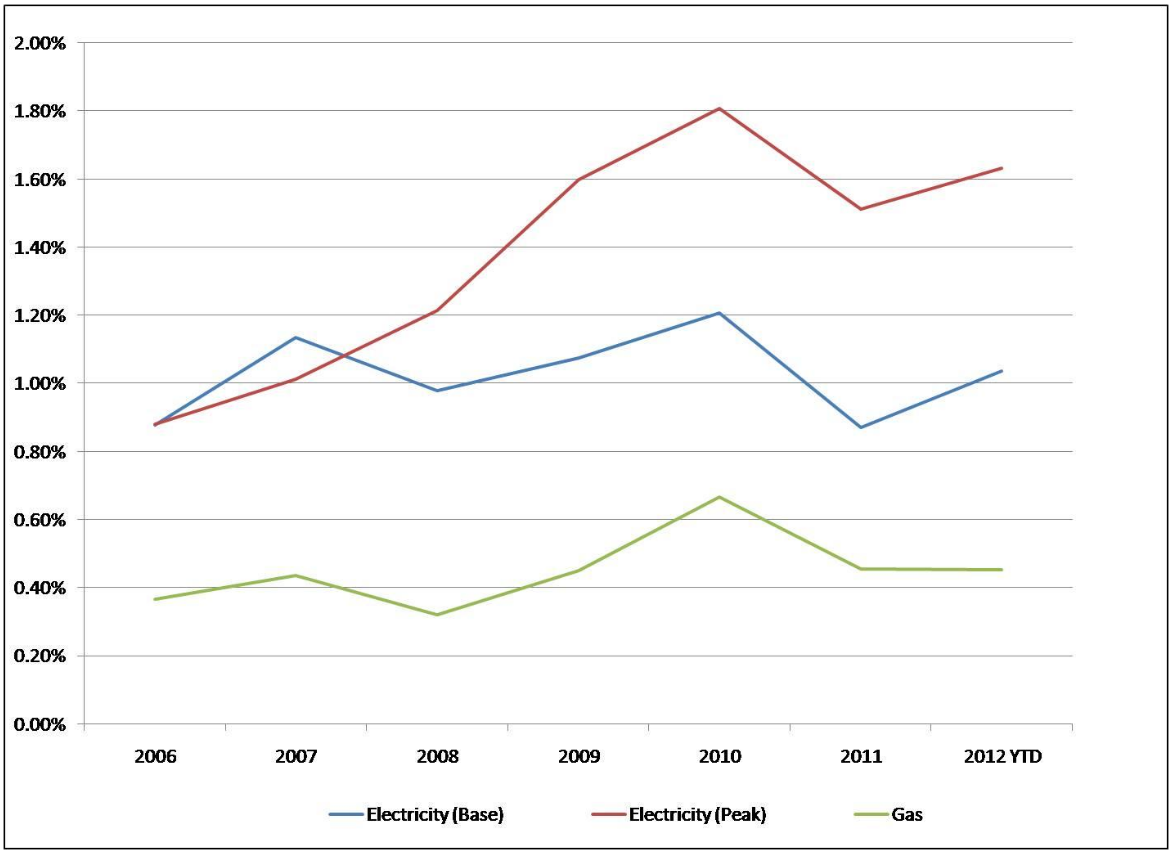

Figure 3 - Bid-Offer Spreads: Season+4 Products

A tight spread between the bid price (the price at which buyers are willing to buy) and the offer price (the price at which sellers are willing to sell) is a good indication of a liquid market.

Our updated analysis suggests that for most of the longer-dated products analysed, bid-offer spreads widened slightly in the first half of 2012 (for example, see Season+4 products in figure 3). This reversed the general narrowing of spreads seen in 2011. However, for Season+1 peak products bid-offer spreads continued to narrow in 2012. It is also important to note that bid-offer spreads widened for some forward products in the gas market, suggesting wider factors (for example the economic outlook) could be having an impact.

Volumes traded in financial products

Financial contracts based on a physical market reference price provide an alternative hedging tool for market participants. Until 2011, volumes traded in financial products in the GB market were very low. However, since the Autumn of 2011 there has been a notable increase in trading in these products, with more than 12TWh traded so far in 2012 (see figure 4). While this increase has been significant, volumes remain uncertain and are still a small proportion of the overall market.

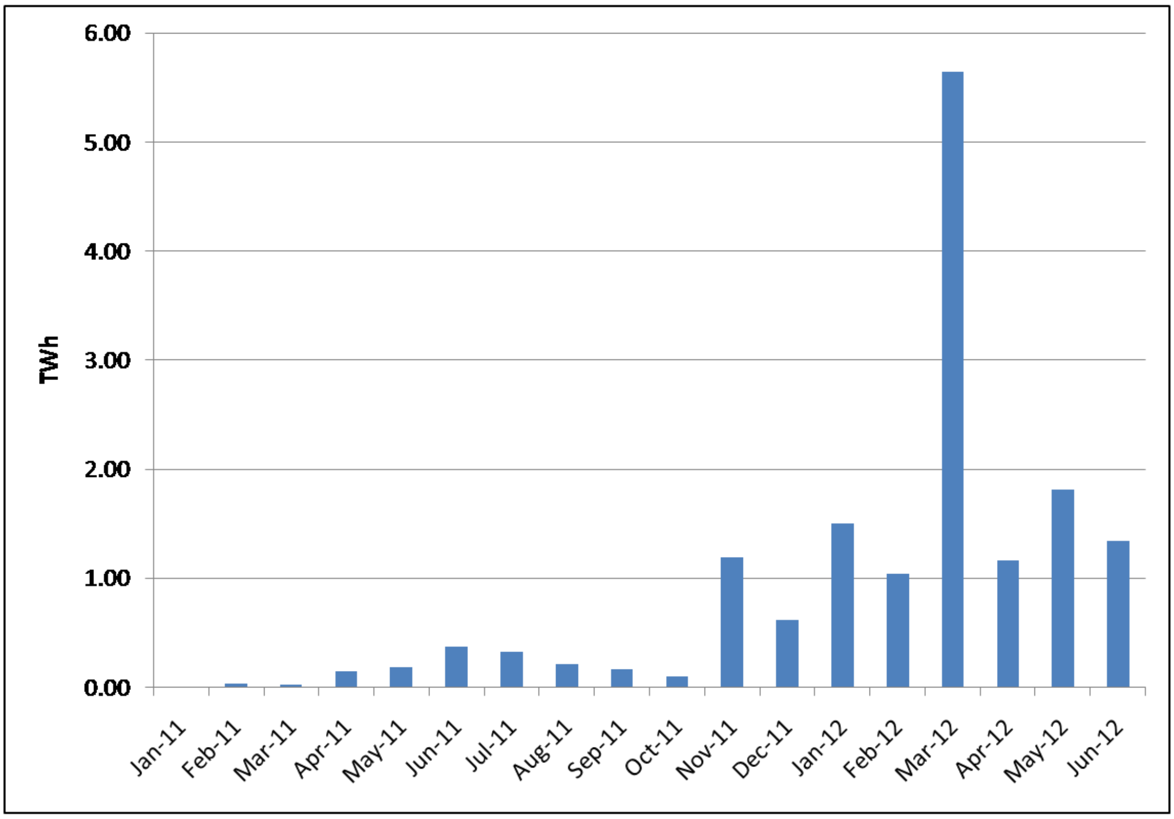

Figure 4 - Volumes traded in financial products

Volumes traded on near-term exchange platforms

An effective near-term market is important to ensure that market participants are able to meet their shaping requirements and avoid cash-out payments. One indicator of the health of near-term markets is trading on near-term exchange platforms.

As noted in our February 2012 consultation document, there was a significant increase in volumes traded on near-term exchanges starting in the Autumn of 2011, driven largely by commitments by the large vertically integrated players to enter into gross-bidding arrangements on the N2EX day-ahead auction. This increase in traded volumes has been sustained in the first half of 2012.

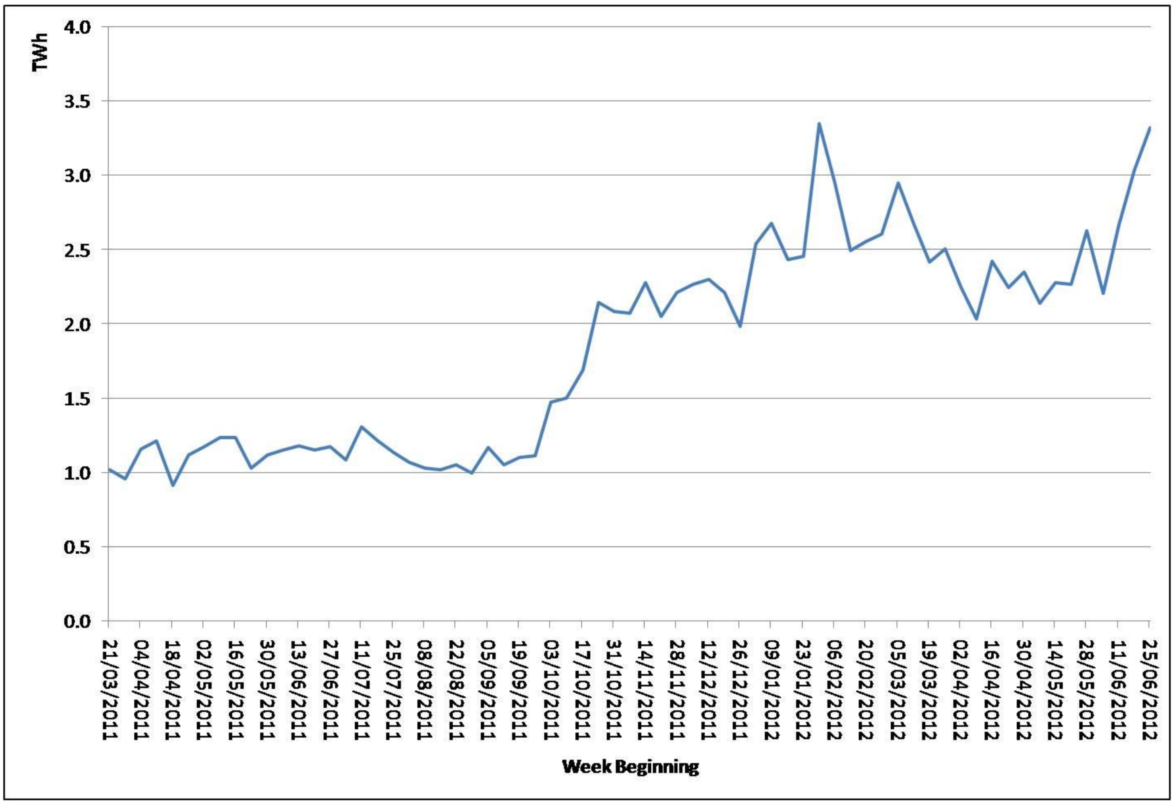

Figure 5 – Volumes traded on near-term exchange platforms (inc. OTC-cleared volumes)

ANNEX THREE: Summary of responses to February 2012 consultation and stakeholder engagement

In this annex we capture some key messages from the responses to our February 2012 consultation document[19]. Where indicated we also highlight themes from the two industry roundtable events we hosted during the consultation period. The first of these events focussed on market developments and the design of the MA. The second focused on participants' views of how the MA platform should be selected and governed.

Chapter 1 – Our objectives for liquidity

Question 1: Do you agree with the objectives we have identified?
There was evidence of support for the broad objectives, though some respondents suggested that further detail could be beneficial. There was interest in Ofgem providing more information about detailed objectives and measureable success criteria. It was felt that this could aid transparency and regulatory certainty.

Question 2: Do you think there are other objectives we should be considering?
Some respondents had suggestions for additional objectives; the three primary suggestions were recognising the importance of credit, supporting financial trading (especially to align with the European Target Model) and encouraging entry in generation, intermediation and supply.

Chapter 2 – Market developments

Question 3: Do you agree with our views on market developments since summer 2011?
There was good support for the view that our February consultation document had correctly captured market developments.

Many respondents agreed that developments in the near-term market have been positive, although a minority remained unconvinced about developments on the day-ahead market. Responses were divided on the current state of the longer-term market, although most respondents agreed that longer-term markets are less effective than the near term market.

Views were expressed about uncertainty arising from the wider policy environment inhibiting long-term liquidity. Examples of policies mentioned included the Carbon Price Floor and the Electricity Market Reform package.

Question 4: What specific future developments would be necessary to meet our objectives?
Suggestions were made in responses and at the first roundtable that the recent growth in trading of financial products is a source of optimism. Views were expressed that the progress in near-term liquidity would, as market participants gained confidence, provide the basis for the development of financial products to meet Ofgem's objectives related to longer-dated products.

In terms of developments to help smaller players in particular, it was argued that improved credit arrangements and increased availability of smaller clip sizes along the curve would be helpful.

Question 5: Do you agree that objectives one and two are current priorities given market developments?
The views expressed about developments on the near-term market supported the case for not intervening in support of objective three (effective near-term markets). While the majority of responses did not consider intervention to reach objective three to be a priority, a variety of opinions were expressed as to whether objectives one and two were current priorities.

[19] Published here: http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=84&refer=Markets/RetMkts/rmr

Chapter 3 – Our proposal: A Mandatory Auction

Question 6: Do you agree that the MA is the appropriate mechanism to meet our immediate objectives?
Support was voiced for some form of action to improve liquidity. Opinions about the MA itself were mixed. This was sometimes because respondents would prefer another option, while still recognising that the MA could have some benefit. Of those parties who did support the MA, there was a desire to see a more detailed design. Firms who may be subject to the obligation were opposed to the MA as an intervention.

Concerns were raised that the MA would not meet the needs of small suppliers, whether due to a lack of a continuous market imposing risks between auctions or due to credit and collateral acting as a barrier to direct participation. Concerns have also been expressed about the effects of an intervention on other areas of the market, such as OTC trading.

Some suggested that the MA might not be sufficient to reach Ofgem's liquidity objectives; in particular it was questioned whether it would deliver a robust reference price. This was linked to worries about potential gaming of an MA.

Question 7: Do you agree that, at the present time, the other mechanisms identified would not be appropriate for Ofgem to pursue?
Respondents to the consultation and participants at the roundtables did discuss alternative interventions to the MA. These included Mandatory Market Making and Self-Supply Restrictions. These alternative interventions have been considered as part of the liquidity project, and we remain concerned that these interventions would not meet our objectives as effectively as the MA. The primary justification advanced for market making was that it would support continuous trading, as opposed to a monthly auction.

Chapter 4 – Proposed detailed design features
Question 8: Do you agree with the key features of the MA we set out?

Feature	Views
Participation	A range of opinions were expressed about whether the obligation should be expanded beyond the six large vertically integrated firms.
Products	Respondents had differing views about the types and mix of products (baseload/peak/shape) that should be offered through any MA. Suggestions were received for alterations to the indicative product list presented in the February consultation document. Those attending the roundtables agreed that the MA should support products which reflect the needs of market participants. Views were expressed that any requirement to sell shape should reflect the make-up of the generation market. Most responses agreed with the need for products to be sold in small clip sizes.
Volume	Supportive statements were made by independent firms about the 25% volume figure. Arguments in favour of smaller volumes were received from potential obligated firms. Ideas were put forward about the methodology for the calculation of the obligation.
Frequency	Suggestions were made that a monthly MA could be too infrequent to meet the needs of firms for hedging.

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?
In terms of the rationale for buy-side rules, views were received against unrestricted buy-side participation by the obligated firms. However, some of these responses argued against any buy-side participation by obligated firms, rather than being in favour of buy-side rules. Concerns were raised about potential distortions resulting from the buy-side rules, especially in terms of price volatility and the consequent negative impact on the reliability of reference prices. Potential obligated firms were also worried about any arrangement which increased the risk of distressed trading.

Some respondents and participants at the first roundtable recognised that there was no easy answer to the choice and design of buy-side rules.

Chapter 5 - Identifying a platform

Question 10: Do you consider there are benefits and risks to the approaches that we have not identified?
We consulted on two different approaches to platform selection. Approach 1 was an Ofgem-led procurement of a single platform, while under approach 2 each obligated party would individually choose a platform or platforms through which to meet their obligation. Respondents discussed the potential effects of the choice of approach on the speed of platform procurement. Respondents also brought up the costs of credit and collateral as a relevant factor for the choice of approaches.

Participants at the second roundtable noted the tension between the benefits of flexibility in the MA design (eg in relation to products) and ensuring that market participants and platform providers have sufficient certainty. Participants also wanted more detail about the relative governance roles of Ofgem and industry under both approaches.

Question 11: Which approach do you consider is best placed to deliver our objectives at least cost and risk?
The benefits of a single platform were highlighted, leading to support for approach one. This was apparent in both the consultation responses and at the second roundtable. However, the argument was raised at the second roundtable that there was the potential for a 'hub' which could unite liquidity over several platforms under approach two.

Question 12: Do you consider that both approaches are able to meet our objectives?
Suggestions were made that multiple platforms (under approach two) may be unable to meet our objectives, as it would lead to fragmentation of liquidity. In terms of costs, it was argued that having several platforms could lead to high costs and inefficient use of credit. Worries were also expressed that multiple platforms could reduce transparency, could be complex, and could increase the potential for delay. A minority of respondents were in favour of approach two. Views were also expressed by respondents opposed to the MA that neither approach would be able to meet Ofgem's liquidity objectives.