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Dear Camilla,

RETAIL MARKET REVIEW: INTERVENTION TO ENHANCE LIQUIDITY IN THE GB POWER MARKET

We are pleased to respond to Ofgem's consultation of 22 February 2012 on its proposed intervention to enhance liquidity in the GB power market.

We agree with the major objectives identified for the GB wholesale power market: availability of products which support hedging, robust reference prices generated along the curve and an effective near term market. Achieving these objectives will ensure that the wholesale power market supports competitive supply and generation markets through robust signals and reliable trading in key products.

ScottishPower has played its part in the recent industry-led initiative to expand liquidity in the day ahead market, and we are committed to building on this success to develop market solutions that will help deliver improved liquidity along the curve. Ofgem has noted an increase in volumes traded in financial products on N2EX's UK Power futures platform and an increase in parties registered to trade on this platform. We believe that this futures platform could play a central role in such voluntary initiatives and as a first step we have committed to join this platform, with a view to increasing our trading in base load products. We would be pleased to engage with Ofgem and other stakeholders to explore how such voluntary initiatives can best be taken forward, and will be happy to keep Ofgem updated on our progress.

We are also extending our programme of agreeing bilateral trading relationships with new entrant suppliers. We continue to believe that this is of value to entrants, especially because of the lower collateral requirements than with exchange trading.

We are concerned that Ofgem's mandatory auction (MA) proposal carries a significant risk of unintended consequences, and we have serious concerns about buy-side rules which have potential to distort prices and disrupt markets. For example, if the choice of products does not reflect market needs, the objectives of the MA might not be met. And virtual power plant auctions, which have been introduced in a number of European energy markets, have had mixed results. A danger of such auctions is that design problems may cause them to be settled at artificially discounted prices, which

adversely affects the economics of generation investment, and detracts from the robustness of reference prices. We have had direct experience of such impacts in the Spanish market.

We therefore strongly favour an industry-led market solution. However, should Ofgem decide to proceed with the MA, we have three main comments:

- The MA should be introduced in a cautious phased manner, to minimise the risk of market disruption. In particular:
 - The MA should be launched without any buy side rules and allowed to operate for long enough allow normal market mechanisms to take effect. Only if there is clear evidence that Ofgem's concerns are being realised should consideration be given to introducing buy side rules.
 - The MA should be launched with a lower volume requirement (say 15%), and only if this is insufficient to deliver the required objectives should Ofgem consider increasing it to 25%.
 - The MA should not include any periods for which the carbon price support rate of CCL has not yet been set (as this would expose participants to unacceptable basis risk). Significant testing of the product list would also be needed to ensure it met market needs (for example, we doubt the viability of including peak, and there may be too much emphasis on the longer dated products).
- Any proposed buy-side rules should be subject to rigorous and transparent assessment by appropriate experts in auction design as well as by stakeholders. Our assessment is that the 80%/120% rule suggested by Ofgem is fundamentally flawed.
- If Ofgem decides to impose buy-side rules, the rules should be introduced in a way which gives licensees a route of appeal to the Competition Commission over the detailed content of the rules. (For example, the rules could be incorporated as an annex to the licence condition, or within a code that is designated as subject to appeal under section 173 of the Energy Act 2004.)

The financial implications of inappropriate buy side rules are such that we would be unable to agree to licence changes which included inappropriate rules or did not provide the procedural safeguard mentioned above.

Our responses to the detailed questions in the consultation are in the Annex attached. I hope you find these comments useful. Should you wish to discuss any of these points further then please do not hesitate to contact me or Alex MacKinnon, our Market Arrangements Manager, on 0141 614 3011.

Yours sincerely,



Rupert Steele
Director of Regulation

RETAIL MARKET REVIEW: INTERVENTION TO ENHANCE LIQUIDITY IN THE GB POWER MARKET

SCOTTISHPOWER RESPONSE TO QUESTIONS

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

We agree with the major objectives identified for the GB wholesale power market as:

1. Availability of products which support hedging
2. Robust reference prices generated along the curve
3. Effective near term market

Achievement of these objectives is key to ensuring that the GB wholesale power market supports competitive supply and generation markets through reliable trading in key products and provision of robust signals.

While we fully support addressing these objectives, we do not think that there is evidence that general liquidity levels in the GB electricity market, in terms of volumes of products being traded at various maturities, is a major factor affecting new entry in the domestic retail supply market. We think that risk, complexity (including regulatory complexity) and persistently low margins may well be more significant for potential entrants.

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

While encouraging investment in generation has been identified as an important outcome we do not think it has been given sufficient importance. Mandatory measures which could impact future prices or distort markets are a discouragement to potential investors who are accustomed to operating in fully competitive markets and are likely to have many other options outside the GB generation market for their investment.

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

While the GB annual churn rate has reduced in 2011 from the 2010 level, it is still over four times generation volume, which we believe is sufficient for the market to operate successfully. Ofgem recognise that the decline in churn does not have a direct bearing on the three major objectives. However, we would like to see additional liquidity in the forward market and robust futures prices, and therefore we support industry led measures to achieve this.

Ofgem have noted initiatives by some integrated companies to facilitate access for small independent suppliers but believe this is not sufficient on its own to ensure access to the range of products they need. We believe that the initiatives by ScottishPower and some other major generators have recently significantly improved access for small suppliers. We have given commitments to improve market access for small independent suppliers and generators by expediting and simplifying master trading agreements, providing trade notification services free of charge, providing initial lines of credit, streamlining financial regulatory compliance, trading small clip sizes and transferring qualifying over-the-counter sales to exchanges for clearing where the supplier is a member of the exchange.

We have recently written to all independent suppliers with whom we have not yet established a bilateral trading relationship alerting them again to our commitments and inviting them to establish a bilateral trading relationship with us. This initiative has received an encouraging response and we are in negotiation with a number of small suppliers as a result. Because bilateral arrangements can involve less onerous collateral requirements than exchange trading, we continue to believe that they will be an important part of the solution going forward.

Ofgem have noted strong growth in trading on the N2EX day-ahead auction platform and recognise that this could increase the robustness of the reference price on which financial products are based giving market participants greater confidence. Trading on this platform is continuing to increase and we are now trading a minimum of 30% of our daily GB power generation volume through this day-ahead auction. This is helping to increase liquidity in the day-ahead market, leading to more robust reference prices and greater transparency - which in turn is helping the development of liquidity along the forward curve.

Ofgem have also noted an increase in volumes traded in financial products on N2EX's UK Power futures platform and an increase in parties registered to trade on this platform. As we set out below we intend to join this platform with a view to increasing our trading in baseload products and so help to increase liquidity along the forward curve.

We agree that the recent growth in volumes traded on exchanges at the day-ahead stage marks significant progress towards achieving Ofgem's objective of an effective near term market.

We agree that liquidity is currently sufficient in the intraday market.

We do not believe that bid-offer spreads are having an adverse impact on the market. Bid-offer spreads in the GB market are similar to those observed in German and Nordic markets. These have in fact tightened all along the curve in 2011 and thus any concerns in relation to the forward market should reduce. The essence of the market is that positions can be balanced by adjusting bid and offer prices and this ensures the rise of uncontrolled large positions is minimised. In our view it would be counterproductive to attempt to set bid-offer spreads administratively as this could prevent the market from matching supply and demand.

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

Our initiative seeking to establish trading relationships with small independent suppliers is enabling more of them to access to the products they need in the market at robust prices all along the curve. We have made significant progress in the last 6 months and believe that initiatives such as this could play a key role in meeting Ofgem's objectives.

The N2EX day-ahead market is now very liquid and we are now trading over 800MW throughout each day through its day-ahead auction. This market is now delivering a transparent and reliable reference price and can now be used to provide shaping at the day-ahead stage. We therefore now believe that the most important new initiative should be to improve liquidity in baseload products in the forward market which could then be shaped in the period up to and including day-ahead. The N2EX/Nasdaq futures market offers the opportunity to improve baseload liquidity and we are committed to joining this market and trading baseload products through it.

The Government's Electricity Market Reform (EMR) review is currently considering major changes to the market and the interaction between the EMR measures to be implemented and new initiatives aimed at increasing liquidity in the forward market requires to be assessed.

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

We agree that the growth in volumes recently seen in trading on exchanges at the day-ahead stage marks significant progress towards achieving Ofgem's objective of an effective near-term market.

We agree there is scope for improving liquidity along the curve and that this would improve the availability of products which support hedging and robust reference prices along the curve.

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

We are concerned that Ofgem's mandatory auction (MA) proposal carries a significant risk of unintended consequences, and we have serious concerns about buy-side rules which have potential to distort prices and disrupt markets. For example, if the choice of products does not reflect market needs, the objectives of the MA might not be met.

Virtual power plant auctions have had mixed success when introduced in a number of European energy markets. A danger of such auctions, particularly when there are buy-side rules, is that they may be settled at artificially discounted prices, which adversely affects the economics of generation investment. We have had direct experience of this impact in the Spanish market. The auctions in Spain, in which major players were obligated to sell but not allowed to buy, did not attract new entrants into the retail market; instead the major purchasers were speculators who resold the energy at market prices.

Our primary concern with the MA proposal relates to the imposition of buy-side rules. However, there are a number of other potential disadvantages which cause us to prefer an exchange based solution such as the N2EX futures market:

- We believe there is a danger that the MA would come to be regarded as a separate market and that volume sold through this market by the integrated companies would not be subject to the same re-assessment and hedging as volume sold through other non-mandatory channels. This could result in the MA having the opposite effect to that intended, reducing trading volumes and liquidity.
- A monthly auction in which relatively large volumes are required to be traded is less convenient than a continuously traded exchange for managing fuel and carbon price risk; in the case of an exchange, fuel and carbon can be traded at the same time as the power, largely eliminating the risk; by contrast, a monthly auction does not sit so well with the other major markets generators may require to participate in for fuel and carbon, hence potentially increasing risk.
- An MA does not recognise the reluctance of suppliers in the competitive GB market to contract ahead outside their customers' termination notice period. This is a particular issue for smaller suppliers with a limited number of customers who

As noted above, we are committed to joining the N2EX futures exchange, and believe that it will be possible to meet Ofgem's liquidity objectives through voluntary industry initiatives rather than imposing a Mandatory Auction (MA) at this stage. As Ofgem acknowledges, voluntary initiatives have already proved effective in the day ahead market, and this would avoid the risk of market distortions that mandatory measures could otherwise create.

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

We agree that market developments in 2011 have removed the need to intervene in the near-term market through establishing a Mandatory Market Maker.

We agree that since most of the vertically integrated companies already trade multiples of their generation volumes then a Self-Supply Restriction would be unlikely to help in achieving Ofgem's objectives.

We agree that a Direct Trading Obligation would be unlikely to help in achieving Ofgem's objectives. We have taken the initiative in offering trading terms to small suppliers which we think should be attractive to them. Such voluntary actions are much preferable for delivering access for small suppliers while minimising the risk to the overall market.

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

As noted above, our main concern with the proposed features of the MA is the adverse impact that buy-side rules could have on the settled price. We comment further on these in response to Question 9.

Ofgem's rationale for obligating the integrated companies is that those companies with a significant position in both the generation and supply markets are responsible for discharging the obligation. However the significance of a company's position in these markets is determined by that company's individual market share and not by the share of the "Big 6" in total. Ofgem therefore need to define 'significant position' and ensure that this definition is applied non-discriminately in deciding who is covered by the obligation.

Ofgem also target the obligation at vertically integrated companies on the basis that they can manage risks through participation on the buy side of the auction. However obligated companies will only be able to do so if they are able to participate fully on the buy side.

Ofgem have removed shaped products from the product list but have extended it along the curve to season + 5. We are concerned that the take up further along the curve is likely to be low, detracting from the robustness of reference prices. Careful thought would therefore need to be given to the profile of the obligation over time. In any event, generators would find it difficult to contract further ahead than the period for which the carbon price support rate of CCL has been set (as this would expose participants to unacceptable basis risk); it would be essential to respect that horizon. We also believe it is ambitious aiming to provide a 'one stop shop' for products needed for hedging.

Ofgem have recognised the need to have sufficient volume to provide a robust reference price in each auction but not so much as to impose disproportionate costs on market participants. It would be less risky to start with a smaller target volume (perhaps 15%) concentrating mainly on the front end of the forward curve. Only if this proves insufficient should it be increased to 25%.

We agree with no regulation of reserve price and that there must be clear principles governing its operation at the outset.

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?

We understand that Ofgem's rationale for imposing the buy-side rules is a concern that, in the absence of such rules, the auction may not settle at a reliable price. For example, if vertically integrated suppliers went into the auction with the intention of buying and selling exactly equal amounts of power, they would be indifferent to the clearing price and may simply offer at a very low price (to be sure of selling the desired amount) and bid at a very high price (to be sure of buying that amount).

Although we can see that such a strategy may be a theoretical possibility, we do not believe that it would arise in practice or that if it did, it would be sustainable. Such strategies imply that the player concerned is indifferent to the price at the market clears – this is hardly likely to be the case. If the auction clears at a price above or below the true market price, this would act as a signal to attract new participants into the auction who whose participation would be profitable for them (at the expense of the integrated companies) and lead to the formation of a more realistic price. (Furthermore, unlike day ahead auctions, a futures auction would be subject to derivative trading regulations and the type of behaviour hypothesised by Ofgem may be prohibited.)

By contrast, if all the integrated participants are obliged to maintain a 20% imbalance, there is a strong probability that the balance of supply and demand in any given auction will be displaced from the balance that would have arisen naturally in the absence of buy side rules. This in turn may distort the price at which the market settles. The risks to a participant which chooses to bid at <80% could include:

- auction prices for all output may fall to the reserve price (if no reserve is in place, clearing prices may deviate significantly from the 'fair market value'), unless unsold volumes are removed from the calculation of prices for volumes for which there is demand. In other words, the effect of the MA and buy-side rule could create a 'fire sale' where integrated generators could not be reasonably considered 'willing sellers'; and
- one or more independent retailers or other speculative traders could attempt to benefit from the arbitrage opportunity of buying at a low price in the auction and subsequently reselling the power through other channels. This could lead to a discount in the auction equal to the cost of attracting the marginal provider of liquidity outside of the "Big 6". As a guide, this discount could be related to the forward premium—that is, the cost of bearing price risk reflected in the difference between the forward market price and the (typically unobserved) expected future spot price. This has been estimated to be up to £5/MWh.¹

¹ Oxera (2009), 'Hedging your bets: why pay over the odds for forward electricity?', Agenda, April, p2-3. Available at: http://www.oxera.com/cmsDocuments/Agenda_April%2009/Hedging%20your%20bets.pdf

The converse risks would apply if a majority of suppliers by volume took the option of bidding above 120% of sales. Without a more detailed explanation of how the buy-side rules would work in practice, it is difficult to be specific about the risks. However, it seems likely to us that the buy side rules will lead to some level of distortion in how the market clears, and even a small price distortion could have a significant financial impact on participants.

To minimise such risks, we believe Ofgem should adopt a cautious approach in which the MA is first allowed to operate for a reasonable period without any buy side rules. Only if there was evidence that this was not working should consideration be given to introducing buy-side rules.

In view of the particular risks associated with buy-side rules, we regard it as essential that any such rules are introduced in a way which gives licensees a route of appeal to the Competition Commission. For example, the rules could be incorporated as an annex to the licence condition, or within a code that is designated as subject to appeal under section 173 of the Energy Act 2004.

We would also suggest that any proposed buy-side rules should be subject to rigorous assessment by appropriate experts in auction design, to minimise as far as possible, the risk of adverse consequences.

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

The risks associated with either of the two options identified by Ofgem for selecting the platform(s) to provide the MA highlight the benefits of adopting the alternative approach of encouraging the industry to deliver Ofgem's objectives through the market.

Significant progress has already been made by the industry in achieving Ofgem's objectives for the near-term market without distorting the market. Ofgem should assist in setting the framework to facilitate extending this success into the forward market on a voluntary basis.

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

We believe the approach where each obligated party is individually responsible for selecting a platform or platforms and making arrangements with their chosen platform is less risky than the alternative of requiring all obligated parties to participate in an MA on a platform identified by Ofgem.

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

Although approach two would be more likely to meet the objectives, we are concerned that both approaches may result in reduced liquidity through sterilising auction volumes and reducing hedging volumes. They may also distort the market through reducing the robustness of reference prices along the curve and may not improve access for small independent suppliers.