

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

Executive Summary:

This paper is in response to the consultation document issued by Ofgem on February 22nd concerning the proposals to enhance liquidity in the GB power market.

N2EX welcome the recognition that Ofgem has given to the improved function and liquidity of the Day Ahead Market. Volumes and membership have increased markedly over the past year with 39 companies now able to trade the full range of N2EX contracts under a single membership and collateral solution without the need for multiple GTMA signup. We believe that this centralised model is a dramatic improvement upon the previous market structure and that this is demonstrated in the current activity levels with 28TWh of physical contracts being cleared by N2EX during Q1 2012. This progress has been hard-won and we accept that whilst OFGEM is satisfied with the current level of development in the near term market, they will continue to monitor its ongoing development.

N2EX now joins Ofgem in focusing its attention upon the long term wholesale market for UK Power. We agree that liquidity, participation and transparency all need drastic improvement. The N2EX based futures listed by NASDAQ OMX have shown promising signs of organic growth during Q1 2012 but both liquidity and participation are still far too low. Total cleared volumes reached 8TWh during Q1 2012 across a broad range of contract structures. GCM's and Brokers have adopted the contracts and the Auction Index is both liquid and transparent. Progress is in line with both our expectations and experience gained from setting up the near term market and we encourage Ofgem to allow this market led initiative more time to take root.

It is the significant time required for genuine organic growth of the futures contracts which prompts our concerns over the proposed Mandatory Auction. N2EX is willing to support all practical measures to improve the function of the long term wholesale market. However, we are concerned that a mandatory auction which requires the largest participants in the market to contribute to a separate longer term auction may well reduce liquidity in the benchmark Day Ahead Auction. In addition the regulatory uncertainty over the path of market development may well be discouraging new entrants from engaging with the existing futures market which we believe to be the best model for developing an efficient and liquid wholesale market in tune with the wider aims of European Market Coupling.

N2EX accept that there is an expressed desire from certain smaller participants for both more shape and more physical alternatives for hedging. We would like to work with these participants to develop suitable tools based around our existing product range to satisfy this perceived omission and reach out with training programmes to demonstrate how both long term and day ahead shape

can be accessed through the N2EX market model. In so doing we hope to continue to move towards a more standardised European Market structure where physical trading is centralised around the intra-day and day ahead market and financial products have been developed along the forward curve.

Questions and answers:

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

N2EX would agree with OFGEM that the long dated wholesale markets for UK power need rapid development. We see this process as a natural step to follow on from the changes already made to the short dated market. Greater liquidity, transparency and participation are necessary in order to ensure competitive markets for both supply and generation. Consensus is that the Day Ahead Market is now fulfilling this requirement for short dated trading and we agree with Ofgem that there remains a need for a more efficient, sophisticated and liquid solution for longer term trading.

N2EX would also encourage Ofgem to incorporate the on-going developments in Europe around market coupling and the harmonization of European electricity markets into its UK development strategy. We believe that this is best served by concentrating liquidity into the Day Ahead Benchmark and the associated futures trading. N2EX has now begun the build process for a GB Virtual Hub and this will see the synchronisation of auctions between GB and Mainland Europe as well as the formal coupling of reference prices.

N2EX continue to believe in the primacy of a single index price against which all other products are based, physical or financial is essential for developing tools for hedging further out on the forward curve.

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

A Mandatory Auction solution would also need to consider the following challenges:

Credit Requirements

If the purpose of this intervention is to make a more level playing field for market participants to transact in a liquid common market, then the credit terms and the collateral requirements need to be addressed before any platform can be implemented.

The financial threshold that the platform operator is required to set in order to preserve the integrity of the market may prove to be too great for those this initiative is designed to benefit. In addition the risk associated to trading longer dated products may also prove to be prohibitive to some market entrants as the collateral requirements would be consequently increased.

Platform Provider

If it is the intention of OFGEM to select a platform provider beyond those already active in the market today, then OFGEM would need to be conscious of the time scales associated with implementation

If OFGEM's intention is to go live with a new platform within reasonable timescales then we would recommend that platform selection be restricted to current market operators in the UK in order to reduce implementation time. This would also allow participants already established in the market to trade in the new market by centralising collateral on one platform and maximise the potential of other tradable markets and products (intraday, Day ahead etc..)

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

N2EX would agree with OFGEM that liquidity has built in the near term market since the summer of 2011, this is primarily to do with the implementation of Gross Bidding on the N2EX market, whereby a large vertically integrated utility commits to trade a percentage of its annual generation capacity in the day ahead auction and match this volume on the supply side. In this case we see 3 large VI's committing to trade a minimum of 30% of their annual generation which has seen day ahead volumes raise from 50Gwh per day in September 2011 to 190Gwh per day.

Unfortunately what OFGEM's report does not reflect is the growth in the UK futures during Q1 2012. With the increased volume in the day ahead market we have seen a marked increase in traded volumes and open interest on the futures market and whilst this continues to grow, any intervention by OFGEM would undermine this organic growth.

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

Whilst RMR highlights the need to develop liquidity in the forward curve, the industry as a whole is keen to identify what the key performance indicators OFGEM are using to identify whether the objectives are being met.

It is our belief that the market is keen to help OFGEM build liquidity in the forward curve, but unless the industry knows what we are aiming for then it makes it very difficult to initiate market led initiatives without knowing whether these initiatives are meeting the KPI of OFGEM.

An example of this is the development of UK futures on N2EX. The industry has repeatedly asked OFGEM for a statement as to whether the development of futures contracts and a cleared market are the preferred market solution of OFGEM, irrespective of the operator. Such an endorsement would enable market participants to commit to the market on the understanding that OFGEM was largely supportive of such a structure.

It is our belief that an endorsement from OFGEM of market led initiatives that focused on clearing and financial trading would allow the industry to commit to a market structure without the threat of change and intervention.

Question 5: Do you agree that objectives 1 & 2 are current priorities given market developments?

It is the opinion of this market participant that the development of a reference price in the UK power market is essential for giving clear price singles to market participants and potential market entrants. It is equally important, as part of the European initiative, to couple markets and reduce the complexity of cross border trading.

To have a focal point reference price that stimulates trading around it enables the development of a forward curve as the contracts benchmarked against this price carry limited basis risk as the price these contracts are derived from is pure in terms of what the market is trading.

To create multiple reference prices would limit the growth of any products attributed to these indexes as they would carry unnecessary basis risk as liquidity is forcibly split out along the curve.

Options 1 & 2 largely go against the European and Nordic trading model, both of which have proven to have liquid near term markets and forward markets. The added complexity of these priorities would threaten to alienate the GB market from the rest of Europe.

OFGEM is right to focus on the need for liquidity in longer dated products however the endorsement from OFGEM that the current market led initiatives on building a forward curve could lead to the market having confidence on what it is developing already.

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

Until the credit and collateral requirements are understood by all parties involved it is not clear whether a mandatory auction is appropriate to meet OFGEM's objectives.

With the growth in the futures volumes and membership on N2EX we feel that any market intervention would threaten the development of this market which is now gaining traction and designed to address the issue surrounding liquidity in the forward curve.

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

N/A

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

N2EX feel that the MA needs additional work, especially to set out the selection criteria for the operation of the mandatory auction and to detail the credit and collateral requirements for participants.

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

N/A

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

Additional products and additional liquidity would benefit small customers. Our main concern is that a Mandatory Auction may detract from the existing liquidity pools currently available and restrict the development of the futures market operated by NASDAQ OMX.

Additional questions that we would raise are as follows:

- Will the Mandatory auction affect the growth of liquidity in the near term market if the large VI's have to hold back volume for the Mandatory auction.
- If the requirement of the VI's is to put in 25% of their total annual generation (this includes assets not 100% owned by the Utility), then is there a danger of non-profitable plants being closed early so as to lower the demand on the Utility to generate the 25% requirement.
- If MA volume is taken out of the Day Ahead Market then the single reference price that is being generated by N2EX would be undermined if it didn't reflect all available volume in the market. This would have an adverse effect on the developing futures market.
- What impact would a Mandatory Auction have as a result of EMIR and REMIT?

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

It is our opinion that if a MA were to be implemented then option 1 would prove to be the most viable approach and least costly.

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

It is our opinion that both approaches could meet Ofgem's objectives but both would require significant cost in both time and money to implement. However by utilising an existing platform operator under option 1 would enable participants to centralise collateral and trade a larger range of products in one place with a single counterparty