



To all stakeholders

*Promoting choice and value for
all gas and electricity customers*

Direct Dial: 020 7901 7487
Email: Ian.Marlee@ofgem.gov.uk

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Dear Colleague,

Liquidity in the GB power market: Update

Over the last 18 months we have been monitoring and investigating the liquidity of wholesale power in Great Britain. We have concerns that the wholesale market might not be delivering the products and signals that all market participants need to operate their businesses effectively. In particular, independent suppliers and generators have expressed concerns that they find it difficult to manage risk with the wholesale products currently available. This could be having a negative impact on the outcomes for consumers in the supply market, especially if it means that there is no viable threat to existing suppliers.

Earlier this year, we published possible options for intervention¹ and a further assessment of the market², and stated our commitment to take action in the event that we do not see sufficient improvement. However, our preference has always been that the industry develops its own solutions.

The industry still hasn't achieved enough

Improvements are clearly necessary. Most of you tell us that forward market liquidity should be deeper, and that it is difficult to hedge a long term position. Small suppliers continue to tell us that it is hard to access products of the right size and granularity. Independent generators report that short term liquidity makes it difficult to balance their position, especially if their portfolio includes less predictable renewable sources. Others remain concerned that the market is slow to deliver a reliable reference price – which is especially important for investment in generation.

We share these concerns and our commitment to action remains. However intervention is not without cost or risk. We therefore understand the importance of giving positive initiatives a chance to take hold, and of making sure that any intervention is aligned with wider market developments.

The market is evolving

We outline some examples of industry-led changes which show positive signs in annex one. In particular, we note that the products and volumes available on exchanges continue to increase. The anticipated launch of futures products on N2EX may be another important

¹ Liquidity Proposals for the GB wholesale electricity market, 22 February 2010, Ref: 22/10
<http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=95&refer=Markets/WhlMkts/ComandEff>

² GB wholesale electricity market liquidity: summer 2010 assessment, 29 July 2010, Ref: 95/10
<http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=130&refer=Markets/WhlMkts/ComandEff>

step towards providing participants with the tools to manage risk. We also encourage the concerted effort by participants to make trading easier for small players. This includes the recent offer, from one of the Big 6, of bilateral trade in small clip sizes³. This could be a useful development, particularly if such offers become more widespread. We are also encouraged by "light membership" initiatives on exchanges, which could be suitable for smaller suppliers⁴.

Externally, the framework in which the industry operates could be entering a period of transformation as the Department for Energy and Climate Change (DECC) commence consultation on their proposals for Electricity Market Reform.

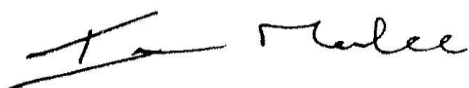
Any decision must be aligned with ongoing change

It is in the best interests of the market that any possible intervention to bolster liquidity is fit for the future. We have therefore decided to:

- Align our work on liquidity with wider market developments
- Continue to develop the detailed design of our options for intervention
- Continue to monitor the market, with a view to publishing our next assessment in Spring 2011
- Continue to press for further development of a liquid wholesale market

We would like to thank you for your continued engagement – and ask that you continue to let us know how effectively the market is meeting your needs. If there is anything in this letter which you would like to discuss with us – please contact Camilla Egginton (email: Camilla.Egginton@ofgem.gov.uk, tel. 020 7901 7433).

Yours sincerely,



Ian Marlee
Partner, GB Markets

³ See the outcomes of our 8 November roundtable in Annex 2

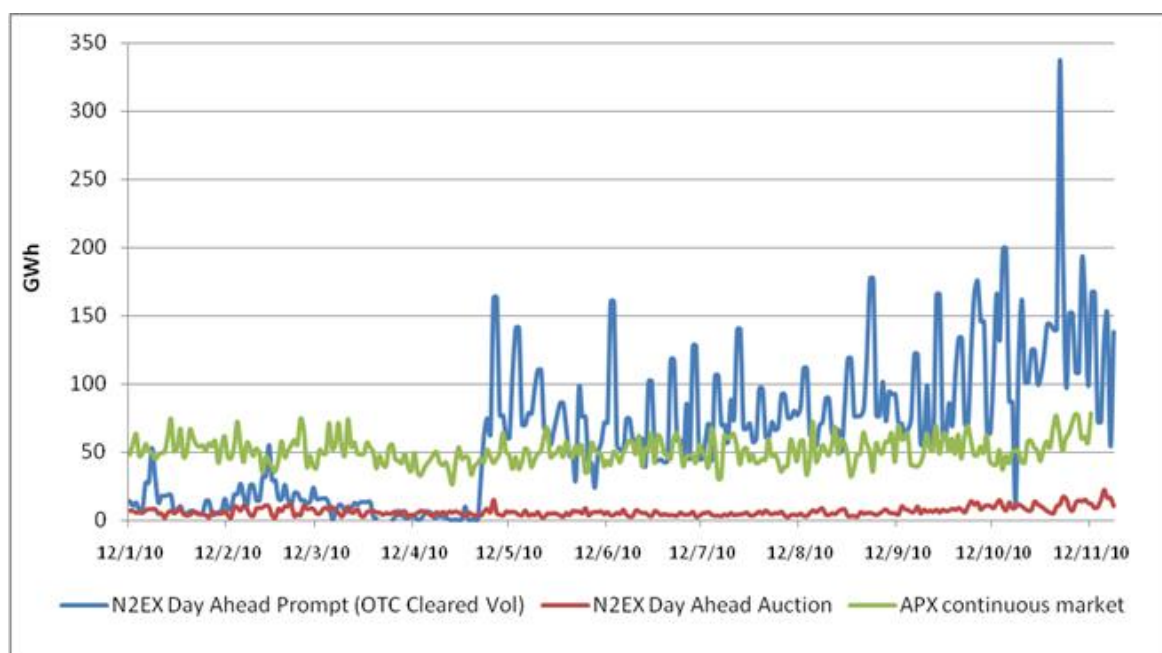
⁴ Additionally, we will consider the credit and collateral arrangements in the market further

Annex One: Market Developments

- 1.1. This annex provides an update on developments we have observed in the GB power market. Overall, these provide some evidence of positive change – though not enough to eliminate the question of intervention. However any forthcoming decision will take into account the full range of metrics we considered in our July assessment⁵.

Overall liquidity

- 1.2. Evidence suggests that churn has fallen since the summer and is on a downwards trajectory. While this trend is arguably consistent with developments in other European markets, it puts the following more positive developments into context.
- 1.3. Exchange-based trading has seen a moderate upward trend from a low base. N2EX did experience record volumes in both the day-ahead prompt and the day-ahead auction during October. Prompt volumes traded on the exchange in recent months were in the region of 180GWh representing roughly 18% of GB daily demand⁶ with volumes reaching 337GWh on 2 of November. However it should be noted that prompt volumes are OTC traded and then given up for clearing on the N2EX rather than trades originated on the platform itself and thus have no impact on overall churn. We also note that the launch of the spot market on N2EX has been delayed.
- 1.4. Volumes traded at APX ENDEX registered significant increases during September and are up 7% year on year. This increase has continued throughout November with maximum traded volume of around 80GWh.



Source: N2EX/APX

Other market developments since July 2010 assessment

- 1.5. There is still very limited trading in financial derivatives on the GB wholesale electricity market but we welcome the anticipated launch of (financially settled) futures products on N2EX in early 2011. The presence of such products could encourage participation by non-physical market players which could bring improvements to liquidity.

⁵ GB wholesale electricity market liquidity: summer 2010 assessment, 29 July 2010, Ref: 95/10
<http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=130&refer=Markets/WhIMkts/CompanEff>

⁶ Based on GB daily consumption of around 1TWh/day

- 1.6. N2EX have exhibited a slow but steady increase in membership since initiation with a total of 21 members at present of which six are financial institutions. We note that two additional financial institutions have joined the exchange since July and that the first small supplier (SmartestEnergy Ltd) recently joined. Likewise, APX continue to grow their membership base (currently at 60 members for the spot market and seven for the forward market) and have recently launched a light membership scheme⁷ aimed at Industrial and Commercial customers. It is our understanding that N2EX are also considering introducing a similar initiative to enable smaller participants to join the exchange.

⁷ 'Light Membership' enables organisations to trade through 'full' members. The 'light' members face lower barriers to entry and a reduced membership fee.

Annex Two: Participant Feedback

Overview

- 1.1. We have been actively engaging with market participants since we published our assessment in July. In addition to analysing your responses to our assessment and hearing about your experiences during bilateral meetings, we held a stakeholder roundtable event on 8 November 2010. Attendees considered how the market was developing and discussed the challenges of intervention.
- 1.2. Written responses to our assessment expressed a dichotomy of views regarding whether or not the market was able to meet participants' needs without intervention. Certainly, there remains no clear view on the timing or form of any intervention. The lack of a preferred route forward was also evident at the roundtable. However three themes emerged at this event, which we outline below.
- 1.3. We consider that allowing more time, making sure that any decision aligns with wider changes and continuing to work on the detailed design of our intervention options is an appropriate response to your feedback.

Themes from the workshop and bilateral discussions

(1) Focus should be on establishing a liquid market – contestability features will emerge

- 1.1 One key outcome was a recognition that the problems the market needs to solve are of a fundamental nature; deficiencies in broader liquidity prevent the features required for contestability to develop. It is important to establish the building blocks of a truly liquid market, rather than patching gaps which may or may not deliver specific aspects for contestability. In relation to this, some smaller participants highlighted the importance of banks and other intermediaries as natural counterparties to independent players rather than their competitors (i.e. the Big 6). It was felt that existing liquidity, both in the short and long term, was not enough to make it viable for intermediaries to emerge.
- 1.2 Independent generators in particular stressed that near-term liquidity should be deeper. This will become especially important if cash out incentives are sharpened.

(2) Some contestability challenges could be addressed

- 1.3 Independent participants continued to claim that they experience difficulty obtaining the specific products they need at reasonable terms including those regarding credit and collateral⁸. Concerns regarding process were also raised - i.e. who new entrants and small suppliers should approach in order to trade with the Big 6.
- 1.4 Positively, the Big 6 expressed their willingness to trade with smaller suppliers. One supplier offered to trade in small (sub 1MW clip sizes) – and committed to publish an open statement, with contact details, regarding their ability to offer products.

(3) There are concerns about interaction with the policy landscape

- 1.5 It was recognised that a more holistic approach is needed to align work on liquidity with ongoing market reforms (specifically DECC's Electricity Market Reform). There was no significant push for urgent action until these alignments were considered.

⁸ We have therefore decided to consider credit and collateral arrangements further