OFGEM RETAIL MARKET REVIEW:

INTERVENTION TO ENHANCE LIQUIDITY IN THE GB POWER MARKET

A response by the Futures and Options Association

MAY 2012

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1. Introduction

1.1 The Futures and Options Association (FOA) is the principal European association for the exchange-traded derivatives industry, representing its interests in the public and regulatory domains. It delivers a wide range of support services to its core membership of banks, brokers, fund managers, energy and power market participants, commodity trading and spread betting companies, exchanges and clearing houses. It is an active and founder member of financial services parliamentary groups in Brussels and the UK. It is also an active member of financial services parliamentary groups in Brussels and the UK (see Appendix 1).

1.2 The FOA welcomes this opportunity to respond on behalf of its member firms to the Ofgem proposals.

1.3 The FOA believes strongly that authentic liquidity must evolve naturally in the marketplace, insofar as it will migrate to the most efficient markets that meet appropriate standards of supervision, transparency and price integrity and that, in this context, it is inevitable but some markets will have low levels of liquidity, in the same way that liquidity will vary as between contracts and different classes of contracts.

1.4 In the context of the UK power market, it was the concern of the members of the FOA's Power Trading Committee (see Appendix 2) over (a) the low level of liquidity in the UK power market; and (b) the lack of financial participation that led to the FOA's issuance of a Request for Proposals to existing exchanges to develop a central clearing solution and execution platform. The purpose was to encourage greater participation in the UK power market and, as a second stage, to list a new set of exchange-traded derivatives to better facilitate management of risk. Contango Markets, which has submitted its own response to the Ofgem Review, was contracted to assist the FOA and, in particular, its Power Trading Committee, in drafting the proposals, reviewing the responses and assisting in the consequential analytical work undertaken by members of the Power Trading Committee. In the event, the exchange that was selected by the FOA on the advice of its Power Trading Committee was Nasdaq OMX and Nord Pool Spot. Ofgem will be aware of this process and the outcome.

1.5 The FOA supports the points made in the response submitted to Ofgem by Contango Markets. As a result, this response does not seek to recycle those observations, but to add to a number of them in relation to some of the questions. In all other respects, the FOA would refer to the response by Contango Markets.

2. General comments

2.1 While the desire to increase liquidity in UK power markets is understood and appreciated, FOA member firms involved in UK power markets have expressed universal concern over the proposals for the mandatory auction ("MA").

2.2 The primary concern is the potential for the MA to create a false market by mandating trading activity which does not accurately reflect genuine levels of voluntary economically-driven supply and demand and, in the view of the FOA, undermines the price formation process. The requirement for obligated parties to make up to 25% of their annual generation available via auction does not consider the generation required by those parties to meet their own obligations. Several potential obligated parties have suggested that they could be obliged to buy back their own generation following the auction.

2.3 The definition of market abuse in the FSMA needs to be considered carefully in the context of a mandated auction process, insofar as it specifically prohibits trades which:

> *"… give, or are likely to give, a false or misleading impression as to the supply of, or demand for, or as to the price of, one or more qualifying investments. "* - (s.118(5)(a))

All market operators need to exercise considerable caution when looking to incentivise liquidity and this arises particularly in the concept of "wash trading", which covers trades that do not reflect genuine economic activity, but which are designed to create the impression of liquidity in nascent, small or immature markets. This became an issue of significant importance in the context of the activities of the then London Commodity Exchange, which sought to enhance liquidity and incentivise trading in a range of new property contracts launched by the Exchange. Following an investigation by what was then the Securities and Investments Board (essentially the predecessor to the FSA), it was found that the market was, in effect, an improper market and, as a result, both the Chairman and Chief Executive resigned. The FOA would urge Ofgem to exercise considerable caution in its proposal for an MA and consider carefully the position in which market participants might find themselves in the light of s.118(5)(a). Further, the FOA would urge Ofgem to discuss this issue carefully with the FSA in the context of the markets regulated by it, where this kind of mandated trading does not exist.

3. Specific questions

Q1 Do you agree with the objectives we have identified?

3.1 We agree in principle with the objective of increasing the availability of products to support hedging, and with the general goal of producing an effective near-term market, but we question the second objective of generating reference prices along the curve as the only point on the curve where a reference price is required is the front of the curve – the day ahead price for the UK power market.

In practice, we question also the focus of the first objective. We are not aware of a shortage of actual products for hedging, and feel that the real concern is over liquidity and the availability of counterparties. To the extent that the availability of products for hedging is concerned with the ability of firms to trade those products on a liquid market the objective is valid. The FOA would point out, however, that complex underlying risks in the power market can be managed through the use of tailored OTC transactions, but it should be noted that these contracts are subject to the overall post-crisis regulatory programme. This could mean that the pricing of these contracts will increase significantly and that this, in turn (together with the accompanying compression on OTC market trading), could impact the economics of risk management using OTC products to the point where they may not be viable as a risk management methodology in relation to UK power.

Q2 Do you think there are other objectives we should be considering?

3.2 The objectives themselves are reasonable. The FOA believes that there are more appropriate methods of achieving those objectives. The FOA believes that the MA is likely to create, albeit intentionally, a false market and that, far from increasing liquidity, the resulting uncertainty around the price formation process and the impact of "forced" liquidity is likely to dissuade potential market participants from dealing in the market and will undermine attempts to hedge price risk.

Q3 Do you agree with our views on market developments since summer 2011?

3.3 No comment.

Q4 What specific further developments would be necessary to meet our objectives?

3.4 No comment.

Q5 Do you agree that objectives one and two are current priorities given market developments?

3.5 No comment.

Q6 Do stakeholders agree that the MA is the appropriate mechanism to meet our immediate objectives?

3.6 See general comments above, particularly in para 2.1. The FOA believes that the MA is likely to create a false market and that, far from increasing liquidity, the resulting uncertainty around the price formation process could dissuade firms from using the available tools to manage price risk.

Q7 Do you agree that, at the present time, the other mechanisms identified would not be appropriate for Ofgem to pursue?

3.7 No comment.

Q8 Do you agree with the key features of the MA we have set out?

3.8 The FOA does not accept that the Ofgem proposal for an MA is an appropriate means to achieve its objectives. Further, it does need to be fully appreciated that the electricity power market is a complex market where significant levels of financial participation to enhance liquidity are unlikely to be achieved and, secondly, it is, by its nature, a regional market of limited size, suggesting that, until such time as the market has become an EU market, liquidity will not be particularly deep.

Q9 Do you consider it appropriate to have buy-side rules in place and do you have any comments on the details of such rules?

3.9 No comment.

Q10 Do you consider that there are benefits and risks to the approaches that we have not identified?

3.10 See above.

Q11 Which approach do you consider is best placed to deliver our objectives at least in terms of cost and risk?

3.11 No comment.

Q12 Do you consider that both approaches are able to meet our objectives?

3.12 See above.