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Dear Ijaz

Liquidity Proposals for the GB Wholesale Electricity Market

Thank you for the opportunity to respond to this consultation document. The comments below are offered on behalf of Shell Energy Europe Ltd (SEEL), an active participant in European power, gas and CO2 traded markets.

This consultation raises important questions regarding the relationship between liquid traded markets and matters such as competition & investment signals. In broad terms, we agree with a view that a liquid traded market is symptomatic of a healthy & competitive market, with resulting benefits for consumers. The higher liquidity levels in the gas market are generally considered as one of the reasons, along with others such market structure, why previous regulatory and Parliamentary enquiries have compared the GB gas market favourably to the power sector in terms of new market entry and investment levels.

We agree with Ofgem's general approach to the issue of liquidity in the power market, ie. the preferred outcome would see the market developing solutions to address the liquidity issue and the availability of products that market participants need. The success criteria by which Ofgem would judge the impact of market initiatives would also seem appropriate. However, the timeframe by which success would be judged is not clear.

As such, we agree on the advisability of consulting now on possible measures to increase liquidity should market-led initiatives not prove successful. The consultation document details four possible proposals:

a) a direct trading obligation;

b) a market making agent;

c) mandatory auctions; and

d) a self-supply restriction.

All of the above could be expected to have a beneficial impact on liquidity levels. However, while each of the options should be developed further in the event that market-led initiatives do not prove successful, the introduction of mandatory auctions would appear to be the option that potentially offers the most immediate results. It is for that reason our response is limited to the questions contained in Chapter Five.

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

An issue for smaller or new market participants is their inability to forward hedge their volume/price risk with any degree of price certainty or confidence. Greater market liquidity would provide such transparent reference prices that would help such parties to do so.

Auctions are an option that could be expected to help increase liquidity. However, on their own, auctions are of limited value if volume is only sold/bought once; in that sense, we agree with the view that secondary trading is the primary factor behind increasing market liquidity.

A proposal for mandatory auctions would help increase liquidity, thus partially addressing the above concerns, because they help overcome the difficulties caused by a lack of interconnection capacity and limited access to generation volumes. New and small entrants currently have limited opportunities around which to build a trading position, thus making an increase in trading volumes difficult to achieve, hence the beneficial impact of auctions.

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

A basis for calculating the volume to be auctioned could centre on an ex-ante regulatory assessment of the degree of market concentration, eg. HHI calculation, that currently exists and a preferred figure that was deemed to offer competition benefits (that would ultimately flow through to consumers). The difference between the two figures would then be the volume to be auctioned.

Auction volumes could be divided into say 4 auctions per year. In each auction one year, two year and three year base-load and one year, two year and three year peak-load products should be auctioned off.

To replicate customer load profiles, there would be merit in auctioning twice as much baseload than peak-load product. In terms of volume per auction, we would suggest that the one-year contract should be offered with three times that contained in the three-year product. The volume in the two-year product should be offered with twice that offered in the three-year product. This split would reflect the management horizon and management focus of a power portfolio manager.

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

A contributory factor to low liquidity levels in any market may be the degree of vertical integration. In that context, an argument could be made to suggest that all vertically integrated undertakings should be obliged to participate. However, the issue of materiality and market impact needs to be considered.

A broad principle, therefore, might involve considering a de minimis level of market share, below which inclusion in any auction process was not required. In that sense, such a proposal would seem in line with what the document says in relation to the possible introduction of a Self-Supply Restriction (see para 7.5).

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

Based on our experience of such auctions elsewhere, it would be unusual for the retail arms in question to be allowed to participate. The degree of regulatory oversight and scrutiny required to ensure that affiliated businesses were not bidding on the basis of access to privileged or auction sensitive information would be unduly onerous.

With regards to questions of reserve prices, auction frequency and product duration, we would offer the following comment:

- reserve prices: ideally, these should be set to zero. However, to the extent that this is not possible, there should be regulatory oversight to ensure that they are not set at a level that deters auction participation. To the extent that prices are index-linked, experience elsewhere suggests that this linkage needs to be to a transparently tradable commodity;

- in addition to our comments in response to Q2, we would state that the frequency is a function of the number of auctioned products and the auctioned volumes. If the auctioned capacity is small then the frequency and number of products should not be too big as the auction size will not be meaningful;

- moreover, there is merit in the dates for these auctions not coinciding with those for cross-border products. Otherwise, there is a possibility that some companies might be limited to just taking part in one of the two auctions should they take place on the same day; and

- it may be helpful for the auction of longer dated products to release volume on a rolling basis, so that at least some of the products sold in earlier auctions are still available when the next auction takes place. This gives buyers confidence that they can adjust their contract cover

As a final comment, we think the market would be interested in annual products, e.g. 1 calendar year, 2 calendar years, 3 calendar years, 4 calendar years.

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

A requirement to auction could apply to both day-ahead and longer dated forward products. Shorter term auctions, perhaps held at a day-ahead stage, could be of benefit to parties seeking to optimize or balance short term purchase/consumption differences rather than lead to fundamental increase in trading liquidity.

However, given that we observe day-ahead power trading at APX UK, N2EX or OTC, there is already some, albeit limited, day-ahead liquidity. Hence we see a lesser need for short-term power auctions. Rather, it is in the forward market where there is no liquidity in UK power at any exchange and very little liquidity in the OTC power forward market.

Longer-dated auctions, however, would provide a more fundamental improvement to liquidity levels. Greater product certainty could be expected to provide not only longer and more competitive price signals but ones that would act as a spur to product development, eg. derivatives. In such circumstances, smaller and new market participants would be considerable helped with respect to their hedging activities/costs.

Question 6: *What costs would this option impose?*

As auctions have already taken place in the Netherlands, Germany (E.On/ RWE), Italy, Spain and are currently taking place in Hungary, Germany, Denmark, France, it would seem logical to conclude that whatever the costs, they are unlikely to prove prohibitively high. Additionally, given there is more than one platform, competition could be expected to keep costs down.

I trust that you have found these comments useful; we are, of course, more than willing to discuss our views with you in person. In the meantime, should you have any questions or require further clarification, please do not hesitate to contact me.

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Yours sincerely

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