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Subject: APX-ENDEX response to the Ofgem consultation on "Intervention to enhance liquidity in the GB power market" (Ref 21/12).

Dear Ms. Egginton,

Thank you for providing us with the opportunity to respond to the Ofgem consultation paper "Retail Market Review: Intervention to enhance liquidity in the GB power market".

As long term providers of successful energy markets with 65 participants trading over 1200 contracts each day averaging 48 GWh/day in the GB markets, we share your desire to improve liquidity and market access and welcome the opportunity to offer our views on possible measures to increase liquidity in the market. We have a diverse mix of members and recognise the difficulties that smaller and non integrated participants can face through low levels of liquidity and demanding credit terms, and we are working hard with our members to address these issues.

APX-ENDEX agrees with Ofgem's conclusion that in the near term market in the UK there have been positive developments. APX-ENDEX operates a highly liquid continuously exchange traded within-day power market, attracting a diverse range of members who constitute practically all of the market parties in the UK. The start of market coupling over the BritNed cable has brought further improvements to the UK market at the day-ahead stage. On Saturday 14 April we witnessed an all time daily high of volumes traded on the APX-ENDEX UK Day-Ahead Auction with 19,432 MWh traded for an average price of £47.12/MWh and 17 participating members. For the period starting from the first of January 2012 until now the HHI¹ index of merely 0.063 for the APX UK Day-Ahead Auction indicated a highly competitive market with no dominant parties setting price.

Further improvements in the near term power market are expected after the development of an integrated North West European (NWE) electricity market that will link together the Nordic, Central West European and GB Day-Ahead markets using the method of price coupling. The development of a 'virtual hub' will help facilitate the Day-Ahead market coupling planned to link Britain to the emerging integrated European electricity market. The virtual hub solution which is being developed by National Grid enables all exchanges in GB to pool liquidity and share a common price on a non discriminatory basis. The start of NWE also allows APX-ENDEX to extend its product offering and introduce "block orders" and "smart bids", something that is not possible with the present coupling arrangement over BritNed.

As recognized by Ofgem's objectives of creating more availability of products which support hedging and the generation of robust reference prices along the curve, the problem for the UK remains in the forward power market. In this context APX-ENDEX would recommend giving priority to the accessibility of the forward curve as the assessment criteria, as we consider the

¹ Herfindahl index (also known as Herfindahl-Hirschman Index, or HHI) is a measure of the size of firms in relation to the industry and an indicator of the amount of competition among them.

accessibility of these products as one of the main issues of concern in the GB wholesale electricity market. Especially for small suppliers, the question is whether they are able to trade products with small clip sizes and a small bid offer spread further ahead on the curve. Access to credit on affordable terms is a critical issue in this context.

We understand that the mandatory auction is being proposed as a remedy to this problem of market access for smaller, non-integrated players. At last week's Roundtable there were a number of concerns expressed about the proposed approach – including whether it can achieve its objectives and the implications of Ofgem having to interfere in the free operation and competition in the market. In this response APX-ENDEX would like to put forward two ideas for possible ways to tackle these concerns.

- **Simplified Clearing Solution.** This potential solution for the Mandatory Auction addresses the problems associated with a single platform and minimises collateral requirements for buyers and sellers.
- **Auction of Standardised Tolling Contracts.** This solution offers the buyer the right to exercise the spread between forward power and a given fuel (or basket of fuels) at a given price. This solution amongst others removes any competitive advantage a vertically integrated participant may have over non-vertically integrated suppliers. Independent generators by taking part in this auction would now have a route to the supply side for delivering their power at a competitive price whilst not exposing them to greater market risk.

Both above mentioned potential solutions for the Mandatory Auction are further discussed in the Annex.

Concluding, APX-ENDEX fully supports Ofgem's activities in the field of further developing liquidity in the GB wholesale electricity market. APX-ENDEX wishes to work with regulators, transmission owners, market participants and all other relevant parties in order to develop the right solutions to achieve this.

Should you have any queries please do not hesitate to contact myself or Jethro van Hardeveld, Sr. Public and Regulatory Affairs Advisor, email j.vanhardeveld@apxendex.com or phone +31 (0)6 3164 3760.

Yours sincerely,

Derek Abernethy
UK Commercial Director

ANNEX – Response to specific questions raised in the consultation

Question 1: Do you agree with the objectives we have identified?

We agree with Ofgem that the near term market has seen encouraging developments. APX-ENDEX operates a highly liquid continuously exchange traded within-day power market, attracting a diverse range of market parties in the UK. At the day-ahead stage, the UK has clearly benefited from an increasingly integrated European power market. The introduction of market coupling over the BritNed cable has been positively received as a part of larger European market coupling. On Saturday 14 April we witnessed an all time daily high of volumes traded on the APX-ENDEX UK Day-Ahead Auction with 19,432 MWh traded for an average price of £47.12/MWh. For the period starting from the first of January 2012 until now the HHI index for the APX UK Day-Ahead Auction was merely 0.063, indicating a highly competitive market with no dominant parties setting price.

Further improvements are expected in the context of the enduring solution for the integration of day-ahead electricity markets of Great Britain within North West Europe. APX-ENDEX is currently heavily involved in the development of the integrated North West European (NWE) electricity market that will link together the Nordic, Central West European and GB Day-Ahead markets using the method of price coupling. The target is to implement this new arrangement by the end of 2012. A “virtual hub” will be implemented as part of the NWE price coupling, so that more than one exchange can operate in GB in a completely non-discriminatory way and providing open access to all market parties. The virtual hub solution being developed by National Grid, should enable all exchanges in GB to pool liquidity and share a common price. The start of NWE also allows APX-ENDEX to extend its product offering and introduce “block orders” and “smart bids”, which will further enhance trading and market efficiency.

The removal of the UK transmission charge BSUoS and the change in the treatment of system losses, which is currently under consultation by National Grid, has the potential to further increase cross border trade and thereby increase competition in the GB market. APX-ENDEX welcomes these developments.

Question 2: Do you think there are other objectives we should be considering?

APX-ENDEX agrees with Ofgem that priority should be given to the forward market. The main issue, however, to consider when finding solutions which address the issue of the lack of liquidity in the forward market is the accessibility of the forward curve and the issue of credit.

APX-ENDEX would recommend giving priority to the accessibility of the forward curve in the development of any solution, as we consider the accessibility of products further ahead on the curve as one the main issues of concern in the GB wholesale electricity market. Especially for small suppliers, the question is whether they are able to trade products with small clip sizes and a small bid offer spread further ahead on the curve. Access to credit and reducing the costs of collateral should be given priority in this context.

Question 3: Do you agree with our views on market developments since summer 2011?

In assessing liquidity on the exchange it is essential to make a clear distinction between exchange based traded volumes and OTC cleared volumes. OTC cleared volumes consist of bi-lateral trades and represents volume which is not accessible to the wider market. Any figure which adds these OTC cleared trades to the exchange based traded volumes (which in our case is accessible

to all 65 of our current APX-ENDEX UK Power members), is potentially misleading regarding the state of liquidity in the market as a whole and in particular on the exchange.

Figure 6. “Exchange trading- weekly volumes” (on page five of the consultation document) and the relevant text on the graph do not make this distinction. If Ofgem considers that a section on OTC cleared volumes is relevant in the debate on liquidity in the context of price transparency and the creation of a robust price index, the figures should be published separately. By doing so, the figures on liquidity on the exchanges remain valid.

Question 4: What specific further developments would be necessary to meet our objectives?

Please refer to the answer given under the Questions 6, 7, 8 & 9.

Question 5: Do you agree that objectives one and two are current priorities given market developments?

APX-ENDEX agrees with Ofgem that priority should be given to the forward curve.

Question 6, 7, 8 & 9:

Recognising the concerns expressed at last week’s Roundtable, including the role of a regulator in the free operation and competition in the market, APX-ENDEX would like to put forward two ideas for possible designs of the mandatory auction.

There are significant technical complexities with multiple auction platforms if the desire is to couple them in order to have a common price, and in our view a single platform will be the most cost effective solution. However, a big drawback of a single platform procured by the regulator would be that Ofgem would in effect be selecting the GB futures market operator and clearing house. Once significant open interest is established it would be very hard to change (making a regular retender of the role impractical). The implication is that the futures exchange and clearing house becomes an institutional role which should probably be subject to some form of Ofgem regulation (not just financial).

The alternative of an industry-governed single platform (i.e., under licence obligation) is also quite difficult to establish and govern. The old Electricity Pool operated under a similar construct, and you would need a carefully designed governance structure to ensure, for example, fair decision making (including role of Ofgem, handling of disagreements) and how to involve/represent all interested parties (obligated parties, other industry generators, other suppliers, financial parties, customers). This of course can be done, but should not be underestimated.

APX-ENDEX therefore proposes two alternative modifications to the mandatory auction, a “simplified clearing solution” and alternative auction proposal, which we think could better realize Ofgem’s objectives.

1. A Simplified Clearing Solution

A possible solution for the Mandatory Auction that addresses the problems associated with Ofgem procuring a single platform would be to limit what is being procured. Rather than procuring a full CCP clearing arrangement, a simplified clearing solution for the Mandatory Auction could be adopted. Such a solution could e.g. focus mainly on settlement arrangements broadly based on

either existing multi-lateral settlement schemes and/or agencies. This would only require buyers to collateralise their unrealised settlement on delivered power (which could for example be settled monthly or even daily). This solution minimises collateral requirements and associated costs for buyers and sellers, and would avoid any short term margin calls.

In this clearing solution the Obligated Party faces the risk of a potential default by the buyer. The collateral covers payment for power delivery. With respect to the open position, either the buyer defaults at a time of high prices (in which case the generator is happy to be released from the contract) or wilfully during low prices. The latter could be discouraged by banning the buyer from all future Mandatory Auctions.

Unrealised settlement and near term clearing could be organised in a number of ways, avoiding the need for the Mandatory Auction to mandate a particular single clearing house. For example, positions could be guaranteed by collateral deposits, bank guarantees or guarantees from power exchanges/clearing houses that are already active in the market (thereby taking advantage of existing collateral deposits).

If short term clearing is done via power exchanges/clearing houses, then nomination and settlement could also be done by them. This service to buyers could be done on a competitive basis (e.g., N2EX, APX, ICE). The buyer would select the preferred settlement service provider, who would have to have been approved by Ofgem. The settlement and nomination could be done under the rules of the chosen power exchange / clearing house, minimising the need for new contracts/agreements.

As a consequence of this approach, the Mandatory Auction tasks, associated contracts and governance would be quite modest:

- Operation of a monthly auction, with associated compliance, assurance and reporting functions;
- Managing participation (e.g., participation agreements, contract terms).

Consequently, Ofgem could be able to take responsibility for procuring this solution without the risk of excessive interference in the market while avoiding significant cost.

2. Alternative Auction Proposal

Given the objectives set by Ofgem and the concerns raised by participants at the round table discussions we could offer an alternative proposal that we believe might better meet the objectives and satisfy the relevant concerns.

An auction of standardised tolling contracts could deliver the following benefits:

- Non-vertically integrated suppliers would be able to purchase a toll to give them the same portfolio exposure as an integrated participant, thus removing any competitive advantage a vertically integrated participant may have over them.
- Independent generators by taking part in this auction would now have a route to the supply side for delivering their power at a competitive price whilst not exposing themselves to greater risk through only being hedged on one leg of the spread, as would happen if they entered an auction for outright power.
- The vertically integrated participants would not be required to sell a product that would expose them to greater market risk, as could be the case in an auction for outright power.

- Credit exposure and thus credit requirements would be lower as the market replacement cost of the spread will be lower than the more volatile outright power leg. Further credit measures are likely to still be required to assist new entrants but these should be lower.
- Tolls reflecting the underlying characteristics of the generation mix of a participant could be offered. This removes the increased exposure faced by a generator obliged to offer peak when their portfolio mix is base load, and vice versa.
- The ability to exercise and trade around these tolls will naturally increase liquidity in the electricity market and that of the underlying fuels as both sides would operate hedging policies similar to those currently operated by the vertically integrated players.
- Although tolling contracts can be mathematically complex to value, this is no more complex than pricing in the risks of a single legged forward contract which is ultimately determined by a number of these same complex tolls and is more volatile and hence higher risk than the spread between the power and the component fuels.
- In simplistic terms an auction of tolls offers the opportunity for all participants to become financially vertically integrated. Smaller independents can obtain the exposure of a vertically integrated player on a scale appropriate to the size of their portfolio whilst the operational risks and responsibilities remain with the experienced plant operators.

This is a very brief summary of the benefits of an auction of tolling contracts which we believe would have significant benefits to liquidity and market access. Should you wish to explore either of these ideas further we are very happy to discuss them with you.