

## Appendix 1

### Chapter 1

#### **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?**

Yes, lack of access to wholesale product at the right level of granularity and clip size is a major barrier to entry and hence competition, and is one of the main reasons for the high level of concentration amongst the big six in the supply market.

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

The issues of product granularity, clip size and collateral which prevent new entrants from cost effective wholesale hedging are present in both the electricity and gas forward markets. An explanation of the difficulty of implementing a volumetric hedge with standard products at standard clip sizes is shown in Appendix 2 (this appendix is confidential to Ofgem). We believe that to improve competition addressing issues with the wholesale gas market are as pressing as those with electricity.

### Chapter 2

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

The key success criteria for new entrants will be availability of longer dated products (2 to 3 years) at suitable clip sizes and granularity to efficiently hedge the price risk between retail prices and wholesale markets. In our view these should be physical rather than financial.

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

We believe that an expert group should be convened by Ofgem to identify and measure the current and appropriate target performance against agreed measures.

#### **Question 3: When should market success be judged?**

This matter needs to be addressed as soon as possible. The issues have been 'on the table' for at least the last five years, and the initiation of prompt trading on N2EX presents only a small shift towards the provision of appropriate products for hedging retail customer demand for new entrants. We are particularly concerned that the short term excitement surrounding N2EX should not distract Ofgem from moving forwards with the structural changes required. In principal we believe that final decisions should be made by the end of summer this year. In the meantime further detailed development of the proposed solutions should be undertaken by Ofgem.

### Chapter 3

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

We believe that an effective solution will probably encompass a hybrid of self supply restriction, information provision from vertically integrated companies (gas and electricity) and regulated market maker.

### Chapter 4

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

Whilst this solution would provide access it would not provide price visibility unless combined with the market maker option.

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

The obligation should be placed on large generators and suppliers.

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

Ofgem would need to put clear guidance and compliance monitoring in place across the range of parties subject to the obligation, and this would not be as effective as discharging these responsibilities through a regulated market maker.

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

Yes.

## **Question 5: What costs would this option impose?**

We believe that this option does not meet the objective of price visibility and is not the most cost effective.

## **Chapter 5**

### **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?**

The market maker provides a key mechanism to address the issues of product and price transparency to support hedging of retail customer demand. Detailed design will be required to make this solution effective and prevent gaming.

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

The market maker should provide product at the right level of granularity and clip size for new entrants to hedge retail customer demand over a 2 to 3 year forward horizon.

### **Question 3: What volume obligation would be appropriate?**

We believe that a volume obligation of 500,000 customers per supplier participant is appropriate.

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

A well designed regulated market maker in conjunction with a self supply restriction on vertically integrated companies would improve liquidity, which in turn would attract market making.

## **Chapter 6**

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

It is difficult to see how mandatory auctions can address the issues of the provision wholesale product at the right level of granularity and clip size.

## **Chapter 7**

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

We believe that a self supply restriction on vertically integrated suppliers (both gas and power) alongside a well designed regulated market maker would provide a solution to the problems of access to wholesale product at the right level of granularity and clip size experienced by new entrants.

**Question 2: Who would be covered by the self-supply restriction?**

Self supply restriction should cover all vertically integrated suppliers (both gas and power).

**Question 3: How should the extent of a self-supply restriction be set? Should it relate only to the supply to domestic customers?**

Self supply should be applied above a minimum threshold of supply market share in MWh

**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?**

Yes, product at the right level of granularity and clip size for new entrants to hedge retail customer demand over a 2 to 3 year forward horizon.

## Chapter 8

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

Collateral requirements are a major issue for small suppliers, we believe that an effectively operating regulated market maker would provide the infrastructure for further market based solutions to the collateral problem.

## Chapter 9

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

We agree with the high level assessment criteria

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

We believe that an effective solution will probably encompass a hybrid of self supply restriction, information provision from vertically integrated companies (gas and electricity) and the regulated market maker.



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23<sup>rd</sup> April 2010

Dear Andy

### **Liquidity proposals for the GB wholesale electricity market**

First Utility welcomes both Ofgem's and the Government's recognition that wholesale market liquidity is a barrier to entry and operating in the energy supply market.

As a supplier our principle requirement of wholesale markets is for competitively priced access to physical product at the appropriate level of granularity and clip size to effectively risk manage our fixed price retail supply contracts. Alongside access to power and gas physical product we also require access to more efficient mechanisms for collateralisation of our forward positions which currently represent a significant proportion of our working capital.

Whilst good progress has been made in recognising these as issues, we do not believe that current market based initiatives focussed on the prompt market and asset optimisation will bring about any meaningful change to address the issues of new entrants. It is also clear that the potential remedies outlined in the consultation would require a significant level of detailed design to ensure effective implementation when regulatory intervention is required.

As always First Utility is happy to discuss with you further our response contained in Appendix 1 and 2 (Appendix 2 is confidential to Ofgem).

Yours Sincerely

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