ALPIQ's

Response to the Ofgem public consultation on "Liquidity Proposals for the GB wholesale electricity market"

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Introduction

Alpiq is a new leading energy company based in Switzerland, active in most fields of commercial energy services. We generate and transport electricity, and are also engaged in electricity and gas trading and sales across the EU.

In 26 countries throughout Europe, our energy trading and sales subsidiaries maintain direct contact with our customers. Energy services are delivered by 30 companies at around 200 different locations. Our power generation facilities are spread across Europe, to guarantee optimal security of supply for our customers. We operate power stations in Switzerland, Italy, France, Norway, Hungary, Germany and the Czech Republic. And we are currently building new power stations in Germany, Italy, France, Bulgaria and the Czech Republic (for more information please *see* www.alpiq.com). We are also an active electricity and gas wholesale trader in the UK market, and are directly affected by Ofgem's consultation on the "Liquidity proposals for the GB wholesale electricity market". We therefore welcome the opportunity to respond to Ofgem's consultation. As we are not affected by all of the outlined questions we have chosen to summarize our view in the points below.

1. Is there a liquidity problem in the UK electricity market?

Apart from the question on how one defines the appropriate level of market liquidity, we do share Ofgem's view that the churn rate on the UK electricity market is shrinking. This factor must raise concerns amongst all market participants, and therefore we do support Ofgem's consultation. Nevertheless we feel that several of the proposed measures are not necessarily the right ones, as they may unnecessarily increase regulatory intervention, without benefiting the UK energy market or increasing liquidity.

2. Identified problems

We as Alpiq have identified the following items which, from our point of view, reduce the market attractiveness and create barriers of entry to the UK electricity market:

- *Insufficient market integration:* We think that UK should be more active in the ongoing market coupling initiatives. While continental Europe is in deep discussion about proper future market integration (via market coupling) the UK market is not sufficiently included in these integration concept developments. From our point of view, higher liquidity could also be gained by proper market (coupling) integration of UK and Continental Power markets. Experiences with market integration of the Nordic and German electricity markets have shown that this can lead to higher liquidity.
- *More market harmonization with EU power markets:* We are of the opinion that standardized products should be used and brought in line – i.e. harmonized – with the continental power markets. In this respect we have identified the following aspects that should be harmonized with the Continental power markets:

- Administrative costs for traders are much higher in the UK than in other EU power markets. These costs are a decisive factor for reduced market attractiveness.
- It must be considered whether the EFA calendar is still applicable for today's market needs (also, because it is not used on the Continent).
- Market integration could be reached by introducing the Euro currency (and no longer British Pound). This measurement has proven to be effective in other markets (e.g. Nordpool and the Swiss power market). This has significantly reduced currency risks and costs.
- Power trading and Interconnector trading (IFA) include very high charges and financial costs due to distribution of balancing and administration costs to traders. It is not only the cost by itself, but also the associated administration work, operational risk and the requirement of bank guarantees. No other European power market applies those charges.
- The Balancing Market shows continuously high buy and sell spreads which means potentially high imbalance costs, and therefore higher risks.

- *Transparency*: Although the GB energy market is at the forefront of providing detailed, and very valuable, market information, we feel that this should be even further improved. For instance, more detail in the publication of planned of power plant dispatch, down to each fuel type – comparable to EEX market information – or even each power plant, as done voluntarily by the German producers.

3. Things we do not agree on

As mentioned above, we do agree with Ofgem's initiative. Nevertheless we think that following elements should not be introduced:

- We question whether the introduction of a market making agent would actually improve the GB electricity market and would add any real value, as it just introduces another administrative body. If the market making agent model is introduced this function should be handled by the exchanges. We do not think that mandatory auctions, and self-supply restriction, will be beneficial to the market. These instruments will only increase the regulatory risks and could potentially scare away new participants.
- Proposed changes to the existing credit/collateral arrangements are questionable. The ENRON case and the recent financial crisis have demonstrated that proper credit/collateral arrangements must be in place. Any changes – required by the national regulator – must be done in a careful manner as the reduction of credit requirements could lead to (further) exit of trading organizations, and a further reduction in market liquidity. The fact that the UK electricity market is suffering from a lack of liquidity clearly indicates that artificially facilitating the entry of small domestic players will not change anything to the current situation. The UK problem is not a problem of market concentration. As already pointed out, as long as the UK electricity market remains an island poorly connected, coupled and not harmonized with EU

continental markets, liquidity will be low. Furthermore in mature capital-intensive industries, entry barriers will always be naturally high for small new participants. Artificially promoting the entry of such new market participants amounts to confusing the law of competition (i.e. enhancing competition, not selected competitors) with the law of competitors (i.e. protecting them under the assumption that a fragmented market structure always yields social welfare). For these reasons we are in principle opposed to the measures proposed under the collateral requirements. However, assuming that the benefit of artificially supporting small players was demonstrated, the drawbacks of the proposed measure would make the market unfair and inefficient. The financial liquidity risk arising from margining is worse than credit risk, both for large incumbents and potential small entrants. Master netting agreements allowing an overall close-out of a complete position between small and large counterparties - as the one being drafted by EFET – would be useful in eliminating the need for margining. Moreover, if Ofgem still wanted to introduce command and control economy measures, a better a more straightforward tool would be to grant temporary (i.e. to be reviewed on a regular basis) state guarantees to small players to enhance their ratings.

4. Possible solutions?

Taking the above-mentioned points into account we believe that the following could improve the current liquidity situation in the UK energy market:

- We suggest that Ofgem should seek to try to reduce costs, increase market transparency, and lobby for better European market coupling / integration. In this respect, Ofgem should seek to ask for further market integration by inter alia promoting the consolidation of EU power exchanges, which then offer homogenous trading products which will generate more attractive wholesale and retail markets. Also, that proper stakeholder involvement is guaranteed.
- Any regulatory intervention needs to be done in a step-by-step approach starting with the less far-reaching measures. If any changes are to be implemented, we feel Ofgem should begin with voluntary market making, as this instrument has proved to be successful in achieving higher liquidity.