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Ofgem
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Monday, 13th September 2010

Dear Robert,

Re: Wholesale Market Liquidity: Summer 2010 assessment

Thank you for the opportunity to comment on the Summer Assessment paper. This non-confidential response reflects the views of the Centrica group of companies excluding Centrica Storage and may be placed on the Ofgem website and in the Ofgem library.

The summer assessment is the document signalled in the previous document rather than further policy development at this stage, we note that the document is merely describing and seeking views on Ofgem's proposed metrics and reporting an initial evaluation against these metrics. As such, it is explicitly not seeking to move forward against the policy objectives and hence we offer only limited remarks.

It is clear from the summary of responses to the February document in appendix 2 that Ofgem received a wide range of comments on the proposals and that there was a fair degree of consensus in a number of areas. We agree with a number of respondents that current initiatives should be allowed time to work before further intervention is planned; given the developments around N2EX and additional interconnection, it seems likely that the end of this year may be too soon for that decision.

We believe that it is important Ofgem respond fully to previous responses and representations made prior to consulting on further policy development. Ofgem sets out in the consultation that it is developing further the range of potential regulatory interventions set out in the February document. This would enable Ofgem to consult on these interventions should they conclude that industry-led initiatives will not deliver the improvements that Ofgem believes are justified. The range of views indicated by the response summary suggests to us two things: firstly that a clear case for regulatory intervention in competitive market mechanisms has not been made and secondly, that even if intervention were deemed necessary, the form which such a mechanism might take is not clear. Given that the case has not been made, we believe it is essential that a full regulatory impact assessment is conducted in advance of any decision being made, quantifying the costs and benefits of such market

interventions. We are concerned that Ofgem should seek to develop and evaluate such market interventions in isolation from the market.

The GB electricity market is a wholesale, traded commodity market, which was never designed to support very small suppliers in micromanaging their positions within day and hedging out complicated but small positions on the forward curve. To support a liquid, traded market, the requirement is for high volumes of a small number of standard products that meet the buying and selling requirements of the major users. It is not clear that it is realistic to expect a bulk wholesale commodity market trading huge volumes of electricity daily to also meet the highly specific needs of very small players representing tiny fractions of throughput. In our view, it would be appropriate to consider carefully whether such needs are better (and more efficiently/economically) met via bilateral trading arrangements. We are encouraged that a smaller player recognises a more open approach to trading, but reiterate, we have received only the most limited of requests in this area.

In terms of the actual assessment criteria put forward by Ofgem to assess liquidity, it is not clear in drawing up the criteria to what degree Ofgem has taken account of the responses provided to the February consultation or how those responses will be built in to Ofgem's additional work. We would welcome additional information from Ofgem on these points and would be happy to discuss further any aspects of our previous response.

We believe that it will also be important to consider, that where Ofgem's assessments against the criteria and the information contained in responses to questionnaires or responses to consultation are widely disparate, what the underlying causes of the differences might be. For example, we note that smaller participants assert that they have not seen improvements in availability to small clip size highly shaped products. Conversely, our traders indicate almost no requests for this type of trade or service. Equally, markets will generally respond to demand for particular types of product if it is economic to offer them. Where such products are only available to a limited extent, the most likely explanation for this is limited demand. This tends to be supported by the figures and evidence in the report, viz. the figures quoted in table 10.

While we do not oppose the criteria set out in the document as being useful in assessing market liquidity or aspects thereof, we would caution against the use of individual criteria or indeed attaching undue weight to any one criterion. It must be clear what weight Ofgem is attaching to each criterion, given that the document confirms that some measures are likely to be more important than others in providing insights to market performance. We accept that it may not be possible to give precise weightings, however, it is essential to provide clear relative rankings as to which criteria will have greater or lesser importance attached to them particularly as some are quantitative and others qualitative. Presently, we feel that this area is opaque and lacking in quantification, which risks a high degree of subjectivity in the absence of greater transparency. We believe that greater weight should be given to metrics explicitly based on observable data.

Tables 1-3 set out a useful summary of the criteria being applied, however, we believe that in all cases it would be appropriate to include additional commentary or notes of explanatory variables/assumptions. For example, on numbers 7 and 10 (product diversity and clip sizes), it would be helpful to include explicit evidence of unsatisfied demand. This kind of commentary/evidence if properly informed and presented may be helpful in stimulating market response. At present, there is only anecdotal evidence of unsatisfied demand: hence incentives to invest in developing additional standard products over and above those already expected to arise through the emerging market initiatives, are limited. Equally, on criterion 1, while recognising churn ratios in different markets, providing a short summary of the impacts of structural differences would enable the reader to make a more balanced assessment of the value of the figures reported. Finally, while it is desirable for longer

term products to be available, individual organisations will take a view as to how far out they wish to enter into more costly longer term arrangements, it may be that many players prefer not to take positions out beyond 18-24 months because of the costs of managing the additional uncertainty.

Having reviewed the criteria in detail, we believe that there is scope for a small number of additional metrics which could be based on observed or reported data. In particular we would like to see table 10 expanded to include international exchanges, listing for each the products and clip sizes available together with the relative volumes, both for within day and out on the curve. We suggest below several further metrics:

- An evaluation of which exchanges can cope with sub 1MW clip sizes for all demanded products both now and as a result of planned development
- Where such development is not currently planned, an assessment of the costs of such provision
- A table of unsatisfied demand for products, by product type, product duration and volumes required and expected to be required going forward

We have also reviewed the questionnaire set out in appendix 5, and would appreciate some further information. It would be very helpful if Ofgem could expand the reporting on this section to categorise the responses received by the groupings in question 3. Further, we would like to see the questionnaire clarified (for example defining “further along the forward curve”) and expanded to include questions on the following points:

- Whether the respondents perceive any general barriers to entry, including explicit reference to IS systems and credit issues
- Whether they have noticed an increase in the number of counterparties willing to trade
- Whether smaller players have approached counterparties to trade and been rebuffed and if so for what reasons
- What products and volumes they would like to have available and for how long¹
- An expansion around credit issues, 3.79 makes it clear that commentary was received, we would like to understand more detail on the issues experienced and whether these are changing

We continue to believe that Ofgem’s work in this area needs to include more detailed explorations around the issues associated with credit, especially the cost and availability of credit. If a major hurdle to greater liquidity developing further out on the forward curve is credit, then the perceived lack of liquidity is merely a symptom.

A final area which merits further attention is the effect on the market of success under each of the criteria and where the best long term balance may lie. There are a number of examples in this area including evaluation of the costs of exchange based trading, the issues around credit provision and product demand. A further helpful illustration can be under criterion 2, where Ofgem would like to see a decline in spreads. Wide Bid/Offer spreads encourage certain types of participant into the market reflecting arbitrage opportunities. However, very narrow Bid/Offer spreads may indicate a liquid market which is conversely less attractive to financial participants who may well seek more attractive returns elsewhere.

¹ Niche products in small clip sizes are, almost by definition, self limiting. If parties are successful and grow, their need for such products is likely to be commensurately reduced

In conclusion, we believe that the criteria suggested are a fair starting point in terms of assessing liquidity. However, they need to be supported and complemented by careful commentary/additional evidence and a greater degree of transparency around the weighting Ofgem attaches in each area.

If there are any of the points raised in this response that you would like to discuss in more detail, I would be happy to help and can best be contacted on 07789 570046 or Alison.russell@centrica.com.

Yours sincerely,

By e-mail

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