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GB Markets
Ofgem
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10 September 2010

Dear Vanja,

GB wholesale electricity market liquidity: summer 2010 assessment

Thank you for the opportunity to respond to the above consultation document.

This response has two parts: this covering letter, and the attached appendix which contains our detailed response to Ofgem's questions. I can confirm that this response may be placed on Ofgem's website.

EDF Energy supports the development of efficient, liquid, and contestable wholesale markets. Like Ofgem, we are keen to see the removal of any inappropriate barriers to entry which might impede the development of the market. We also support Ofgem's monitoring activity, and are pleased to see that there have been a number of positive developments within the GB market: specifically increased churn rates, and increased activity and participation on the N2EX platform.

We remain concerned that the focus of Ofgem's work in this area still lacks clarity. In particular, we do not believe it is clear form Ofgem's observations whether it is concerned about barriers to entry, bulk liquidity, or about the performance of the GB market compared with those of European neighbours. However, as we discuss in our response, even the threat of intervention can change the behaviour of markets, and so it is a serious matter for Ofgem even to contemplate it. Given that, Ofgem needs to be very clear about the issues it is trying to address.

In the light of this uncertainty, we are pleased to see that Ofgem has made some progress in distinguishing between measures of contestability (the availability of products and prices to support smaller suppliers) and measures of liquidity (bulk wholesale market liquidity over a range of products and timescales as evidence of an efficient market for all players). We believe that these are two very distinct issues with equally distinct intervention drivers and tools. It is essential, that when evaluating the need for intervention, Ofgem makes a clear distinction throughout all of its deliberations. We believe that further work is required in this area.

When the Britned interconnection comes on stream, we expect it not only to improve liquidity, but also to provide a degree of coupling with European markets – something we expect to be part of a wider process of market integration across European markets. Closer to home, changes will arise out of the Government's review of market arrangements, and we expect the roll out of smart metering to provide greater differentiation of shape in the domestic and SME sectors (once the decision is taken for settlements to move away from profiling), which should provide more variety of shape for

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all players, including the smaller ones. We do not believe that it would be an appropriate time for regulatory intervention, given all these developments underway and given that it will take time for these to develop and for their impact to be fully visible. Any regulatory solution should only be considered if in the future market liquidity does not improve because as a result of industry players failing to make the necessary commitments to ensure the market is sufficiently efficient and liquid.

We agree with Ofgem that it is important to look at trends in liquidity over time. We believe this is particularly true when attempting to make comparisons between GB and other European markets, where the absolute level of liquidity will be a function of each market's particular circumstances, for example with regard to the degree of interconnection. We note that the UK has the best trend over the last four years compared to all the other European countries mentioned in Ofgem's paper. It is also worth noting that both in the Nordpool and the Netherlands market churn rates fell over the last two years, with the Netherlands actually falling below 2005 levels

Wholesale market liquidity

Given the increasing levels of trading activity being seen on the market platforms, we currently do not see a case for Ofgem proceeding with preparations for intervention (preparations which themselves will undermine market development by creating uncertainty). A number of recent market initiatives were intended to create a robust and trusted short-term index price which could then be used as a reference price to trade longer-dated financial products: an outcome which is likely to significantly increase liquidity through the entry of non-physical players.

Market development takes time to get established, particularly because individuals need to get comfortable with new arrangements. Indeed, some players actively hold back their participation until they gain comfort from seeing the success of the early movers.   To eventually reach a tipping point requires patience and encouragement, and is not helped by the uncertainty caused by even the discussion of regulatory intervention.

It is also fair to say that all new arrangements experience teething troubles, and in our view N2EX is no different. For example simplification of the sign-up arrangements and improvement to the collateral rules could both encourage entry. Collateral posting is required for appropriate risk management; it cannot simply be waived to increase market liquidity. However, increasing the efficient use of collateral within the market, for example by netting rules on the N2EX, should be examined as a way of reducing the costs of participating on the exchange.

Ofgem's analysis reveals a shift by participants to shorter dated products, which we believe is partly explained by capital constraints – longer dated products need to be supported by higher collateral postings to reflect the higher credit risks. Financing collateral is an issue for all players, but particularly smaller ones with less robust balance sheets. The financing issues related to collateral have grown because of a combination of general economic uncertainty, together with specific uncertainties around other developments, such as carbon price support. The solution here is to resolve the uncertainties – not to intervene in the market.

Contestability and smaller supplier needs

We believe there is a real risk of Ofgem intervening in the wholesale market whilst having no material impact on entry. This would risk the development of the wholesale market, and the N2EX in particular, for little or no beneficial result for new entrants or consumers.

With regard to barriers to entry for new suppliers, we have identified the following key issues:

- Lack of sustained profitability in the domestic sector combined with volatile wholesale prices (themselves driven by the volatile cost of primary fuels);
- Cost of credit risk and collateral requirements;
- Costly and unattractive customer shape/small volume requirements and the lack of any aggregation services (contestability) which might be used by smaller suppliers;
- Other scale economies – including the need for complex billing and customer service processes;
- The increasing regulatory burden and the cost of regulatory compliance requirements.

We do not regard (bulk) wholesale liquidity as a major barrier in comparison to these matters and therefore believe that intervention in the wholesale market cannot be justified.

We note that Ofgem has received feedback from market participants who are concerned about the availability of products tailored to meet the needs of small market entrants, including the availability of long-dated, shaped products. We do not believe that this feedback stems from inappropriate behaviour, but is merely the natural consequence of parties with economies of scale operating in a wholesale market rather than a bespoke/shape market. Indeed, over the years, EDF Energy has priced many bespoke and shape contracts for market participants, over a number of trading horizons, and will continue to do so upon request.

We also believe that Ofgem needs to recognise that the majority of priced shapes have a relatively high proportion of shaped volume in Block 5, where the price risk is highest (because this shape will not be backed by a thermal unit, which will tend to be scheduled at a constant level over the block). Instead, the detail of the shape will be sourced from the market close to real time, when the price could have moved significantly. There is therefore a transfer of risk from the buyer of the shape to the seller and so it is reasonable that the seller of the shape charges a risk premium for acquiring this risk. We have found that the majority of purchasers of shape are not generally willing to pay this risk premium. Within EDF Energy this risk premium is charged to our B2C business if they wish to transfer shape risk out of their trading position.

Our preference in addressing this bespoke/shape requirement issue is for the market to develop independently some form of aggregator. Market participants who have these issues could voluntarily establish an aggregation service which might help in pooling and/or managing their shape needs over longer timescales. Should efforts by the market to establish a voluntary service not succeed, we recognise that it may be appropriate for Ofgem to introduce obligations on participants to develop an aggregation service. This might include the socialisation of aggregator administration costs between all suppliers. However, the underlying product, collateral/credit and clearing costs should still be managed by those suppliers using the aggregator service because to do otherwise would destroy incentives for efficiency.

We hope that you find this response helpful. If you need any further information on any aspect of this response, please contact Paul Delamare on 020 7752 2187, or myself.

Yours sincerely

Denis Linford
Corporate Policy and Regulation Director

Attachment

GB wholesale electricity market liquidity: summer 2010 assessment

EDF Energy's detailed response to Ofgem's questions.

Chapter 2

Q1. Do you agree that the proposed framework provides an adequate range of evidence for assessing market liquidity?

In their responses to Ofgem's February paper, a number of parties noted that the objectives for Ofgem's project were unclear. In particular, questions were raised as to whether it was (a) to improve overall liquidity or (b) reduce barriers to entry for smaller suppliers and other participants. These are two distinct objectives; for example the former could be measured by the churn of products (such as those with large clip sizes) which are of little interest to new entrants.

We are pleased that Ofgem has positively responded to these comments by labelling its measures as "L" for overall levels of liquidity, and/or "C" for supply market contestability (i.e. market entry). However, this distinction seems to have been lost in some of the actual assessments, and this significantly weakens the conclusions drawn.

We consider each of the measures in turn below.

High volumes traded in standard products

M1. Aggregate Churn (L)

Aggregate churn is a useful measure of general liquidity but is of little relevance to smaller players. In particular, reporting high volumes of trade in standard 1MW+ products says little about the availability of the products needed by smaller suppliers. If the measure of liquidity were focused on these products, we also believe that liquidity would be similarly low across the European comparators which Ofgem has chosen to use (for example, we believe that most of these markets have a minimum clip size of 1MW except for day-ahead trades).

We agree with Ofgem that it is important to look at trends over time. This is particularly important when attempting to make comparisons between GB and other European markets, where the absolute level of liquidly will be a function of each market's particular circumstances, for example with regard to interconnection. We note that the UK has the best trend over the last four years compared to all the other European countries mentioned in Ofgem's paper. It is also worth noting that both in the Nordpool and the Netherlands market churn rates fell over the last two years, with the Netherlands actually falling below 2005 levels.

We agree with Ofgem that greater interconnection is likely to raise liquidity. We also believe that it would provide the GB system with greater resilience in the context of increased volumes of intermittent generation. Encouraging inter-connection is a policy goal which would therefore have a number of benefits.

We agree that high levels of churn may reflect high levels of trading between incumbents. This suggests that the current market is operating efficiently given the players currently taking part.

M2. Bid-offer spreads (L, C)

We agree that bid-offer spread is a useful general measure of liquidity, although like the churn measure (above) it would not seem particularly informative with regard to the needs of small suppliers.

We agree that bid-offer spreads are relatively high for longer-dated products. In general we would expect longer-dated products to have a wider bid-offer spread as price uncertainty increases with time to delivery. In addition, we believe that the widening of longer-dated bid-offer spreads, together with a tightening of shorter-dated bid-offer spreads confirms our view that collateral is a real constraint in the market which is reducing liquidity further out along the curve.

M3. Use of platforms (L, C)

Exchange trading can provide a degree of price transparency which is useful to all players large and small. We therefore agree that it is a useful measure of liquidity and of contestability.

As one of the promoters of the N2EX exchange, we are pleased to see that it continues to make progress. As we, and other respondees, said in our responses to Ofgem's February consultation paper, market solutions are far preferable to regulatory intervention. Indeed, one respondent rightly commented that regulatory intervention could undermine N2EX by introducing uncertainty, and others noted that it could also undermine it directly by taking volume out of the exchange and into, say, an auction process. Without intervention, N2EX will continue to develop in terms of participants and the choice of standard and shaped products.

Availability of longer dated products (including financial derivatives)

M4. Volume of trading along the forward curve (L, C)

We believe that the volume of forward trading is a measure of liquidity. The availability of forward products to small players, and not the volume of trades, is important to contestability, although we would agree that the establishment of a robust index price is important to both considerations.

We agree that the picture here is mixed, but are pleased to see an increase in forward trading of off-peak and peak products. As we discuss above, we do not believe that comparisons with other European markets are particularity helpful, because of the inherently different circumstances faced.

M5. Availability of financial derivatives (L, C)

The availability of financial derivative products can provide useful a hedging tool for all players, including new entrants. We therefore agree that it is a useful indication of both liquidity and contestability.

We agree with Ofgem that since NETA the availability of financial products has reduced, but there are encouraging developments which could improve the situation. In particular, N2EX is intending to launch cash-settled futures contracts for the second half of 2010. Standardised futures products will be based on the N2EX reference price, and will be available to the broader NASDAQ OMX membership (with nearly 400 participants). The take-up of these products will take time to develop, particularly as activity will be linked, via the robustness of the reference price, to the level of participation and activity in the underlying physical exchange.

M6. Participation by banks/other financial institutions on trading platforms (L, C)

We regard this measure as an extension of M5 above, which is relevant to both liquidity and contestability. We agree that the presence of banks and other financial institutions is a useful indicator regarding the prospects for trading financial products. It is our view that continual threats of regulatory intervention in the market could deter some of these participants from entering.

Meeting independent suppliers' and others' wholesale requirements

M7. Diversity of products (C)

We would agree with Ofgem that the availability of products suitable for smaller and/or independent players is a useful indication of contestability. However, Ofgem's analysis does not differentiate between product types needed by smaller players and therefore is not particularly useful as a measure of contestability.

We believe it would be useful for Ofgem to develop a measure which focuses on those products that are useful to small suppliers, such as shaped products at longer dates (larger suppliers tend to buy long-dated based-load products and only exchange them for shaped trades closer to delivery).

We believe that such an approach would also focus Ofgem's attention on the risks to larger players in offering shape products in the context of a market demanding long-dated non-shaped products. It is inevitable that small suppliers will seek long-dated products which reflect the shape of their more limited (compared with large suppliers) customer portfolio, and that other suppliers might not be able to trade-on these shapes. To help ameliorate this problem, we would like to see better aggregation opportunities for small suppliers, which might help to reduce the impact of each particular shape and duration requirement.

M8. Number of counterparties active in the market providing hedging offers to small, independent suppliers (C)

We are pleased to see that small suppliers and generators have access to counterparties, and that the number of active players is set to increase.

M9. Participation of small/independent market participants on trading places (C)

We do not believe this to be a conclusive measure of contestability, since it says little about whether smaller suppliers can access the products they need directly from third parties.

We would expect credit requirements to be a significant issue regarding the participation of small players on exchanges. Credit and collateral costs change with changes to the macro-economic circumstances and the cost of counter-party default risk is real cost that cannot be avoided. It is also a cost which should not be subsidised through regulatory intervention, as this would be unfair, distort the market, and would raise overall costs for consumers.

M10. Availability of suitable products with small clip sizes (C)

We agree that clip size is an important issue for contestability.

In our view, Ofgem's approach of looking at the percentage of volume traded at the minimum clip size is not particularly useful. After all, we would not expect much activity in the low clip sizes in a market in which most of the volume is traded by large players. What matters to smaller players in such circumstances is that products which meet their needs are available at an appropriate cost. Ofgem's analysis does not help answer this question.

M11. Qualitative feedback (C)

Whilst it is appropriate for smaller players to express their views on wholesale trading conditions, we do not agree that it could ever represent an objective measure of contestability. It is inevitable that such parties express concern with the current arrangements if they believe this might improve their competitive position.

Chapter 3

Q1. Do you agree with the assessment of the metrics in this chapter?

We have addressed this question in our answers to question 1 above.

Q2. Do you have any comment on the level of improvement in the metrics that would make a significant difference for market participants?

As we have discussed above, we believe it essential that Ofgem makes a clear distinction between measures of liquidity and measures of contestability.

On liquidity, we are encouraged by the sustained rise in GB churn rates which began in 2006. The fact that they are improving year on year strongly suggests to us that there is no case for intervention. We note that there are relatively wide bid-offer spreads in longer dated products, which in our view is largely driven by collateral constraints, which will not be removed by market intervention. We believe that liquidity is sufficient to meet the needs of the existing players (the needs of small players and new entrants are discussed under contestability above). We continue to be encouraged by the progress of N2EX and believe that Ofgem should allow its increasing activity to develop and continue to monitor this. We also believe that the development of derivatives will be an important step, not only because it would improve liquidity, but because it would also signal the emergence of a trusted and transparent reference price.

With regards to contestability, we believe that the market should introduce an aggregator service which might be helpful to smaller suppliers.

EDF Energy
September 2010