Appendix.

CHAPTER: Two

Question 1: *Do stakeholders agree with our findings of the Review in relation to causes of persistent consumer harm and barriers to entry in the energy retail markets.*

We do not agree with the conclusions that Ofgem has drawn in its review. Ofgem's wording throughout the review document and in its public statements refers to 'persistent harm', but it has not explained what it means by this. Does Ofgem define harm as customers switching to more expensive tariffs, never switching, increased in and out of area differentials? In particular, SSE does not agree with the accusation that we make more profit from in-area customers over out of area, nor do we make more from disengaged or so-called 'sticky' customers.

Ofgem must define what a successful market is. Is it narrow price differentials or wide price differentials, product innovation serving different needs or one size fits all, rapid cost to price transmission or price stability, one switch for satisfaction or serial churn at high cost? We believe that there is a risk that Ofgem pursues its next phase of reform, however well-intentioned, without setting out a clear vision of what it intends to achieve in terms of outcomes for customers.

Perceived flaws can be found in any market. It does not mean that intervention is required. Similarly, if Ofgem does feel that intervention is necessary, then this should not limit choice for customers, but should support them in making effective decisions.

A significant barrier to entry in the energy retail market is the inability to earn a decent margin. There is no scope for a new entrant to recover their initial outlays and manage debt, whilst being competitive on price when margins are so low.

We have developed some alternatives that we believe will address the issues that Ofgem has identified. Our alternatives will make comparisons easier, lowering perceived confusion around tariffs and therefore increasing customer engagement. We have suggested improvements to the proposals on liquidity and the annual segmental statement whilst broadly being in agreement with the suggested changes.

CHAPTER: Three

Question 2: *Do stakeholders consider that Ofgem should take action to reduce the complexity consumers face and enhance engagement with the energy market?*

Ofgem should only act where it finds clear evidence of market structures or behaviour which is to the ongoing detriment of customers. We are unconvinced that the proposals will address the perception that the market is complex. Indeed, an increase in the number of fixed-term products on offer is likely to make customers' perception of the market more complex, exacerbating mistrust.

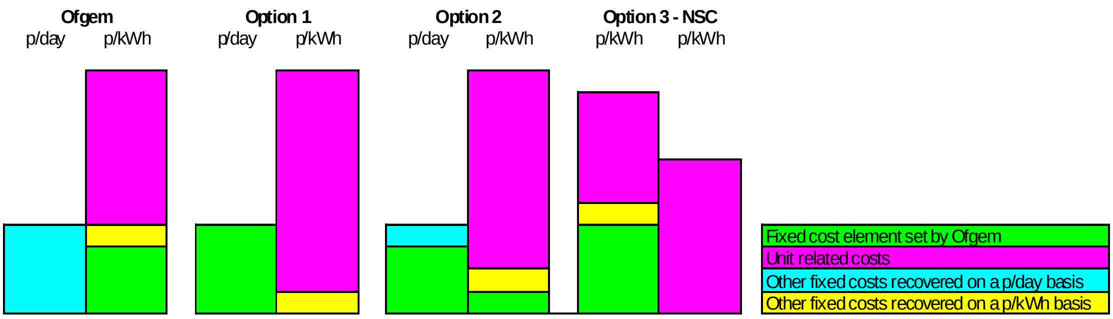
Ofgem states that the complexity that customers face is due to the total number of tariffs available. In our view, the proposals will not do anything to reduce the number of tariffs, indeed they are likely to increase.

Any change that benefits customers is welcome; therefore Ofgem's proposals must not be detrimental to customers or remove benefits which they currently enjoy at no extra cost. For example, SSE has a number of loyalty products, which are based on our standard tariffs, and give benefits to customers or charitable bodies at the same price as a General Domestic rate tariff. We do not believe that it is appropriate for these products to be made fixed-term. Ofgem has not explained why it believes that the tariff restriction proposal will deliver outcomes that will benefit customers, nor has it considered the consequences of such a move in stifling competition.

Question 3: *Do stakeholders agree with our initial proposal for intervention to reduce the complexity consumers face and enhance engagement in the energy market?*

SSE's understanding of Ofgem's proposal on tariff standardisation is that Ofgem would set a p/kWh element which suppliers would then be able to adjust upwards, competing on the total p/kWh unit rate. It is not clear from Ofgem's proposal whether the standard tariff is likely to include a fixed daily standing charge or not. Given Ofgem's historical dislike for no standing charge tariffs we have assumed that it does include a daily standing charge which suppliers would also be free to set.

SSE has identified three alternative options alongside Ofgem's, which are set out below. Please note that the size of the blocks is illustrative and are not reflective of the actual levels or their size relative to each other.



If Ofgem were to pursue the proposal to set an element of suppliers' standard tariffs, then we believe that the only viable option is number one. The reasons for this are that comparisons will always be based on the blue, yellow and pink elements of the tariffs. It would be confusing for customers if these comparison elements were split between different blocks of the tariff, as they would be comparing against at least two elements.

There are alternatives to Ofgem's proposals which will work better. Ofgem should not be setting prices or parts of tariffs in a competitive market. Nor should it be defining tariff structures or the elements therein. Any such move would only cause further price convergence and the already narrow margin within which suppliers compete would be further squeezed.

We are not convinced that all of the proposals will enhance engagement in the market. Ofgem has identified that price is the overriding reason which drives customers to switch, yet it has made it extremely difficult, almost impossible, to compete on price through its licence conditions on price differentials and other interventions.

If Ofgem wants simplicity and transparency for customers, then this can be achieved in a far more straightforward way than is currently proposed.

It would not be appropriate to make heating, load shifting and time-of-use tariffs fixed-term. Likewise, it would not be appropriate to make products based on a standard tariff fixed-term. Both of these would have detrimental impacts for customers. The former would face prohibitively expensive charges for their heating if they forgot to, or did not, renew. The latter would lose out on benefits which currently come at no extra charge. Similarly, SSE has over 3 million customers on nil standing charge tariffs, and a similar number on tariffs with a daily standing charge. Should we have to write to all of these customers to advise that their tariff was being restructured, then we would expect a huge number of complaints from customers unhappy that they are being put onto something that the do not want or is unsuitable for their needs.

In addition to the above, we are concerned about the implications for our partnership agreements. We have enclosed a statement from one of our partners EbiCo, who operate under SSE's supply licences. EbiCo's tariff structure is completely different to and separate to that of SSE's, with the direct debit discount being waived by those customers who should receive it and passed onto pre-payment customers. Ofgem's proposal would mean EbiCo's tariffs would have to be fixed-term, which is of no use for the purposes and principles of the company and their customers. Indeed, the EbiCo tariff design is similar to that of recent new entrant Co-operative Energy, whom Ofgem's proposals would also seem to exclude from the market unless its offerings were adjusted to become fixed-term.

Finally paperless, prompt pay and online sign-up discounts are not complex or confusing. They offer a discrete benefit to customers without the need to be tied into a product or pay a premium on top of a standard tariff. They are not payment types. Indeed, prompt-pay is dependent on the customer taking action, so it cannot be fixed-term as the rates may not apply from quarter to quarter (or indeed ever) if the customer does not pay promptly.

We therefore believe that there are so many pitfalls, unintended consequences, derogations and carve-outs required should Ofgem choose to implement its move to a fixed-term market that the customer detriment far outweighs the perceived benefit which Ofgem envisages.

Question 4: *If not, then do stakeholders have alternative suggestions for proposals to reduce the complexity consumers face and enhance engagement in the energy market?*

We believe that perceived complexity, engagement and increased confidence in the market can be achieved without the need for the limitation, standardisation and the move to fixed-term tariffs that Ofgem proposes.

Instead of having one 'evergreen' tariff per payment method and standardised elements of tariffs, SSE suggests that no changes are required in the number of standard tariff products that suppliers can offer. Instead we propose the introduction of a standard metric by which comparisons can be made. This could be based on agreed average low, medium and high consumption levels by region. This metric would be displayed on bills, marketing materials and comparison websites to enable customers to make easy comparisons. The metric would be set using approved calculations across suppliers. It would negate the need for the restrictions which Ofgem proposes and maintain competition and innovation across suppliers. The metric will also be simpler and quicker to implement, we would suggest, than the current proposals and will achieve Ofgem's stated policy objective.

Multi-rate, No Standing Charge, premium and fixed-price products could all have their equivalent comparison metric easily displayed on bills, switching sites, and so on. The matrix below shows how this may look on a pricing table. The prices used are illustrative.

Electricity Usage	Product	Standing Charge	Unit Rate(s)		Standard Consumption Metric
Low	General Domestic	25p	11p		**14p**
	General Domestic NSC	0	14p	11p	**11.6p**
	Economy 7	30p	12p	7p	**12.4p**
	Online sign-up	25p	10p		**12.7p**
Medium	General Domestic	25p	11p		**13p**
	General Domestic NSC	0	14p	11p	**12.7p**
	Economy 7	30p	12p	7p	**12.3p**
	Online sign-up	25p	10p		**11.4p**
High	General Domestic	25p	11p		**12.5p**
	General Domestic NSC	0	14p	11p	**13.1p**
	Economy 7	30p	12p	7p	**12.1p**
	Online sign-up	25p	10p		**10.8p**
Gas Usage	**Product**	**Standing Charge**	**Unit Rate(s)**		**Standard Consumption Metric**
Low	General Domestic	29p	4p		**7.2p**
	General Domestic NSC		7p	3.3p	**6.6p**
	Online sign-up	28.3p	3.8p		**7p**
Medium	General Domestic	29p	4p		**7p**
	General Domestic NSC		7p	3.3p	**5.5p**
	Online sign-up	28.3p	3.8p		**6.8p**
High	General Domestic	29p	4p		**6.8p**
	General Domestic NSC		7p	3.3p	**4p**
	Online sign-up	28.3p	3.8p		**6.6p**

Therefore on a comparison site, the customer may see something similar to this:

		Elec.	Gas
Your current product:	*Online sign-up 5*	**12.7p**	**6.8p**
Your chosen product:	*General Domestic NSC*	**11.6p**	**4p**

We have started discussing the development of our alternative with consumer groups and other suppliers and their initial reaction has been positive. We would be willing to work on this further with all stakeholders in the coming months.

Question 5: *We are proposing to standardise evergreen contracts across suppliers. Do stakeholders agree with the proposed contents of the standardised charge?*

There is too little detail of Ofgem's proposed content to enable us to make an informed assessment. However, within a competitive market, we do not believe that it is appropriate for Ofgem to set the price element of any tariff.

SSE looked at the four simplified options outlined above and concluded that it might be suitable for Ofgem to set a p/day standing charge, which cannot be topped up by suppliers, with suppliers then free to compete on the p/kWh element. However, we also believe that our proposed comparison metric is easier to accomplish and simpler for customers to understand. It removes the need for Ofgem to standardise tariffs in the way it proposes.

We are extremely concerned that if Ofgem were to move to standardise and set any element of customer prices, it signals the end of the competitive market and a return to price regulation.

Question 6: *We are proposing to create a standardised metric to allow consumers to compare evergreen and fixed term contracts across suppliers. Do stakeholders agree with our proposal for a standardised metric?*

A standardised metric could be useful if designed properly. We believe that the APR type metric described in our response to question 4 is better.

Our comparison metric has received support from stakeholders, is simpler, easier to implement and can be put in place quickly. It also addresses the perceived confusion identified in Ofgem's review paper by giving customers a consistent and identifiable reference point across all products.

Question 7: *Do stakeholders have any comments on the costs and risks of our proposal, or any alternative suggestions that you have put forward, to reduce the complexity consumer face and enhance engagement in the energy market?*

The risks are that the proposal will have the opposite of the intended outcomes and cause customers confusion and increase disengagement, as they are faced with an increasing number of fixed-term offers.

Ofgem must understand that not all customers are alike. SSE has designed products which meet the needs of different types of customer. If this range of products were to be made fixed-term at a premium, then customers will not engage and will not receive the benefit of the product. Similarly, if customers did not want these products, then no-one would be on them.

For customers who are disengaged, who may never want to change supplier, we would be unable to offer discrete savings such as a paperless and prompt-pay discounts, as these too are proposed to be in the domain of fixed-term offers under Ofgem's proposal. We fail to see what benefit this brings to either the customer or supplier.

There is also the risk that Ofgem will get the standardised cost element wrong, causing uncertainty and higher prices.

Further unintended consequences and risks of Ofgem's proposals are wide ranging and significantly damaging. The aforementioned time-of-use and bespoke heating tariff customers would be severely penalised. As these tariffs are the closest thing we currently have to the offerings during and after smart meter roll-out, Ofgem's proposals are completely at odds with the plans for smart metering, particularly demand reduction messages.

SSE's prepayment customers would immediately be penalised through any standardisation that meant they have to switch to a product with a standing charge. Any token meter customers would have to be visited to update or exchange their meter. This could cause significant disruption, expense and reputational damage if warrants for entry to customers' properties had to be gained. It also exacerbates asset stranding for suppliers, and will add to customer confusion ahead of the mass market roll-out of smart meters.

The logistics of moving huge numbers of customers onto different tariffs should not be underestimated. A straightforward migration of one customer alone would require an advisor to manually estimate meter readings, close and open a new service plan (account), bill the customer, ensure the meter and all other relevant fields were activated and complete. This can take an individual advisor around half an hour. Applied across SSE's customer base, it makes the exercise impossible without significant investment in resources and time. Whilst this timescale is for a straightforward change, should other work be required, i.e. meter exchanges, messages being sent to prepayment devices, infrastructure changes, etc. then the total time needed to move millions of customers onto new tariffs is impossible within a sensible time period.

Ofgem must also consider the number of complaints suppliers will receive from customers when they are switched onto a product they neither want nor had asked for, or when they have to have meter exchanges and lose out on the benefits associated with their product. Estimating huge numbers of meter readings also causes complaints and issues due to incorrect bills, miscalculated direct debits, incorrect annual projections, issues on change of supplier and associated settlement costs.

A move to fixed-term proliferation where the supplier cannot vary prices before the end of the fixed-term would lead to these products coming at a premium, therefore making them unattractive to customers and suppliers. Customers also want the ability to change their supplier without penalty at any point, not just at defined times each year or after paying a termination charge.

Finally, setting any standardised element of any tariff will lead to one or more groups of customers becoming unattractive, i.e. where fixed costs cannot be recovered from low users, these customers will effectively be removed from the market.

All of these detrimental factors must be taken seriously and are of significant concern to SSE, given our preparations to deliver the mass-market roll-out of smart meters and the investment in our supply transformation programme, whilst continuing to meet the needs and requirements of our customers.

Liquidity

As we have stated in previous submissions to Ofgem, we continue to believe that there is sufficient liquidity in the electricity market. As we trade bilaterally with a range of counterparties, and in a variety of ways, offering volume and shape into the market, we consider that we already make a significant contribution to liquidity in the market. In this regard, we consider it is important for Ofgem when considering solutions to perceived problems to make a distinction between the inability to purchase energy at desirable price, from liquidity, which, as described below, can be measured on the basis of churn and bid-offer spread.

Liquidity and Fair Market Prices

Increased liquidity will not in itself necessarily change market prices. Indeed, in our opinion there is enough liquidity in current products to ensure that the market does reflect a fair value of forward prices.

We are aware that there is a view held by some interested parties that the major six players unduly influence forward prices in order to hold them at a high level and restrict access to new participants. It can be shown that the day-ahead market price accurately reflects the cheapest marginal generation available that is required to meet the current level of demand. It is therefore an economically efficient price. The supposition that participants inflate forward prices above the economically efficient level therefore does not make sense. There are sufficient financial players already in the market that if there were an inefficiency in the price it would be exploited till the point of removal. i.e. these players would sell long-term power and buy this back at the day ahead stage to the point that this inefficiency would be removed.

Another way of measuring whether the price of forward power is fair is through the relative profitably of power stations going forward. The profitability of gas fired power stations is used as the general level to set power prices against forward fuel costs. The ‘spark spread’ is the relative cost of power output to gas input assuming an efficiency similar to the average of gas fired power stations in the UK. Including carbon in the calculation provides the ‘clean spark spread’ which is the same calculation but includes the cost incurred to cover carbon emissions.

The clean spark spread represents the actual profit a gas generator would make for every 1MWh produced and sold. Since summer 2008 average out-turn spark spreads have been £15.9/MWh and clean spark spreads £9.8/MWh. Market spark spreads for W11-W12 are less than £10/MWh and clean sparks less than £1.5/MWh. This shows quite clearly that, according to forward prices, gas fired power station profitability looks extremely low going forward. This also implies that, against the cost of the UK’s primary fuel, power prices are significantly lower than they have out-turned in the past.

Churn

The churn level can be described as the number of times power is traded before it is physically delivered. Churn levels improve for two main reasons: first as a consequence of parties taking speculative positions which have to be traded out prior to physical delivery; and second when asset owners actively trade their forward optionality as prices change. Speculative positions are primarily taken by financial institutions. Their involvement in the market is therefore key to enhancing churn. Trading of asset optionality includes trading interconnector volumes between countries.

Bid-offer spread

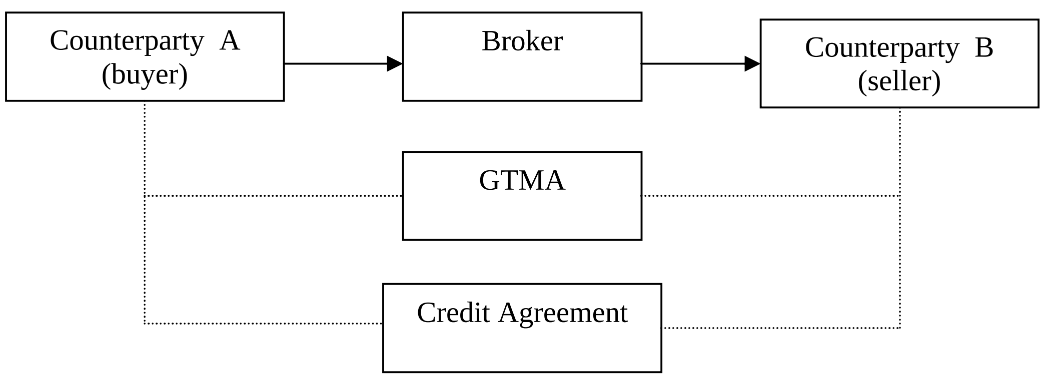
The bid-offer spread is the difference at any given time between the available price a contract can be purchased at (bid) and the available price it can be sold at (offer). Tight bid-offer spreads imply a liquid market as there is a small difference between the available price and the mid-market price or what could be taken as the "true" market price at a given time.

Brokers

Currently the vast majority of forward contracts are traded bilaterally through brokers. There are four brokerages active in the electricity market and they all compete on price and service to attract counterparties to use their services to trade. We believe that brokers enhance liquidity in the market and provide a valuable service to all participants.

Brokers facilitate trades between two counterparties; they do not usually transact trades themselves. In order for the trade to be executed, a Grid Trade Master Agreement (GTMA) and credit arrangements are required between the two counterparties. Brokers therefore know which counterparties have GTMAs and credit arrangements in place and can instantly trade with each other. There are around 20 active players in the forward markets so GTMAs and credit must be established with all of these counterparties in order to allow trading to be conducted with any of them. If participants do not have a GTMA or credit arrangement in place and wish to conduct a trade with a counterparty, a "sleeve", who has agreements in place with those particular counterparties can be found to act as the middleman in the transaction.

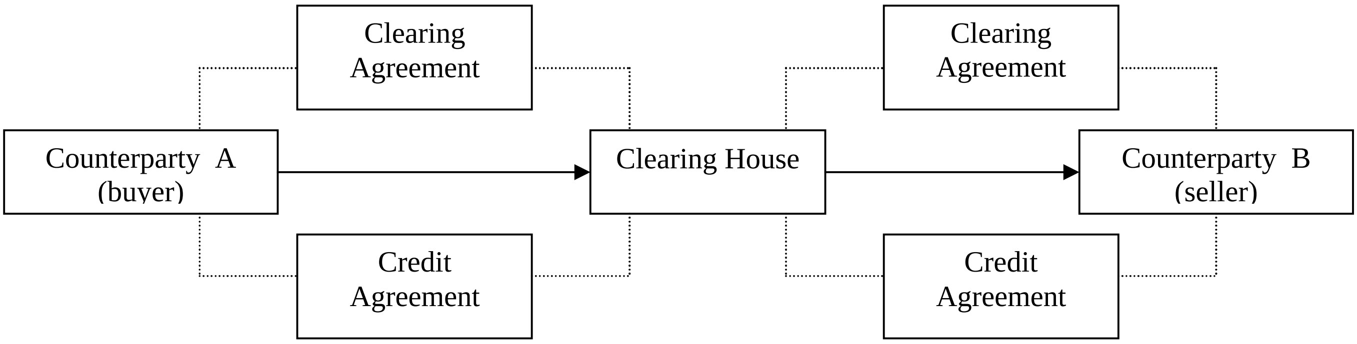
The diagram below illustrates the contractual relationships between parties in a brokered market.



A cleared market means that all counterparties need only have legal and credit arrangements in place with the clearing house, removing the need for multiple

GTMAs and credit arrangements. In return for arranging the trade the clearing house takes a small payment from buyer and seller.

This structure potentially provides access to counterparties that might not be available through bilateral or brokered arrangements. The diagram below illustrates the contractual relationships between parties in a cleared market.



Question 8: *Do stakeholders consider that low electricity market liquidity constitutes a barrier to entry in the domestic retail supply market?*

Whilst we do not agree that there is a fundamental issue with liquidity in the wholesale electricity market, nevertheless SSE is supportive of moves that further increase liquidity and is willing to work with Ofgem and other market participants to develop the best solution. Having said that, we are concerned by the suggestion that there are barriers to entry in the domestic retail supply market and that these are caused by low liquidity or to the behaviour of SSE and the other larger market participants.

Under the current competitive market arrangements, suppliers are incentivised to purchase electricity to meet their customers' demand. This can be achieved either by entering into a bilateral agreement with a counterparty; purchasing via a broker; or purchasing through a cleared market. In all of these transactions there will be a requirement to post credit and enter into GTMA agreements.

If a supplier is unable to purchase sufficient electricity to meet customer demand in any settlement period, it will pay the prevailing cash-out price. Therefore market participants do have to meet some minimum requirements in order to enter the market; however these are a consequence of the market structure itself and are therefore a fair requirement on participants. Indeed, the minimum requirements are intended to afford protection to all market participants and ultimately consumers, as the costs of any failure will be borne by the remaining participants and passed through to customers. Even the failure of a relatively small counterparty in the market can have significant consequence for market participants.

The provision of credit to multiple counterparties and the requirement to enter into GTMAs could be considered to be slightly more complex for new entrants. However there are many other entry requirements to be met, particularly in the domestic market, and steps have been taken to streamline and simplify the process in recent years, whilst ensuring that customers' and market participants' interests are protected.

With regard to the purchase or sale of energy, participation in a cleared market could be considered to simplify the trading process for new entrants as all trades are conducted through the clearing house. This means that once the appropriate credit has been posted with the clearing house, and the GTMA established, any participant will have access to multiple counterparties.

This objective was the underlying principle behind the establishment of the new power exchange which is now known as N2EX. SSE was instrumental in the set-up of N2EX; is active in this market, and remains pleased at the progress being made via this platform in increasing liquidity in the market. SSE does find it disappointing, however, that smaller players feel they are unable to participate in the market and that some larger vertically integrated players have not been as active as SSE in supporting N2EX.

Summary

We do not believe there is a low level of liquidity in the GB electricity market. We therefore do not consider that low electricity liquidity currently constitutes a barrier to entry in the domestic retail supply market.

Whilst an increased level of liquidity is an aspiration which we support, an increased level of liquidity will not remove these "due" barriers faced by small and independent players. However, it will make it easier for these players to hedge their customer demand at the time of striking contracts, provided they meet the costs of market participation i.e. credit and collateral. We do not believe that these costs are unreasonable.

Question 9: *Do stakeholders consider that our proposed interventions (MA and MMM) could improve the ability of the wholesale electricity market to meet independent participants' needs, and will ultimately improve the likelihood of retail supply market entry?*

Market Makers

SSE is committed to working with Ofgem and other industry participants to improve liquidity in the wholesale electricity market and believe that a Market Maker solution is the best way to achieve this.

Market making is the process of entering an order to buy and an order to sell on the market simultaneously. This provides the market with a price range and is currently used by market participants to attract other players who have an interest in the product. Typical use of market making is by market participants who would like to buy or sell a product that does not trade regularly. We have described this activity below.

Baseload products tend to be fairly liquid and to have a reasonably tight bid offer spread. From this most market participants will have a view on other parts of the market. The participant who has an interest in a product (for instance winter overnights) will make a market around the price they have derived from that product from the baseload. So, for instance, if baseload winter price is £50 they believe the overnight price should be £40. They enter a bid for overnights at £39.75 and an offer at £40.25 and let the broker, who they have posted the numbers with, know they have an interest. The broker will then let other participants know that they have a market on winter overnights and other parties who have an interest may start to get involved. They may have a different view on what the price of winter overnights should be given the baseload price or may just have an interest to buy or sell the product. These other parties start to put their numbers on screen and eventually the spread becomes tight enough that the product starts to trade.

This is a very effective way of creating liquidity in a product that is not trading regularly and is commonly used in the market. Having market makers on a wide range of products encourages market participants to show their interest more consistently and would increase liquidity in the products that markets are being made on. Having a sufficient number of market makers that would also ensure that there is reasonable volume on both the bid and offer side at all times showing a level of interest that is likely to attract other parties.

We comment in more detail on the options for taking a market maker solution forward in our response to question 12 below. We believe, however, that the adoption of a market maker approach will have a positive effect on liquidity for the reasons outlined above and we are therefore supportive of this approach.

Mandatory Auctions

SSE is not convinced that the other proposal put forward by Ofgem, Mandatory Auctions, will address the underlying concerns identified by Ofgem in the Retail Market Review. We have set out our reasoning below.

First, we believe that implementing auctions will be costly and time-consuming. Furthermore, mandatory auctions threaten the progress being made presently through N2EX, and we are concerned that the uncertainty created by an Ofgem intervention may cause a liquidity vacuum until the new system is implemented. Such a vacuum will make it even harder for small and independent suppliers to hedge customer demand at the time of striking contracts. We understand that Ofgem's proposals for mandatory auctions envisage a monthly auction. We have reservations about the implications that this process could have for liquidity for the periods in between the mandatory auctions. There is therefore a serious risk that players would be unable to meet their hedging requirements. In addition, monthly auctions are unlikely to provide the price transparency required to give confidence in the market and could have a distorting effect.

SSE believes that attracting financial players is the best way to increase liquidity in the market. However they are unlikely to participate in a market structure they are unfamiliar with, namely Mandatory Auctions. Mandatory Auctions also create regulatory uncertainty for players, and could act as a deterrent to financial players.

Finally, mandatory auctions make it harder for parties to justify new investment, which supports the case for capacity payments.

Conclusion
In summary therefore, we believe that a market maker can be made to work, but we do not believe that it should be assumed that such an intervention will necessarily result in increased entry into the domestic energy market. Whilst we are not completely opposed to mandatory auctions, we do not believe that they will address the concerns identified by Ofgem and therefore the market maker option should be pursued as the first preference.

Question 10: *Do stakeholders consider that both interventions could be necessary to meet objectives stated in 8&9?*
Ofgem's stated objective for intervention is increased liquidity and retail supply market entry. SSE does not believe that a Mandatory Auction will deliver the increased liquidity and market entry sought by Ofgem. In our view, Mandatory Auction is likely to lead to a disjointed market and prove prohibitive to suppliers of all sizes for hedging customer demand when contracts are struck.

Assuming that low market liquidity is a barrier to new participants entering the retail supply market, then Mandatory Market Maker (MMM) agreements are likely to increase liquidity and should therefore spur market entry. Offering a tight bid/offer spread over a range of products is likely to engage existing market participants and attract financial institutions which will increase liquidity. Small players participating will not in itself increase liquidity. Liquidity will only increase through MMM participation by the vertically integrated major six utilities plus large generators with more than 500MW installed capacity which will, in turn encourage the financial players to participate.

If it is determined that Mandatory Auctions is Ofgem's preferred way forward, the design of the process will be key. For instance, it is not clear if 10% of capacity is to be auctioned, or the basis on which it will be determined. We are also concerned that Mandatory Auctions could have an adverse effect on the case for investment in new generation.

Conclusion
We do not believe that both interventions are necessary to meet the objectives stated by Ofgem. As we have explained above, we believe that if any intervention is to be pursued, the market maker solution is the most appropriate and will best meet Ofgem's criteria.

Question 11: *Do stakeholders consider that there are other intervention options we should be developing?*
Fundamentally, SSE believes that Ofgem intervention in the market is not desirable as it creates regulatory uncertainty. However, the following alternative options could be explored:

- Expedite and simplify master trading agreements for bilateral trading
- Act as sole notification agent, free of charge
- Streamline regulation and compliance checks
- Trade small blocks: <1MW peak contract

- Transfer OTC trades to exchange (N2EX) for clearing
- Offer market reporting and site visits
- Ofgem to facilitate another round table for all market participants to ensure that concerns and ideas are heard

Question 12: *On the basis that we could decide to take forward these interventions, do stakeholders have comments on the indicative design choices we have made, as set out in Appendix 2. In particular, views are welcome regarding our initial position on each of the following:*

- *Volume requirements*
- *Product requirements*
- *Frequency*
- *Governance arrangements*
- *Participation*
- *Platform*

Our views on the indicative design choices have been informed by our knowledge of the EEX market in Germany where market making is undertaken.

Volume and Product requirements

Our proposal is that market makers should be obliged to make markets on baseload, peaks and overnights for the front three months, front two quarters and front two seasons. This would ensure there are bid-offer spreads available on a large number of products without making the volumes unmanageable for traders.

This type of market maker activity would give larger players as well as small and independent suppliers even more options to access the volume and shape they require to hedge their customer demand via the N2Ex cleared platform. It would also increase liquidity by encouraging participation from the financial institutions.

We have set this out in the table below:

Product	Min Vol	Min time available	Spread Baseload	Spread Peak	Spread Overnights
M+1	50	80%	1%	1.5%	1.5%
M+2	50	80%	2%	3%	3%
M+3	50	80%	2%	3%	3%
Q+1	10	80%	1%	1.5%	1.5%
S+1	10	80%	1%	1.5%	1.5%
S+2	10	80%	1.5%	2%	2%

So for the month ahead (M+1) the bid offer spread provided should be no more than 1% of market price on baseload, 1.5% on peak products and 1.5% on overnights and these should be available 80% of market open hours.

It is important to note that the market maker would not be restricted around the price offered, so the market making obligation would apply only to the bid-offer spread and volume being provided on a continuous basis.

We believe that the volume requirements proposed by Ofgem are reasonable and achievable.

Market Makers – participation and selection process

Liquidity and churn in the market stems from increased participation, and we believe that to increase participation in the market we must create the conditions that will attract financial institutions to trade wholesale electricity. Banks are active in the German wholesale market and also Nordpool, and the liquidity in these markets is superior to that of the UK wholesale market, although this is in part a consequence of the interconnection of the German and Nordpool markets with other markets.

The practical selection of market makers could prove to be the most difficult part of setting up a market making agreement. There are two main issues here, first how to select the participants that should be market makers and second how to ensure that other participants will get involved once the cleared market has been set-up.

Options for introducing Market maker(s)

There are three potential approaches to market maker:

1. Voluntary: National Grid (or another) tenders for a market maker and players can choose whether to participate. Market Makers would be rewarded for providing the service.
2. Obligation to participate in tender: National Grid (or another) tenders and parties have an obligation to participate. The appointed Market Maker would be rewarded for providing the service.
3. Obligation to be market maker on relevant market participants – probably via a generation licence obligation.

SSE's preference is that National Grid should run a tender process with the objective of attracting maximum participation from a range of players, including the major six, other large generators and the financial institutions, and this tender process should secure sufficiently many market makers, on a voluntary basis. In Nordpool and Germany market makers participate voluntarily based on preferential clearing fees and this is one possible route for selection.

A more Draconian approach would be to impose a licence condition on generators to either participate in a tender to be a market maker or to impose market making on them. If there is to be an obligation to participate in the tender, we believe that it should not fall only on the major six, but should include all generators of a sufficient size, e.g. more than 500MW capacity. We have provided our reasoning for this in the section below.

Importance of 'Niche' Trading parties

Market participants will hedge their forward positions based on the characteristics of their particular stations and the relative power, fuel and carbon prices. The Major six players have some diversity in their portfolios but tend to have similar mix of plant in terms of age and efficiency. Thus when the market moves in a particular direction all players tend to try to buy or sell in the same direction and hence the market corrects to a price that players are neutral to quite quickly.

The involvement of players with a different mix of generation is therefore important to improve the level of trading in the market. Specifically, the involvement of Drax with 3.6GW of coal generation which is significantly more efficient than any other coal stations in the market and the inclusion of First Hydro with 2.1GW of pump storage generation (over 70% of installed pump storage) brings two different trading angles to the market and hence their involvement in any new market is particularly important. International Power and Coryton also bring a different mix through the particular efficiencies of their gas station and should also be involved.

Ideally market participants would move volume onto the cleared market once market makers have been set-up. However given how difficult this has been to implement on the prompt market it is possible that a more prescriptive arrangement should be put in place. An obligation on all generators to be set-up and able to trade on the N2Ex market is a possible solution to this issue.

Selection process

The process for selection of market makers could take various forms. Based on Ofgem's indication of the volumes required, we believe there is a need for at least four market makers to ensure sufficient depth in the market (40MW on bid and offer in a given market).

There are currently two market makers on the N2EX directly cleared market. We believe that liquidity is still evolving due to the fact that these market makers are directly cleared and not enough market participants are set-up to trade cleared products.

Our preference would be for Ofgem to ensure that there are market makers at all times but for the selection process to be voluntary. From our knowledge of Germany, Nordpool and Italy market makers are usually happy to volunteer based on the improved fee arrangements offered by exchanges. However we would not be against a tender process or an obligation provided it is imposed on all parties, as SSE supports initiatives to improve and enhance liquidity.

Governance arrangements

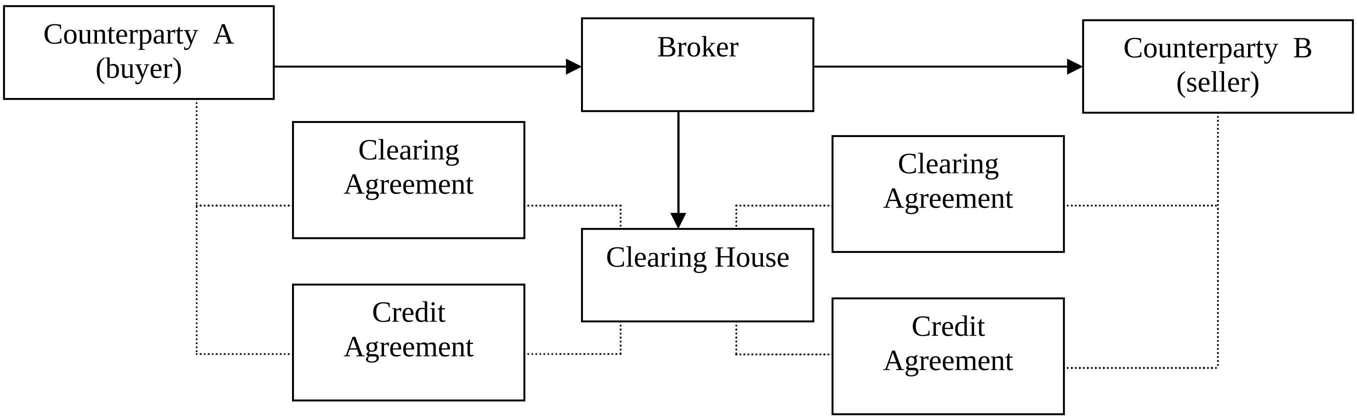
If there is to be an obligation on parties to be a market maker, Ofgem needs to consider how it will monitor their activities to ensure compliance. Monitoring will also need to take into account where the market making occurs. For instance, market making arrangements in Germany and Nordpool are governed by the exchange in order to measure whether participants are meeting their obligations. However, this measurement can take place only on directly traded orders as the exchange owner will have access to all orders. We would need different arrangements for the UK Market if orders are to be placed through brokers, which is our preference as described below.

If the market making is to be carried out on N2Ex, Ofgem will need to ensure that it has processes in place to facilitate the reporting of bid-offer spreads by the market maker(s).

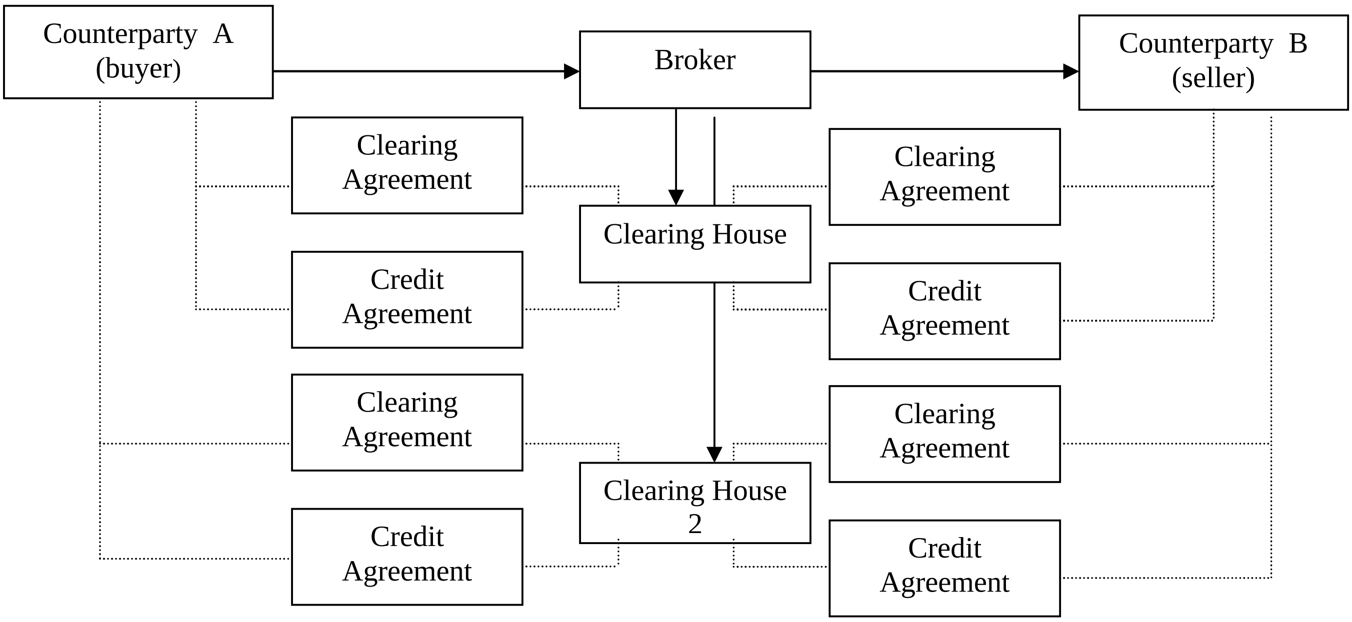
Platform

A cleared end to end platform to trade UK power provides benefits to all participants. We believe that, as now, broker participation in the exchanges delivers a valuable service to all participants.

As it takes time to establish trading platforms, we believe that any market making solution, be it voluntary or mandatory, should seek to build on existing arrangements. We therefore believe that N2Ex should be the trading platform through which market making activities should be driven. However, we do not believe that we should be obliged to use the N2Ex platform to trade 'on exchange' as this would effectively give N2Ex a monopoly going forward. We believe that the brokers should be used to "put up" the trades to the clearing house and therefore trading can continue as it is currently through the brokers but on a cleared basis. This approach is illustrated in figure 3 below.



In the longer term this would also allow other clearing houses to get involved in the market creating competition in clearing prices and bringing down the cost to trade for all participants. If we set up a directly cleared market at this point it would not be possible for other clearers to create competition in the future.



Question 13: *Do stakeholders have any comments on the costs and risks of our proposal, or any alternative suggestions that you have put forward, to take action to improve wholesale electricity market liquidity?*

Ofgem has proposed to intervene in the market and therefore it is absolutely vital that the design of the regulatory regime is clear and that the solutions chosen meet the stated objectives. There is also a risk that a clear distinction has not been made between liquidity and price and therefore efforts made to increase churn, tighten bid offer spreads and allow better access to the market may not necessarily have a downward effect on prices.

We believe that there are some key measures of success which need to be considered:

- Forward power trades in the same way as day ahead power trades currently, with participation by all; and
- An increase in the amount of cleared trading, reduced bid offer spreads and an increase in the available volume.

In terms of costs, we consider that Mandatory Auctions is likely to be very expensive and time-consuming to implement, especially given our experience of the N2Ex project. A further risk of Mandatory Auctions is that it is unlikely to deliver the desired liquidity and market entry.

The participation of small and independent players is vital. We would be concerned at implementing new projects if they do not meet the requirements of the smaller players.

Finally, any new arrangements need to be given time to bed down. We suggest that this is at least a year, if not longer as it provides certainty to all participants.

Question 14: *Do stakeholders consider that Ofgem should strengthen licence conditions around suppliers' communications and interactions with their customers, to give suppliers less freedom in how they interpret these obligations?*

We do not believe that this is necessary. Instead we consider that it is damaging to suppliers' ability to differentiate between each other and compete and therefore not of benefit to customers. As we have indicated earlier in this response, the margins in which suppliers have to compete have been made extremely narrow, for Ofgem to now instruct suppliers on what to say, when to say it and how to say it, is something that we could not support. This would be a retrograde step and is not appropriate in a competitive market.

Suppliers must be allowed to interpret and fulfil their obligations in the manner they see fit. If Ofgem has issue with any supplier or group of suppliers, then it has sufficient powers to investigate compliance and take action. Ofgem should not be dictating the manner in which compliance is to be achieved through further licence obligations.

Question 15: *Do stakeholders consider that Ofgem should increase its monitoring and enforcement activity to enhance suppliers' compliance with licence conditions?*

We would not take issue with this. However, Ofgem would need to revisit its enforcement guidelines to ensure that investigations are carried out for the correct reasons. An increase in regulatory uncertainty through Ofgem investigating where it does not need to will serve only to increase customer detriment as suppliers withhold offerings and innovation due to the regulatory uncertainty that such changes would attract.

Question 16: *Would stakeholders welcome the extension of some elements of the Standards of Conduct into domestic supply licence conditions?*

We believe that moving any of the existing Standards of Conduct into the Supply Licences would be extremely difficult, as these are aspirations and therefore extremely difficult to ensure compliance with and enforce. Ofgem would be required to issue extensive guidance on any Standard of Conduct introduced as a Licence Condition. We therefore do not believe that it is workable or proportionate.

SSE's Customer Charter contains the standards and promises by which our staff must abide and on which customers can judge us. Ofgem's Standards of Conduct are reflected in this and in our policies. We suggest that this is a better home for such aspirations.

Question 17: *Do stakeholders agree that more needs to be done to improve consumer trust and use of switching sites?*

We are not aware of any widespread mistrust or loss of confidence in switching sites and are therefore unsure what Ofgem would wish to do.

The Consumer Focus Confidence Code sets out what these sites must do in order to become accredited under their Code. Should Ofgem intend to take over the running of the Code following Consumer Focus's demise, then this may be an opportunity to address any shortfalls, including those of the Code, i.e. where fixed-term offers are concerned.

Ofgem must remember that switching sites are independent commercial bodies which have agreements with certain suppliers. There is currently no obligation on them to be party to any code(s) and to do so would be extremely difficult.

We would not support any obligations on suppliers in this area.

Question 18: *Do stakeholders have any comments on the costs and risks of any of our suggested policies under Proposal 3?*

The main risk that SSE sees is the regulatory uncertainty and risks associated with continual amendments to the Licences. This also has an impact on suppliers' investment plans, such as SSE's supply transformation programme.

We would also reiterate the point made earlier in this response, namely that Ofgem must not inadvertently drive the wrong behaviour from customers by legislating and over-protecting them. This would increase customer disengagement and lessen customers' ability to learn from experience in the market.

Question 19: *Do stakeholders consider that Ofgem should strengthen licence conditions to prevent unfair contracting practices in the non-domestic sector?*

We agree that Ofgem should take action in this area. SSE has had concerns over the practices of a number of competitors in the non-domestic arena for a considerable time.

We believe that Ofgem already has the powers that it requires to investigate and take the action it deems necessary where it finds deficiencies.

Question 20: *In particular, would stakeholders welcome additional licence conditions surrounding the objections procedure?*

We would support Ofgem taking steps to tighten the condition around non-domestic objections.

We would also like Ofgem to look again at the renewal process in the non-domestic market. We are concerned that the volume and repetition of paperwork that requires to be sent to customers at various points is both time consuming and results in unnecessary complexity, especially for micro-business customers.

Question 21: *Would stakeholders welcome the extension of some elements of the Standards of Conduct into non-domestic supply licence conditions?*

In line with our response to the same question in the domestic market (Question 16), the Standards of Conduct, whilst useful, are aspirational and therefore difficult to comply with and enforce without significant guidance being issued.

Question 22: *Do stakeholders agree with our position, at this stage, not to extend our proposals on tariff simplification into the non-domestic sector?*

Yes.

Question 23: *Do stakeholders agree that Ofgem needs to look further at the role of third party intermediaries (TPIs) in the non-domestic market?*

Yes. Whilst a Code of Practice for TPIs is desirable, the OFT already has powers to intervene in this area. SSE would encourage Ofgem to work with the OFT and others to improve the way that non-domestic customers are engaged by some of these agencies, including in particular, transparency of pricing.

Question 24: *Do stakeholders have any comments on the costs and risks of any of our suggested policies under Proposal 4?*

In line with our response to Question 16, the main risk perceived by SSE is that of regulatory uncertainty and risks associated with continual addition to and tightening of the Licences.

We would also reiterate the point from earlier in this response, that Ofgem must not inadvertently drive the wrong behaviour from customers by legislating and over-protecting them. This would increase customer disengagement and lessen customers' ability to learn from experience in the market.

Question 25: *Do stakeholders agree with Ofgem's proposal to appoint a leading firm of accountants to review the transfer pricing and hedge accounting practices of the vertically integrated suppliers?*

We believe that we have complied fully with the requirements of the new licence condition to produce a Consolidated Segmental Statement (CSS) and Ofgem's overview document published alongside its Retail Market Review has confirmed that this was the case. As part of its review Ofgem consulted on proposed amendments to the Guidelines associated with the CSS and has recently published its amended Guidelines for implementation in this year's statements.

We note that one of Ofgem's objectives is to improve transparency and the cross-comparability of the statements produced by the major six suppliers. Whilst we understand the aspiration, Ofgem must recognise that there is a limit to cross-comparability because of the different business models operated by the companies. We welcome Ofgem's acknowledgement of the tensions associated with the disclosure of commercially sensitive information in a publication and that it seems minded not to require more comprehensive reporting.

We continue to believe that the approach we have adopted to transfer pricing and the way in which it has been reported is appropriate. Whilst we do not think that there is a need for Ofgem to appoint accountants to review our transfer pricing and hedge accounting practices, we will, of course cooperate with such a review if it is considered necessary, provided that the appropriate steps are taken to preserve the confidentiality of this commercially sensitive information. We would also welcome the opportunity to discuss the terms of reference in detail with Ofgem. We do, however, consider that there is merit in Ofgem carrying out a further assessment of the Statements published under its revised Guidance before initiating such a review.

Question 26: *Do stakeholders have views on how Ofgem could improve segmental reporting in future years?*

Ofgem has now published its proposed amendments to the Guidance, and we will work to make the necessary changes in our next Consolidated Segmental Statement. We do not believe that further improvements are necessary, but will continue to discuss the evolution of the reporting requirements going forward.

Question 27: *Do stakeholders consider that our proposals will be sufficient to protect the interests of consumers, including vulnerable consumers, or are additional consumer protections measures necessary?*

Ofgem needs to more clearly define which group or groups of customers it has particular concerns about. It must not put in place any further restrictions or obligations until it is sure that these will not cause widespread unintended detriment to the generality of customers.

The best solution is for Ofgem to ensure that customers have access to the necessary information that they need to make informed choices, not restrict the competitive market further.

The Probe Remedies need proper time to bed-in and develop before any assessment can be made on whether they are working or not. Any such examination should only be carried out after a sensible amount of time has passed.

Question 28: *Do stakeholders consider that our measures to simplify tariffs will reduce the ability for suppliers to price discriminate between regions and so reduce the need for a licence condition prohibiting undue discrimination?*

It may be necessary to remove this condition for other reasons, as it has a negative impact on suppliers' ability to compete by narrowing the margin in which we can do so on price.