Camilla Egginton
GB Markets
Ofgem
9 Millbank
London
SW1P 3GE

Head Office
Inveralmond House
200 Dunkeld Road
Perth
PH1 3AQ

Telephone: 01738 456726
roger.hutcheon@sse.com

11 May 2012

Dear Camilla,

Enhancing wholesale liquidity

Thank you for providing SSE with the opportunity to respond to the consultation on intervention to enhance liquidity in the GB power market as part of the Retail Market Review.

Given the pace of recent developments in the wholesale power market, Ofgem's willingness to engage with as wide a cross-section of interested parties as possible is extremely positive. SSE has participated in the two round table events which Ofgem organised on the Mandatory Auction (MA) and is represented on both the N2Ex Council and the Electricity Trading Committee of Energy UK. What has been apparent at each of these forums is that the MA has failed to gather much support from market participants. Even the small suppliers, who should benefit the most from Ofgem's proposed intervention, have generally been less than enthusiastic about the MA.

SSE has consistently argued that the MA will not deliver the best outcome for market participants. We continue to question the assumptions behind Ofgem's current proposals and whether the MA can actually meet the defined objectives.

Rationale for intervention in the market

We do not believe that Ofgem has successfully established the case that improving liquidity on the curve would lead to more affordable energy for customers. Electricity prices in Great Britain are already amongst the lowest in Europe (only countries where nuclear or hydro generation predominate are cheaper). Reported margins earned by suppliers compare favourably with those earned in other competitive areas of the economy (such as supermarkets). Given that the market already delivers competitive power prices for customers, great care needs to be taken to avoid intervention in the market that might increase costs for existing suppliers and hence for the majority of consumers.

The second underlying assumption is that current forward liquidity levels have a negative impact on investment in new generation. This is not the case. Generation investment appraisals are based on an assessment over the economic lifetime of an asset, typically at least 25 years. This requires a bottom-up assessment of the market, encompassing demand forecasts, expected generation mix and projected levels of spark-spreads. This long term assessment requires certainty in the regulatory and political framework – wholesale market liquidity is of secondary importance in this context.

Ofgem's stated objectives

Whilst we do not agree with Ofgem's underlying assumptions, we are supportive of the goal of improving forward liquidity as we believe this is in the best interests of all participants in the GB power market. The objectives Ofgem has defined are normative - they describe a healthy and well functioning market which no participant can reasonably argue against. The objectives themselves, however, are not easily translated into a particular regulatory intervention. SSE has consistently argued against intervention in the market and we have also made clear that if intervention is considered, we do not believe that Mandatory Auctions are the best solution.

Issues with the Mandatory Auction

We do not believe that the proposed MA will meet the stated objectives for the following reasons:-

- Monthly auctions can provide only sporadic liquidity
- Focusing on physical products will limit the degree to which auctions will appeal to banks and hedge funds (whereas the objectives could be met equally well through improved liquidity of financial products which are likely to attract more financial players)
- There is a significant risk that MA prices could be extremely volatile, making the auctions particularly unattractive for smaller players
- The proposals do not address the cost of credit and collateral requirements which pose the biggest obstacle for new and existing small suppliers
- The obligation to sell 25% of generation will have little impact on market churn
- Liquidity levels could be more directly addressed if the obligation is placed on all large generators, rather than to large vertically integrated suppliers only (albeit for a smaller percentage of each supplier's generation)

Added to these concerns, there is the issue of whether Ofgem favours approach one or approach two to identify a platform for the MA. SSE believes that the only credible arrangement is for a single provider to be identified – if the auctions are to attract support from across the market then it is imperative that the auctions are not fragmented across numerous platforms.

All of these issues are discussed in more detail in our answers to the specific consultation questions.

SSE's view of market development

We believe that all market participants would benefit from sufficient forward liquidity to allow positions to be opened and closed easily. The current market-led developments will, in our view, deliver this level of liquidity in due course. The market makers in the N2Ex futures market will shortly start using the brokered screen – this is more popular with some market members than the NASDAQ OMX screen and we believe that this development will quickly lead to improved futures volumes. It is our view that current regulatory uncertainty, coupled with the prospect of a potentially unsuccessful intervention being imposed on market participants, represents a real risk to the continued improvement of liquidity through market-led initiatives. In the presence of this regulatory uncertainty it will be almost impossible to attract into the GB power market the kind of financial players that currently contribute significant liquidity in the gas market.

If Ofgem deems that intervention is necessary, then we believe that it should not pursue the proposed MA and should instead revisit the large-scale mandatory market making (MMM) proposal. This is the only intervention that can credibly meet the stated objectives without putting at risk the momentum of recent industry led improvements in liquidity. We believe that MMM would also ensure that the cost of market development is borne equally across all major players. We see no reason why Ofgem could not implement MMM as the required regulation of bid-offer spreads (and specification of how these would be relaxed in 'fast markets') need have no impact at all on the price setting process. MMM currently works successfully in several European markets where the regulations have had no detrimental impact on the price setting process and have therefore not presented any obstacle to efficient price discovery.

An alternative approach that Ofgem could consider is whether there is anything that could be done to reduce the impact of credit and collateral costs on new and existing small suppliers.

These issues represent the biggest barrier to entry or expansion and the current proposals do nothing to address them.

It is also worth investigating the specific concerns that may have prevented smaller suppliers making more use of the offers from SSE and others to facilitate access to bilateral trading. If a lack of access to forward products is cited as a justification for intervention then further steps need to be taken to understand this problem more fully. Ofgem is well placed to look at this given its position.

SSE has attempted to address the requirements of small suppliers directly, through our recently announced trading commitment to suppliers with up to 250,000 customers. We have provided clarity over the range of products, clip sizes and tenors that we will trade and have also stated clearly that we are willing to trade at the prevailing mid-point price available in the market at the time. This commitment is effective immediately and represents a cheaper approach to meeting the requirements of smaller suppliers than the MA.

Conclusion

SSE urges Ofgem to seek ways to support the continued evolution of market-led initiatives to improve liquidity. The outcomes which Ofgem is targeting can best be met through continuously traded markets. We believe that if financial players can be encouraged to enter the GB power market – through improved liquidity and the removal of regulatory uncertainty – then the objectives Ofgem is pursuing could be achieved relatively quickly. Whilst the current proposals do not preclude further industry-led action, we believe that they do inhibit progress.

Our answers to the specific consultation questions explore these views in more detail. SSE will continue to engage constructively in this process. We are keen to participate in any further events or discussions to identify how to achieve the best outcome for all participants in the GB power market.

If you would like to discuss any elements of this response further then please do not hesitate to get in touch.

Yours sincerely,

Roger Hutcheon

Roger Hutcheon
Regulation, Markets

APPENDIX ONE: Responses to consultation questions

CHAPTER: One
Question 1: Do you agree with the objectives we have identified?
Question 2: Do you think there are other objectives we should be considering?

We present our response to these two questions together.

Rationale for intervention
The consultation document explores possible means of achieving Ofgem's two outstanding objectives. However, there is no discussion or evidence provided in support of the fundamental assumptions underpinning Ofgem's rationale for intervention, namely:

- Competition in supply is currently ineffective (and increasing the number of suppliers will necessarily result in more affordable energy prices for consumers; and
- Investment in generation is currently impacted by the lack of robust reference prices along the curve.

The first assumption does not stand up to scrutiny. Margins earned by large suppliers (as reported in the most recent Consolidated Segmental Statements) are generally below 6%[1] and compare favourably with other competitive sectors, such as supermarkets. Similarly, domestic electricity prices are amongst the lowest in Europe – only countries with a predominance of nuclear or hydro generation are cheaper.

Increasing the number of suppliers in the market is not guaranteed to lower costs to customers. Given that small suppliers have proportionately higher fixed costs per customer, they tend to focus on niches where there is scope to attract high value customers – for instance through offering green tariffs or online fixed-term contracts designed to appeal to customers with higher usage.

Given that there is already sufficient competition in the supply market to keep supply prices low relative to European peers, Ofgem needs to consider the unintended consequences of potentially costly intervention very carefully. It is critical that any intervention imposes minimal incremental costs on existing suppliers to avoid customers being adversely affected.

The argument that investment in new generation is impacted by liquidity over the front four or five seasons is not sound. Generation investment appraisals are based on an assessment over the economic lifetime of an asset, typically at least 25 years. This requires a bottom-up assessment of the market, encompassing demand forecasts, expected generation mix and projected levels of spark-spreads. This long term assessment therefore requires certainty in the regulatory and political framework – wholesale market liquidity is of secondary importance in this context.

However, Ofgem is correct to suggest that uncertainty over key policy developments, such as the Government's Electricity Market Review, inhibits forward liquidity. The suggestion that introducing further regulatory uncertainty will mitigate this is certainly counter-intuitive.

Ofgem's stated objectives
Ofgem's objectives are normative - they describe a healthy and well functioning market which no participant can reasonably argue against. The objectives themselves, however, are not easily translated into a particular regulatory intervention. Indeed, SSE has consistently argued against intervention in the market and believes that if Ofgem consider that intervention is necessary then Mandatory Auctions are not the best solution.

We note that in discussion of possible unintended consequences of the MA, Ofgem has implied that objective one is already largely met. The proposed obligation to sell 25% of generation "would be equivalent to five percent of the OTC market" (paragraph 3.30). If the only refinement offered by the MA in terms of available volume is that this volume would be offered through a single platform (and is therefore simpler for all participants to access) then it is simply replicating the benefits of N2Ex, which was set up with exactly that intention. In that

[1] Financial Information Reporting: 2010 Results, Ofgem, Jan 2012

light it would be preferable for Ofgem to identify ways in which existing market developments could be enhanced or accelerated.

The discussion of market design in the consultation document emphasises that “bids and offers need to reflect market prices” (paragraph 4.1), again implying that current levels of liquidity already provide adequate price discovery. Whilst we recognise that the provision of robust prices is a key element of objective two, we would argue that daily settlement prices would meet that objective if, for example, the current market-led developments on N2Ex are allowed sufficient time to develop further.

<u>Alternative objectives</u>

We strongly advocate measures that would enhance forward liquidity in continuously traded markets as this is the only credible means of delivering a better outcome for all market participants. This approach is more likely to attract speculative financial traders to the market. Banks and hedge funds are unlikely to participate in a market in which they are not able to unwind their positions quickly. These players have been identified as possible intermediaries with the flexibility to provide small suppliers with the credit arrangements and shape that they need.

Continuously traded markets provide the opportunity to open and close positions as required. This is of fundamental importance in realising the full value of generating assets. Power stations can be regarded as ‘physical options’ – in order to recover the ‘time value’ of these assets, the clean spark or dark spread is traded to reflect the likelihood of running at a particular point in future. This probability changes in line with fluctuations in market prices. This process of ‘delta hedging’ requires that markets are sufficiently liquid that participants can trade around their position as required.

We would urge Ofgem to consider ways of encouraging liquidity in this kind of market, rather than progressing with MA which we do not believe can meet the stated objectives.

CHAPTER: Two

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

Yes, we broadly agree with Ofgem’s assessment of current trading levels.

<u>Market developments</u>

The increase in near-term traded volumes, particularly on N2EX since October 2011, has been marked. We believe that this will be followed in due course by an increase in the volume of futures traded, once the auction is more firmly established as the most credible and robust reference price for the GB power market.

SSE announced a trading commitment to suppliers with up to 250,000 customers last month. This commitment builds on our previous efforts to facilitate access to bilateral trading for small suppliers and clarifies the products, tenors and clip sizes that we are willing to trade (our letter to small suppliers is included as an Appendix to this response).

Through this commitment we are offering to provide small suppliers with all of the products that would be available on Ofgem’s proposed MA, effective immediately. We have provided clarity that trades would be executed at the mid-point of bids and offers in the market at the time of trading (a very clear commitment of the type that Ofgem have proposed under the MA, as described in paragraph 4.1). Of particular importance is the fact that this commitment is aligned with existing trading arrangements (and is therefore available now) and ensures that small suppliers can access volume without the burden of setting up numerous GTMAs. Our announcement generated interest from a number of counterparties. This type of commitment can be easily implemented and potentially offers a more promising means of meeting the demands of small suppliers than the proposed MA.

<u>Assessing liquidity</u>

We agree that narrow bid-offer spreads are a feature of liquid markets, but it is important to avoid unfair or inappropriate comparisons with other markets. Clearly the levels of churn and widths of spread witnessed in the UK gas market reflect the fact that NBP effectively serves as the European hub of the international gas market. This is in contrast to the GB power market, which has only limited interconnection capacity. Whilst at first glance the German power market and the volumes traded on Nordpool may appear to be an appropriate comparator or benchmark for GB power, it is worth noting that Germany has over 14GW of interconnection with other markets, all with different cost drivers. This has the result that the German market serves as a de facto hub for European power, with obvious consequences for liquidity. A fairer comparison could be drawn with the French power market – this has interconnector capacity somewhere between the German and GB markets, and does not serve as a hub in the way that Germany does.

With this in mind we would urge caution in drawing comparisons with spreads and churns in other markets.

Question 4: What specific further developments would be necessary to meet our objectives?
Question 5: Do you agree that objectives one and two are current priorities given market developments?

We present our response to these two questions together.

We agree with Ofgem's current assessment that developments in the near-term market over the last six months have effectively removed any justification or requirement for further intervention to achieve objective three.

Since SSE announced our plans to play a more active role in the DA auction in October 2011, there has been a steady and sustained increase in both the daily volume and the number of participants on N2Ex. Since the beginning of January, EOn, Scottish Power and most recently EdF have announced their own gross bidding agreements with N2EX – real progress has been made and we believe the market will look very different in another six months time. A factor that we believe has inhibited trading of N2Ex futures is that the market makers were using the NASDAQ OMX screen. There are plans to shortly start using the brokered screen – this is more popular with some market members and we expect to see an upturn in futures volumes once this change has been implemented.

SSE believes that prompt liquidity begets liquidity on the curve - the market is going through this transition process at the moment. As the market becomes more confident in the sustained level of trading in the day-ahead auction, there will be more participants willing to trade futures products which settle against the auction price. If the current developments are given time to come to fruition - in the absence of increased regulatory uncertainty - then no further intervention would be required in order to achieve the remaining two objectives. Suppliers could hedge their supply book in the financial futures market, and convert this to physical volume in the DA auction with no exposure to the market clearing price. This model works well in the Nordpool market and, given sufficient liquidity, would provide small suppliers in the GB market with access to the products they need. Meanwhile, liquidity in the developing futures market would attract financial players who may be less inclined to trade physical products.

Whilst we agree that objectives one and two represent desirable outcomes for the GB power market, we would not regard them as priorities requiring intervention from Ofgem. On the contrary, we would argue that the prospect of Ofgem intervention will actually serve to inhibit current initiatives by a number of market participants to improve liquidity.

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

No, SSE does not believe that the MA will meet Ofgem's objectives.

In our response to last year's consultation on the RMR (dated 1 June 2011) we highlighted several areas of concern around the MA. These concerns have not been addressed by the latest proposals. We discuss the issues as we see them under each of the objectives below.

<u>Objective one: availability of products which support hedging</u>

The MA will provide only sporadic liquidity – any suppliers reliant on the MA for hedging purposes would be exposed to significant market risk in the time between auctions. Low probability, high impact events such as the Fukushima earthquake impact significantly on market prices and highlight the importance of access to liquid traded markets (as opposed to monthly auctions). For this reason we do not believe that the MA would meet the needs of existing and new entrant small suppliers.

The proposal will have only a marginal effect on churn. Allowing obligated parties to participate on the buy-side is necessary to ensure that there is sufficient demand in the auction to ensure that all of the volume is sold – however, this means that the obligation is really for a net sale (or purchase) of at least 5% of annual generation, which would have an even smaller impact on churn levels. Ofgem estimate that even at 25% of generation, the MA would constitute only around 5% of the OTC market.

There is actually a significant risk that the MA will have a detrimental impact on liquidity levels in the existing market – if the MA removes some of the volume currently traded elsewhere to fulfil the requirements of the proposed obligation, this could actually result in a net reduction in liquidity.

It is not clear whether Ofgem intends to measure success in meeting objective one through an assessment of which products are liquidly traded or in terms of the degree to which intervention has helped "to secure affordable energy supplies for consumers" (consultation document, paragraph 1.2). The latter measure encompasses an assumption which we do not believe Ofgem have produced sufficient evidence to justify (see Question 1 above).

<u>Objective two: robust prices in longer-dated products</u>
As discussed under objective one, auction prices will only be available once a month so cannot provide a reliable reference price in the weeks in between. This feature means that participants could not hedge their positions effectively using the auctions alone.

More fundamentally, we do not believe a market where parties are obligated to sell a fixed volume will result in a robust price curve in the first place – the danger of there being a significant and variable mismatch between demand and supply in each auction could result in extremely volatile prices. Even if care is taken to establish sensible caps and floors, or reserve prices, there is a danger that the auction clearing price will be at or near these limits. Such price volatility is likely to scare smaller players away from using this mechanism and would limit the general level of interest of non-obligated parties in the auctions (including independent generators). We regard this risk as significant and believe that it calls into question the extent to which the MA can provide any of the benefits Ofgem intends.

<u>Summary</u>
We do not believe that Ofgem will achieve the best outcome for consumers by implementing MA. Resolving the issues around this intervention is likely to be a lengthy and expensive process that will ultimately be paid for by customers. We do not believe the process will meet the objectives as stated above.

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

SSE favours a market-led solution – preferably without regulatory intervention.

If intervention is deemed necessary then we believe that Ofgem should not pursue the proposed MA and should instead revisit the large-scale MMM proposal. This is the only intervention that can credibly meet Ofgem's objectives without putting at risk the momentum of recent industry led improvements in liquidity. We believe that MMM will also ensure that the cost of market development is equally borne across all major players.

Ofgem has discounted this proposal as a result of a concern that any regulation of bid-offer spreads would impact on the price setting process. SSE believes that Ofgem is mistaken in this assessment and that large-scale MMM could be implemented more easily and more cheaply than the MA.

MMM operates successfully in European markets[2] with no indication of any problems relating to the issue of interference in price setting which Ofgem is concerned about. The arrangements are designed to ensure that bid-offer spreads are tight enough to show liquidity in the market but not so tight as to force the market maker to offer or bid very close to the current trading price unless they wish to. The obligations are loosened at times of high volatility ('fast markets') to avoid participants being obliged to trade something they do not wish to trade. Declaration of 'fast markets' is a role for the exchange in question but can be identified by clearly defined rules:

- 'Gap opening' whereby a trade is executed at a price that differs from the preceding trade or mid-spread price by greater than the allowed market maker spread; and
- 'High volatility' whereby the price moves by an amount greater than an agreed multiple of the market maker spread within a defined period (*x* minutes)

The EEX agreement describes an 80 tick bid/offer spread for front month. This would mean trading parties would have to make a market 80p wide. The bid offer spread is usually around 10-20p wide so this obligation would not force companies to trade on things that they do not want to trade on. If they wanted to buy they could put their bid close to market and their offer 80p off and vice versa. In the case of MMM, where the obligation would apply to several parties, the effect is to reduce the spread – each party will have a slightly different view of where the value is (reflecting the differing drivers in their trading books) so the bids and offers will not coincide exactly: the market spread is then the difference between the highest bid and lowest offer.

Market making remains our preferred method of intervention, should intervention be deemed necessary. For this solution, Ofgem would need to specify the initial width of the market maker spread for each product, the criteria to identify fast markets and the rules defining how spreads can be widened when these criteria are met. Regulation of this type would affect neither the pricing of available products nor any party's freedom to choose which side of the trade they would prefer to be on. If such an obligation were applied to large generators as well as to vertically integrated suppliers it would attract even more volume to the market as other players respond to the increased liquidity.

We agree with Ofgem's assessment that neither the self-supply restriction nor the direct trading obligation would be appropriate interventions for Ofgem to pursue. The former would not have a significant impact on liquidity as most obligated companies would already churn sufficient volume to satisfy this requirement. The latter would not add anything to what is already available in the market.

<u>Summary</u>
SSE believes that the arguments which have led to Ofgem abandoning MMM are not sound. Of the various approaches to intervention described in the consultation document, MMM is the solution which best fits the key policy design principles and is the only mechanism that could deliver the objectives which Ofgem has identified. We also believe that it could be implemented in a manner that would be directly aligned with the current improvements in the market.

CHAPTER: Four
Question 8: Do you agree with the key features of the MA we set out?
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 present our response to these two questions together.

There are several aspects of the MA that cause concern.

[2] Details of market making agreements in Germany and Nordpool can be found at: www.eex.com/en/Transparency/Exchange%20owned%20data/Market%20Making/Conditions and www.nasdaqomxcommodities.com/trading/marketmakers/ respectively.

The determination of the obligated volume is contentious – the proposal that this could be determined a priori based on the preceding year's output is not workable. The impact of the more stringent standards required by the Industrial Emissions Directive and the increased costs associated with the carbon floor price is likely to be the closure or reduced running of large coal stations. The erosion of spark spreads over the last year has brought into question the long term viability of many older CCGTs. Meanwhile the large variations in levels of renewable generation make forecasting output extremely uncertain. For instance, SSE's reported hydro generation in the financial year 2010-11 was 2.5TWh, compared to 3.0TWh in 2009-10. On top of the variation of output due to weather or plant economics there is uncertainty due to asset acquisitions and sales. These considerations make an a priori calculation of the obligated volume unworkable.

Ofgem have identified four key policy design principles but have not fully assessed the MA against these criteria. The MA does not align with what works well in the market at the moment – as discussed under Question 6 above, there is a risk that the MA will simply move volume from one platform to another. Meanwhile the regulatory uncertainty introduced by discussion of possible interventions in the market by Ofgem inhibits the development of improved liquidity on existing platforms (an effect which Ofgem explicitly acknowledge in the context of the Electricity Market Review in the Executive Summary of the consultation document). There are therefore significant costs associated with the MA over and above the costs of implementation (in terms of delay or derailment of existing market developments).

There is also a risk associated with the potential lack of consistent interest in the auctions themselves. The impact of unexpected demand levels in the auctions could cause them to settle at either unusually low or unusually high prices relative to other platforms. We believe that the auction clearing prices could be extremely volatile, and that this problem will be exacerbated if Ofgem were to favour the option of requiring obligated parties to individually identify service providers (such a fragmented approach is likely to result in less well supported auctions).

In paragraph 4.11, Ofgem has described the rationale for excluding large generators from the MA. Since it is not clear who would buy 25% of large vertically integrated suppliers' power (constituting approximately 17.5% of total GB generation) the proposal allows for obligated parties to buy most of the volume back. The result is that obligated parties will net buy or sell a volume equivalent to at least 5% of their annual generation through the auctions. The argument that big generators should not be obliged to sell their output since they would not ordinarily buy large volumes of power, or if they did so would have to trade it out again is specious (generators who delta hedge their position will routinely buy and sell volume). If this concern were valid, why have Ofgem not proposed that a smaller volume be sold through the MA and all significant generators be obligated to participate? There is nothing in the stated objectives that should necessarily limit the obligation to large suppliers. Since the key concern is the availability of products to support hedging, sold through a mechanism producing robust prices along the curve, we believe that the MA obligation should be for a lower percentage of generation and should apply to all large generators. This approach would also allow Ofgem to address the concern about large suppliers being active on both sides of the auction, which was raised by several attendees of the first round table event.

We believe that Ofgem have asked, "What buy-side rules are required in order for obligated parties to sell 25% of their generation?" A better question would be, "What percentage of generation can obligated parties reasonably sell without the requirement to participate on the buy-side?"

The MA proposal specifies auctioning of contracts for physical delivery. The objectives could be met equally well through increased trading of financial products. We believe that key providers of liquidity, such as banks and hedge funds, are more likely to participate in a market for financial products. Small suppliers would still be able to hedge their supply books by purchasing futures and converting these to physical by trading the equivalent volume (with no price risk) in the market against which the futures are settled.

CHAPTER: Five

Question 10: Do you consider that there are benefits and risks to the approaches that we have not identified?
Question 11: Which approach do you consider is best placed to deliver our objectives at least in terms of cost and risk?
Question 12: Do you consider that both approaches are able to meet our objectives?

We present our response to these questions together.

The most significant risk is that, under approach two, interest in the auction is fragmented and one or more auctions fail to gain sufficient traction for the obligated parties to meet the obligation to sell. We believe that for the MA to have any prospect of success it is crucial that a single platform is identified. This approach may result in slightly higher costs for one or two participants but is likely to produce the lower priced solution when all costs are considered together. Whilst the proposed one-stop-shop may not gain the trust and support of all small suppliers, a six-stop-shop would seem guaranteed to fail.

APPENDIX TWO: SSE's trading commitment to small suppliers

April 2012

Dear,

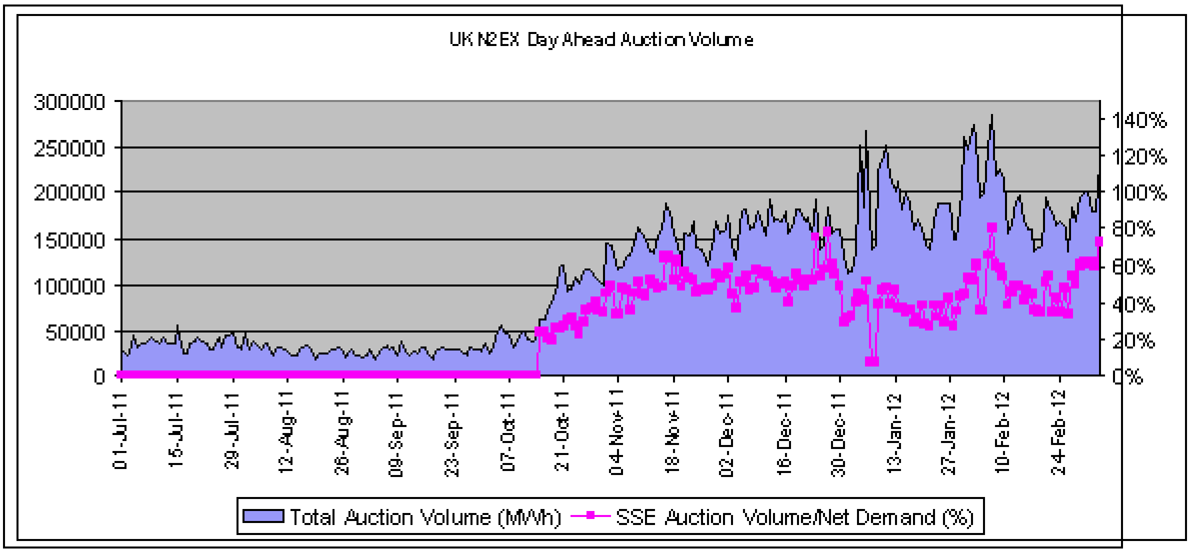
SSE's Electricity Trading Commitment to suppliers with up to 250,000 customers in the GB Market

I am writing to you to inform you of SSE's trading commitment to suppliers of electricity with up to 250,000 customers in the GB market.

It has been argued that such suppliers have struggled to gain access to contracts for wholesale electricity of the right size and shape to enable them to manage their risk profile, and that this has proved to be an impediment to their growth and to the entry of new suppliers into the market. SSE has a strong commitment in this area, which is summarised in this letter.

As you know, SSE is one of the most active participants in the wholesale market for electricity and has always taken an "open door" approach to trading in this market. In October 2011, SSE transformed transparency in the Day Ahead market by beginning to phase in the auctioning of all of its electricity supply, and the purchasing of all of its electricity demand, in the Day Ahead market.

As a result of SSE's move, a deeper Day Ahead market has emerged and over time this will result in a more liquid forward market and more efficient price discovery which will benefit suppliers, market competitiveness and consumer choice. The graph below demonstrates the increases in trading volumes.



We understand that it is imperative for suppliers with a smaller number of customers to access the wholesale market to obtain electricity in bespoke volumes of electricity over appropriate time periods and at fair prices and credit terms.

Correspondingly, we are writing to make available to you (and all VAT registered suppliers with a customer base of up to 250,000 customers) the opportunity to contract for a secure forward electricity product with a transparent market price and shape. An indication of the standard terms for the period of the contract is detailed below:

1. Any normal volume – SSE will make available forward contracts in any standard traded product in any volume up to the supplier's total customer demand. There will be no

minimum contract (or 'clip' size). *This means suppliers can access the right volumes of electricity for them.*

2. Benchmarked market prices for that volume – SSE will take the mid-point of the prevailing bid-offer spread (i.e. the difference between the price quoted for a sale and that quoted for a purchase) on the market for the period desired and agree a sale of the volume. *This means suppliers will get a fair price.*

3. Flexibility – Suppliers with up to 250,000 customers can trade 'in and out' of this position as many times as they wish. This allows them the option to reposition as market conditions and risk metrics change.

4. Deliverability - At the Day Ahead stage SSE will settle the existing trade position as a Contract for Difference' against the Day Ahead market auction and then sell back the nominated shape at the hourly auction price. This effectively gives the supplier a chance to forward hedge and provides them a market price for the shape of volume (i.e. the profile of demand over time), at cost only, substantially de-risking the exposure for the supplier.

We hope that these arrangements will provide you with the confidence to engage in longer term contracts, significantly reducing the risk that your business is exposed to.

SSE is prepared to take on some additional credit risk to assist suppliers in these purchases. Any additional credit risk will be treated under our standard terms.

In summary, this is a very flexible and fair approach which confirms SSE's commitment to a strong and effective wholesale market for electricity which contributes to securing greater trust on the part of electricity customers in the Great Britain market.

We will contact you next week by phone to allow you to consider this letter and begin to try and structure what you require.

Yours,

Alistair Phillips-Davies
Generation and Supply Director