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9 Millbank
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Thursday, 29 April 2010

Dear Kersti,

Re: Liquidity Proposals for the GB wholesale electricity market

This response reflects the views of the Centrica group of companies excluding Centrica Storage. The non confidential sections may be placed on the Ofgem website and in the Ofgem library. The response takes the form of this paper in which we set out Centrica's views and three annexes in which we address the questions and proposals raised by Ofgem and provide some confidential data.

If there are any of the points raised in this response that you would like to discuss in more detail, I would be happy to help and can best be contacted on 07789 570046 or Alison.russell@centrica.com.

Yours sincerely,

By e-mail

Alison Russell
Senior Regulation Manager, Upstream Energy

Centrica's response to Ofgem's consultation on Liquidity Proposals for the GB wholesale electricity market

Executive Summary

1. Centrica believes that liquidity levels are sufficient in both the GB gas and electricity wholesale markets to support and promote effective and sustainable competition both in generation, and in downstream supply.

2. We have reviewed the traded data we have available to us which indicates a stable to improving picture for liquidity. The number of times quarterly UK electricity demand has been traded has increased over the last 5 quarters[1] from 2.6 to 3.5. In addition the number of times we churn our own generation has increased from 5.5 in 2008 to 6.5 in 2009[2].

3. In terms of absolute volumes traded, Peak liquidity has increased between 2007 and 2010, with some of that increase relating to periods beyond 12 months. Whilst cyclical, EFA block 5 liquidity also seems to show a small increase, again with some volumes out beyond 12 months[3]. This information is provided in Confidential Annex 3.

4. The focus on levels of liquidity in the wholesale markets was triggered by the Energy Supply Probe (the Probe) initial findings in 2008. This analysis found that inadequate liquidity was one of a range of possible reasons raised by respondents to explain a lack of new entry, and the inability of any new entrant to grow a business of significant scale. Other issues also raised at the time (and given a similar level of importance in the Probe document) included scale economies, branding, cost of finance, pricing policies and costs faced by new entrants resulting from regulatory and compliance requirements.

5. One of the main reasons for the absence of substantial new entry to the domestic market is not liquidity of wholesale markets, but the lack of sustained, significant retail profitability. The government's Energy Market Assessment (EMA) points out that suppliers' net margins on customer bills have been close to zero in recent years, and that evidence suggests energy companies have not been making excess profits. Our experience supports this finding. While retail margins have started to increase in the last year our retail business (British Gas) made margins of around 3.6% on average over the preceding five years. The EMA's findings have also been supported by Ofgem's own analysis in its quarterly report, which has shown that net margins earned on a typical dual fuel customer have averaged close to zero between 2007 and 2010.

6. Given the absence of attractive profit margins over the cycle, there is no basis for placing such an emphasis on intervention to promote liquidity on the grounds that that this will further stimulate retail competition. The impact of all the other issues identified in the probe are especially relevant at the smaller end of the electricity market where customer demand is more uncertain, shape requirements greater and the larger, more complex systems and processes to handle domestic customers are more expensive to build and operate. We do not believe the market arrangements need drastic change, and the disruption and uncertainty caused by more significant intervention could in fact be counterproductive.

[1] Based on OTC data from Trayport and UK consumption data from DECC's Energy Trends publication
[2] Centrica's own data
[3] Based on Trayport OTC data

7. Ofgem's analysis also overlooks the non-domestic supply market. A 2009 Datamonitor survey of 2000 customers in the I&C segment found that less than 50% of contracts signed were renewals[4]. The fact that 12 different suppliers hold more than 1% of the market shows low levels of concentration. Moreover evidence over a number of years shows that there are no barriers to new suppliers entering the market and building significant market share in different segments of the non-domestic market.

8. Of the barriers to entry for small suppliers identified by the Probe, we believe that credit risk, rather than liquidity is likely to be the most important in the current environment. Our own experience has shown us that credit risk concerns have increased levels of transaction costs in recent years (particularly when contracting for our larger commercial customers). We include a confidential example of credit costs we would typically incur for a large customer in Confidential Annex 2. The large levels of contingent capital required in current trading conditions to secure volumes of energy for large customers are a cost that any supplier must face.

9. In addition, given the very specific concern raised that smaller participants are unable to secure shaped, small volume products to support their hedging requirements; we believe it would be helpful to explore this specific issue in more detail before considering the more interventionist measures in the document. We would be happy to work with Ofgem and industry to move this area forward.

10. Ofgem also suggest that the current level of liquidity in the GB wholesale market is a barrier to the new investment needed to meet the Governments low carbon targets. We do not believe this has any material relevance to such investment decisions.

11. Much has been made of the "benefits" that the Big 6 gain through vertical integration which are not available to small/independent suppliers. Owning fossil generation only provides a natural hedge for the clean spark or dark spread and as such only provides a partial asset hedge. Variations in gas, coal and carbon prices are the major causes for power price volatility which are not "fixed" by owning fossil generation stations.

[4] In gas, the proportion was 42%, and in electricity 48%. For more details, see the 2009 Major Energy Users Survey from the question is "What was your switching status when you signed your contract with your supplier? Was it a renewal or a switch?"

Centrica's views on the document

Ofgem's analysis of the issue:

12. Ofgem asserts that liquidity in the GB wholesale electricity market is low in comparison with other commodity markets and some other European countries. The 2008 Energy Supply Probe (the Probe) found that there has been very limited new entry in energy supply markets and those who have entered have not grown to a size close to that of the former incumbents. The domestic supply market remains highly concentrated with the Big 6 accounting for 99% of the market.

13. The Probe also found low liquidity is one of the most important barriers to entry in GB supply markets. Subsequent Ofgem investigations have found that existing small and independent suppliers complain of difficulties in accessing the forward products that they need to meet their customers' demand and manage the wholesale market risks they face.

14. The threat of new entry acts as an important competitive constraint on incumbents as it provides incentives to price keenly, innovate and improve efficiency.

15. In addition, Ofgem argues that "A liquid wholesale market is also important for investment in generation. Given scale of investment required over the next decade and beyond, we need to ensure that there are no material obstacles to attracting new investors into the market". In their responses to the June 2009 Liquidity Discussion document, independent and small generators were of the view that forward product liquidity is insufficient to allow them to manage effectively their market related risks.

Centrica's perspective on the issue:

16. Liquidity in the GB electricity market is strong in the prompt and satisfactory in the forward market up to 12-18 months out. We agree that liquidity is weaker the further out on the curve, but believe that there is a significantly reduced demand for product out beyond 18 months due to uncertainty and credit issues. Annex 3 shows that traded volumes are often several times physical volumes. Another indicator of healthy liquidity is that our own churn volumes have increased from 5.5 in 2008 to 6.5 in 2009 (see Confidential Annex 3).

17. As mentioned above, we have reviewed the traded data we have available to us which indicates a stable to improving picture for liquidity. Consideration of the number of times quarterly UK electricity demand has been traded has increased over the last 5 quarters[5] from around 2.6 (Q4 08) to around 3.5 (Q4 09). This is based on OTC trades for delivery in a particular quarter compared to UK electricity consumption in that quarter. Exchange/bilateral trades are excluded.

18. Peak liquidity has increased between 2007 and 2010, with some of that increase relating to periods beyond 12 months. Whilst cyclical, EFA block 5 liquidity also seems to show a small increase, again with some volumes out beyond 12 months[6].

19. We do not believe there is causality between the UK markets being less liquid than some European markets and the concerns of small domestic suppliers that they have trouble procuring the hedges that they need. As Ofgem acknowledge, the main difference is over how many years forward are liquid; this is not relevant for domestic supply hedges beyond

[5] Based on OTC data from Trayport and UK consumption data from DECC's Energy Trends publication
[6] Based on Trayport OTC data

12-18 months which is the period over which most residential customers could be considered to have fixed prices.

20. We further note that Ofgem report a study carried out for the European Commission as follows "2.30. A Europe wide study[21] of wholesale energy markets in 2008, which surveyed a wide range of market participants, ranked the UK fairly highly (5th out of 19 countries) with respect to liquidity and efficiency in the wholesale electricity market[22]. The UK market scored well in a range of categories including number of active traders (4th), ability to trade forward (4th) and volume of trading (5th), but less well in others, including the number of new entrants (7th) and representative prompt market price (11th)." This would seem to support the view that major changes are not required.

21. In addition if Ofgem is focussed on liquidity in complex products of sub 1MW trade size suitable for very small domestic retailers then we do not believe any market in Europe would be considered "liquid" because this is not a product that any generators would normally want to sell and only the very smallest suppliers want to buy. We understand that most European forward markets have a minimum trade size of 1MW and only deal in smaller units in the day-ahead auction (for day ahead volumes only).

22. Thus we believe that the link between GB wholesale market liquidity and the absence of significant market share in the domestic sector being held outside the main six suppliers is unproven. It is more likely that large scale new entry has not materialised because of the low margins that are not sufficiently attractive to large scale players that might otherwise consider entry. In the I&C and SME sectors there is plenty of evidence of exit and entry over the last ten years and a large number of suppliers. These are markets where suppliers sell 1-2 year fixed price contracts and hedge the volumes at the point of sale typically by using the wholesale market.

23. We agree that there is a need for massive investment and all barriers to efficient investment should be removed. However, the investors who will support the £100's billions of investment will have to be large players with substantial balance sheets. Notwithstanding this, external finance will also be needed as the recent EMA report discusses. While investors can gain some insights into forward electricity prices from a futures market this will only be one small element in their investment decision. Even the most liquid electricity markets in Europe only give price indications a few years forward – this is insignificant in terms of the construction period and operating life of new assets and the likely duration of external finance.

24. To our knowledge, no independent generators are now seeking to develop projects based on wholesale market trading as this would likely be unacceptable to prospective project finance banks in the aftermath of the complete failure of this business model in the early 2000's. Since then, all new independent power plants have only proceeded on the basis of passing all or most of the energy market risk to a third party (typically a Big 6 supplier) via long term tolling contracts as in the case of Spalding and Marchwood. Alternatively projects have been sold at the start of construction to larger utility players such as Dong in the case of Severn Power.

25. Thus we believe it is wrong to suggest that the current levels of liquidity in the GB electricity market are a material obstacle to the new investments needed in the power generation sector.

26. Finally, the statement is made that vertical integration provides players with a natural hedge against volatile power prices. This is only partially true because most of the volatility in power prices is usually caused by volatility in the cost of fuel for the marginal generators (normally gas in the winter, sometimes coal in the summer), combined with volatility in the cost of carbon. Thus a stable generation cost is only achieved if the input fuel and carbon costs have also been fixed in other markets via traded or bilateral deals. These fuel and carbon contracts generate similar counterparty credit exposures as do power contracts.

27. Thus being vertically Integrated with conventional generation only gives the owner certainty of the clean spark or dark spread component against the fixed costs of owning and operating these assets. They are not the panacea that is implied in the document.

Centrica's view of the proposals:

28. Centrica supports the continuing operation of a healthy and liquid wholesale power market. We believe that there is sufficient liquidity in the front 18-24 months and, that while not as liquid as the NBP gas hub, the GB power market is among the most liquid in Europe, especially on the prompt.

29. Increasing liquidity is a positive aim which we believe can be achieved through a market based approach such as the introduction of new indices/products.

30. Recently N2EX launched with the aim of increasing market liquidity and the choice of standard and shaped products further. This exciting new initiative needs to be given a chance to prove itself before major changes are planned; indeed there is a danger that further non market interventions may stifle the new N2EX market due to perceptions of regulatory risk.

31. There are now two cleared exchanges available to participants. For the size of the market we believe that this is sufficient and that further compulsory auctions might risk inefficient fragmentation without increasing traded volumes.

Provision of a trustworthy index:

32. Centrica supports Ofgem's view that there is a clear need for the creation of a trustworthy index in order to build a financially traded UK power market – this would encourage new entrants and address some of the more onerous processes/complex contractual arrangement currently in place. A financial contract should facilitate financial players (such as hedge funds), and on the credit issue, a cleared prompt may also make it easier for smaller players to access volumes.

33. There are two main options that we believe would be workable for the creation of a robust Index, both of which should be explored prior to considering any more radical approaches to the issue.

Using the Prompt to create a trustworthy Index

a. We think that the LEBA (8-9am) DAH index is a suitable base, but it has not been perceived as 'trustworthy' enough by a few large players despite the fact that it is monitored by an independent body. The LEBA index however, accounts for around 50-60% of all traded DAH volumes in the market and we believe could be established as reliable. This may involve the offering up of additional volumes for clearing.

b. For any financial swap product to be attractive the index needs to be 'hedgeable'. We would assert that a continuously traded window index - either LEBA or a comparable N2EX product - is far more hedgeable than an auction product. We already have 2 auctions (APX and N2EX) so smaller players have access to shaped products with the clearing houses. Forcing another auction or one of these as the 'index' seems to go against a well established and high volume index that we have already.

Using the Front Month as an Index against which to launch Derivatives contracts

c. Brent Crude and NBP Gas both have benchmark front month indexes that act as a reference price for Derivatives contracts. LEBA has a Front Month Window Index which settles between 16.00/16.15 each day and incorporates all trades executed OTC via the 4 main power brokers (Spectron, ICAP, Gfi and Prebon). There is no reason why this index if supported by market participants couldn't become a benchmark index against which to settle a derivative. The added benefit of this index is that it settles in the 16.00/16.15 window which is the same as the NBP ICE Front Month contract; these two together could create a benchmark sparkspread reference price which would further support liquidity in UK Power.

Costs of market participation – Credit and Collateral

34. The costs of participating in the market should not be underestimated, whether these costs relate to administration, power purchase or credit support. As a major participant, Centrica believes that a major issue facing all participants is that of credit support. In this uncertain world, confirming the creditworthiness of trading counterparties is both prudent and the norm, required by risk policies and the application of directors' duties.

35. In many cases we believe that the issue of credit is a greater problem for new entrants and smaller suppliers than the trading arrangements, hence this is a crucial point to consider in evaluating the barriers to market entry. Options to consider may include greater use of clearing such as the new N2EX; however this is not a cost free solution, since the transaction costs of doing so will add to the costs of power and would have to be factored in to the detailed cost benefit analysis (please see our response to chapter 8 in annex 1).

36. Credit and collateral requirements have increased over time which makes trading more difficult. Credit has also become more costly and difficult to obtain in the light of financial market uncertainties.

37. These increased requirements reflect the real costs of participating in energy markets. Wholesale price volatility reflects underlying supply and demand conditions, playing an important role in transmitting signals of market conditions to participants and thereby inducing the supply and demand responses needed to keep the market in balance.

38. If players wish to hedge their market exposures by locking in prices in advance of real time, this has a real cost and one that should be paid, to ensure that the level of forward contracting is efficient. However, in order to commit to market positions that may become significantly out of the money by the time of exercise, as in any financial market, market participants can put in place margin requirements where deemed appropriate to minimise the risk in the case of counterparty default. This margin requirement is simply a cost of doing business, and should not be subsidised or distorted through regulatory intervention – which would result in greater costs of doing business across the market as a whole, distorting the market signals needed to ensure efficient generation and consumption patterns.

Annex 1: Centrica's responses to Ofgem's questions

CHAPTER: One – DEFINING THE PROBLEM

Question 1: Do you agree that the harm caused by low levels of liquidity is sufficient to merit policy intervention, if such low levels persist?

39. Centrica believes that there are reasonable levels of liquidity in the prompt and in the first 18-24 months with liquidity tailing off sharply after this. For the most part, there is sufficient liquidity within the GB market to support a healthy and competitive wholesale and retail power market.

40. On this basis we are not convinced of the need for policy intervention, but if such intervention is to be made, it is essential that it is fully evaluated in advance, both in qualitative and quantitative terms, to ensure that the unintended consequences of the implemented measures do not damage the market, either by perception (in terms of regulatory risk) or by direct effects such as fragmentation. Ofgem has recognised this risk, but has not explained how it could be avoided under the proposals.

41. It is also important to recognise that there are a number of reasons for lower liquidity further out on the curve, including credit risks, lack of certainty and increased risk. If the market perceived a value to trading "detailed" shaped products out on the curve, there would be a market for them. The premia attached tend to mean that these shaped products will naturally be traded more close to time when the purchaser can fine tune requirements and buy only what is needed of these "expensive" products.

Question 2: Do you agree that the focus should be on electricity markets?

42. We believe that there is sufficient liquidity in both gas and electricity markets, however it is clear that there is relatively more liquidity in gas than in electricity, hence we understand the reasons behind Ofgem focusing on the electricity market.

CHAPTER: Two – SUCCESS CRITERIA FOR MARKET INITIATIVES

Question 1: Do you think our high level success criteria are appropriate?

43. While Ofgem has set out high level criteria, greater detail is needed for constructive comment. For example, the "High volumes traded in standard products" – there are currently high levels traded in some products, does Ofgem mean higher than currently? This criterion also needs a date range and clarity over the time periods covered for example there may be greater liquidity at different times of day.

44. In addition, the criterion around longer dated products and/or financial derivatives – again some longer dated products are already available. We would find examples helpful of what additional products Ofgem believes are necessary.

Question 2: Do you have views on how these can be quantified and the appropriate target level of performance?

45. In addition to the points of clarification raised above, we believe that costs of trading in the market are an important criterion. Since the transaction costs to the industry as a whole might be unacceptable in terms of the premium which would need to be added to the cost of power.

46. There is a risk that in a physical market which needs to be balanced, non physical players might simply increase prices at which they are willing to trade, meaning that increasing liquidity may simply bring increased costs.

Question 3: When should market success be judged?

47. It is important to allow initiatives such as N2Ex time to bed in hence it would be a mistake to make rushed interventions.

CHAPTER: Three – OVERVIEW OF THE POSSIBLE REMEDIES

Question 1: Are there any other policy options, beyond those set out in chapters 4-8, which merit attention?

48. A key issue in the liquidity debate is the creation of a trustworthy index in order to build a financially traded UK power market – this could bring in new entrants and avoid the onerous physical nominations processes and lengthy contractual set up that we have today. We have elaborated this point in paragraph 32 above.

CHAPTER: Four - DIRECT TRADING OBLIGATION

Question 1: Is a direct trading obligation an appropriate solution to the problems related to wholesale market liquidity?

49. Centrica has doubts as to whether a direct trading obligation on larger generators to offer terms to supply power would have the effect of improving liquidity as intended. We believe that compelling parties to trade with potentially less creditworthy counterparties may create market distortions and perverse incentives.

50. In terms of extending an obligation to require large suppliers to purchase power from small/independent generators, while the risks identified above do not eventuate in the same way, we do not understand what additional benefit would be achieved as we believe that this would generally happen in any case where purchases are economic.

Question 3: What requirements should be put in place relating to products, pricing, collateral and other conditions of trade?

51. If the approach of applying a direct trading obligation were to be undertaken, it would be essential to allow the party being compelled to offer terms to have some control over those terms. For example, a reasonable approach would be to require the licensed entity to apply the same terms of trade to equivalent counterparties or to be able to reasonably justify any differences.

52. In terms of the products and pricing to be offered, again, a reasonable approach is needed to minimise cost and maximise efficiency. Therefore a limited number of products of limited volume would need to be available at market related prices. It would not be practical to require supply to smaller suppliers at below market prices as this would increase the distortionary effects.

Question 4: Is it appropriate to extend the obligation to cover generation purchases?

53. As observed above, this may be a more practical option, but it would be essential to do a fully quantified cost benefit analysis to ensure that it is a cost effective option for consumers. In addition, we believe that such purchases will already be taking place where it is economic to do so.

Question 5: What costs would this option impose?

54. There would be a number of costs. Ofgem has correctly identified the administrative costs and that these could grow in relation to significant new entry. There is also the possibility that unless there was some standardisation of approach, these costs would be multiplied by multiple approaches by small suppliers to the same or different licensees in respect of small volumes.

55. While the volumes would be expected to be small initially, there is also credit risk associated with continuing supply to these small suppliers/new entrants. It is also likely that volumes required under these arrangements might grow to be significant over time. It is also necessary to ensure that this did not become an open ended obligation.

CHAPTER: Five – MARKET MAKING AGENT

Question 1: Is a market making arrangement of the kind set out in this chapter an appropriate solution to the problems related to wholesale market liquidity?

56. We believe that an obligation for a market participant to provide bids and offers with a pre determined spread could expose them to a significant increase in risk. A participant who is attempting to hedge could find themselves becoming more exposed if their bid is taken rather than their offer or vice versa. In practice this may happen automatically if there is matching of bids and offers and a participant could incur a considerable loss just in an attempt to return to their initial position.

57. Allowing participants to set their own bid-offer spread would impose less risk on participants and minimise the potential costs. In addition, it would improve cost reflectivity by ensuring that the costs to participants inherent in being pushed further out of balance can be properly factored in to the prices offered.

58. Presently, market participants who wish to buy or sell indicate their bids or offers with brokers who publish in real time the best bid and best offer clearly showing where the market is pricing.

59. The proposals in this section generally seem to relate to a day-ahead market maker. It is important to note that while limiting the proposals to day ahead may relieve the credit risk issue it does not help the smaller players with hedging requirements further out.

Question 2: What products should be made available through a market maker?

60. We would not support the creation of a market maker. However, if one were to be established it would be important to ensure that the products and prices offered were as close as possible to those in the real market to maintain a level playing field and minimise market distortion.

61. As with all interventionist policies of this type, it is preferable to minimise the impact and to provide incentives to move into the normal market (thus improving liquidity there) as soon as possible. On this basis, we would suggest that only minimal products in very small volumes should be made available to avoid perverse outcomes. While initially volumes are likely to be very small, with significant new entry or growth in customer bases, this would no longer be the case and the distortion would increase.

Question 4: Would the establishment of a “Market Making Agent” facilitate the introduction of market making?

62. We believe that there would be a number of difficulties with this proposal. As above, it would be important to maintain the incentive strength to transact on the main market where possible, hence this should be a provider of last resort rather than the "first choice" it would be likely to be if implemented in the way currently proposed.

63. As electricity is a physical product and ownership remains with the big 6 owner, it will be important to understand how close to gate closure such volumes will have to be available for supply and what the balancing implications might be if the volumes are not purchased by the smaller supplier. Who will meet the costs of such balancing? As above, while initial volumes may be small, unless this is structured as a last resort rather than a first choice option, these risks could grow to be more significant over time.

Question 5: What costs would this option impose?

64. There will be significant costs associated depending on scale and design, whether this is a minimum service or first choice product and the amount of risk borne both initially and if the portfolio grows.

CHAPTER: Six – MANDATORY AUCTIONS

Question 1: Are mandatory auctions an appropriate solution to the problems related to wholesale market liquidity?

65. It is not clear that a mandatory auction could have the intended effect without introducing unintended consequences. This proposal raises important questions in terms of market design and implications for related issues in the market, for example, the impact of price on related contracts.

66. In addition, the amount of physical generation is limited and is already churned several times over. On this basis it is likely that creating a mandatory auction in addition to the two exchanges currently operating would just move generation from one place to another, increasing market fragmentation. A further complication is the limited number of players who would potentially participate in the mandatory market.

67. It may be that there is scope for a strictly limited and defined auction to serve a shaping requirement for smaller players, but as stated elsewhere in the response it will be important not to remove the incentive towards balancing.

68. As above, we believe that before expending effort on creating a mandatory auction, it would be better to put effort into establishing a robust and trustworthy index as described in paragraph 8 above.

Question 2: How should the volume of generation subject to a mandatory auction be set?

69. While this would be crucial to minimising the adverse impacts, there is a danger of a pool type arrangement if all the volume associated with smaller suppliers or new entrants is supplied through a mandatory auction as it removes the obligation/incentive to balance unless costs are attached.

Question 6: What costs would this option impose?

70. Costs will be related to the design and scale of the auction. It is important to remember when trading further out (depending how far out the auction would extend) that credit risk issues for the trades still need to be addressed and these will add costs to auction participants.

71. As well as the costs noted in the previous paragraph, there are potentially significant costs in managing auctions for smaller players in terms of administration, margining issues and calculation of risk. In the light of these demands, it is not clear that smaller players have fully understood the difficulties attendant on auction processes or that this is, in fact, what they would like to see as a solution.

CHAPTER: Seven - SELF SUPPLY RESTRICTION

Question 1: Is a self-supply restriction an appropriate solution to the problems related to wholesale market liquidity?

72. As with the previous proposals, it is not clear that this would increase liquidity, it does not change the amount of generation in the market, only externalises trades and reduces choice.

73. A supplier will consider the costs of the generation required to meet its demand and will seek to optimise across its portfolio. In the case of its own generation being cheaper, it would be expected to use that or, depending on fuel source etc, if other power is cheaper, it would source externally. A self supply restriction reduces the ability to net internally, and means that the supplier may have to pay a premium price for additional external purchases (with associated credit and transaction costs) leading to potentially higher costs for consumers.

74. It is also the case that a supplier's own generation will not necessarily provide the best match for demand. For example, Centrica will try and achieve a reasonably close match in terms of supply and demand in advance of the day through a variety of trading activities (including some purchases from Centrica Energy), but fine tuning will take place at the day ahead and within day stage once there is more information on customer demand and asset positions.

75. Restricting suppliers/generators on the way in which they may trade could well have adverse impacts on efficiency and cost effectiveness to the detriment of customers. For example, based on the previous self supply restriction, Ofgem reasoned that the condition could incentivise more complex corporate structures (at additional cost) enabling trading via an affiliate, believing that was the most likely route to compliance.

76. The previous licence condition also required apportionment of generation purchased to particular customers in particular areas. This is not generally the way in which wholesale purchasing works and the allocation of specific contracts to particular customers would be unusual and inefficient. As the supplier moves towards gate closure, what matters for the supplier (and the system as a whole) is whether the supplier's overall demand is balanced. There are benefits for suppliers in managing risk where they have a large and balanced portfolio, arising specifically from the fact that many individual contracts will be aggregated to form the supplier's overall demand.

77. We also agree with Ofgem that it is not obvious that a self supply restriction will increase the availability of small clip sizes if that is the issue which matters most to smaller suppliers.

Question 4: Should a self-supply restriction be accompanied by measures to ensure that small participants have access to the products they need? If so, which products?

78. We do not support such a restriction. However, if a mechanism such as the one proposed were to be employed, it would be important to minimise its effects on the market., This would best be managed by ensuring that the incentive on the beneficiaries of the policy remains to trade in the market where they can and relying on the policy as a last resort rather than a first port of call. On this basis, we would suggest that only a minimum range of base products should be made available as a result of the accompanying measures and that the

incentives on participants to balance are not removed.

Question 6: What costs would this option impose?

79. As pre our previous responses to this question under the other sections, the costs will relate to the scale and design of the measure when implemented, together with the additional risks imposed on the restricted party and costs associated with market distortion.

CHAPTER: Eight – COLLATERAL REQUIREMENTS

Question 1: Do you think that any of the possible approaches outlined in this chapter have merit and should be pursued further?

80. We have elected to comment more generally in respect of this chapter, but we do believe that this is an important area which should be explored in more detail. While there are no costless solutions in terms of credit, efforts should be made to assess whether helpful measures could be introduced to improve the position for smaller participants without distorting the market.

81. In general, industry practice has developed to offer a large variety of instruments to manage inherent risks of different types and magnitudes. Examples include unsecured credit lines, margining agreements, parent company and third-party guarantees, netting agreements, Letters of Credit, deferred / advance payment and/or delivery terms (including on associated products like e.g. ROCs), credit derivatives, collateral requirements triggered by rating changes, and combinations thereof.

82. The choice of risk mitigation instruments available enables counterparties to negotiate what is most appropriate for them given the specific circumstances. For example, one counterparty may not be able to support an unsecured credit limit but may have access to a Letter of Credit (LC) on favourable terms, whilst another may have only limited access to LCs but does cash available to provide as collateral.

83. Enforcement of a certain type of risk instrument or policy across the whole or wide parts of the market may actually make it more difficult for companies to comply with the specific requirements, which in turn could reduce liquidity.

84. On balance, we are concerned that enforcing/restricting the choice of risk mitigation instruments (including, but not limited to forms and types of collateral) rather than increasing access to the market, might instead increase barriers to entry and limit the ability of companies to trade with each other because of the concentration of counterparty-related risks in one area.

85. The issues around credit are not limited to smaller or new entrant participants. Large players also need to maintain a balance between taking credit risk and posting collateral as a way to mitigate credit risk. An excessive collateral requirement can result in companies requiring to use large amounts of cash to support the collateral agreements to finance it may have reduce their capital investments or incur in more debt.

86. Supporting collateral agreements needs a minimum of operational infrastructure to calculate collateral values, value exposures accurately and compare with the collateral held in order to safely support the daily movements of cash or letters of credit. This implies additional costs and investments in the back/ medium offices that small players may find challenging to meet. In the absence of robust administrative arrangements. Smaller players may experience increased operational risk which may result in default due to operational errors.

87. When considering non-standard forms of collateral, it is important to recognise that such collateral (in the form of assets less liquid than cash or different from Letters of Credit) poses additional challenges.

88. It may be very difficult to attach a consistent value as the price of most instruments (such as bonds, equities and even renewable certificates) changes frequently. Valuing these instruments therefore requires access to market quotes and expertise. In addition, in order to accept such collateral as security, companies need to be able to compare reasonably accurately the value of these instruments with the underlying exposure that they are intended to mitigate.

89. The correlation between risk mitigation instruments and the underlying exposure will probably be imperfect leading to the use of a buffer zone, which would value the collateral instrument at a proportion of the market valuation, again potentially leading to a requirement for additional security as the values of such instruments change.

90. Effective use of these types of collateral requires the operational infrastructure to value these alternative assets in a timely manner. If parties do not have this infrastructure in place, this may well delay the use of this practice or render it impractical other than in exceptional circumstances.

91. The ability to flexibly manage counterparty risks supports efficient trading between market participants; it could benefit from a further increase in the diversity of instruments available to mitigate credit risks in the industry. In particular, it may be beneficial to explore the availability of credit ratings and financial information, in particular for smaller market participants; Credit insurance (or similar products such as payment guarantees or credit support for obligations in excess of pre-agreed thresholds) provided by strong institutions and/or government-backed entities on transparent terms; and the use of Price reference indices (as discussed above) for calculating mark-to-market positions and /or the development of financial derivatives for hedging.

92. Two further options worth exploring may be the development of a pool cover insurance policy and the provision of a credit line to rated entities.

93. The cost of pool cover insurance could be taken by the participants in proportion to the volume traded, assuming that small players would then trade volumes up to an amount that they can cover the risk on. New entrants may be given a defined grace period, with free insurance cost for a limited amount of initial volume and the cost of this socialised.

94. A credit line could be provided to the rated entities in proportion to their company size and rating on a predetermined scale – this would need to apply to all participants. Volumes above the credit line would then require insurance at a flat fee across all players.

CHAPTER: Nine – CONCLUSIONS AND NEXT STEPS

Question 1: Do you agree with the proposed assessment criteria?

95. Subject to our comments in the response above, the proposed assessment criteria appear reasonable as high level objectives. However, we can only offer conditional support in the absence of additional detail as to how performance against the criteria would be measured in both quantitative and qualitative terms.