

## Chapter 1

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

Low liquidity has been recognized as a central weakness of the GB Wholesale Power Market for several years by participants and regulator alike. Lack of liquidity in a market hampers hedging activities, discourages new entrants and limits trading opportunities. All participants that N2EX has met with have expressed their eagerness to see this situation remedied.

From this perspective, policy intervention is clearly a valid course of action for the market regulator to consider. However, such intervention should be carefully weighed against the market's own initiatives to correct the situation by its own means. The FOA's Power Trading Forum spent many months drawing up a detailed RFP in an attempt to redress the key weaknesses of the Wholesale Power Market – Low Liquidity, Limited Credit Access and High Barriers to Entry. As the Exchange and Clearing Provider selected by this extensive process, N2EX believe that these weaknesses are best resolved through a fundamental redesign of the market infrastructure aimed at building liquidity in standardized products, removing key barriers to entry and providing a centralized clearing counterparty for all participants.

N2EX opened for business on January 12<sup>th</sup> and progress is demonstrable. Membership now stands at 15 along with an additional 30 companies engaged in the membership process. Volumes have been modest thus far but both the Condico Clearing Platform for OTC Trades and the Sapri Day Auction are functioning well. We believe that because of the explicit buy-in from key market participants and the ongoing cooperation with the cross-industry body the Market Council that recent progress will be maintained and accelerate over the coming year.

## Chapter 2

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

Ofgem's high level success criteria are well considered and accurately reflect the key weaknesses of the GB Wholesale Market. These criteria also correspond closely to the key objectives of the RFP by which N2EX is being measured. We intend to fulfill all of Ofgem's success criteria through the following actions:

- i) We aim to produce standardized core liquid contracts for both physical and financial settlement. During its current primary phase N2EX has developed clear and transparent reference prices, standardized credit access for its members and put in place a formal banking structure for the settlement and margining procedures.
- ii) The next phase of our development will be to produce a comprehensive suite of financially settled futures contracts based upon the N2EX reference prices. These will be directly accessible to all NASDAQ OMX Members as well as to non-Members through a recognized network of GCM providers. NASDAQ OMX will act as the CCP for these products removing the troublesome credit arrangements currently limiting activity in curve trading for GB Power and simplifying the route to market for smaller market entrants. This project is currently working towards an end-June deadline for internal readiness.
- iii) N2EX has developed two platforms specifically for the GB Wholesale Market – Condicto for the Prompt Products and Sapri for the Day Ahead Auction. These platforms come with extensive technological support and are free of charge to all members along with a complete set of historical data.
- iv) The initial period following the N2EX launch has concentrated on getting the large core trading participants live and active on the market. This task is now close to completion and we expect liquidity to follow as a direct consequence.

The next task for N2EX is to attract small participants by highlighting the benefits that we provide to satisfy their needs:

- a. Removing the need for multiple GTMA set up
- b. Simplification of Credit Access – single relation with NOMX as CCP
- c. Single liquidity pool with all prices available to all participants

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

Ofgem's high level criteria match the key objectives of N2EX:

- i) to radically increase liquidity
- ii) to establish a transparent and accessible curve market
- iii) to standardize and make available trading and clearing technology to the broader market
- iv) to gain buy-in from small market entrants and satisfy their diverse business needs

Liquidity is the easiest criteria to quantify especially given the transparency of the cleared N2EX platform. Volumes can effectively be compared to both historical data from the GB Power Market as well as to other international power markets and benchmark energy contracts. Ofgem has accurately documented the volume performance of the GB Wholesale Market in recent years and N2EX has utilized this data for its own analysis of the market. We expect N2EX volumes to grow in parallel with membership levels and believe that the advantages described previously of simplified credit arrangements, GTMA setup and a concentrated liquidity pool will serve as a catalyst for the type of volume increases that Ofgem is seeking.

Financially settled futures based upon the N2EX reference prices will shortly be available from NASDAQ OMX. The internal project working upon the delivery of these contracts has aimed to minimize the barriers to entry – producing standardized financial futures based upon the regular calendar, removing the need for GTMA setup and offering

instant distribution to the broad NASDAQ OMX membership and GCM network of clearing providers. The success of these contracts will be readily quantifiable through the transparent publication of volume and price history for all trades through the NASDAQ OMX data channels. Performance levels should be monitored against the breadth of contracts available and the extent of participation both in terms of volume and the number of active participants.

The broad availability of trading platforms will also be advanced by the N2EX initiative. All N2EX trading platforms are provided free of charge to all members. Whilst for the curve market NASDAQ OMX is working to extend its spectrum of ISV providers to work alongside the own brand Click trading platform. Measuring success in this area is more troublesome although the membership levels at N2EX will provide a good indication of uptake and penetration.

The all important positive feedback from small participants and new entrants should arise from the successful completion of the previous criteria. N2EX believe that the integrated provision of a combined Day Ahead Auction, automated Prompt Clearing system and robust reference prices for financial futures will attract a new community of direct participants to the GB Power Markets. Success in this area is less quantifiable than for the other criteria but we hope to see both new names participating as well as more direct participation from established small generators and heavy consumers.

### *3. When should market success be judged?*

N2EX already recognize demonstrable progress in the GB Wholesale Market. Cooperation between participants in developing the new market structures is high; the platforms are proven and fully functional; banking and legal formalities are in place and membership is increasing rapidly.

Progress according to Ofgem's criteria should now be measured on an ongoing basis but with the acceptance and recognition that this initiative will take many months to gain traction. The development of N2EX requires membership to a new clearing house and

new exchange alongside new banking structures, regulatory format and technology platforms. Participation at N2EX is a major undertaking for all would-be members.

We believe that Ofgem will be able to conclude that concrete progress has been made by N2EX for all of its high level criteria by the end of 2010. However, a final judgment will take much longer. Nord Pool's experience from developing the Nordic Power Market has shown that many years are needed for a market to reach maturity. This will certainly be true of GB Power as well and we encourage Ofgem to allow the market as much time as possible to remedy itself now that its own initiative is finally open for business. In due course a successful N2EX aims to:

- create a direct route to market for small market entrants and remove the need for multiple GTMA set up
- provide risk management products currently unavailable to SME's and encourage wider participation in the UK Wholesale Electricity Market
- bypass the complex bilateral credit arrangements currently required in the market – Clearing members are always able to trade with all other clearing members creating a level playing field
- provide a transparent single trading platform for Auction/Prompt/Spot to make possible the creation of a low cost trading desk with minimal personnel
- allow SME's to access shape at the same transparent market prices used by their larger competitors
- produce robust reference prices and matching financial contracts to facilitate longer term hedging activities – financial settlement further streamlines solution
- ultimately phase out the need for 'full requirement' contracts for SME's

## Chapter 6

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

N2EX is of the general opinion that market participants together with the market place should develop attractive products for managing their energy portfolios. Once the market model has been selected liquidity must be created through a market driven initiative. The Nordic Market underwent gradual development over many years with products being developed with input and experience from both market participants and market operator. This created a deep-rooted commitment towards the market solution and gradually built the wholesale market liquidity currently seen behind the Nord Pool Spot reference price for electricity.

We believe that this interaction is the smoothest way to create liquidity for both short term contracts for trading and balancing of physical obligations as well as long term contracts for risk management. Additionally, a market driven initiative secures the long term commitment of participants that is needed in order to build confidence and reliability.

In order to be successful mandatory day-ahead auctions also need a strong natural support from the market participants. If this support is lacking mandatory auctions might prevent market participants from adopting the market model as the best and preferred solution in the long term perspective. Auctions on longer term (as VPP) are mainly a tool to proactively stimulate competition and not necessarily a generator of additional the daily liquidity.

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

Either a prescribed share of the total market volume is required to be traded through the auction or else the vertically integrated companies are required to split their internal portfolios and trade each of them separately through the auction.

*3. Who should be obliged to offer into the auction?*

This has to be imposed on producers and vertical integrated companies above a predefined threshold.

*4. What design features should be incorporated into the auction process and rules?*

It has to be decided on which platform this should be used to concentrate liquidity and the market needs efficient hedging possibilities to an index coming from this market.

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

As mentioned N2EX believes that the focus should be on the Day-Ahead. It is also important that this is followed by efficiency trading platform for handling the forward trading to handle the risk exposure.

*6. What cost would this option impose?*

A gross bidding fee has been presented to the market, but is still not implemented. Gross bidding minimizes the transaction costs of this setup for the customer.