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Dear Ijaz,

Liquidity Proposals for the GB Wholesale Electricity Market

Thank you for the opportunity to respond to this second consultation on liquidity proposals for the GB wholesale electricity market. We have provided our response to the questions posed in the consultation in the attached annex, but would also like to take the opportunity to provide some additional high level comments on the proposals.

Liquidity

Liquidity in the wholesale electricity market is sufficient for the needs of most market participants. It is also improving, and radical intervention by Ofgem could damage its growth. Ofgem need to be careful that initiatives, perhaps aimed at small players, do not kill off the liquidity that currently exists. We certainly do not believe that the current level of liquidity merits radical intervention by Ofgem. Like Ofgem, our preferred outcome would be for market initiatives, such as the new N2Ex, to be allowed to deliver improved liquidity. These initiatives though need time to bed in, before Ofgem's policy options are further developed. In our view, the threat of radical policy intervention will have a detrimental effect on the market, in particular in terms of investment in generation. This makes policy intervention inconsistent with the initiatives under Project Discovery. Even if the current level of liquidity persists, we strongly believe that Ofgem should not implement the more radical policy interventions of Mandatory Auctions or Self-Supply restrictions.

Our trading volumes have increased threefold since 2003. The market has also seen banks re-enter over the last 12 to 18 months. This is a sure sign that liquidity is improving and should provide comfort to Ofgem. In our view, all players have access to liquidity, but some are choosing not to use it. It should not be presumed that just because some companies may make comment on a lack of liquidity that it is not there.

With particular regard to small players, the APx is already there for the short term, and we have seen volumes of some 300/400MW being offered day-ahead through the N2Ex auction, more than sufficient for small participants' needs, in 1MW clips. We do not believe that small players will get smaller clip sizes than this from a market solution, even if a large number of banks came in and dramatically improved liquidity. Indeed, we don't believe they would get this in the gas market (which is widely acknowledged as being liquid).

Whilst the electricity market has been compared unfavourably with other European electricity markets and the GB gas market, there are good reasons why the level of liquidity is lower. The UK electricity market is islanded, unlike the interconnected European markets, and is also not subject to the range of variables of the European markets. In GB gas, the market is linked into global trends and markets and as such has a broader appeal to a wider variety of institutions. Whilst electricity market liquidity is improving, it will never get to the levels of these other markets. If that is Ofgem's goal then it will not be achieved. One issue with Ofgem's proposals is that they fail to define what Ofgem believe is an adequate level of liquidity. It means that judgements on market initiatives, or indeed Ofgem's policy proposals can only be subjective.

N2Ex

A significant amount of effort has been put into establishing the N2Ex over the past 5 years, with the needs of small players a significant focus of that. The exchange should be given the chance to develop, rather than have the effort and its purpose undermined by regulatory intervention. In our initial response we suggested that it would need some 12 to 18 months for a representative price for derivative trading to be established. We remain of this view. We were involved through the development of the exchange. Since it has been up and running we have matched our volume of offers to the market onto the N2Ex (but with tighter spreads). A few other large players have similarly contributed to trading on the exchange, but there are some players whose activity has been very disappointing. Rather than pursue regulatory interventions, Ofgem should be encouraging the use of the platform by the other large players. Whilst we did not support the implementation of an auction as part of the N2Ex for fear of it splitting volumes (and this remains a concern), we will continue to support the exchange as long as others are encouraged to do so.

Obligation requiring large generators to trade with small/independent suppliers

We believe that a direct trading obligation applied across all participants would be an overreaction to the perceived problems of small players. In our view, small players have the opportunity to trade, but chose not to. As noted above, small players can already trade on the N2Ex down to clip sizes of 1MW.

This obligation, aimed at small players, would not increase overall liquidity in any significant way. It is also likely to be difficult to enforce. It may improve access for small players, but putting it in place through a licence condition would be viewed as a disproportionate response. An alternative would be for Ofgem to introduce guidelines as an interim measure without the licence condition.

Market Making Arrangements
A market-making arrangement could improve liquidity in products that are not traded very much, e.g. overnights. However, as noted above, we do not believe that there are fundamental problems with overall wholesale electricity market liquidity. In addition, any issues that there are perceived to be for small players could be managed through guidelines or obligations for trading with small players as above.

We already put significant volume through the existing market, in effect we already carry out a market-making role. For this reason, we would be critical of an obligation being imposed on us, though it may be beneficial for bringing others to provide volume. If market-making arrangements are to be put in place, in our view they should be aimed at providing standard products for small players. Large players are more than capable of taking part in what is a sufficiently liquid wholesale market. Those that do not trade should be encouraged to do so, or be obliged to do so, rather than have a regulated approach apply to all.

Regardless, a market-making solution should not be implemented until after the market led initiatives have had time to fully develop and should certainly not be implemented ahead of guidelines or an obligation to trade with small players.

Mandatory Auctions
We fundamentally believe that the introduction of a mandatory auction would be a backward step for the market. OTC trading provides information, parties know who they are trading with and they can see the volume that is flowing through it. A move to force an exchange in parallel with the OTC would fragment volumes and reduce the liquidity that currently exists in the market. The consultation document recognises this adverse impact.

With an auction, generators and suppliers would effectively only trade once, e.g. at 09:00, based on a snapshot view of gas prices. However, the gas market moves all the time, and therefore so should the scheduling of CCGTs. There is no opportunity to re-price against fluid gas prices with an auction. There would be no re-trading, no re-optimisation, no speculation, and therefore no liquidity. For example, should a major infrastructure failure hit the gas market at 10:00, no-one would be able to buy out power and sell the gas back to the gas market in response to the increase in prices. Not only does the auction mean that there would be no liquidity or churn, it could have implications for security of gas supply.

In addition, auctions exclude brokers. Brokers create liquidity through encouraging trading, generating interest, sharing information and seeking new product angles etc. Without brokers, the market would be significantly less liquid than it is at present. As well as the impact on brokers, the banks are also likely to look suspiciously on an auction that, unlike those in the interconnected European markets, could be subject to influence of the large physical players.

Mandatory auctions will also mean a forced sale of output. However, any forced sale of output is likely to have an adverse effect on the build of new generation and this is likely to have a significantly greater impact on the market than any increase in liquidity as well as being inconsistent with Project Discovery.

The introduction of a mandatory auction is intended to provide robust reference prices and lead to the development of financial derivatives, yet the document also recognises that such an outcome cannot be guaranteed. The purpose of the market initiatives such as the N2Ex is to address this. A significant amount of effort has been put into the N2Ex over the past 5 years and it should be given the chance to develop, rather than have the effort and its purpose undermined by regulatory intervention.

We are firmly of the view that the introduction of a mandatory auction would be a wholly disproportionate measure. Given the level of liquidity we create in the market, it would be particularly punitive, discriminatory and unreasonable and we would object to any such move to introduce one on us.

Self-supply Restrictions

We believe that we have shown, by our activity in the traded market, that there is no linkage between vertical integration and a lack of liquidity. This can be shown through the level of churn in our trading position. We do not believe that a self-supply restriction would improve liquidity, rather, such market intervention will increase risk, and reduce participation. Any intervention to force liquidity is also likely to have an adverse effect on new generation build. Participants will reassess the economics of new build if they are forced to sell some of their output on into the market. This is likely to have a significantly greater effect on the market than could be had from any increase in liquidity. It makes this initiative inconsistent with the Project Discovery initiatives.

Even if a self-supply restriction was introduced, we do not believe that it will be possible to enforce it, that participants will be able to enter into contracts without adding to market liquidity. The significant costs that would be involved in monitoring compliance and enforcement would be disproportionate to the impact it will have on liquidity.

As we have previously shown, we contribute significantly to market liquidity. If a self-supply restriction were to be imposed, then it should only be imposed on those players who make no significant contribution to liquidity. We are firmly of the view that the introduction of a self-supply restriction would be a wholly disproportionate measure and we would object to its imposition.

Collateral Requirements

We agree with Ofgem’s conclusions that an arbitrary reduction in collateral requirements could allow the entry of participants that are unable to bear the market risk, imposing additional risks on all players. We would be opposed to any arrangements that removed individual parties’ rights to evaluate and set credit requirements.

The evaluation of credit worthiness is an issue for each individual party. It is a commercial decision and is formed through experience of operating in the market and particularly of trading failures. The level of collateral requirements properly reflects the level of risk faced by market participants in the current market conditions and reflects the risk that small players impose. As market conditions change so too can credit requirements. The introduction of “predefined credit terms”, even if it was possible to put such arrangements in place due to their complexity, is likely to reflect a snapshot of current practices of market participants. Given market conditions and credit risks change, it is not clear what benefit they would bring. With regard to small players, we would not support arrangements that imposed particular beneficial arrangements for small players to the cost of others in the market, e.g. through the pooling of credit or insurance costs.

We do not believe that any of the credit/collateral approaches put forward in the consultation would bring about an increase in liquidity proportionate with the increase in costs and risks they might bring.

I hope that you find our comments helpful. I would be happy to discuss any of the points made with you, so please do not hesitate to contact me.

Yours sincerely,

Robert Hackland
Regulation Manager

Annex

Consultation Questions

CHAPTER: One

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?

Whilst low levels of liquidity can have a detrimental effect on markets, we do not believe that the current level of liquidity in the electricity wholesale market merits radical intervention by Ofgem. We believe that market initiatives such as the new N2Ex exchange need time to bed in, and further, that even the threat of radical policy intervention will have a detrimental effect on the market, in particular in terms of investment in generation. Even if the current level of liquidity persists, we strongly believe that Ofgem should not implement the more radical policy interventions of Mandatory Auctions or Self-Supply restrictions.

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

We agree that the electricity market is less liquid than the gas market, but there are good reasons for this. We do not consider that the electricity market should necessarily be a focus of radical intervention by Ofgem.

CHAPTER: Two

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

Overall, no. The success criteria are on the whole subjective, and would not be appropriate to base radical intervention on. One question that Ofgem have not answered in declaring that liquidity in the wholesale electricity market is low, is what level of liquidity does Ofgem consider acceptable.

In terms of the criteria suggested:

i) High volumes traded in standard products - requires a similar question to be answered, as to what is defined as “high”. It may be more appropriate to define through seeing a continuous growth in liquidity.

ii) Availability of key longer dated products and/or financial derivatives – this should indicate whether e.g. the N2Ex has been successful. However, it is subjective, and it is likely to take the N2Ex longer than through to the summer before a representative price for derivative trading is established and a view taken on whether this has attracted greater liquidity.

iii) Use of trading platforms by small/independent suppliers – this relies on small /independent suppliers coming forward with suggestions for products that they need to take part in the market. It may be possible to put some additional products in place. That being the case, the availability of these products could be a reasonable criterion.

iv) Positive feedback from small/independent suppliers and potential entrants – again this criterion is subjective and it would not be acceptable to base radical reform on this.

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

We believe that the current level of liquidity is adequate for our purposes. As noted above, the only criterion that may lend itself to quantification would be the level of trading in standard products. Any growth in liquidity in these would be considered a success.

Question 3: When should market success be judged?

We strongly believe that the N2Ex needs to be left to be established for at least a year to 18 months, before a representative price for derivative trading is established and only then for a view to be taken on whether this has attracted greater liquidity. On this basis, the timetable put forward by Ofgem is far too short, in particular the decision on whether to proceed with developing potential policy interventions in the summer of 2010. In the context of this consultation, in trading terms, summer 2010 has already started.

CHAPTER: Three

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

One initiative that we reported on in our previous response was the “flexibility” contracts that we have been providing to supply customers over the last two years, and that other suppliers have also introduced. Rather than the customer getting locked into a contract for their whole demand when they sign a contract at the start of the year, they are able to hold back on contracting for part of the volume, e.g. a baseload tranche, until the market conditions suit them. This in effect gives them access to the traded market and customers frequently trade in and out of the market to try to achieve the lowest possible price. We have some 60 customers with an annual volume of 12TWh and trade 14TWh on their behalf. This product was requested by the market and suppliers have put in place arrangements to meet their customers’ needs.

CHAPTER: Four

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 applied across all participants would be an overreaction to the perceived problems of small players. In our view, small players have the opportunity to trade, but in the main chose not to.

In our view, this option would not increase overall liquidity in any significant way. It is also likely to be difficult to enforce. It may improve access for small players, but putting it in place through a licence condition would be viewed as a disproportionate response. An alternative would be for Ofgem to introduce guidelines without the licence condition, with this monitored to see the if it provided small players with improved access.

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

We create significant market liquidity. In our view therefore, the imposition of such an obligation on us would be an unfair penalty. The large players that are not active in the market should be the only ones subject to any licence obligation. Large players in this instance would be those defined as those having an obligation under the Community Energy Saving Programme (CESP). If the obligation is to have mass application, then it should be applied to all but unlicensed parties.

Question 3: What requirements should be put in place relating to products, pricing, collateral and other conditions of trade?
The single biggest issue for putting in place arrangements with small players is the collateral arrangements. We would insist on continuing to set collateral requirements on an individual basis. We would not accept a lower standard of collateral just because they were small. With the collateral arrangements in place, a template agreement (e.g. a GTMA) could be set up. This would make subsequent trading easier. With regard to pricing, we would suggest that this should be related to market prices, to aid transparency, rather than some form of related internal pricing. In relation to products, we would not wish to see a multitude of prescribed products, but rather that there should be a short list of standard products. Non-standard products would need to be considered further. Once collateral and template arrangements were set up, the timescale for making standard products available would be short. Finally, there needs to be an acceptance that a minimum volume of trade would need to be put in place.

Question 4: Is it appropriate to extend the obligation to cover generation purchases?
Small/independent generators are already taken care of in the market arrangements though mainly associated with the sale of renewable energy to suppliers. We do not believe that it would be necessary to extend the obligation to cover generation.

Question 5: What costs would this option impose?
Given our experience of trading with small generator parties, we would not anticipate the costs of this obligation being high.

CHAPTER: Five
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 could improve liquidity in products that are not traded very much, e.g. overnights. However, as noted above, we do not believe that there are fundamental problems with overall wholesale electricity market liquidity. In addition, any issues that there are perceived to be for small players could be managed through guidelines or obligations for trading with small players as above.

We already put significant volume through the existing market, in effect we already carry out a market-making role. For this reason, we would be critical of an obligation being imposed on us, though it may be beneficial for bringing others to provide volume. Regardless, a market making solution should not be implemented until after the market led initiatives have had time to fully develop and should certainly not be implemented ahead of guidelines or obligations to trade with small players.

Question 2: What products should be made available through a market maker?
If market-making arrangements are to be put in place, in our view they should be aimed at providing standard products for small players. Large players are able to take part in what is a sufficiently liquid wholesale market. Those that are not trading should be encouraged or indeed obliged to do so, rather than have a regulated approach apply to all.

Question 3: What volume obligation would be appropriate?
As noted, we believe that if it is to be put in place, it should be aimed at small players, therefore volume requirements would be low.

Question 4: Would the establishment of a "Market Making Agent" facilitate the introduction of market making?
A Market Making Agent may help small players get access to defined products if it is aimed at them. It will not necessarily help small players if it is put in place solely to improve overall liquidity.

Question 5: What costs would this option impose?
It would be anticipated that a market making role would impose costs similar to exchange costs. However, the ultimate costs would depend on the scope of the market-making arrangement. More importantly, on funding, if a market-making arrangement was to be put in place voluntarily by an exchange, then it would be for the exchange to fund. However, if it is to be an obligation, then it should be funded by the market as a whole, rather than targeted at only the big 6 as suggested in the consultation.

CHAPTER: Six
Question 1: Are mandatory auctions an appropriate solution to the problems related to wholesale market liquidity?
No. We fundamentally believe that the introduction of a mandatory auction would be a backward step for the market. OTC trading provides information, parties know who they are trading with and they can see the volume that is flowing through it. A move to force an exchange in parallel with the OTC would fragment volumes and reduce the liquidity that currently exists in the market. The consultation document recognises this adverse impact.

With an auction, generators and suppliers would effectively only trade once, e.g. at 09:00, based on a snapshot view of gas prices. However, the gas market moves all the time, and therefore so should the scheduling of CCGTs. There is no opportunity to re-price against fluid gas prices with an auction. There would be no re-trading, no re-optimisation, no speculation, and therefore no liquidity. For example, should a major infrastructure failure hit the gas market at 10:00, no-one would be able to buy out power and sell the gas back to the gas market in response to the increase in prices. Not only does the auction mean that there would be no liquidity or churn, it could have implications for security of gas supply.

In addition, auctions exclude brokers. Brokers create liquidity through encouraging trading, generating interest, sharing information and seeking new product angles etc.

Without brokers, the market would be significantly less liquid than it is at present. As well as the impact on brokers, the banks are also likely to look suspiciously on an auction that, unlike those in the interconnected European markets, could be subject to influence of the large physical players.

Mandatory auctions will also mean a forced sale of output. However, any forced sale of output is likely to have an adverse effect on the build of new generation and this is likely to have a significantly greater impact on the market than any increase in liquidity as well as being inconsistent with Project Discovery.

The introduction of a mandatory auction is intended to provide robust reference prices and lead to the development of financial derivatives, yet the document also recognises that such an outcome cannot be guaranteed. The purpose of the market initiatives such as the N2Ex is to address this. A significant amount of effort has been put into the N2Ex over the past 5 years and it should be given the chance to develop, rather than have the effort and its purpose undermined by regulatory intervention.

We are firmly of the view that the introduction of a mandatory auction would be a wholly disproportionate measure. Given the level of liquidity we create in the market, it would be particularly punitive, discriminatory and unreasonable and we would object to any such move to introduce one on us.

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

We do not believe that a mandatory auction should be set. We believe that there is sufficient volume already on the N2Ex auction to satisfy the needs of small suppliers and independent generators. If a mandatory auction was to be set, then it should be for minimal volumes to satisfy small players' requirements. A mandatory auction with large volumes would destroy the liquidity that exists by squeezing out brokers. The banks are also likely to look suspiciously on an auction that, unlike those in the interconnected European markets could be subject to influence of the large physical players.

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

We already trade significant volumes in the continuous traded market. We would not wish to be compelled to trade volume in a mandatory auction. We did not support the introduction of an auction platform on the N2Ex for the reasons given above, that it would split volumes and be detrimental to overall market liquidity. Certain of the large players appear reluctant to trade volumes anywhere near the levels we do. If any large players are to be compelled to trade on an auction, then perhaps an obligation should be placed on those that are trading at very low levels at present. As noted above, we would object to a move to compel us to trade through a mandatory auction.

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

We believe that it is inefficient to attempt to design a mandatory auction at this stage whilst the N2Ex is developing. If an auction is to be developed it should be done through a development group made up of industry and market participants, rather than through an Ofgem consultation process. We would clearly wish to take part in this process.

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

As noted in the consultation document, the APX and N2Ex already offer day-ahead auctions. Again as noted in the consultation, there are a number of reference prices in the market, but without any having universal acceptance. However, a central purpose of the N2Ex is to create a robust reference price. We believe that the N2Ex should be allowed to develop. If it fails to do so there may be some justification to consider development of an auction for longer dated products.

Question 6: What costs would this option impose?

The costs would be expected to be in line with the costs to set up and operate the N2Ex.

CHAPTER: Seven

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

No. We do not believe that there are significant problems related to wholesale market liquidity, nor that such a condition is appropriate or necessary. We believe that we have shown, by our activity in the traded market, that there is no linkage between vertical integration and a lack of liquidity. This can be shown through the level of churn in our trading position. We do not believe that a self-supply restriction would improve liquidity, rather, such market intervention will increase risk, and reduce participation. Any intervention to force liquidity is also likely to have an adverse effect on new generation build. Participants will reassess the economics of new build if they are forced to sell some of their output on into the market. This is likely to have a significantly greater effect on the market than could be had from any increase in liquidity. It makes this initiative inconsistent with the Project Discovery initiatives.

We are firmly of the view that the introduction of a self-supply restriction would be a wholly disproportionate measure and we would object to any such move to introduce one.

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

As we have previously shown, we contribute significantly to market liquidity. If a self-supply restriction were to be imposed, then it should only be imposed on those players who make no significant contribution to liquidity.

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

If it were to apply, it should not be restricted to any particular part of the market.

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?

Any self-supply restriction should not be implemented until after the market led initiatives have had time to fully develop and should certainly not be implemented ahead of guidelines or obligations to trade with small players. We believe that guidelines or obligations to trade with small players would be sufficient without resorting to self-supply restrictions.

Question 5: How could the previous problems related to enforceability be overcome?
We do not believe that it will be possible to enforce a self-supply restriction, that participants will be able to enter into contracts without adding to market liquidity.

Question 6: What costs would this option impose?
An attempt at imposing an effective self-supply restriction is likely to cause significant costs in monitoring compliance and enforcement, disproportionate to the impact it will have on liquidity.

CHAPTER: Eight

Question 1: Do you think that any of the possible approaches outlined in this chapter have merit and should be pursued further?
No. We agree with Ofgem's conclusions that an arbitrary reduction in collateral requirements could allow the entry of participants that are unable to bear the market risk, imposing additional risks on all players. We would be opposed to any arrangements that removed individual parties' rights to evaluate and set credit requirements.

The evaluation of credit worthiness is an issue for each individual party. It is a commercial decision and is formed through experience of operating in the market and particularly of trading failures. The level of collateral requirements properly reflects the level of risk faced by market participants in the current market conditions and reflects the risk that small players impose. As market conditions change so too can credit requirements. The introduction of "predefined credit terms", even if it was possible to put such arrangements in place due to their complexity, is likely to reflect a snapshot of current practices of market participants. Given market conditions and credit risks change, it is not clear what benefit they would bring. With regard to small players, we would not support arrangements that imposed particular beneficial arrangements for small players to the cost of others in the market, e.g. through the pooling of credit or insurance costs.

Overall, we do not believe that any of the approaches for credit/collateral put forward in the consultation would bring about an increase in liquidity proportionate with the increase in costs and risks they might bring.

CHAPTER: Nine

Question 1: Do you agree with the proposed assessment criteria?
It is not clear why the assessment criteria for the market initiatives is not the same as the criteria of the policy options, other than that only the policy interventions would be expected to be judged against "*least cost and disruption to efficient market outcomes and minimising unintended consequences"*. It is clear however that this is the most significant criterion that the policy interventions should be judged against.

Question 2: Which do you think is the best policy option or combination of options?
As noted above, we believe that it is crucial that the market initiatives such as the N2Ex are allowed to develop to maturity before any decision is taken to develop any of the policy options proposed. We do not believe that wholesale market liquidity is lacking to the extent that the more radical policy interventions such as mandatory auctions or self-supply restrictions need to be considered. Indeed we would object to such policy initiatives. If it is felt that small players need some assistance in the market, then guidelines or obligations to trade with small players may be acceptable. We would not wish to see market-making arrangements brought in before such guidelines or obligations.