James Grigor
Economist, Energy Economics
Ofgem
9 Millbank
London
SW1P 3GE

23 April 2010

Dear James,

Liquidity Proposals for the GB wholesale electricity market

EDF Energy welcomes the opportunity to respond to the above consultation.

The key points of our response are as follows:

- EDF Energy supports the development of a liquid UK wholesale power market. We recognise that the UK has lower liquidity than some other European countries and therefore support initiatives to enhance liquidity in the UK.
- We agree with Ofgem that there should not be a specific target level of liquidity as a judge of success. In this respect, it is not necessarily appropriate to benchmark the UK against other power markets which have higher levels of interconnection.
- Liquidity may also be affected by the mismatch in generator and supplier trading horizons. For example, generators may look to secure a return on the investment in plant and to cover fixed costs by selling on a longer time horizon (e.g. 1-5 years), whereas suppliers may wish to manage the risk associated with uncertain customer volumes in the time horizon 0-3 years.
- We agree that the market should be given the opportunity to develop solutions to enhance liquidity rather than direct regulatory intervention, which, however well intentioned, may have adverse consequences.
- Market initiatives such as the new N2EX power exchange should facilitate and enhance liquidity. UK market participants (including EDF Energy) have been proactive in developing N2EX, with this objective as a key deliverable.
- We acknowledge that the N2EX is in its infancy, but it is in the process of securing significant additional participants. However, it should be noted that collateral requirements in general, including those required by the N2EX, may be a barrier to entry for some participants. This is certainly more acute in the current economic climate.
- The future challenge for the industry and Ofgem is to ensure that the N2EX is an attractive trading platform for all market participants in terms of both product availability and entry requirements. Measures to reduce barriers (e.g. appropriate collateral requirements) in order to attract smaller and or independent players are to be

encouraged. However we need to be careful that, in doing so, risks or additional costs are not transferred to others in the exchange community.

- We agree with Ofgem that appropriate success criteria should be developed for the industry led initiatives. Whilst supporting the first two criteria, we are concerned by criteria 3 and 4. Firstly, these success criteria seem to be addressing the availability of specific products required by small suppliers rather than market liquidity. Many small players are seeking bespoke, shaped products in smaller clip sizes than 1MW, and so it may be the case that their needs are not naturally met by a standard wholesale electricity market. Other critical factors, most notably credit and collateral requirements, may also deter small and/or independent suppliers from participating on trading platforms. More appropriate success criteria may be to measure the depth of bids and offers quoted on the exchange.

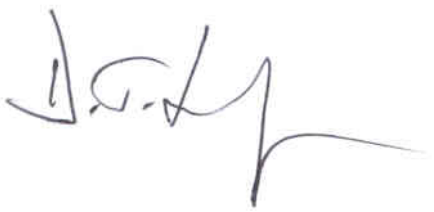
- We agree that Ofgem should continue to monitor the impact on liquidity levels of any market initiatives. However, sufficient time should be given in order to judge the success of N2EX in achieving a more liquid power market. We believe an interim review after 6 months is useful to understand how liquidity levels have progressed since the start of the year. However, Ofgem's mid-year conclusions should not lead to any direct regulatory intervention. A full year is required to ascertain whether the N2EX and other market initiatives are beginning to deliver value.

- If Ofgem decided to implement a new policy option, the most appropriate of those presented would be the introduction of a requirement on all market participants to trade a proportion of their available capacity through a consolidated day-ahead auction. This would concentrate liquidity and allow for the development of a robust price index, which would facilitate the creation of a financial forwards market and further enhance market access and liquidity. Clearly the design of the auction would be critical; it should be robust enough such that it cannot be manipulated.

Our detailed responses to your consultation questions are found in the attachment to this letter.

If you have any queries on this response or would like to meet to discuss it further, please do not hesitate to contact Rob Rome on 01452 653170, or me.

Yours sincerely,



Denis Linford
Corporate Policy and Regulation Director

Attachment

Liquidity Proposals for the GB wholesale electricity market

EDF Energy's responses to the questions raised in the consultation

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?

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

EDF Energy acknowledges that the UK electricity market has lower liquidity than some other European countries and therefore supports market initiatives to enhance liquidity in the UK. We agree with Ofgem that there should not be a specific target level of liquidity as a measure of success. In this respect, it is not necessarily appropriate to benchmark the UK against other power markets which have significantly higher levels of interconnection.

Generators looking to secure a return on the investment in plant and to cover fixed costs will normally wish to sell on a longer time horizon (say, 1-5 years) than suppliers wishing to manage the risk associated with uncertain customer volumes (say, 0-3 years). This timing mismatch may be partly covered by the trading activities of intermediaries, such as financial institutions, but, to the extent that is not covered in this way, it forms part of the perceived liquidity problem.

We agree that the market should continue to develop solutions to enhance liquidity rather than direct regulatory intervention, which, however well intentioned, may have adverse consequences.

Chapter Two: Success criteria for market initiatives

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

We believe the first two success criteria are appropriate; indeed high volumes traded and availability of key longer dated products are relevant for any liquid traded market and so should be pursued in any event.

High volume traded will indicate an active market, but it should be noted that substantial market depth (high volume of tradable prices quoted at any particular time) will also indicate a liquid market even if little is actually traded. It should also be recognised that even in the most liquid markets liquidity is concentrated in the front two years (and mainly in the front two seasons).

Ofgem should be careful in adhering to criteria 3 and 4 as a measure of enhanced market liquidity. These success criteria seem to be addressing the availability of specific products

required by small suppliers rather than market liquidity. Many small players are seeking bespoke, shaped products in smaller clip sizes than 1MW, and so it may be that their needs are not naturally met by a standard wholesale electricity market. Ofgem should consider tackling these two issues separately.

Margin collateral and credit requirements are likely to remain a significant concern to smaller participants which success criteria 3 and 4 do not address.

With regard to larger participants, EDF Energy is disappointed by the level of uptake in terms of their registration on the N2EX. We believe that more time should be given in order to allow participants to register and become comfortable with trading through the exchange. This time is required to enable the necessary back office functions, for example margining, to be established and the necessary trading hardware and software to be installed.

Positive feedback from small/independent suppliers and potential entrants is desirable but we believe more rounded feedback would include responses from all market participants.

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

Ofgem should look at a range of indicators such as volumes traded (churn), range of products, market depth, numbers of participants in N2EX, volumes of bids and offers on the exchange and the relative spreads between these. Trends over time rather than absolute measures should be assessed; i.e. it would not be appropriate to set any particular target level.

Question 3: When should market success be judged?

We agree that Ofgem should continue to monitor the impact of any market initiatives on liquidity levels. However, sufficient time should be given in order to judge the success of N2EX in achieving a more liquid power market. We believe an interim review after 6 months is useful to understand how liquidity levels have progressed since the start of the year. However, any mid-year conclusions should not lead to any direct regulatory intervention. A full year is required to ascertain whether the N2EX and other market initiatives are beginning to deliver value.

The future challenge for the industry and Ofgem is to ensure that the N2EX is an attractive trading platform for all market participants in terms of both product availability and entry requirements. However, any measures to attract smaller and/or independent players by reducing barriers (e.g. collateral requirements) should not transfer risks or additional costs on to the remainder of the exchange community.

Chapter Four: Obligation to trade directly with small independent suppliers

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

We believe that a direct trading obligation is not necessary in the current market. This is because large participants will always seek to provide prices to customers, as this is their primary source of revenue, and, if small suppliers approach them in this capacity, they will always receive prices. A direct trading obligation is not really helpful since successful trading requires the matching of a willing buyer and willing seller; an obligation could only realistically cover very standard products on very standard terms, which would not necessarily meet small suppliers' needs.

Question 2: Which licensees should be subject to the obligation?

N/A

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

Requirements are very much dependent on the type of product sought by any customer. The time and resource required to structure an offer for bespoke and/or shaped products should not be underestimated. We would be reluctant to provide collateral discounts to customers if their credit rating were not adequate, particularly in the current economic climate.

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

A similar approach to the above would be used for generation purchases as applicable.

Question 5: What costs would this option impose?

If the proposed option involves standard products, it is an extension of the sales and trading functions already employed by most market participants. However, the time and resource required to structure an offer for bespoke and/or shaped products should not be underestimated.

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?

We believe that the market making agent proposal is not an appropriate solution for the reasons given below. In fact the proposal in its current form could reduce liquidity in comparison with a free market approach. The proposal envisages each of the big six being

required to submit prices to a market making agent, who then selects the best bid and offer and places them on the exchange. If the 'big six' had such an obligation, liquidity would be best served by their placing their bids and offers onto the exchange directly. This will still enable the best bid and offer to be shown to the market on the exchange but further increases liquidity by increasing market depth, as six different bids and offers would be shown to the market rather than just one set under the market making agent proposal. In addition all exchange prices are shown anonymously (the exchange is the counter party to every trade), and so there would be no disadvantage to participants in this approach.

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

If a market maker obligation was implemented, we believe that it could only cover standard products rather than bespoke, shaped contracts. Otherwise it would be a straightforward passing of shape risk from small suppliers to those underwriting the market maker function.

Question 3: What volume obligation would be appropriate?

The volume obligation will vary according to the underlying contract, with shorter contracts facing a high obligation due to their smaller size in terms of hours. For example, while a 5 MW obligation would be appropriate for the longer dated contracts, such as seasons and years, shorter contracts such as months and weeks may have a higher obligation of around 20 to 50 MW.

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

No. See above.

Question 5: What costs would this option impose?

Under the market making agent option there would be two primary costs. The first is a very significant financial cost of underwriting the underlying products as well as operating and administering the market making function. The second is the cost to the market resulting from a reduction in liquidity caused by only one set of bids and offers being shown to the market.

Chapter Six: Mandatory auctions

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

With regard to the day-ahead option, we believe that a mandatory auction will only provide a sufficiently robust reference price if it is compulsory for all. This would require all generators to offer a proportion of their available capacity, with all suppliers being required to bid in a proportion of their forecast demand to the auction process on a day-ahead basis. Clearly the design of such an auction would be critical.

Under the forward contracts option, these are currently traded in the market in any event, either through OTC or an exchange and there does not seem to be any additional benefit to be gained.

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

We believe that, in order to achieve the robust reference price desired, a proportion of available plant should be offered into the exchange as above. Further all suppliers should be required to bid a proportion of their forecast demand.

Question 3: Who should be obliged to offer into the auction?

All licensed generators should offer a proportion of their available plant and all licensed suppliers should bid in a proportion of their requirements.

Question 4: What design features should be incorporated into the auction process and rules?

Any mandatory auction should be based on marginal tranche pricing. As above, all licensed generators and suppliers must offer or bid in a proportion of their available plant or forecast demand to the exchange. The exchange would then calculate the highest price necessary to fulfil all the suppliers' bids. This price would then become the reference price for the day.

Question 5: Should the mandatory auction apply to day-ahead volumes and/or to longer dated forward products?

The auction should only apply to day-ahead, with allowances made for weekends and public holidays, for example, prices for Saturday, Sunday and Monday are set on the previous Friday. Longer dated products are likely to receive some stimulus if participants are confident that the day-ahead index is a robust reference upon which to trade.

Question 6: What costs would this option impose?

The auction process clearly has a cost involved in its administration; this will need to be borne by all participating parties, who would be required to register with the exchange and pay exchange fees on the volumes transacted. There may be significant costs for participants who may have to deviate from current or future trading strategies in order to fulfil their obligations under a mandatory auction regime.

Chapter Seven: Self supply restrictions

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

We believe that self supply restrictions may not be effective in promoting wholesale market liquidity. Firstly, vertically integrated companies are unlikely to be perfectly balanced between generation and demand, either in total volume or in shape. Secondly, the normal hedging activities of most vertically integrated companies will lead to some timing differences between the sale of generation output and the purchase of volumes to meet customer demand, with generation volumes typically sold earlier than the corresponding supply purchases. As a result, there are good commercial reasons why companies will buy a proportion of their supply requirements from the market in the absence of a self-supply restriction. If companies trade to a greater extent than determined by these commercial drivers, they are likely to increase their collateral requirements and their risk exposure, leading to increased costs that may ultimately fall on customers.

Self-supply restrictions will, in many cases, lead to very little incremental trading activity beyond current levels of activity; to the limited extent that they do lead to increased trading activity, they are likely to lead to increased costs. They may also give perverse incentives to create artificial trading structures which may be difficult to police effectively.

Chapter Eight: Collateral

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

We believe that collateral is the most important issue affecting market liquidity. Collateral requirements can be a barrier to entry. This is more pronounced in the current economic climate. The future challenge for the industry and Ofgem is to ensure that the N2EX can reduce these barriers without imposing additional risks on the remaining market participants.

The approach which would have most beneficial effect on market liquidity would be for trades to be cleared on an exchange. This may help to remove credit risk from the market and potentially enable a wider range of participants to become involved.

Another important consideration is that exchanges typically are the notification agents for trades conducted on the exchange, thereby also removing notification risk. Again this may encourage additional participants into the market.

On the exchange the margin calculations are identical for all participants, with the obvious exception of individual trades size. This means that small participants pay the same margin rates as large ones. The advantage to small participants of trading on the exchange on a cleared basis is therefore that they not penalised for their relatively small size and lack of credit rating.

Chapter Nine: Success criteria for market initiatives

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

Please refer to our comments on the questions covered under chapter two.

Question 2: Which do you think is the best policy option or combination of options?

If Ofgem concludes that regulatory intervention is required to enhance market liquidity, the most effective of the measures proposed would be the introduction of a mandatory day-ahead auction as discussed above. This would provide a robust reference price, which would enable the trading of financially settled forwards and futures. In turn this would encourage the entry of new participants, such as hedge funds and other financial institutions.

EDF Energy
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