SCOTTISHPOWER

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28 April 2010

Dear Sirs,

LIQUIDITY PROPOSALS FOR THE GB WHOLESALE ELECTRICITY MARKET

Thank you for the opportunity to respond to your consultation on this subject. We at ScottishPower are strong advocates of competitive energy markets and see liquid and transparent markets as a vital component of a competitive energy sector. We welcome the scope for new entrants to enter the supply market and the vitality and new ideas that they bring.

In responding to Ofgem's concerns on this topic, it is very important to be clear as to the nature of the concern that the possible remedies are intended to address. We can see two possible issues:

(a) bulk liquidity in the market, in terms of high volumes of products being traded at various maturities; or

(b) the availability of appropriate products to enable small suppliers to enter and retain their position in the market.

In our view, there is only a very limited connection between these two issues. For a small independent, seeking to buy a few GWh of power over a year, it matters little whether the total annual traded volume is 1,000 TWh or 5,000 TWh. Much more important is ensuring that there are appropriate clear price references; that power is available in small parcels (or "clips") which are more digestible for a small supplier; and that credit or contractual requirements are easy to understand and deal with.

We believe that contestability of the market, as opposed to bulk liquidity, is Ofgem's principal focus. But the two concepts are conflated in much of the paper which means that a number of the remedies suggested lack clear objectives. We would make the following observations:

- new entrants can find the legal and credit arrangements that are necessary to enter the wholesale market difficult to understand. We would like to see ways to assist in this – perhaps through guidance documents – recognising that a sound contractual basis and proper credit management are necessary for the market to run properly;

- we would like to see better aggregation (and possibly market maker) opportunities to assist new entrants dealing in small clip sizes. While we do try to assist smaller companies with small clips, we generally can't trade them on, so they involve additional risk for us;

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- third party sites such as Heren do in our experience provide solid and dependable price references;

- the trading mechanics cannot ultimately protect participants from the underlying volatility in the market and the need to have adequate risk management procedures in place. This is the issue which has tended to cause solvency issues for a number of participants over the years.

While there could be scope for improvement as described above, we would not be supportive of an obligation to offer terms to new entrants. It is unclear how such an obligation would sit with the credit and contractual requirements, and we do not see any basis upon which Ofgem could regulate the prices of such offers.

Turning to bulk liquidity, we find it to be adequate, though not plentiful. Our total trades equal roughly three times our generation volumes. There is reasonable liquidity in baseload electricity for at least two years, but the forward market in shaped products in more limited. We would prefer to see more trade in longer dated shaped products – but not at the expense of fragmenting the market such that the present longer liquidity in baseload power was put at risk. Although the value of shape does vary, for example, in response to the supply/demand balance, market participants can hedge the majority of their risk through baseload products and switch them to the appropriate shape nearer to delivery.

Recent market and political developments have tended to push energy retailers (and major users) into shorter hedging strategies. Many market participants are wary of buying long term commitments that might be out of the money. This has affected the demand for buying long dated products at fixed prices (though it is possible to strike longer term deals with floating prices). That lack of demand can affect liquidity for longer dated products. Nevertheless, the GB market already trades several times physical delivery, and accordingly the regulatory options suggested for bulk liquidity (such as self supply restrictions and compulsory auctioning) are likely to have little or no positive impact.

The latest European Commissioning benchmarking report shows that GB has the least highly concentrated electricity market with the highest number of significant market players (market share >5%) and the smallest share of the market owned by the largest 3 companies. Markets which are more liquid are not necessarily as competitive and open as the GB electricity market. The GB gas market has significantly better liquidity than the power market and yet the domestic share for small suppliers is not significantly greater (both around 1%). Indeed, the Nordpool, which has traditionally been held up as a model of liquidity, does not offer particularly long trading options.

I attach a note which gives some further comments and provides answers to your specific questions. In essence, we would strongly recommend that Ofgem clarifies its thinking around the issues described above before initiating a regulatory response that might be ineffective and/or have unintended consequences.

We would like to take the opportunity of holding further discussions about this matter. In the meantime, please contact me if you have any questions.

Yours faithfully,

Rupert Steele

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Director of Regulation

ANNEX

Liquidity Proposals for the GB wholesale electricity market

ScottishPower Comments

Like Ofgem, we would like to see market initiatives delivering improvements in liquidity for the GB electricity wholesale market. All trading activity requires a willing buyer and a willing seller and we believe that market based initiatives will be the most successful in improving liquidity, by encouraging those who wish to trade energy commodities to participate in the market.

However, we do not believe that evidence has been produced linking a lack of new entry in the energy markets to the general liquidity levels observed in the GB power market. It is generally agreed that there is sufficient liquidity in the GB wholesale gas market and yet the domestic market share of small gas suppliers is not significantly greater than the market share of small electricity suppliers even though liquidity is lower in the GB electricity market. The requirements for new entry into the half-hourly balancing electricity market are more onerous than for the daily balancing gas market, but this has not manifested itself in the market share of small electricity suppliers being significantly less than the market share of small gas suppliers.

We remain fully committed to offering small suppliers or other market participants the ability to purchase energy from ScottishPower at competitive, market-based prices on the same basis as our own retail business. Naturally such prices will need to reflect costs associated with shaping power and gas to meet the purchaser's needs, as well as dealing with risk and credit considerations.

It remains our belief that the major deterrent to entering the supply market has not been the mechanics of the trading arrangements but the underlying volatility and risk of energy prices, which is driven largely from international circumstances. That risk and volatility has also been a key factor behind many of the small supply failures observed in the GB market, where the suppliers may have had insufficient risk management and the lack of an effective commodity hedging strategy.

We set out below answers to the specific questions in the consultation document.

1. 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?

We see liquid and transparent markets as vital in the energy sector. While current liquidity levels are acceptable in our view, we support practical initiatives to improve market liquidity as this would have general benefits both for existing market participants and for potential new entrants.

However we do not believe that evidence has been produced linking a lack of new entry in the energy markets to the overall liquidity levels observed. It is generally agreed that there is sufficient liquidity in the GB wholesale gas market and yet the domestic market share of small gas suppliers is not significantly greater than the domestic market share of small electricity suppliers, even though liquidity is lower in the GB electricity market.

It is also important to be aware of the risk that policy interventions could be counter-productive if they fragmented liquidity or forced trading to take place in products that were not helpful for risk management.

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

We agree that the focus should be on the electricity market.

2. Success criteria for market initiatives

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

We think that the suggested success criteria do not clearly map to the objectives of the exercise. For example, high volumes of trade in standard products will be of little or no use to potential market entrants and will not be indicative of the availability of shaped products at longer dates.

Some sort of measure as to whether there are appropriate options available for small and independent suppliers to meet their hedging and shaping needs would be appropriate (noting that even large suppliers may trade baseload for hedging and do the shaping trades closer to delivery).

We think that caution should be attached to a success criterion couched in terms of the opinions of independent and small generators. Inevitably, if such parties believed that expressing concern could lead to credit support or shape being provided to them on better terms (even if below the efficient cost), they would have a strong incentive to make negative comments whatever the position.

We think that there is little alternative but for Ofgem to make an objective assessment as to whether small/independent suppliers are broadly able to meet their needs in relation to volume, shape and duration at an efficient level of cost.

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

We doubt that much would be achieved by targeting a particular level of trading churn and we question whether attempting to micro-manage the amounts of liquidity in particular products is a feasible strategy that would deliver what is wanted.

Any specific targets would need to be carefully judged to avoid unintended effects. For example, a policy aimed at increasing liquidity of shaped products could be counter-productive if its effect was to fragment liquidity in baseload power.

We do not believe that there should be a target market share for small/independent suppliers. We believe that the key assessment should be the availability of appropriate products rather than their take up by small/independent suppliers as there are many other factors influencing the market share of small/independent suppliers.

Question 3: When should market success be judged?

We are broadly content with Ofgem's proposed timetable for further consideration of this issue, though we think that it is important to clarify objectives at an early stage.

3. Overview of the possible remedies

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

All trading activity requires a willing buyer and a willing seller and we believe that market based initiatives will be the most successful in improving liquidity by encouraging those who wish to trade energy commodities to participate in the market. We believe Ofgem should continue to work with the industry to consider how to enhance liquidity and – more importantly – the practical steps that could assist smaller and independent parties to enter the market on fair terms.

4. Direct trading obligation

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

We offer small suppliers or other market participants the ability to purchase energy from us at competitive, market-based prices and we are aware that we are competing with other market participants when doing so. It is unclear how an obligation would add to this position since it would be difficult for Ofgem to supervise the prices of trades offered. In addition, before we can offer terms to a new party, the necessary contractual formalities must be completed and a suitable credit limit set, based on the party's credit rating or other similar information. Again, these negotiations are not ones which can be directly supervised by the regulator.

We would be happy to explore the options for a voluntary "code of conduct" which might help small and other new suppliers set up trading agreements and indicate what might be expected of them, so as to make the process smoother for all parties. This might include procedures to enable trades in smaller clip sizes to be more readily undertaken.

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

We do not consider that any licensees should be subject to this obligation.

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

We think that attempting to specify products, pricing, collateral requirements and other conditions of trade could be fraught with difficulty. For example, if Ofgem specified pricing for a particular product that did not accurately reflect its worth, the result could be to open up arbitrage opportunities and windfall gains for the parties exploiting them.

Similar concerns relate to credit terms where we suspect that Ofgem would not wish to impose credit conditions that were inappropriately weak, with all that could entail for the risk of failure.

Market participants could agree to trade in clip sizes attractive to small suppliers without the need for a licence condition. Similarly, we could investigate mechanisms to simplify the assessment of risk and credit considerations. But an obligation to trade with parties we did not judge as sound could be detrimental to the market as a whole.

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

We already purchase electricity from small generators at competitive, market-based prices and we are aware that we are competing with other suppliers when doing so. Volumes of

individual trades and risk and credit considerations are not the issue for small generators that they are for small suppliers. It is therefore easier for small generators to operate in the market than it is for small suppliers and we do not see the need for any such obligation to be extended to cover generation purchases.

Question 5: What costs would this option impose?

We consider that there could be significant costs associated with this option from attempting to specify appropriate risk and credit considerations and monitoring compliance. Voluntary agreement from large market participants to offer trades in quantities attractive to small suppliers, and perhaps other procedural improvements, would achieve the benefits without incurring significant costs.

5. 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?

A market making arrangement based on the model outlined could enable small suppliers to trade in the volumes they wish with the agent. This might be a worthwhile option to addressing the issues of small clip sizes for small and new entrant suppliers and we would be interested in exploring this idea in more detail.

We doubt that the market making agent would be handling sufficient trades to make a significant impact on overall market liquidity, However, it is not clear to us that higher overall liquidity would make any difference to new and smaller suppliers entering the market. We would therefore suggest that further development of this idea is based on making a suitable market in small clip sizes rather than upscaling the concept to the hundreds of TWh that would be necessary to make a significant impact on bulk liquidity.

We would want to consider further whether sufficient trading through the market making agent could be secured through a voluntary approach or whether some mandatory approach was needed. In any event, by keeping the volumes small, distortion to the wider market could be avoided.

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

For the market maker to benefit small suppliers forward products with small clip sizes should be those made available initially. If this proved successful then additional products could be considered.

Question 3: What volume obligation would be appropriate?

It would be prudent to adopt a limited volume approach concentrating on the products and volumes which would be beneficial to small/independent suppliers. Mandating large volumes of trade with the market making agent would we think be counterproductive. We believe success can only be achieved by making it attractive for major participants to trade with the agent.

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

Initially we believe the benefits would only be for small suppliers rather than for the market as a whole but if successful and attractive to larger participants in increasing volumes then this could facilitate market making for the whole market.

Question 5: What costs would this option impose?

There are potentially significant costs around collateral and market exposure but if these can be minimised at the outset then arrangements could be developed where these costs were able to be borne by the market and the agent.

6. Mandatory auctions

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

We do not believe that either mandatory day-ahead auctions or mandatory auctions for forward products are appropriate options to increase wholesale market liquidity.

Day-ahead auctions do not address the issue of liquidity in longer term products and making these mandatory would distort the competitive bi-lateral market. Voluntary day-ahead auctions already exist.

Mandatory auctions of longer term products are similar to virtual power plant auctions which have been successful in some of the less competitive European energy markets but do not recognise the realities faced by suppliers in a competitive market. In the competitive GB market, suppliers are reluctant to make long term fixed price purchases for power because of the risk that these commitments become out of the money, especially as market and political pressure pushes suppliers towards shorter hedging. Generators are of course happy to sell a proportion of their output on longer term contracts but each trade needs a willing buyer as well as a willing seller. It is possible that mandatory long term auctions would be settled at discounted prices which would adversely affect the economics of generation investment.

Given that the electricity market already churns several times physical demand, it is also questionable how any feasible auction obligation would help. The quantity to be auctioned would have to be a moderate percentage of expected generation, so that the generator was not short in the event of planned or unplanned outages, and this would be a small amount compared to current liquidity.

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

We believe no volumes should be mandatory but voluntary volumes should continue for day-ahead markets.

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

Any auctions should be voluntary. ScottishPower already sells its generation output into the market when spreads are right.

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

Any auctions should be open and voluntary with rules based on the current voluntary day-ahead auctions.

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

Both forms of mandatory auctions would distort the competitive market.

Question 6: What costs would this option impose?

Costs are difficult to quantify but could be very significant if generators were forced to sell long term product into a market with insufficient demand or if they were forced to sell volumes that left them short on outages.

7. Self-supply restriction

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

We trade around 3 times our own generation output into the market and thus such a restriction would have no impact on us. We believe other major participants also trade multiples of their generation into the market and thus we fail to see what impact such a restriction would have. A self-supply restriction would not address the issue of low long-term liquidity and would only impact on the short-term where liquidity is already plentiful.

A self-supply restriction would be unlikely to assist new entrants and smaller suppliers in obtaining power in appropriate quantities, hedging their risks, or fulfilling the necessary procedural requirements.

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

We do not consider it would be beneficial for any suppliers to be covered by a self-supply restriction.

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

It would be inappropriate to apply this to the industrial and commercial market as this is already largely met via the traded market. We believe none of the larger domestic suppliers would be affected by the restriction and therefore the initiative would have no impact.

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?

We believe it would be more beneficial to consider more direct measures giving small suppliers access to the small clip sizes and longer dated products that they are seeking rather than combining this with a self-supply restriction.

Question 5: How could the previous problems related to enforceability be overcome?

In a liquid market where multiples of original production are being traded it is not possible for participants to assign final sales to original generation and thus it would not be possible for Ofgem to monitor this statistic.

Question 6: What costs would this option impose?

A self-supply restriction could result in increased compliance, monitoring, transaction and operating costs.

8. Collateral requirements

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

We agree with Ofgem's concern that an arbitrary weakening of credit requirements could lead to the entry of participants that are not able to bear the market risk. This would not be in the public interest.

We would also observe that the unnecessary use of collateral (as opposed to other credit management strategies) will make long term positions potentially much more expensive to hold and will operate against the aim of encouraging more trade in longer dated products.

We offer favourable credit terms to very small suppliers but as they grow we require them to be subject to the same terms as other market participants. We believe this is the best means for encouraging small suppliers to enter the market. However, we are happy to look at the procedural arrangements for dealing with the credit issue to see if we can make these run more smoothly for small counterparties.

9. Conclusions and next steps

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

We think that bullets 1 and 4 are the key points in this list. The aim should be to improve contestability without distorting the market or creating unintended consequences. General improvement of liquidity (points 2 and 3) would be a bonus, but not at the expense of fragmenting the existing baseload liquidity in order to try to create other longer dated products. We believe that the key assessment should be the availability of appropriate products rather than their take up by small/independent suppliers as there are many other factors influencing the market share of small/independent suppliers.

The GB wholesale electricity market is continually developing and it is important to continue to assess important market criteria including liquidity. We do not believe that specific liquidity criteria can be set nor a specific time set for judging market success.

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

We would like to explore ways to improve the access for small suppliers to the products appropriate to their needs, both by looking for procedural improvements and by finding a way to make smaller clip sizes more readily available.

This could include investigating a market making agent aimed at allowing small suppliers to trade forward products with small clip sizes with the agent. We believe this would only be successful if large participants are incentivised to trade with the agent.

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28 April 2010