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7th May 2012

Response to the Ofgem Retail Market Review: Intervention to enhance liquidity in the GB power market.

Dear Sirs,

We are pleased to be able to provide you with a response to your market consultation having attended meetings hosted by the Futures and Options Association (FOA) and Ofgem. We have studied the published literature at length and would be delighted to have the opportunity to discuss our views and alternative suggestions with Ofgem at a mutually convenient time. This response covers only the wholesale market aspects of the consultation and deals with the impact of the MA, the validity of the key objectives (which are laudable but without any defined parameters are meaningless) and suggests alternative solutions that are cheaper, easier to implement and will be more effective in achieving the goals as set out in the consultation paper.

1 Contango Markets Background

As Contango Markets is a company that is unlikely to be familiar to Ofgem, we feel that it might be useful to provide you with some background in order for you to assess the expertise that underlies our response and (should you so wish) to avail yourselves of that expertise in a mutual desire to create better markets in GB power.

Contango Markets is a company that builds spot and derivatives markets for a living. Since 1999, the company has worked on major projects with global exchanges, banks, brokers and clearing houses (amongst others) and is widely recognised as one of the global experts in the development of traded products in all sectors of commodities and the exchanges on which those products trade.

Our staff are all drawn from the commercial side of the derivatives and commodity industry and are considered to be the best in the exchange industry covering all aspects of the products through the lifecycle as well as operations, technology and the commercial impact of regulation.

In power markets we are extremely active. We run the Power Trading Forum (PTF) for the FOA and were responsible for managing the Market Design Project that led to the recommendation of Nasdaq OMX Commodities as the service provider – this included writing the RFP and dealing with the commercial issues surrounding products that inevitably arose. In addition we have undertaken power exchange-related projects in Hungary, India, Turkey, Poland and Germany. All of these involved developing traded product specifications for power markets and as a result we have witnessed the evidence of intervention and free markets in power at first hand.

We have undertaken a large amount of research on the way in which markets evolve and their phases of liquidity, which we would be interested to present to you should you so wish.

2 Initial Impressions

At the outset we should state that we do not believe that the proposed interventions have any chance of success and whilst it is impossible to disagree with the 3 objectives as set out in the paper, the way in which Ofgem seeks to achieve them is entirely flawed. There is not one single example where a regulator has intervened in a market where that market has thrived and grown. Market liquidity is earned not mandated and defining a market as the result of 3 criteria, which are themselves, high-level at best, is unlikely to yield positive results. Everyone with an interest in the market wants these criteria to be achieved – what you fail to provide is an adequate explanation of why they are essential to Ofgem and the commercial issues that underlie the choice of the MA as a way of achieving them.

2.1 Objective 1 – Availability of Products Which Support Hedging

There is no lack of products that support hedging. Such products already exist and are developed as a result of the commercial development of the market – spark spreads are a good example of such development.

Without any metrics as to the buy-side demand that considers that products are not available, along with the amount of volume needed to adequately fulfil their demand, it is impossible to say what the products might look like but in our experience it is neither time consuming nor costly to build such products. Developing liquidity in them is another matter.

We agree with Ofgem (and the majority of market participants with whom we speak on a regular basis) that liquidity in the GB wholesale power market is not as good as it should or could be. However, we consider that mandatory auctions will have precisely the opposite effect of that hoped for by Ofgem and that liquidity will dry up, rather than grow, as mandated parties hold back volume from the freely traded market to ensure that their own generation covers their obligations. Should Ofgem then require further volumes to be provided to the market by these parties, eventually the only multiple of production that could possibly be traded would be 1 times the underlying as no derivatives or other instruments could possibly exist in an environment where there is no freely-traded volume. This would mean that objective 1 is unachievable.

Freely traded markets achieve significant multiples of their underlying markets in OTC and exchange traded derivatives. In the exchange-traded market alone, products such as crude oil, aluminium and soybeans, trade 11, 18 and 19 times their underlying markets. Such multiples are not achieved through intervention but through the natural development of market participants wishing to manage or assume risk.

We work with commodity markets every day in every area of the commodity complex and there is not one single product (including crude oil and base metals) where volume trades in tight spreads 5 years forward – even less so in physical markets. The requirements have simply been plucked out of thin air and are so ridiculous that we can see no basis for their development. We would be most interested as to how (other than using an arithmetic distribution model) that these requirements have been arrived at as it is evident that no reference as to how any other market has developed has been used. It is neither robust nor safe for a regulator to be so cavalier with obligations that will cost participants money and ultimately harm the underlying market.

We have some concerns about the volume that Ofgem wishes to make available to the market. 25% of generation is a significant amount of volume and far in excess of that required to satisfy the needs of the independent suppliers. If that is the case we then question what other commercial interests have pressed for availability of significant volume on a forward basis. This leads us to question whether the volume requirement is in fact essential to make a better return on capital calculation available for the companies who have committed to develop future generation projects in the UK – both renewable and nuclear. Having worked on renewable generation projects, we are aware that this is a key factor for the companies undertaking the projects but should not be a factor in influencing the GB power market regulator to intervene in the market.

2.2 Objective 2 – Robust Reference Prices Generated Along the Curve

The second objective is expressed wrongly in our opinion. It should read 'A robust forward curve'. The only point on a curve where reference prices are required is the front of the curve – in this case the day ahead. Everything else trades off that benchmark. If the index is robust then traders have confidence in it and are more willing to make forward markets, as they trust the underlying. To suggest that benchmarks are required on the forward curve is erroneous. All that is required is a daily settlement price that eventually settles in to the front-end benchmark for that point on the curve when it reaches spot (or day-ahead in the case of power).

A good example of this is the Euribor Short Term Interest Rate contract traded at NYSEliffe (one of the most liquid futures contracts in the world with around 1 million contracts traded each day – a value of €1 trillion). This contract is based on the 3 month Euribor index produced daily by the European Banker's Federation, which is an independently produced benchmark. NYSEliffe offer markets in futures on the Euribor with contracts listed out 10 years. Not once along this curve is any benchmark produced or used until the final trading day, at which point the Exchange settles all outstanding contracts against the index published on that day.

We are not entirely sure whether this wording is a mistake or that benchmarks really are required – if so by whom? A clarification on which entities have asked for them would be appreciated along with the reasons why they require them. If the requirement is a solid forward curve then this will develop out of the day-ahead index that is now widely accepted in the wholesale power market.

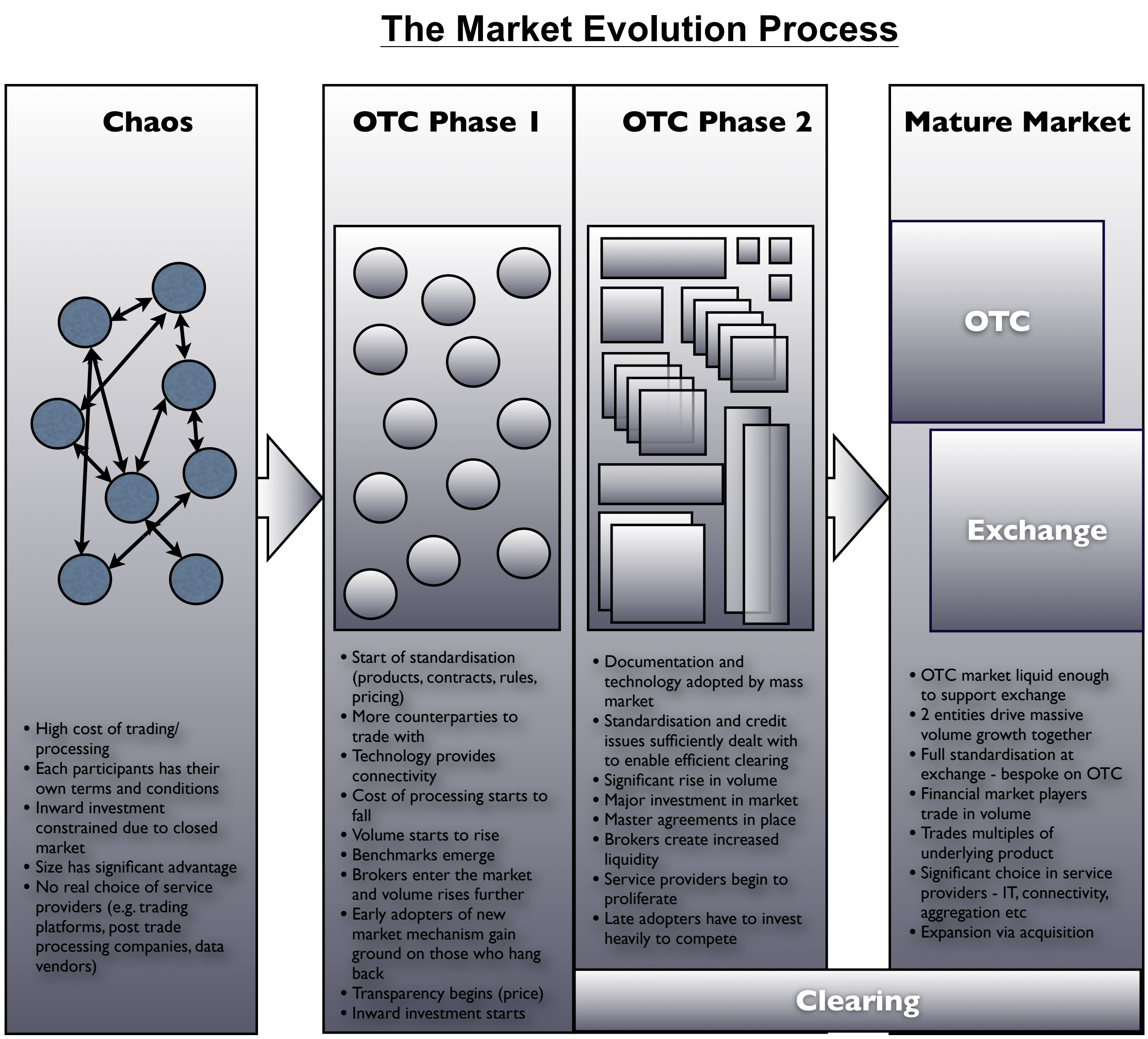
2.3 Objective 3 – Effective Near-Term Market

As outlined in the consultation document, objective 3 is not currently slated to be included as part of the intervention. It is indeed encouraging to note that liquidity in the front of the curve has increased. It is the development of a solid and reliable day-ahead benchmark, that the market has worked hard to achieve, that will deliver – without intervention – a market that provides the liquidity and depth that Ofgem seeks to deliver.

3 Understanding Market Evolution

The way in which markets evolve (an area in which have conducted a significant amount of research) shows that the first element to consolidate is the spot or near-term market. In time this extends further as participants become comfortable that using the benchmark as a settlement figure will not expose them to undue risk. Expecting these to develop at the same time is naïve and evidence of insufficient knowledge of market evolution and development by those who constructed the methodology outlined in the consultation document.

Included below is a flow of market evolution that we have developed. In every market – no matter what the commodity – these are the steps that must take place for a healthy and long-term market to exist. The wholesale power market in GB market is transitioning between OTC phases 1 and 2 and a transition to a mature market cannot be fast-tracked or bypassed (which is effectively what Ofgem is trying to do with the current proposals by aiming to create a nature market before it has earned its right to be regarded as such).



4 The Role of Credit and Centralised Clearing/Volume Development

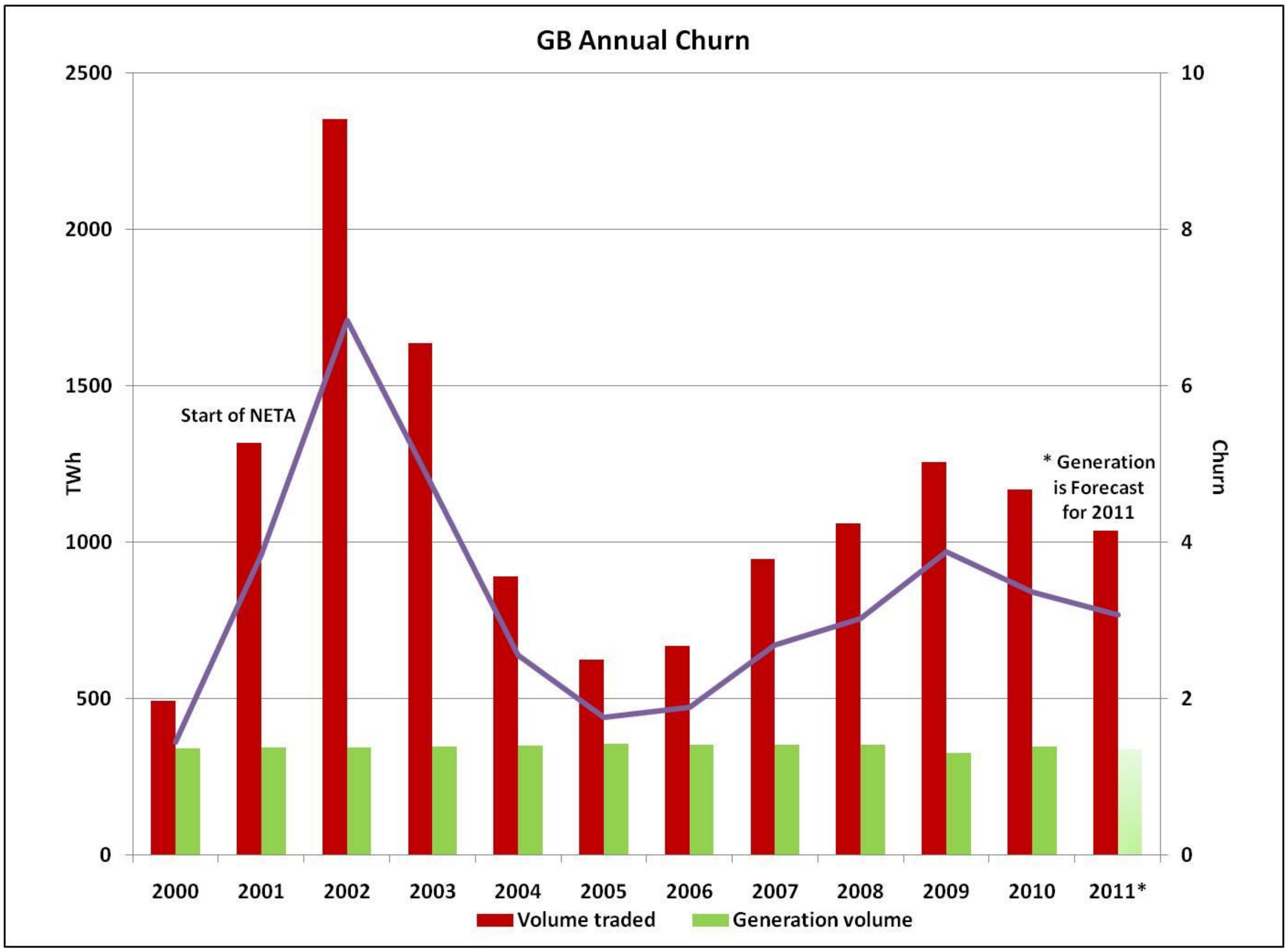
Credit plays a key role in all markets. Products such as coffee where there is a significant imbalance between low credit producers and good-credit end users. This has meant that the high credit end users have been unwilling to accept long-dated risk with the producers leading to a significant contraction in the forward dated market – to the point that coffee is essentially a spot to 6-month (at best) market.

Credit imbalance plays a significant role in the GB power market. Even the larger generators have credit issues between each other that prevent or curtail trading between certain parties. Credit imbalances between participants are inevitable. We therefore find it astonishing that the consultation document does not address the matter of how Ofgem intends to indemnify participants against credit risks that in the normal course of business they would not take.

If the Mandatory Auction does go ahead it MUST be centrally cleared – no participant will willingly accept unacceptable credit counterparties 5 years in the future. This will ensure that all participants have the same credit standing through the use of a Central Counter Party. Of course this raises the issue that small participants are not set up to deal with the daily cash flows that a variation and initially margined contract will require. Ofgem needs to understand the issues and work with the smaller participants to ensure that they sign up to the clearing system – this cannot be the responsibility of the system provider as, if left to their own devices, smaller players simply will not sign up (as is currently the case). This should be a mandatory requirement on the smaller suppliers.

It may well transpire that Ofgem has no control over whether the market is cleared or not as financial regulators in Europe and elsewhere are seeking to force standardised markets to clear.

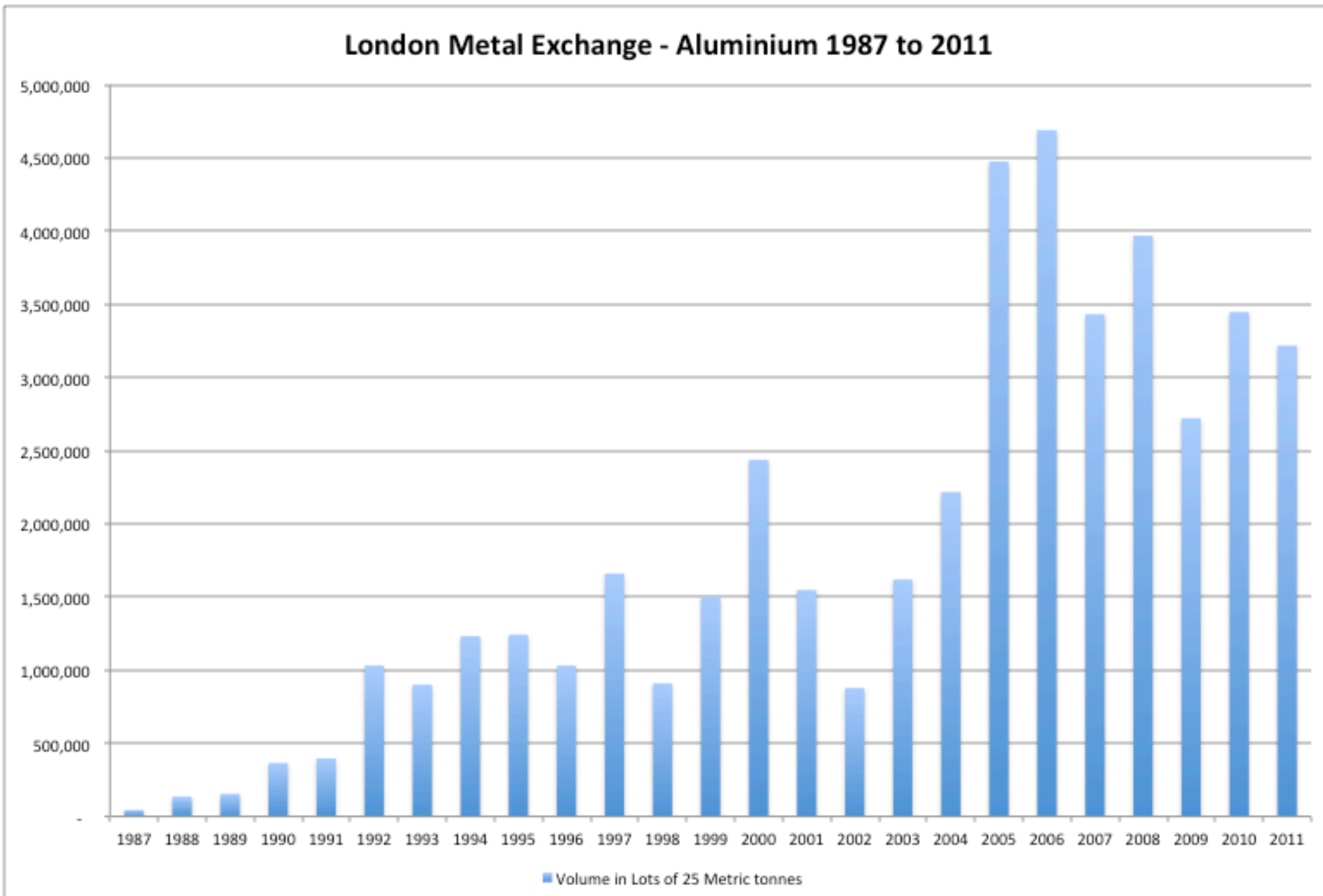
Credit also has a significant bearing on the historical view of liquidity in the GB wholesale power market. The chart below is taken from the consultation paper.



The spike in liquidity in 2001-2004 is a direct result of Enron providing liquidity to the market place and of the presence of US-parent market making companies such as Dynegy, TXU and Duke. Enron were a very low credit counterparty but were operating a quasi-exchange platform while the other market making participants were active in closing the bid offer spreads. Arguably only one company undertakes the market-making role in GB power at the present time.

The presence of Enron and the other market makers meant that the GB power market became very liquid extremely early on after the start of NETA. If we look at the subsequent volume development and compare that to volumes development in other markets, we see quite clearly that 2001-2004 was an anomaly and in fact the curve would have climbed gradually to meet the volume growth curve from 2005 as shown in the chart.

To illustrate this point, a chart of the volume development of the London Metal Exchange Aluminium contract can be found below. This contract is the benchmark for the pricing of over 95% of aluminium produced globally. The volume growth curve is not sharp until the contract has established itself and even after that there are significant volume setbacks. Volume simply does not just appear as Ofgem seems to think it should or could. It is this kind of perspective that we feel the consultation lacks and why we feel it is out of touch with reality.



Source – FOIntelligence

5 Regulatory Issues

Having constructed market making/liquidity schemes for the markets run by major exchanges we know that such schemes are always scrutinised heavily by in house legal teams as to whether the schemes amount to inducement to trade or could create the impression of a false market - in order to satisfy the FSA. The proposal you outline makes us extremely concerned that the mandated activities will break the second of those principles as if the curve created by the mandated auctions is out of line with the curve from the freely traded market.

One might argue that as the requirement to sell is within the generation license it is a fundamental market factor and therefore outside of the provisions. We would disagree as the actions to deliver against the provisions must take place on a public market and therefore have a high risk of creating a false market – both in terms of volume and price. The key problem is that there is an imbalance of mandated parties and that can only lead to a false impression as not everyone who net generates is forced to participate – and no one who net consumes is mandated at all.

We believe that the relevant provisions of the FSMA are contained in and around paragraph **FSMA s118 (5)(a)** although Ofgem must undertake its own investigation as to whether other provisions also apply.

6 Platform Choices and Cost

There are 2 possible methods of platform choice outlined in the consultation document. Of these the only one that can possibly work is the first. The second will cause participants significant cost and will so fragment liquidity that it cannot work (Even Ofgem at the PTF presentation agreed that it was only there as a second option was needed in the paper and that it was not really feasible).

We assume that Ofgem will ask existing regulated market operators to tender for the contract to operate the Mandatory Auctions, as the creation of another market operator would be costly and fragment the market still further. We would be interested to understand the RFP process that will take place and how Ofgem will chose between Recognised Investment Exchanges, MTFs and other Organised trading facilities, as it is not often a like-for-like comparison.

Ofgem should also not underestimate the cost to market participants of the Mandatory Auctions. The cost of setting up IT systems, additional trading capital, collateral and additional staff overhead will amount to many millions of pounds with a very high continual additional cost of operation. Credit risk is also a high cost as we have already pointed out.

7 Alternative Solutions

Whilst we have been negative regarding the proposals you outline and the methods you intend to use to achieve your objectives, we agree that equal access for all participants (in terms of price) would be a most useful asset to the market. We have therefore sought to provide some alternative solutions and guidance as to ways in which volume and participation might be enhanced that does not stop the market in its tracks.

7.1 Ofgem as a Credit Equaliser

Ofgem could act as a credit equaliser for independent firms. Effectively the larger firms would trade with Ofgem and Ofgem would then trade the same position with the smaller firms back-to-back. At this point Ofgem would be taking the credit risk but in order to provide the smaller firms with a fair and effective way of achieving the same pricing in a fair and open market as the larger firms. This is certainly an innovative way of achieving the goal

7.2 Introduce a Request For Quote (RFQ) Facility

Such a facility would enable smaller suppliers to target specific volume requirements across the curve to a range of chosen suppliers. Such facilities are widely used in the bond markets and are extremely effective in creating liquidity in more illiquid markets. We would suggest that this provides a fair and equal opportunity for major sellers and independent suppliers to meet in the open marketplace. Ofgem will be able to monitor whether prices are in line with the broader market and therefore make sure that the larger suppliers are providing a fair opportunity to the smaller companies. It should also be open to other sellers/buyers should they wish to participate - this would also include larger buyers wishing to price further down the curve.

We would be happy to discuss how such a platform would operate and how it meets all of the requirements that Ofgem has set out without destabilising the freely traded and developing market.

7.3 Ensure that any Intervention is Based on the Financial Market NOT Physical

Ofgem has stated that it is happy with the benchmark prices emanating from the day-ahead auctions at N2EX. As we have stated this is the basis for liquid forward curves to develop. If Ofgem feels that it is minded to intervene we would strongly recommend this to be based on the financial market not the physical market. If it is a physical market intervention the likelihood will be that participants will withhold volume and therefore liquidity will fall as they can only trade out of any positions with a limited number of counterparties. A financial market solution would allow for reversal of positions with any number of counterparties (not just physical players) within the open market and will certainly be more beneficial to volumes than a physically-based solution.

Traders would use the financial curve to trade and cover any requirements and would then swap out of that into the physical market at the day-ahead. This is exactly how the market in Scandinavia works and it is extremely effective.

8 Conclusion

As is evident from this document we are fundamentally opposed to any artificial intervention in markets of any kind. Historical evidence shows that they do not work and that the affected markets find alternative ways of trading or other avenues.

Our recommendation to Ofgem is to avoid intervening and to support the development of a freely traded market that grows to deliver exactly what the market wants at a commercial level and is not the result of influences that are non-commercial.

We would be delighted to discuss our thoughts with Ofgem at any time.

Yours Faithfully

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