E.ON's response to Ofgem's Retail Market Review: Intervention to enhance liquidity in the GB power market

General

In Great Britain E.ON supplies nearly twice the amount electricity it generates. To meet our customers' needs, we are therefore dependent upon being able to procure power at competitive rates from the power market. This clearly gives us a vested interest in the power market supporting reliable trading in key products, the continued development of a robust set of forward reference prices and the presence of an effective near-term market.

Over the last few years Great Britain's power market has developed and introduced a day-ahead auction. The introduction of the day-ahead auction has created a basis for developing the trading of CfDs along the forward curve, although the growth in that trading was always going to be dependent upon first establishing confidence in the day-ahead auction itself. Confidence in the day-ahead auction now appears to be well established, with volumes being traded increasing (see Fig. 1). In response, the trading of CfDs linked to the day-ahead auction is now starting to develop.

The developments have now brought the market to a position where it is very likely that, with some small changes to the way N2EX calculates its settlement prices (see our answer to question 4), towards the end of 2013 Ofgem's objectives covering the period out to Season+3 will have been delivered. At that point the market will have:

- a robust outturn reference price formed from the day ahead auction, against which CfDs of any duration can be settled;
- a robust set of forward reference prices formed from the settlement prices of N2EX, out to Season+3, supporting forward trading;
- exchanges offering standard trading arrangements, transparency and a level playing field;
- an exchange that is handling all products, so allowing small players with limited capital, in particular, to focus the use of their capital and trade without multiple Grid Trade Master Agreements;
- trading using small clip sizes, to help small players;
- a range of products available that support hedging; and
- the presence of new entrants, so reinforcing liquidity.

While the market is clearly on course for delivering better support for trading, the development must be sustained. In such an environment care has to be taken to avoid interventions, such as Mandatory Auctions (MA), which carry a high risk of stalling the continued progress, or even undoing much of what has been achieved. For this reason we believe that it would be wrong to embark on introducing MA.

Our concern with the use of MA as an intervention tool is that it would carry the high risk of:

- fragmenting the market, to the detriment of liquidity and undoing the development of recent years carried out by the industry;
- imposing additional capital cost requirements on suppliers, as they have to purchase product earlier than they would often wish to;
- imposing additional operating costs of running additional systems on those who had to use the new auctions;
- not helping, and probably adversely affecting, small suppliers trying to compete with limited capital strength; and
- delaying the delivery of a robust set of forward reference prices out to Season+3, due to the procurement times for delivery of platforms suitable for operating such processes and companies having to develop their own internal systems.

While we believe that the current market design and recent progress is likely to deliver greater liquidity and transparency up to Season+3, for a number of reasons discussed in our answer to question 3, beyond Season+3 the market is likely to remain thin with a lack of buyers. Therefore, to help keep the market developing, action should be focused on the period out to Season+3, but with the clear understanding that this has to be part of preparing the foundations for addressing Ofgem's concerns beyond Season+3.

If the benefits coming from existing market improvements stall, then intervention in support of Ofgem's objectives could be considered. However, threatening to intervene too early could force the market to take the view that intervention is inevitable and so expending further resources, to support the natural development of the market, would be futile.

Despite our concerns about any forced intervention, if Ofgem believes it must act now, a requirement on all licensed generators and suppliers to sell and buy in a calendar year, volumes equal or greater than their total generation and supply volumes, respectively, may carry the least risks of adverse effects on the generation and supply markets. In carrying lower risk than the other options considered by Ofgem, such a requirement would help to give suppliers greater confidence that large generators are not reserving volume for their related supply businesses. However, with the higher levels of trading and churn now established, the self supply restrictions previously used in Great Britain would not be practicable. Therefore, a simplified approach, as described in our answer to question 7, which better recognised market developments, may be worth exploring.

Ofgem's Questions

CHAPTER: One

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

The three wholesale market objectives set out by Ofgem are:

1. Availability of products, which support hedging;
2. Robust reference process generated along the curve; and
3. Effective near-term market.

These align with making sure that liquidity in the power market is sufficient to underpin competitive generation and supply markets. They are therefore an appropriate part of delivering Ofgem's principal objective of protecting the interests of consumers, present and future.

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

A key objective must be that any intervention does not result in adversely affecting the high levels of competition that already exist in Great Britain's generation and supply markets. There must also be a clear objective of not taking actions that are likely to adversely affect liquidity in the power market, or the robustness of the day-ahead auction price, which now provides a robust reference against which CfDs of any duration can be settled.

CHAPTER: Two

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

We broadly agree with Ofgem that there has been some progress towards meeting its objectives, that progress is incomplete and that it needs to be sustained. However, the developments are part of an ongoing progress, where the effects lag the actions. The positive effects of the actions over the last twelve months should only fully materialise through 2013. The degree that the positive effects can materialise is also very dependent upon confidence that the market structure being created is likely to be enduring.

It would be wholly inappropriate to now start to develop proposals for intervention before the benefits have had time to become established. Such actions would reduce longer term market confidence and risk nullifying the recent actions taken by the industry. Rather than developing proposals for intervention, Ofgem should recognise the potential of the actions that have been taken and help the industry focus on making the small changes now required to deliver Ofgem's objectives quickly, at little cost and without the significant risks that MA would bring.

As Ofgem has observed, trading along the curve remains thin. We believe that this is more a reflection of the fact that suppliers are naturally reluctant to procure power forward, rather than because of a lack of products or volume being made available. Producers are making the product available, as the long term asset nature of their business encourages the forward sale of product. Suppliers, for a number of reasons, have a natural driver not to purchase too far forward, including;

- The competitive nature of Great Britain's electricity supply market, when compared to similar markets, means that suppliers cannot guarantee being able to recover costs from their customers and so must price competitively. This means that suppliers seek to hedge only for periods where their customers are willing to have their prices fixed. As a supplier we see little evidence of customers demanding long dated fixed prices;

- The difficulties of predicting renewable generation for specific dates, when compared to conventional generation. As Ofgem has observed this does affect generators as well, but one effect is that forward prices tend to reflect the marginal costs of backup conventional generation, rather than the lower marginal costs of renewable generation. As seen in other competitive markets, this is reducing the appetite for longer term forward products;

- The further forward a supplier procures volume the greater the total volume it has to hold and finance. With the low margin nature of the supply market, financing the holding of large volumes is not practicable; and

- The uncertainty in costs associated with electricity market reform, creating too big a risk for suppliers to confidently price to their customers.

In addition all market participants face:

- the significant uncertainty surrounding the Carbon Price Floor, which is removing the certainty needed for product to trade in the long term;

- the regulation pending, which is likely to have a significant impact on trading, decreasing the appetite of players to trade long term; and

- Great Britain's highly liquid gas market and strong link between gas and power prices.

Our own observations of the market support this view, that there is not a lack of product being offered to the market. While we do not have the overall view of the market, we have observed that further out on the forward curve, most of the trading activity is seller initiated. This suggests that volume is being made available to a greater extent than demand is calling for it. If there was a lack of volume being made available we would expect to see most of the trading activity being buyer initiated, but we have not observed this.

We do believe that the market is delivering a range of products that support forward hedging and that actions are being taken, which when combined with earlier actions will support a robust set of forward reference prices out to Season+3. Nevertheless, given all of the factors present, it is difficult to see suppliers wishing to procure large volumes of product beyond Season+3. Without a realistic supplier demand, trading beyond Season+3, as with many other European power markets, is likely to remain thin, or even become thinner.

We disagree with Ofgem's interpretation on the decline in churn in 2010. As shown in Fig. 2, the fall in churn across 2010 was experienced by other European power markets (e.g. Germany and Nordic). Since then, relative changes in Great Britain's power market's churn have been broadly the average of the German and Nordic power markets' relative changes. Such movement suggests that wider economic factors were influencing the levels of churn and potentially masking if Great Britain's power market is, or is not, independently becoming more liquid. In such a situation the case for regulatory intervention has not been strengthened.

Fig. 2 also shows that churn in Great Britain's gas market fell in 2010, but has since seen significantly more relative growth than the power markets. However, as shown in Fig. 3, despite these high levels of churn in the wholesale gas market, measures of competition in domestic gas supply remain significantly lower than seen in power.

Absolute levels of churn in Great Britain's power market do remain low, relatively to similar markets, but it should be recognised that it is probably naturally lower than in Germany and Nordic. We believe this is because the price setting generation technology supporting Great Britain's power market is very dependent upon the use of gas. This results in Great Britain's power market being tied to the gas market, making power prices a slightly more complicated version of the gas market. As a result, trading in Great Britain's gas market is a more attractive proposition and so gas enjoys greater liquidity and tighter spreads. Also, the low level of interconnection to other power markets restricts power trading in Great Britain. Regulatory intervention is unlikely to change these two fundamental differences.

We agree with Ofgem that increased trading in financial products could offer a valuable hedging tool to market participants and may attract new players. Ofgem is also correct that to date there has been limited uptake. However, the recent market developments, most notably the introduction of the N2EX day-ahead auction and the introduction of voluntary market making, has laid the foundations for the development of financial trading.

Given the experience that is now being established with the day-ahead auction, we agree with Ofgem's observation that there is potential for further improvements in the coming months, indeed we expect to see a significant growth in financial trading over the next 18 months. This expectation is supported by N2EX having steadily attracted new members since it began operating in 2010, with a large number of the members now being financial traders. Also, six members[1] have now signed gross bidding agreements, which are trading agreements offered by N2EX to its vertically integrated members enabling them to commit a minimum of 30% of their generation and equivalent demand into the day-ahead auction. This recent development should support increased trading via that auction. With the market being at this particular point in its development, the industry should be allowed to build on this and be given the necessary time and support to let the effects work through. Interventions to introduce MA now will, at best, delay these market developments and potentially undo what the industry has so far achieved.

We agree with Ofgem that while bid-offer spreads have narrowed slightly, they remain wide compared to gas. However, because of the market developments starting to take effect, the market is now moving into a position where greater levels of trading are likely and consequentially the likelihood of bid-offer spreads narrowing. Also, as explained above, caution is needed when comparing Great Britain's gas and power markets. The gas market naturally offers a more attractive proposition for trading and so enjoys greater liquidity and tighter spreads.

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

As Ofgem notes, the market is now starting to deliver the third objective of, "an effective near term market". With confidence and understanding growing, the effectiveness of the

[1] Centrica, EDF, E.ON, RWE, Scottish Power and SSE

near term market should continue to improve. Therefore, specific further developments are not currently necessary for meeting this objective.

We believe that Ofgem's first and second objectives, "availability of products, which support hedging" and "a robust reference process generated along the curve", align with the current direction the industry has embarked on and can be met with minimal change to the current market arrangements. These minimal changes would carry significantly less risk than pursuing the suggested MA.

Under the two objectives, Ofgem has listed four expected market features. Considering these four features:

1. Reasonable and transparent trading terms

   Reasonable and transparent trading terms are already being delivered through the N2EX platform. Here companies can sign up to a single set of terms in order to access the market products. This has been evidenced through the success of the near term market and the number of active participants, which includes independent players. We believe that, as these terms reflect normal market practice for a professional exchange operating in energy markets, they must be considered as fair and reasonable.

   What constitutes reasonable trading terms, in particular credit requirements is different for different companies. With voluntary exchange based trading, if the trading terms are not acceptable to a particular company it is free to not participate. With MA those companies obliged to participate lose the right not to participate and so could become exposed to levels of risk, in particular credit risk, that they would otherwise find unacceptable and potentially damaging to their business.

2. Robust process in longer dated products

   The current set up of N2EX, with some small adjustments, can meet the need for a robust process in longer dated products and narrow bid offer spreads. The small adjustments are already being discussed by the industry together with N2EX.

   Given longer dated issues, such as Carbon Price Floor, developments in regulation and the lack of buyers prepared to contract much beyond Season+3, the market needs to focus on products up to about Season+3, but no further at this stage. The focus should be on baseload as the key reference point, which we have observed as the case in other liquid power markets, such as Germany and Nordic. If a set of forward reference prices for peak is to develop, it will only do so once a robust set of forward reference prices for baseload has been established. Likewise, the possibility of going beyond Season+3 with a set of forward reference prices for baseload is only a practicable possibility once a robust set of forward reference prices is fully established out to Season+3.

   We believe that the small changes required to aid delivery of a robust forward reference prices relate to N2EX's processes for calculating forward reference prices. Currently N2EX's process for calculating forward reference prices uses the last 5 minutes of each day's trading to select a random market trade as the reference, or if no trades are executed during that time window, to use the average of the bid-offer spread. We believe that the aim should be to create forward reference prices using traded prices, rather than quoted prices. To achieve this, the 5 minute window should be extended to allow more traded prices in the calculation, our suggestion is 30 minutes. Secondly, OTC trades cleared via N2EX, which are executed within the 30 minutes window, should also be included in the calculation of the forward reference price. To increase the robustness of the forward prices, the daily calculated prices could be formally averaged over longer time periods, say a week. This would further increase the number of trades contributing to the prices.

This small adjustment, through utilising all the relevant trading information in producing this settlement price, would have a significant effect on delivering a robust set of forward reference prices for all financial products listed on the N2EX exchange.

The advantage of utilising the exchange, to deliver a robust set of forward reference prices, over that of MA is that:

- The infrastructure is already in place;
- The list of active participants is broad and does not represent a sub section of the market;
- The lead time for this to be successful is considered shorter than developing new platforms;
- There is full exchange oversight to the settlement price, giving it credibility and robustness; and
- The price is formed from trading by all active participants.

It is hard to see why the market would need more than this in order to have a robust set of forward reference prices.

3. Narrow bid offer spreads

If the adjustments are made to the existing arrangements, we expect that, as with the near term market, the volumes of trading will grow. This will lead to narrowing bid offer spreads, as more participants join and companies make the necessary changes to their internal systems and processes to accommodate the change to trading cleared financial products.

4. A range of longer-dated physical products strongly traded in the market

We believe that financial products, rather than physical products, provide a much better framework for facilitating growth in the trading of longer dated products.

The N2EX day-ahead auction has facilitated the launch of financial contract trading on a calendar monthly basis. All the important building blocks required for facilitating strong longer dated trading are now in place and starting to have an effect. To now change course and use interventions to introduce a different structure or different platforms will almost certainly result in reduced market liquidity.

While the right structure is now in place, it does not guarantee longer dated trading. For the reasons set out in our answer to question 3, the further out on the curve the thinner the market becomes. As a result, the trading of significant volumes beyond Season+3 is unlikely for the foreseeable future. In time the obstacles may be overcome, but only once the market is established out to Season+3. Therefore, the focus now needs to be on securing a robust market and a robust set of forward reference prices out to Season+3.

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

The objectives of "availability of products, which support hedging" and "robust reference process generated along the curve", are consistent with market developments. However, given the developments in the market, it is not clear that these two objectives should be the priorities for continued underpinning of competitive supply and generation markets.

The priorities now must be to support the growth of confidence in the current arrangements and establishing the N2EX day-ahead auction's outturn prices as the robust reference price, against which CfDs of any duration can be settled.

CHAPTER: Three

Question 6: *Do you agree that the MA is the appropriate mechanism to meet our immediate objectives?*

We do not agree that MA is the appropriate mechanism for meeting Ofgem's immediate objectives. Given where the market has now developed to, and is likely to develop further, we are concerned that the imposition of MA is unlikely have a positive impact on liquidity and would most probably have an adverse effect due to it carrying the high risk of:

- fragmenting the market, to the detriment of liquidity and undoing the development of recent years carried out by the industry;
- imposing additional capital cost requirements on suppliers, as they have to purchase product earlier than they would often wish to;
- imposing additional operating costs of running additional systems on those who had to use the new auctions;
- not helping, and probably adversely affecting, small suppliers trying to compete with limited capital strength; and
- delaying the delivery of a robust set of forward reference prices out to Season+3, due to the procurement times for delivery of platforms suitable for operating such processes and companies having to develop their own internal systems.

The most appropriate mechanism to meet Ofgem's immediate objectives is in giving the market confidence, by letting it now build on the work that has been carried out over the last few years. This would benefit from Ofgem working with the industry to agree a realistic timeline for delivery of Ofgem's objectives, the obstacles that have to be overcome (recognising that some are beyond the control of the industry or Ofgem) and the parameters for measuring success.

Having established an agreed timeline for delivery of Ofgem's objectives, if the emerging benefits then stall, intervention in support of Ofgem's objectives, including the use of MA, could be considered. However, that intervention should be developed with the knowledge of why the benefits stalled. To speculate why the benefits will stall and to develop interventions based on that speculation is, at best, an inefficient use of resources and could actually cause the stalling of the benefits. For example, the view of the market could easily become that intervention is inevitable and so expending further resources to support the natural development of the market has become futile.

Ofgem presents a number of benefits that MA could bring, these are:

- Alignment with the European Target model;
- Alignment with EMR;
- Alignment with Remit;
- The sale of products on a defined platform or platforms provides opportunities for market participants to maximise the efficiency of their credit and collateral, by enabling them to do a large proportion of their wholesale trading in one place; and
- Positive impacts on the OTC market.

However, the existing voluntary day-ahead auction, when supported by the trading of CfDs, is probably better placed to deliver these benefits. Indeed, day-ahead auctions with CfDs better align with trading arrangements with other power markets and other commodity markets. Introducing a unique arrangement of MA actually risks creating a barrier to entry for new entrants.

Question 7: *Do you agree that, at the present time, the other mechanisms identified would not be appropriate for Ofgem to pursue?*

Interventions that obligate certain parties to carry out certain actions, or restrict the actions of certain parties, will distort the natural development of the market and have an adverse effect on liquidity. It would therefore not be appropriate for Ofgem to pursue mandatory auctions, mandatory market making, large-scale mandatory market making in forward products, or direct trading obligations.

While we have concerns about forced intervention, if Ofgem believes that it must act now, introducing a requirement on all licensed generators and suppliers to sell and buy in a calendar year, volumes equal or greater than their total generation and supply volumes, respectively, may carry the least risks of adverse effect on the generation and supply markets. In carrying low risk, a requirement such as this would help to give suppliers greater confidence that large generators are not reserving volume for their related supply businesses. However, with the higher levels of trading and churn now established, the self supply restrictions previously used in Great Britain would not be practicable. A simple approach which better recognised market developments may therefore be worth exploring. We would suggest that for any intervention consideration is given to having the requirements that:

1) all licensed generators, have to sell to non related parties, or secure the sale on their behalf, a volume no less than the volume they generated in the calendar year; and

2) all licensed suppliers have to procure from non related parties, or secure the procurement of, a volume no less than they supplied in the calendar year.

Placing such a requirement on all licensed generators and licensed suppliers would provide the symmetry for a large number of willing buyers and willing sellers in each of the forums where trading would take place, while not precluding any particular contract arrangements. It would also ensure a diverse mix of buyers and sellers and characteristics.

CHAPTER: Four

Question 8: *Do you agree with the key features of the MA we set out?*

Notwithstanding our belief that MA would have a detrimental effect on market liquidity, below we consider the key features in the form of the five design aspects of Ofgem's proposed MA.

1. Participation

   Having the obligated parties required to sell minimum volumes of defined products in each auction round is not practicable. The obligated parties do not have the generation technology to offer competitive prices in all of the products Ofgem is considering.

   Based on Ofgem's figures, the six obligated companies only account for around 70% of generation buy volume; they do not "control" any part of the market. This means that the average "Big 6" company has achieved a generation market share of less than 12%. 12% is not a "significant position" market share. In supply, the six obligated companies account for around 90% of supply by volume. This means that the average "Big 6" company has achieved a supply market share of less than 15%. 15% is still not a "significant position". If it is appropriate that those companies with a significant position in both generation and supply markets are made responsible for discharging the obligations to improve those markets, then any obligation should be focused on those companies that have significant market power in either generation or supply, i.e. those with a market share of 25% or more; not an arbitrary sub group of six companies from the eight largest vertically integrated companies.

   Given that there are no significant players in both generation and supply, to avoid discrimination against certain companies, any obligation to participate would have to be on all market participants. While vertically integrated companies do have commercial reasons to buy and sell power, unless balanced, they will face the same risks as independent suppliers if they are a net buyer of power, e.g. E.ON, and the same risks as independent generators if they are a net seller of power, e.g. EDF. Because of the lack of commercial rationale that suppliers face in entering into forward contracts, as described in our answer to question 3 above, the net buyers of power are not in a position to manage the risks, in particular the high costs of holding forward volume resulting from having to participate on the forward buy side of an auction.

   The wholesale market does not differentiate between sub groups of the supply market, it only sees buyers. To mandate participation as a buyer in the MA, based on market share of a supply sub group, removes a point of alignment between the auction and the natural market. Such action would introduce an arbitrary discrimination against a group of suppliers.

2. Products

   The nature of the supply market means that it is unlikely that there will ever be a natural level of demand for economic trading of fully shaped products in the forward market. Our experience is that the trading of baseload products is sufficient to provide effective economic hedging on the forward curve.

To ensure the participating generators could provide "a one stop shop of product needed for hedging", all generators would have to be mandated to participate. Only by having participation from all generators can all the different types of generation that create the overall shape be guaranteed to be present at the auctions.

The establishment of a voluntary day-ahead auction is now starting to support the trading of forward financial products and attract new entrants to the market. It also provides a robust outturn reference price, against which CfDs of any duration can be settled. Introducing a number of auctions, the activity of which was not a product of the market, but of an intervention to create a number of prices that are an output of that intervention, would not provide a robust outturn reference price.

Ofgem has asked for views on whether, how and when any move from Electricity Forward Agreement (EFA) products to products based on a standard calendar, as is common in other European markets, should be reflected in the MA. If MA was to contribute to liquidity of the whole market, then its products would need to fully align with other European markets, so as to support trading with those markets. This would mean ensuring that the products offered were on a standard calendar.

3. Volume

Introducing artificial volumes to MA would further reduce the credibility of any reference prices produced by the process. The prices delivered would be that required to achieve compliance by obligated parties, rather than the price suppliers are willing to pay for the product they need.

A requirement "that each obligated party trades a non-trivial amount in each product in each auction" fails to recognise the ability of different companies to absorb imposed trading in all products. Such a requirement would be forcing obligated parties to engage in speculative trading. Compulsory speculative trading should not be a requirement placed on any generation or supply licensee.

4. Governance

Ofgem is seeking a solution that is robust, trusted by market participants and capable of achieving Ofgem's liquidity objectives. It also wants the solution to align with what works best in the market, be flexible enough to respond to market developments and free of Ofgem being involved in the day-to-day running of the trading. Such a solution, in the form of N2EX, has already been developed by the industry, has been recently established and is now starting to deliver Ofgem's liquidity objectives. A duplication of the arrangements for N2EX would therefore seem to be the most practicable way forward for developing MA.

5. Safeguards

Introducing controls on obligated parties, to effectively ensure 20% of product is available to other parties, seems to be based on an assumption, which is either that:

- all obligated parties are naturally balanced (their generation matches their demand) and consequently they will all have the same objectives, or

- there is no natural supply demand for such products and therefore all obligated parties will only buy sufficient volume to meet their obligations.

The first is clearly wrong, few of the "Big 6" are balanced, and if it is the second then the rational for having MA is not valid.

Across the "Big 6" there is a spectrum of portfolios ranging from being long in generation, through being roughly balanced to long in supply. With such diversity it is difficult to envisage all six having exactly the same strategy for the auctions. However, introducing such restrictions does introduce the opportunities for exploiting the auctions by parties not subject to the obligations. As presented, the proposed auctions seem to be reserving volume for parties not subject to the obligation to collectively set a price acceptable to them, which potentially could be below the production costs of the obligated parties' generation. Any such auctions would therefore have to have safeguards to protect the obligated parties from exploitation by parties not subject to the obligations.

Question 9: *Do you consider it appropriate to have buy-side rules in place and do you have any comments on the detail of such rules?*

Because MA is not working on the principle of willing buyers and willing sellers, there would have to be buy-side rules in place. Some more obvious requirements being:

- There would only be one clearing price for all buyers, i.e. no special price for the reserved volume;

- Compulsory participation and minimum percentage purchase by all suppliers, to ensure all suppliers incurred the same additional costs of having to buy forward. This would be in addition to a requirement, which would also be needed, that all generators participate so as to ensure there was sufficient volume of each product made available; and

- Limits on allocation of product and rules for allocation of product where demand could be greater than product offered. This would be to prevent parties not subject to the obligation exploiting their advantage of having access to reserved volumes.

CHAPTER: Five

Question 10: *Do you consider that there are benefits and risks to the approaches that we have not identified?*

We believe that the introduction of MA would bring very high risk to market liquidity, to maintaining a robust outturn reference price against which CfDs of any duration could be settled and to the prospect of generating a robust set of forward reference prices along the curve. Against these concerns, Ofgem does not appear to have factored in the benefit that would be gained from supporting the ongoing development of the existing arrangements. Through the developments of these arrangements, the market is now in a position where it is very likely that, with some small changes to the way N2EX calculates its settlement prices, towards the end of 2013 Ofgem's objectives covering the periods from day-ahead out to Season+3 will have been delivered. At that point the market will have:

- a robust outturn reference price formed from the day ahead auction, against which CfDs of any duration can be settled;
- a robust set of forward reference prices formed from the settlement prices of N2EX, out to Season+3, supporting forward trading;
- exchanges offering standard trading arrangements, transparency and a level playing field;
- an exchange that is handling all products, so allowing small players with limited capital, in particular, to focus the use of their capital and trade without multiple Grid Trade Master Agreements;
- trading using small clip sizes, to help small players;
- a range of products available that support hedging; and
- the presence of new entrants, which reinforces liquidity.

It will also accommodate the fact that most providers and users of platforms have commitments to ongoing development of their software and hardware. Modification to existing arrangements should be delivered quicker than having to introduce completely new programmes to meet the requirements of any new platforms or auctions.

If MA were to be introduced, to limit the adverse impact it would have on liquidity, the number of platforms being introduced would need to be kept to a minimum. Also, the selection and development would need to be by those who would have to contract with the provider. We recognise that Ofgem has concerns that the co-ordination challenges of this approach could incur significant potential delays and complexity. However, the industry has recently completed the selection of a platform provider for delivering an auction, N2EX. Given where N2EX is, it is very probable that it would be the industry's choice. Ofgem should consult with the obligated parties as to if going forward with N2EX is their preference, before considering other approaches.

Question 11: *Which approach do you consider is best placed to deliver our objectives at least in terms of cost and risk?*

The best approach to delivering Ofgem's objectives is to build on what has recently been achieved in developing the day-ahead auction and associated financial products without interventions, such as MA. However, if MA were to be introduced, then auctions developed from the recently established N2EX should be the first consideration.

Of the two approaches presented by Ofgem, having a single approach developed by Ofgem, as set out in to Approach 1, offers potentially the least damage to liquidity and the possibility of a robust set of forward reference prices, as it should result in the minimum number of auctions and platforms. However, such an approach fails to recognise the needs of those who will have to use the arrangements and so would be unlikely to secure use, other than to the minimum level to achieve compliance.

Approach 2, with each of the obligated parties finding their own platform on which they run their own auctions, better recognises the needs of those who are charged with making it work and gives them a level of control over the costs that they will have to incur. Consequently, the solutions for delivering Approach 2 are more likely to serve the needs of generators and suppliers. However, having to have systems that can work with potentially six different platforms could be a significant barrier to entry for small players. We would therefore recommend developing Approach 2, but with the obligated parties having to work together to deliver a single solution.

The draft generation licence conditions would need amending once the adopted approach had been finalised. However, at this early stage of drafting, areas that need further consideration are:

- Affiliates, in particular which affiliates is the licence condition referring to? Also, how is the licensee expected to comply with its licence requirements when it is dependent upon other companies, for which it has no control, carrying out actions for it? and

- The licence conditions fail to provide any transparency on the criteria by which the Authority decides to remove the suspension of the licence condition for the licensee.

Question 12: *Do you consider that both approaches are able to meet our objectives?*

Both approaches can deliver MA. It is doubtful if either approach could deliver a practicable solution that could attract participation from independent generators, suppliers or traders, or secure a level of activity greater than the minimum for compliance by the obligated parties. It is therefore doubtful if either approach will be able to meet Ofgem's objectives.

An approach led by those who would have to use the new arrangements, which was tied to developing further the arrangements that were already established, would offer the greatest potential for MA meeting Ofgem's objectives. This would seem to be Approach 2, but with the obligated parties having to work together to deliver one solution.

Ofgem has set out three main options for how it could authorise obligated parties' choice of platform for Approach 2. Before considering which of these options should be used, if Approach 2 was adopted, the actual approach itself would need to be first agreed.

Fig.1 N2EX Weekly Volumes

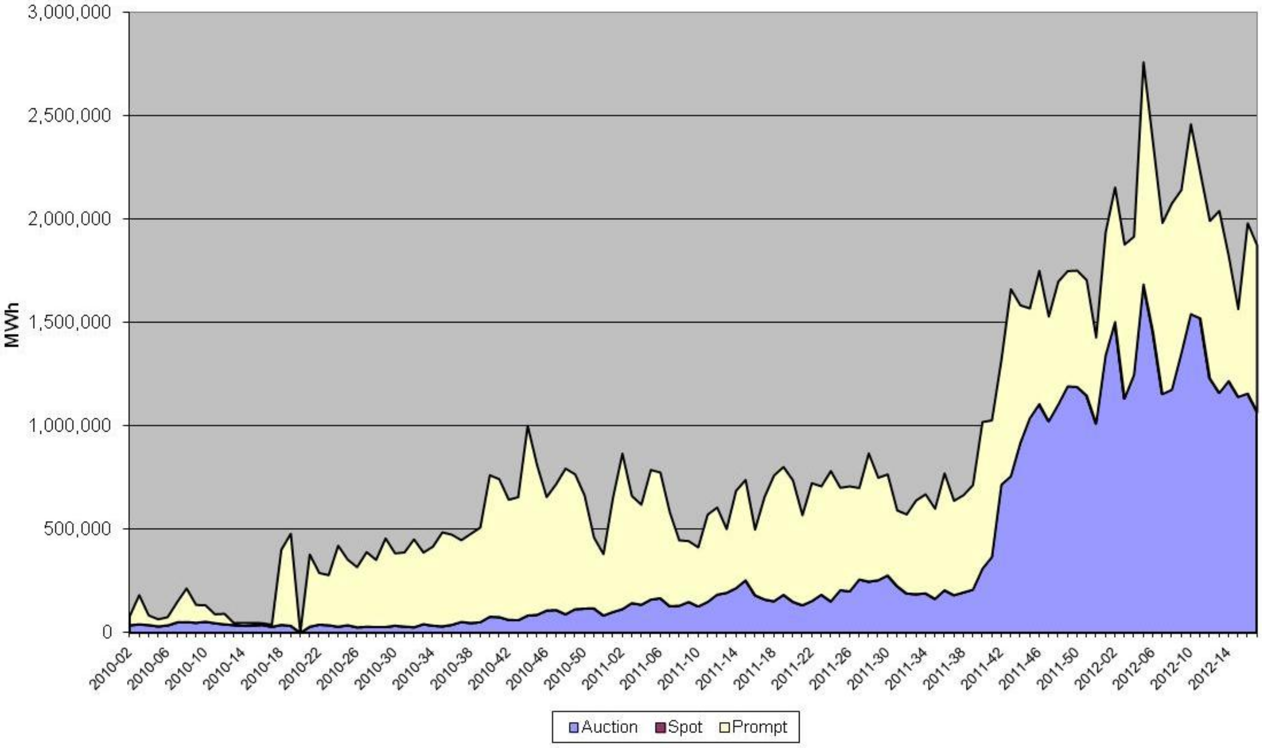

Fig.2 Relative Market Volume Liquidity Growth (base line January 2008)

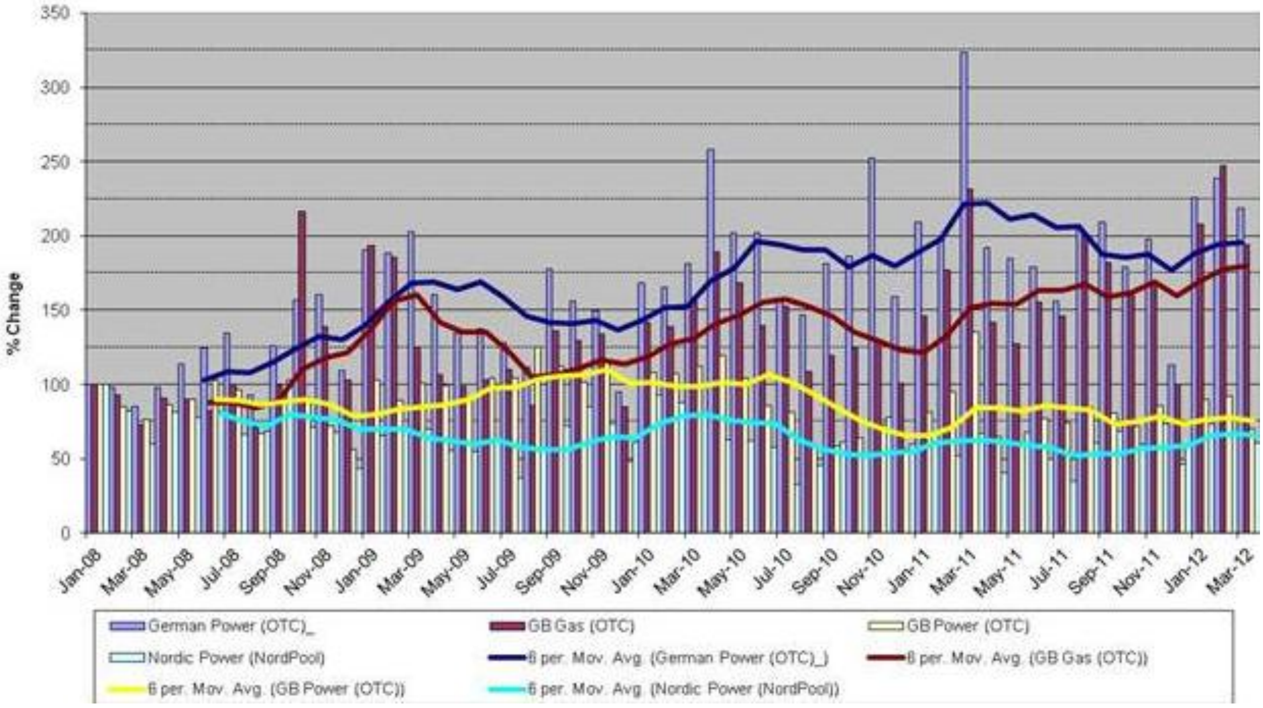

Fig.3 Great Britain Power and Gas Domestic Market Shares at 31/01/12

Company	Power		Gas	
	Customer Accounts	Volume	Customer Accounts	Volume
Centrica	25%	24%	41%	43%
EDF	13%	14%	9%	8%
E.ON	17%	18%	13%	14%
RWE	14%	12%	12%	11%
Scottish & Southern	19%	19%	16%	15%
Scottish Power	11%	11%	8%	9%
Other	1%	1%	1%	1%
Total	100%	100%	100%	100%
Herfindahl Index	1771	1760	2401	2510

Data source Cornwall Energy Associates