SCOTTISHPOWER

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16 September 2010

Dear Vanja,

GB Wholesale Electricity Market Liquidity: Summer 2010 Assessment

Thank you for the opportunity to respond to your consultation on this subject. We at ScottishPower continue to look to improve the liquidity and contestability of the GB electricity market.

We welcome the increases in overall levels of churn in the GB electricity market in recent years, to which we have contributed. However further increases from the current churn level of around 5 to the levels of 8 or 10 found in the Nordic and German markets will not, we believe, have any noticeable impact on supply market contestability. Markets which are more liquid are not necessarily as competitive and open as the GB electricity market. The GB gas market has significantly better liquidity than the power market and yet the domestic share for small suppliers is not significantly greater.

We welcome the entry of the N2EX exchange into the GB market with the expectation that it will offer new market entrants a further simple route to enter the GB wholesale power market by being able to sign documentation with a single centralised counterparty, will offer the security of clearing to mitigate counterparty credit risk, will offer small market participants the option to enter into wholesale power trades of sizes and shapes which meet their individual requirements, and will also provide further competition in the market for arranging wholesale power market transactions.

We have become members of the exchange, but it is expensive compared to competing trading platforms (including OTC brokers) and exchanges (including APX and ICE), both in terms of transaction fees and cash collateral requirements. The collateral presently required to trade on N2EX is, we believe, disproportionately high for the value of the underlying contracts and represents a potential barrier to entry. We have written to N2EX expressing our concerns on their competitiveness and also giving feedback on our experience of gaining membership, a process we would like to see improved in order to assist future new entrants. Our letter to N2EX is included as Confidential Annex A.

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We are committed to working constructively with N2EX to aid the future development of the exchange and therefore of liquidity and market access in the broader GB wholesale power market. Competition between exchanges will, we believe, be beneficial for independent generators who already see benefits from exchange membership. However, we question how much this will benefit independent suppliers, most of whom are not members of any electricity exchange. Some have questioned the value of exchange based products in helping them to hedge demand.

We believe it is key that all market participants are able to transact trades of sizes and shapes which meet their reasonable requirements, whether trading in the OTC market or through power exchanges. We have agreed bilateral master trading agreements with a number of independent suppliers and generators and are continuing to offer these to new entrants. We frequently transact wholesale GB power trades under these agreements, regularly transacting in non-standard shapes and sizes, in trades as small as 0.25MW. We have written to the four OTC electricity brokers asking that if they become aware of a counterparty wishing to transact a trade which is of a smaller than normal size, then they continue to ensure that we are asked for a price quote as we continue to be willing to transact in such trade sizes. We have also reminded them that we continue to be willing to initiate master agreement negotiations and to consider assigning trades to an exchange in order to aid market entry by such potential counterparties. The letters are included in Confidential Annex B.

We agree that any measures to improve the liquidity and contestability of the GB electricity wholesale market should be as consistent as possible with the energy market reforms likely to arise from the Government's current deliberations. While interim steps may well be practicable ahead of those wider reforms, more complex measures will need to be integrated with the Government's process.

We think that Ofgem are right to be cautious about pre-defining precise success criteria for liquidity as market developments may change the optimum way forward. The GB wholesale electricity market is continually developing and it is important to continue to assess important market criteria including liquidity. General improvement in liquidity would be welcome but not at the expense of fragmenting the existing baseload liquidity in order to create other longer dated products. We believe that the focus should be the availability of appropriate products for small or independent suppliers rather than their take-up, as many other factors can also influence the market share of such suppliers.

I attach a note responding to the questions in the consultation. I also attach Confidential Annex C, giving details of the recent actions we have taken to improve wholesale market access for small independent suppliers and generators.

We look forward to meeting you and colleagues to discuss this matter.

Yours sincerely,

Rupert Steele

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<u>Responses to specific questions - ScottishPower</u>

Proposed metrics

Question 1: Do you agree that the proposed framework provides an adequate range of evidence for assessing market liquidity?

The proposed framework comprises eleven metrics relating to overall levels of liquidity or supply market contestability. It recognises that the main measure of liquidity, aggregate churn, does not relate to supply market contestability and that the metrics relating to supply market contestability for small and independent market participants do not relate to overall levels of liquidity.

We agree it is sensible to separate the assessment into the three headings of overall liquidity, liquidity in forward products, and meeting independent suppliers' and others' wholesale requirements. We also agree that metrics should mainly be assessed on the basis of trends over time rather than comparing performance to that in other energy markets as, given structural differences between markets, it can be difficult to draw meaningful conclusions from such comparisons.

Ofgem has recognised that no matter how long and sophisticated a list of metrics is used, judgement will still be required to assess the market's performance. It is clear that some of the proposed metrics will be more important than others in assessing market performance but we agree it would not be appropriate to give a specific weighting to each metric.

In terms of assessing liquidity in standard products aggregate, churn is the most important metric. However, once churn has reached a certain level it is unclear as to whether or not further increases lead to a genuine increase in market depth for participants. It is not clear that the bid-offer spread is a good indication of market liquidity, as other factors such as price volatility could have a major impact on that spread.

There is also no direct relationship between the amount of trade that is exchange-traded and liquidity, as evidenced by time trends in the GB market and comparisons with the French market. Indeed, exchange trading often requires considerable collateral requirements, especially for longer dated products, which may make it less suitable for smaller suppliers than other trading options.

In assessing the availability of longer dated products we agree that it is useful to look at the volume of trade along the forward curve, the availability of financial derivatives and the participation of banks and other financial intermediaries on exchanges and OTC platforms.

In assessing meeting independent suppliers' and others' wholesale requirements we agree with the importance of looking at the diversity of products, the number of counterparties trading with small/independent suppliers, the number of small/independent market participants and the availability of suitable products with small clip sizes. However, while feedback from a sample of small or independent market participants may help guide Ofgem's thinking, we doubt if it is suitable as a formal metric as the objectiveness of the measure is difficult to establish.

Preliminary assessment

Question 1: Do you agree with the assessment of the metrics in this chapter?

We welcome, and have contributed to, the increases in overall levels of churn in the GB electricity market in recent years. However, further increases from the current churn level of around 5 to the levels of 8 or 10 found in the Nordic and German markets would not, we believe, lead to a material increase in market depth for participants.

As an active buyer and seller in the market we would like to see tight bid-offer spreads in prompt and longer dated products. However it is not clear that bid-offer spread is a good indication of market liquidity, as evidenced by the increase in GB bid-offer spreads from 2008 to 2010 coinciding with an increase in liquidity and comparison with the French market which has lower liquidity and lower bid-offer spreads. There are other important factors impacting bid-offer spread such as price volatility and price level and thus it is not possible to conclude that higher bid-offer spreads are necessarily an indication of poor liquidity, or *vice versa*.

We see the increase in exchange trading over the last few years as a positive development, including OTC trades cleared through an exchange as well as trades initiated on the exchange. The volumes generated by N2EX in 2010 to date are encouraging, but we are concerned at the competitiveness of N2EX relative to competing trading platforms, including OTC brokers and the exchanges APX and ICE, both in terms of transaction fees and cash collateral requirements. While we see competition in exchanges benefiting vertically integrated participants and independent generators, we question how much this has benefited independent suppliers, most of whom are not members of any electricity exchange.

It is unlikely to be feasible to use exchanges to deal with longer term hedging deals because of the collateral requirements. It may be more appropriate to assess other means of achieving the requisite price transparency.

We agree there are positive signs of improved liquidity along the forward curve with increased trading in 2010 compared to 2009 for more than a year ahead for baseload and with very significant increases for peak and off-peak. We do not think it is a cause for concern that the volumes of baseload traded more than 2 years ahead in 2010 are down on the levels of 2007 and 2008, since we believe that market movements and political developments since 2008 make participants less likely to seek to hedge significant volumes more than 2 years ahead.

Increased availability of financial derivatives would provide market participants with a wider choice of products to hedge their generation output and supply requirements. To date there has been limited trading of financial products, with the majority of trading physically settled. However, increased competition from exchanges could lead to an increase in the use of financial products.

We agree the level of participation by banks/financial institutions in the GB spot market is comparable with other European markets, but that the number of financial participants trading forward in GB is lower and the market would benefit from greater participation. However, proposed new EU rules on the trading of derivatives could limit the ability of banks to trade other than through exchanges.

The analysis has shown that a significantly greater overall range of products is traded in the GB market than in other European markets with a very wide range of products available for peak and off-peak requirements. Thus while there may be a need for specific products aimed at smaller market participants, there is no more general need for a greater range of products.

Feedback has indicated that up to six counterparties are currently active in providing hedging offers to small independent suppliers. We are one of these counterparties and we believe that six is a sufficient number to allow small independent suppliers to access competitive products.

We believe that the key metric should be participation of small/independent market participants in the market as a whole rather than purely on particular trading platforms. While exchanges have been successful in attracting independent generators, they have not been successful in attracting independent suppliers – one reason being the credit requirements of exchanges. If independent suppliers are able to access market products through counterparties without becoming members of exchanges, then this should be recognised as successful participation.

We believe it is key that all market participants are able to transact trades of sizes and shapes which meet their reasonable requirements, whether trading in the OTC market or through power exchanges. We have recently traded bilaterally with suppliers in clip sizes as low as 0.25MW covering periods from week ahead to March 2011 and we have written to the four electricity OTC brokers asking that if they become aware of a counterparty wishing to transact a trade which is of a smaller than normal trade size then they continue to ensure that we are asked for a price quote.

While the questionnaire sent to a number of small/independent suppliers, potential new entrants, large energy users and independent generators has provided useful information, we do not support inclusion of such feedback as one of the formal metrics. We believe the key assessment should be the availability of appropriate products which is covered by the other metrics.

Question 2: Do you have any comment on the level of improvement in the metrics that would make a significant difference for market participants?

Aggregate churn is currently at historically high levels and it is not clear that any further increases would make a significant difference for market participants.

Increased competition in exchanges should lead to increased volumes being traded through exchanges benefiting vertically integrated participants and independent generators. However it is unclear if this would benefit independent suppliers, most of whom are not members of an exchange. Some have questioned the value of exchange based products in helping them to hedge demand.

In terms of liquidity along the forward curve, maintenance of the recently improved levels of trading for more than a year ahead for baseload, peak and off-peak would benefit all participants. We do not believe there is a need for increased volumes of trading for more than 2 years ahead since we think the appetite for the market to hedge this far ahead has diminished.

We believe that the number of counterparties currently providing hedging offers to small independent suppliers is sufficient and thus an increase in this number would not make a significant difference.

It is key for small market participants that trades can take place below the official minimum clip sizes. From our experience**,** we believe that encouraging trades to take place down to 0.25MW could be significant for some suppliers.