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Phil Slarks
Ofgem
9 Millbank
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February 15th 2012

Dear Phil,

Wholesale power market liquidity: consultation on a 'Secure and Promote' licence condition

Thank you for the opportunity to respond to the above consultation. The annexes to this letter set out our views on Ofgem's proposals. Generally speaking, we remain unconvinced that regulatory intervention is required to improve liquidity in the GB power market. Market-led initiatives have already delivered significant improvements against Ofgem's objectives, and there is no reason to think that this progress will be reversed in the future. Should Ofgem still wish to intervene, the Secure and Promote model should be reviewed to mitigate the risk of distortions and ensure that the costs are proportionate.

Annex 1 to this letter summarises our position, and Annex 2 provides detailed answers to the questions set out in your consultation paper. I hope that these comments are useful. Do not hesitate to contact me if you have any questions.

Yours sincerely,

By e-mail

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Annex 1 – Executive summary

We remain unconvinced that regulatory intervention is necessary to improve liquidity. Two of the three objectives pursued by Ofgem – improved liquidity in the spot market and effective market access for small suppliers – have already been achieved through market-led initiatives. Market participants have taken decisive steps to improve liquidity at the day-ahead stage, and there is no reason to think that the recent progress will be reversed in the future. A number of large companies, including Centrica, are currently discussing trading arrangements with small suppliers. The discussions are constructive, and this market-led process is the best way of dealing with such requests. We see no value in embedding these initiatives into generation licences, particularly when no compelling evidence to suggest this is a necessary or proportionate response to any concerns has been presented.

With respect to the third objective pursued by Ofgem – more robust price signals along the curve – we simply disagree with Ofgem's assessment of the issue. Ofgem's analysis highlights broad trends in high-level indicators (aggregate churn, bid-offer spreads, etc), without considering how this market data relates to the trading needs of market participants. The overall presumption seems to be that 'trading volumes need to increase', irrespective of the market environment. We believe that the current level of liquidity on the curve is sufficient to meet the needs of market participants, and we would argue that any obligation designed simply to increase trading volumes would be artificial, costly, and distortive.

Overall, Ofgem has failed to make the case for intervention. The Secure and Promote proposals simply reflect the concern that 'something must be done', regardless of the nature of the problem. This is bad policy-making.

Should Ofgem wish to pursue intervention, it would be necessary to review the requirements to ensure that the costs are proportionate and the intervention does not introduce any distortions in trading arrangements. We recommend four key changes to Ofgem's proposals.

Firstly, the obligations should be imposed on all large generators, not just on large vertically-integrated players. There is no evidence that the 'Big 6' companies are foreclosing the market through vertical integration, so imposing the obligations solely on these companies would be arbitrary. This approach could also be deeply distortive for the market. Most of the Big 6 companies are structurally short of power, which means that the obligation to sell power to small suppliers would effectively require the Big 6 to intermediate between independent generators and independent suppliers. This approach would actually entrench the central position of the Big 6 in the wholesale market. It might discourage the development of bilateral relationships between independent generators and suppliers, and it might 'crowd out' the services that could be offered by financial intermediaries and independent aggregators.

Secondly, obligated parties should not be forced to accept weak credit protection. It is normal and prudent for market participants to seek protection against the risk of their counterparties defaulting. This is standard business practice, and indeed one that is actively encouraged by financial regulators. Obligated parties should be free to apply their own credit policies provided that they do not discriminate between counterparties.

Thirdly, the governance arrangements should be tightened. We believe that the Secure and Promote model as defined in the proposals might effectively create an open-ended commitment for obligated parties. The terms of the licence conditions are very loosely defined, while the substance of the obligations would be contained in a 'Requirements Document' that could be changed by Ofgem without being subject to normal consultation procedures and appeal rights. Unless governance is tightly controlled, the licence conditions will turn into a 'blank cheque', which would impose a significant risk on obligated parties. We

recommend that Ofgem specify the requirements in the licence conditions. Failing this, Ofgem should set up a tighter governance process for any requirements defined outside licence conditions.

Fourthly, there should be no market making obligation. As discussed above, we believe that there is no need to intervene to increase trading volumes on the curve. We also believe that Ofgem has seriously underestimated the costs of the market-making obligation for obligated parties. There is a significant risk that this obligation would trigger exposure to EU financial rules through EMIR and MiFID, which would create substantial costs for obligated parties and might actually harm liquidity. This obligation would also create a very significant exposure to market risks for obligated parties.

Annex 2 – Consultation questions

Question 1: Do you agree with our assessment of market developments?

No. We think that Ofgem's assessment of market developments is unduly negative, and we continue to believe that the current level of liquidity is sufficient to support effective competition in the GB power market.

We understand that Ofgem's concerns essentially revolve around three key observations:

– aggregate churn has continued to decline in 2012;

– liquidity in long-dated products remains limited, as evidenced by low trading volumes and widening bid-offer spreads;

– independent suppliers have provided mixed feedback on the commitments made by large vertically-integrated players.

We disagree with Ofgem's interpretation of this data, and do not believe that Ofgem has made a robust case for intervention.

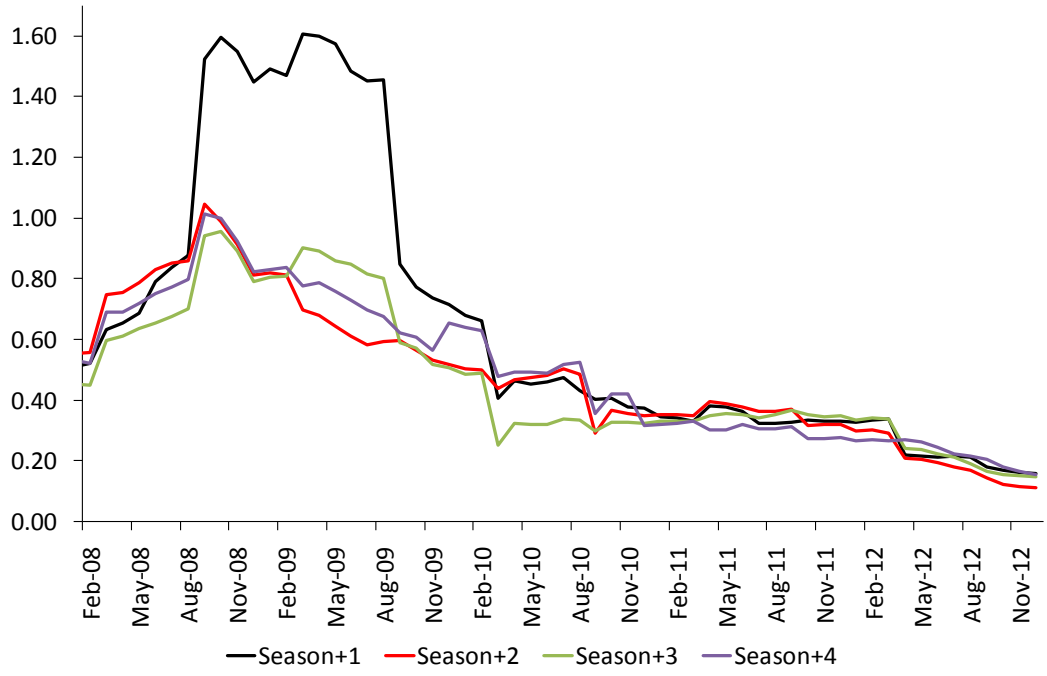
1. Declining churn

Ofgem points to the declining level of churn as an indication that the market is failing to meet the needs of market participants. We think that it is actually a natural response to low and stable spark spreads. The fundamental reason why traded volumes exceed physical generation in the power market is that generators need to adjust their hedge over time in response to changing expectations about generation margins and output levels (and similarly, suppliers need to adjust their hedge in response to changing expectations about demand). When forward prices become more stable, generation forecasts also become more stable, and generators do not need to adjust their hedge so often. In other words, a declining churn can be a sign that market participants' *need to trade* has diminished, rather than an indication that their *ability to trade* is constrained.

Suppose for example that the spark spread for Season+3 is £5/MWh, and that a generator sells his expected output at this price level (say 100MW) in the forward market. If the spark spread subsequently drops to £3/MWh, this generator will expect to generate less (say 50MW) because some of his units will be pushed out of the merit order, and he will therefore need to buy back some volumes in the forward market. If the spark spread increases back to its previous level, the generator will need to sell this same volume again to bring its hedge back to its previous level. Gas generators will need to make such adjustments for every significant movement in the spark spread. If the spark spread becomes more stable, then the level of churn naturally comes down.

Figure 1 below shows that the volatility of clean spark spreads along the curve is currently one third of what it was in 2008. In such an environment it is natural to expect market participants to trade less. This is an efficient response to changing fundamentals, not a market failure.

Figure 1 12-month volatility in GB clean spark spreads



Note: volatility is measured as a 12-month rolling average of monthly volatilities.
Source: Heren data, Centrica Energy analysis.

2. Limited liquidity in long-dated products

Ofgem argues that the small proportion of products traded beyond 12 months ahead is an issue for 'objective one' (availability of products that support hedging), and that widening bid-offer spreads for long-dated products are an issue for 'objective two' (robust reference prices along the curve). We recognise that trading remains thin for certain categories of long-dated products, but we do not agree that this represents a market failure or an obstacle to effective competition. Instead, we would argue that this is broadly consistent with the trading preferences of market participants.

We note that Ofgem typically assumes that suppliers hedge their price exposure over 18 months. If suppliers were churning their volumes at the same level along the curve, then we would expect about a third of volumes to be traded beyond 12 months. In reality, suppliers tend to churn short-term positions to a greater extent than long-term positions, as they need to 'shape' their position as they approach delivery. Overall, we would expect the share of volumes traded beyond 12 months to be significantly lower than a third, and the share of volumes traded beyond 18 months to be fairly small. This is broadly consistent with the product mix observed by Ofgem, with around 20% of baseload volumes and 10% of peak volumes traded for timeframes beyond 12 months. We conclude that the product mix observed by Ofgem is broadly consistent with Ofgem's own assumptions about suppliers' hedging strategies. It does not necessarily indicate a fundamental issue with liquidity.

It is conceivable that some suppliers are using longer hedging strategies, depending on their customer base and contract portfolios. However, retail competition generally limits the extent to which suppliers can 'lock in' their procurement costs far ahead of delivery. If prices were to fall suddenly, new entrants and alternative suppliers with shorter hedging strategies could make more competitive offers to consumers, and the suppliers who hedged their costs over longer timeframe would end up making significant losses. In essence, we should not expect

suppliers to buy large volumes of long-term contracts in the wholesale market if they cannot fix prices with retail consumers over these timeframes.

As such, there is no reason to think that a liquid market for very long-dated products (say, beyond Season+3) is essential to retail competition. If anything, the prevalence of short hedging strategies should be seen as an indication that retail competition is effective, in the sense that suppliers are genuinely concerned about the risk of consumers switching to alternative suppliers when prices fall.

This may be a problem for generators, who typically try to sell a share of their output over longer timeframes in order to mitigate the risk of their investment. However, this is *not* a liquidity issue, in the sense that there is a 'latent' supply and demand for long-dated products, but the two sides of the market somehow fail to meet. Instead, it means that there is no matching supply and demand for these products – suppliers are not interested in the type (ie term or length) of products that generators would like to offer, or are unwilling to pay the price required by generators for these products.

This is a fundamental problem in any market with retail competition: suppliers cannot offer the long-term price commitments that generators seek because they cannot themselves obtain such commitments from end-consumers. Treating this problem as a liquidity issue is not only mistaken as a matter of principle, it could also lead to serious distortions if market participants were forced to trade products that do not match their needs.

3. Mixed feedback from small suppliers

The main argument presented by Ofgem to justify the obligation to offer 'fair and reasonable trading terms' is that small suppliers have provided mixed feedback on the commitments made by large companies. We do not think that this is a sufficient basis for intervention. Over the past two years, large vertically integrated companies have explored various approaches to meet the needs of small suppliers. In general, the discussions have been constructive and the parties have been able to reach agreements. There may have been cases where the parties failed to reach an agreement, or where one of the parties was not fully satisfied with the agreement that was reached, but this is a normal outcome in commercial negotiations; it is *not* an indication that the whole process is flawed and needs to be regulated.

In order to justify intervention in this area, Ofgem should demonstrate that this commercial process is *systematically* failing to accommodate *reasonable* requests from small suppliers. Simply pointing out that certain parties are not completely happy with the deals they got is not a sufficient basis for intervention.

Ofgem mentions credit and collateral as a particular area of concern. It is normal (and sensibly prudent) to expect market participants to seek protection against the risk of their counterparties defaulting. This is a normal business practice, and indeed one that is actively encouraged by financial regulators. In order to justify intervention in this area Ofgem needs to demonstrate that large companies are actively discriminating against small suppliers in their credit requirements, which we do not believe is the case.

Question 2: Do you agree with our description of the policy and regulatory context affecting liquidity?

Not fully. We believe that Ofgem has not properly assessed the following developments.

– **EMR: it is not necessary to improve liquidity in the forward market to support the CfD scheme**. Ofgem seems to argue that it is necessary to improve liquidity in the forward market because DECC is minded to use a basket of forward prices as the

reference price for the baseload CfD. In our opinion this is turning the issue upside down. When the CfD scheme is in force, baseload generators will have a natural incentive to sell their volumes in the reference markets (to capture the reference price of their CfDs), and suppliers will have a natural incentive to buy volumes from these markets (to hedge the volatility in their CfD payments). This means that improved liquidity in the forward market should be a consequence, not a prerequisite, of the CfD scheme. Intermittent generators will have their CfDs indexed on the day-ahead auction price, which is already considered to be sufficiently liquid.

– **Energy Bill: the backstop powers to act on liquidity are a threat to the development of the market.** The Energy Bill contains 'backstop powers' to enable the government to act on liquidity in the event that industry action or Ofgem intervention does not meet their objectives. These reserve powers are drafted in exceptionally broad terms (see Box 1 below). As currently drafted, this clause may enable the government to regulate wholesale prices and trading terms without passing any legislation. We are concerned that the regulatory risk that will result from such provisions might dissuade external counterparties from entering the market. Ofgem should encourage DECC and MPs to frame this clause so that it does not generate undue regulatory risk in the market.

Box 1 Current wording of the liquidity clause in the Energy Bill

(2) The Secretary of State may exercise the power in subsection (1) only for the following purposes—

(a) facilitating participation in the wholesale electricity market in Great Britain, whether by licence holders or others;

(b) promoting liquidity in that market.

(3) Modifications made by virtue of that power may include—

(a) provision imposing obligations in relation to the sale or purchase of electricity, including, in particular, obligations as to—

(i) the terms on which electricity is sold or purchased, and

(ii) the circumstances or manner in which electricity is sold or purchased;

(b) provision imposing restrictions on the sale or purchase of electricity to or from group undertakings;

(c) provision imposing obligations in relation to the disclosure or publication of information.

Source: Energy Bill 2012

– **EU financial regulation: the implementation of the clearing obligation under EMIR is the most significant threat to liquidity in energy markets in the short term**. Ofgem rightly identifies MiFID II as a potential threat to liquidity in the long term. However, there is a risk that energy companies might be forced to clear a substantial proportion of their trades under EMIR as soon as 2014, irrespective of the outcome of the legislative process for MiFID II. EMIR provides that non-financial institutions may be exempted from the clearing obligation under certain conditions, but these conditions are tightly defined, and it is conceivable that a number of energy companies might fail to meet them. If that is the case, then these companies will be forced to clear any contracts designated as subject to the clearing obligation by the Commission. The Commission will decide which contracts are subject to this obligation following a series

of public consultations in the course of 2013. The inclusion of electricity forwards in the scope of this obligation could be catastrophic for liquidity as mandatory clearing would significantly increase trading costs in the market. As such, we would encourage Ofgem to participate in the public consultation processes in 2013 to ensure that electricity forwards remain exempt from the clearing obligation.

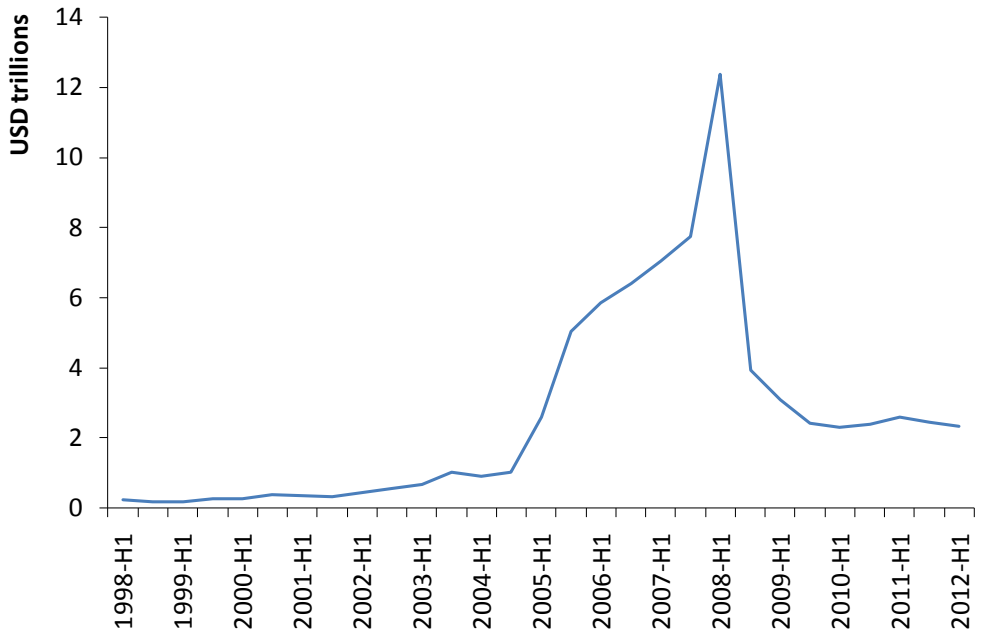
– **European Target Model: a deeper market for transmission rights might facilitate hedging in GB**. Ofgem emphasises the benefits of market coupling for liquidity in the day-ahead market. We believe that the model might also facilitate cross-border trading and hedging for longer-dated products. At the moment, the market for transmission rights is fairly illiquid, and it can be difficult to match transmission rights with forward electricity products. For example, a supplier who might be interested in buying Season+1 in France to supply consumers in GB might not be able to buy the matching transmission right on the IFA. This might become easier in the future as European energy regulators are seeking to deepen the market for transmission rights, potentially by switching to financial transmission rights, which might be easier to trade for small market participants who do not have extensive trading capabilities in the different markets concerned. Overall, we are hopeful that the European target model might expand trading opportunities for GB players along the curve, not just at the day-ahead stage.

Question 3: Are there other factors that we have not identified that may be posing a barrier to improvements in liquidity?

Yes. In our opinion, one of the most important changes happening in the GB power market at the moment is the diminishing involvement of financial counterparties. This might constrain the extent to which liquidity can be increased in the short term, and Ofgem should carefully consider the implications of this development for the liquidity agenda.

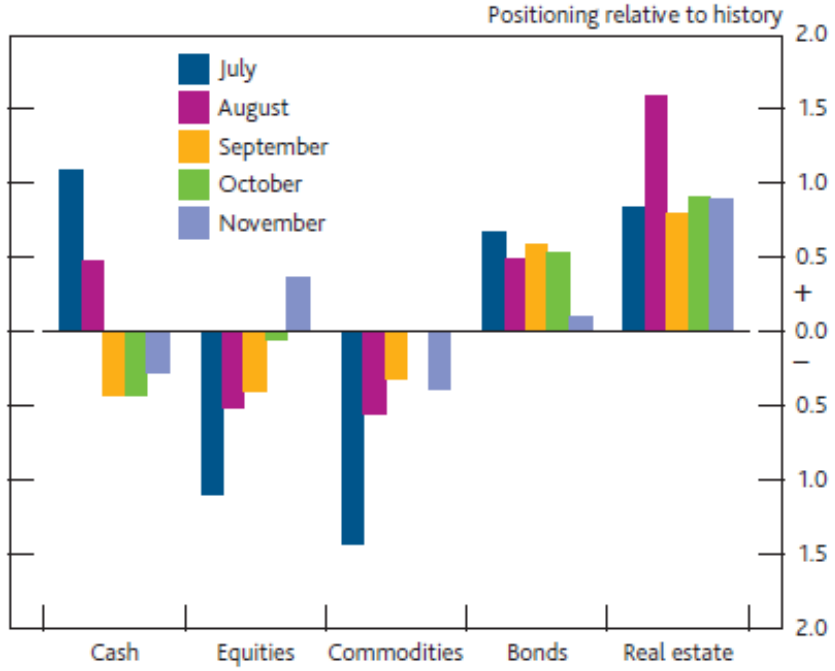
Over the past five years, financial intermediaries have become less active in the GB power markets, and a number of banks have exited the market altogether. This trend is the result of the financial crisis, which has reduced the availability of capital for trading activities, and more generally the risk appetite of financial institutions for non-core markets like commodities. This development in the GB power market is part of a more general trend affecting commodities markets globally. By way of illustration, after 2009 the overall volume of commodities derivatives traded world-wide has dropped to less than a quarter of its pre-crisis level in 2008 (Figure 2). There is also evidence that investment funds have remained significantly underweight in commodities in 2012 compared to historical positions (Figure 3).

Figure 2 Global value of commodities derivatives outstanding



Notes: shows notional amounts outstanding; includes all commodities except gold and other precious metals.
Source: BIS statistical series.

Figure 3 Global asset class positioning by investment funds

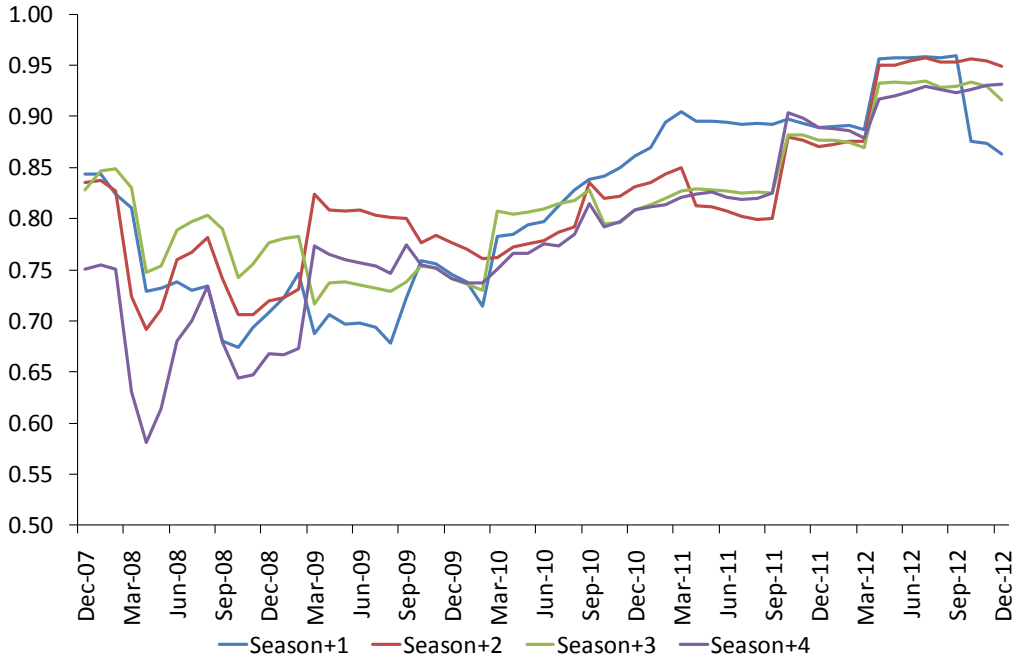


Notes: Positioning captures whether funds are overweight (positive scores) or underweight (negative scores) in each asset class relative to historical asset allocations. Historical asset allocations are based on data since 2006 for commodities and real estate and since 2001 for equities, bonds and cash.
Source: Bank of England (2012), Financial Stability Report, November.

In the UK, this trend is being compounded by the powerful link that exists between the power and gas markets. The correlation between movements in power and gas prices is extremely strong in GB: Figure 4 below shows that the correlation between gas and electricity prices

now exceeds 90% for all forward seasons. However, the gas market is much more liquid than the power market, owing to the NBP's status as a European hub. This means that any financial intermediaries interested in trading around GB energy fundamentals will naturally focus on the gas market. The incremental benefit of trading physical power is very small for such institutions. This trend helps explain why a number of independent traders have recently lost interest in the GB market as a separate opportunity to trade energy fundamentals.

Figure 4 Correlation between movement in gas and power prices



Note: the chart shows 12-monthly rolling monthly correlation coefficients of percentage changes in gas and power prices.
Source: Heren data, Centrica Energy analysis.

The diminishing involvement of financial counterparties in the GB power market probably explains a large share of the decline in churn observed since 2009 (along with the greater stability in spark spreads highlighted above). It means that the trading activity in this market focuses more narrowly on the commercial needs of generators and suppliers, rather than the speculative activities of financial intermediaries.

The implications of this change for Ofgem's work are complex. On the one hand, there is no doubt that it represents a major challenge from the point of view of improving liquidity. Put simply, it is not realistic to expect trading volumes to increase rapidly when some of the main counterparties are exiting the market. Ofgem typically presents 5- to 10-year trends in liquidity metrics, implying that pre-crisis levels represent legitimate benchmarks that the market should aspire to reach again. This approach overlooks the fundamental changes that have happened in commodities markets over the past five years.

On the other hand, the withdrawal of financial counterparties may mitigate some of the risks that have been associated with the 'financialisation' of commodities markets elsewhere. The financial crisis has led financial regulators to reconsider the consequences of high liquidity and churn in traded markets, and there is now a greater awareness of some of the potential side effects of speculative behaviours, as illustrated by the FSA's conclusions on the causes of the crisis.

> 'Belief in the benefits of liquidity in markets has been a fundamental philosophical assumption of most securities regulators, including the FSA. (…) But if liquid traded markets are inherently subject to herd/momentum effects, with the potential for irrational overshoots around rational economic levels, then optimal regulation cannot be based on the assumption that increased liquidity is always and in all markets beneficial, but must recognise that there can be tradeoffs between technical efficiency and susceptibility to irrational herd effects.' (FSA, 'The Turner Review: a regulatory response to the global banking crisis', March 2009)

We think that Ofgem should carefully consider these implications. Current levels of liquidity are broadly consistent with a market structure dominated by the physical trading of power between generators and suppliers. Some of Ofgem's proposals essentially amount to forcing energy companies to take up the role previously assumed by financial institutions, by market-making certain products or intermediating between other players. We believe that this strategy would be artificial and potentially distortive.

Question 4: Do you agree that the Secure and Promote model presented in this document could help to meet our objectives?

No. We are not convinced that this intervention will be positive for the market. Ofgem's approach is premised on two arguments: firstly, that existing commitments (with respect to trading agreements and the day-ahead auction) might be withdrawn; and secondly, that it is necessary to go beyond these commitments to improve liquidity on the curve. We do not think that these two arguments are valid.

Existing commitments will acquire a degree of inertia once in place.

Energy companies have already started to use the clearing price of the day-ahead auction as the reference price for PPAs and other structured contracts. This means that they now have an intrinsic commercial interest in preserving the robustness of that index, irrespective of Ofgem's regulatory objectives. Improved liquidity in the day-ahead auction also makes it possible to implement market coupling and develop CfDs priced on that index, and both these schemes will further reinforce liquidity in this market.

Trading agreements with small suppliers are also likely to become enduring features of the market. Energy companies are investing resources to develop these offers (in terms of systems and processes). Once these fixed costs have been incurred to respond to initial requests, the incremental cost of signing up additional parties will be relatively small. Some companies may actually be encouraged to monetize the capability they have acquired. Moreover, a number of generators are required by their licences to refrain from discriminating between market participants when selling power. If these generators were refusing to extend existing offers to other applicants they would be liable to enforcement action under their licences. We do not see how the proposed licence condition would make a difference.

Overall, we believe that market initiatives have been effective, and that the resulting benefits will be enduring. We do not see any benefits in crystallising these commitments in regulatory licences. In fact, we believe that such an approach would directly conflict with Better Regulation principles. The Regulatory Enforcement and Sanctions Act 2008 requires Ofgem to ensure that it does not impose any unnecessary burdens on companies. Ofgem's statutory duties also specify that regulatory activities should be 'targeted only at cases in which action is needed'. We do not see how a new licence obligation that would simply crystallise existing market practices would meet these requirements.

Ofgem has repeatedly stated that there would be no regulatory intervention if market-led initiatives proved sufficient to meet liquidity objectives. Implementing the Secure and

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Promote model at this stage would contradict this commitment as market-led initiatives have clearly delivered significant benefits.

Trying to crystallise these commitments into regulatory obligations could be counterproductive.

We think that Ofgem's approach could actually be counterproductive if it 'freezes' existing arrangements and discourages market participants from finding new solutions to meet the needs of small suppliers. Different small suppliers face different issues: some, who already have an established position in the market and an effective trading capability, are simply seeking to access standardised products without having to enter into multiple GTMAs; others, who are considering market entry but have not yet developed an effective trading capability, are looking for more sophisticated procurement services involving risk-management as well as power. These needs are very diverse, and they change constantly. Trying to regulate commercial interactions through licences will inevitably lead to a legalistic approach where obligated parties will focus on meeting their licence conditions as opposed to meeting the need of their counterparties. In the area of network regulation, Ofgem has undertaken a series of reforms designed to incentivise network operators to focus on the needs of their customers rather than the agenda of the regulator. We believe that the Secure and Promote model would achieve precisely the opposite effect in trading arrangements.

Moving beyond existing commitments to forcibly increase forward trading is unnecessary and distortive.

We also disagree with the second strand of Ofgem's argument, namely that it is necessary to go beyond existing commitments in order to forcibly increase forward liquidity. As explained above, we believe that the current level of liquidity is sufficient to support effective competition, and that it reflects a natural balance between the trading interests of market participants. It is likely that forward liquidity will further improve following recent developments in the spot market and greater integration with adjacent markets (see our answer to question 9).

Question 5: Does our proposed structure for Secure and Promote seem appropriate?

No. We have two important issues with Ofgem's proposed structure for the Secure and Promote condition: the focus on the six large, vertically-integrated suppliers; and the discretion available to Ofgem in governance arrangements.

The continued focus on the 'Big 6' companies is arbitrary and could be distortive

There is no evidence that the Big 6 are foreclosing the market through vertical integration, and as such imposing the obligations solely on the Big 6 companies would be completely arbitrary. If liquidity is considered to be a 'public good' which is somehow undersupplied by the market due to coordination issues (as opposed to any intentional attempts to foreclose the market), then logically the obligations should be imposed on all market participants. More concretely, by focusing on the Big 6, this proposal would leave out some very large generation units, and it is doubtful whether this approach would be the most effective in improving liquidity.

Triggering the obligation at a specific threshold instead of applying it to all participants could actually constrain competition by creating *barriers to expansion* for medium-sized companies (even if it mitigates *barriers to entry* for very small players). A small market participant might be discouraged from extending its business 'horizontally' if the threshold is defined as a market share in generation or retail. Similarly, a small market participant might be

discouraged from extending its business 'vertically' if the threshold is defined as a level of VI. For example, Drax or International Power might be dissuaded from entering the domestic supply market if the intervention is triggered at a specific level of VI.

The Big6 are not particularly well placed to meet these requirements

We would also question Ofgem's assertion that the Big6 would be able to discharge the obligations 'more cheaply and more easily' than other parties. Ofgem seems to believe that these obligations could easily be 'bolted on' the existing trading activities of the Big6, on account that these companies have 'sophisticated traded capabilities' and 'an inherent need to buy and sell volumes on a regular basis'. In reality, the trading activities of most of these companies are driven primarily by the need to hedge their physical positions, and there is no reason to think that the obligations envisaged by Ofgem would fit in well with this trading business.

For example, most Big6 companies are short of power (especially over peak periods). This means that the obligation to offer products to small suppliers would effectively require the Big6 to intermediate between independent generators and suppliers. There is no reason to think that the Big6 are particularly well placed to perform this function. Banks and trading houses, whose *core function* it is to intermediate between market counterparties, might be equally well placed. Indeed, they might have more flexible systems and a better ability to absorb market and credit risk.

If anything, Ofgem's approach runs the risk of entrenching the central position of the Big6 in the wholesale market. It might discourage the development of bilateral relationships between independent generators and suppliers, and it might 'crowd out' the services that could be offered by financial intermediaries and independent aggregators.

As a rule, we think that Ofgem should refrain from trying to pre-judge which party is best placed to perform a certain market function. The developments in the PPA market illustrate how difficult this can be. Traditionally, the perception has been that the most natural providers of PPAs were the large suppliers, owing to their large power needs and their sophisticated trading operations.[1] However, over the past two years the most successful PPA offtaker has been an independent generator seeking to monetize its trading and forecasting capability. It is not possible to predict who will be able perform certain functions most efficiently in future.

Finally, if costs are an important consideration, we would encourage Ofgem to consider whether it is efficient to require six companies to provide similar services to the market (specifically the trading agreements with small suppliers and the market-making function). This means that all six companies will need to incur the fixed costs involved in meeting these obligations, with no additional benefits for the market.

Should Ofgem still wish to intervene, it would make more sense to run competitive tenders for the relevant services (ie, an aggregation service for small suppliers and a market-making service). The competitive process would reveal who is best placed to perform these functions, and the costs of providing these services. These costs could then be recovered from all market participants on a per-MWh basis.

[1] This is the reason why DECC initially considered a new licence obligation for large suppliers to increase demand in this market.

The requirements should be more tightly defined in licences.

We are concerned that the proposed structure for Secure and Promote might create an open-ended commitment for obligated parties. This is because the terms of the licence conditions are very loosely defined (for example, the term 'fair' has no commonly accepted interpretation when applied to trading agreements), and the substance of the obligations would be contained in a 'Requirements Document' that could be changed by Ofgem without being subject to normal consultation procedures and appeal rights. Unless governance is tightly controlled, the licence modification will turn into a 'blank cheque', which imposes a significant risk on obligated parties.

A flexible governance structure would only be appropriate if we could expect modification proposals to be relatively consensual. In reality, the governance of the obligations is likely to be an inherently antagonistic process, especially if the obligations are only placed on the Big6. Non-obligated parties will have a natural interest in seeking to expand the scope of the obligations, for example by requesting specific pricing and credit terms in trading agreements, or a tighter bid-offer spread in the market making scheme. Obligated parties will have a natural incentive to resist such demands. This misalignment of interests will make it necessary for Ofgem to intervene constantly to arbitrate disputes, which will, in turn, increase the risk of regulatory 'tinkering' with the requirements. Overall, the risk that a flexible governance process imposes on obligated parties would be very significant. In our opinion, this is a further reason why Ofgem should adopt a voluntary approach to developing liquidity.

Should Ofgem still wish to intervene, we think that it would be more appropriate to specify the requirements in the licence conditions. Failing this, Ofgem should set up a tighter governance process for any requirements defined outside licence conditions. Our recommendations are that: (i) Ofgem set up a dispute resolution process with an independent arbiter; (ii) Ofgem refrain from intervening unless this dispute resolution process has failed; (iii) Any intervention by Ofgem should be subject to public consultation; and (iv) there should be clear rights of appeal for obligated parties.

Question 6: Do you think the proposed Secure and Promote model would be a more effective intervention than the Mandatory Auction?

We believe that the Secure and Promote model would be a *less distortive* form of intervention than the Mandatory Auction. However, we doubt that either would be particularly effective.

Question 7: Do you have any views on the requirements we have set out for trading commitments – in particular those points listed under "outstanding design challenges" on page 25?

We believe Ofgem should review the following items in the requirements.

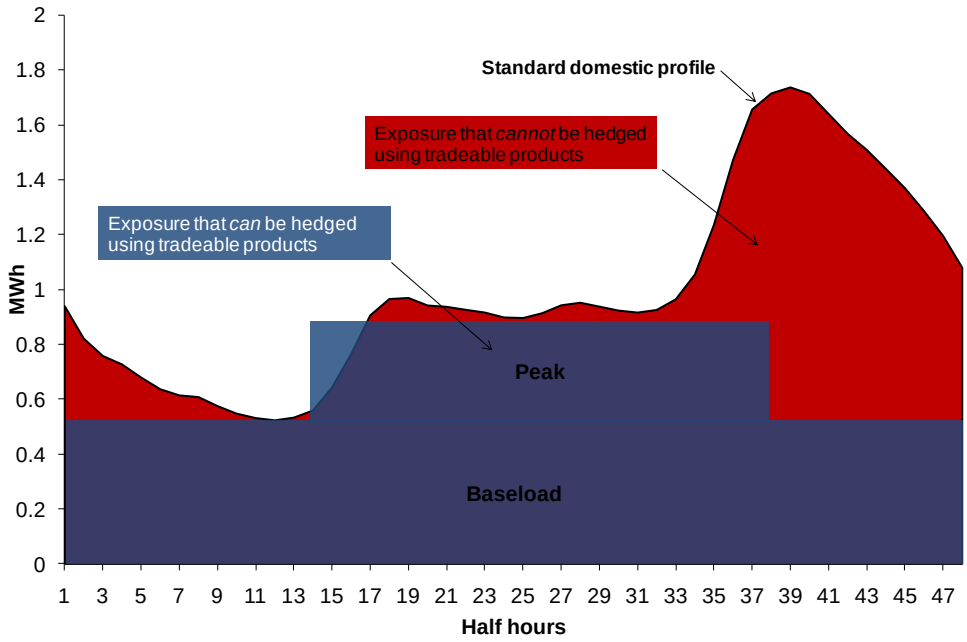
– **Credit—It is critical that Ofgem does not force obligated parties to accept weak credit**. We do not think it is possible to regulate credit terms by reference to standardised credit scores or external benchmarks. Standardised credit scores are a very imperfect proxy of the risk of default, and they certainly say nothing about the capacity of the trading counterparty to absorb credit risk. External benchmarks are equally problematic. We certainly believe that the analogy with the DNOs' credit policy suggested by Ofgem is misguided. DNOs are largely indifferent to credit risk because any credit losses due to the default of a supplier are either mutualised among system

users or recovered as a separate allowance as part of distribution price controls. Obligated parties should be able to apply their own credit policies.

– **Products—The obligation should only cover standard products (baseload and peak).** It should *not* extend to shaped products (for example based on standard domestic profiles). The provision of shaped power is, by nature, a complex, customized service that cannot be covered by a standardised trading agreement. For example, it would not be possible to apply the requirements proposed by Ofgem on fair pricing (since there is no recognised index for such products), and it might be necessary to adopt a more ad hoc approach to credit terms (since the exposure of the parties cannot be evaluated by reference to market prices). Any requests of this nature would be better addressed through customized aggregation services.

A requirement to offer shaped products would also create a very significant risk for obligated parties. A company selling a standard domestic shape over a certain period (say Season+1) could only hedge *part* of its costs by buying baseload and peak products for that period (see Figure 5 below). The other 'blocks' of power needed to match the domestic shape are typically not available until a few days before delivery. The price of these blocks is particularly volatile as they correspond to the periods when the system margin is tightest. As a result, the seller of such a shaped product would have to keep a substantial share of its position unhedged until a few days before delivery (in other words, the seller 'warehouses' the price risk associated with these blocks).

Figure 5 Risk exposure for a counterparty selling a standard domestic shape (illustration)



Source: Centrica Energy.

We also think the obligation should be limited to offering product up to season+3. The sale of season+4 might be complex for obligated parties as the product is thinly traded in the open market and the credit risk involved is particularly high. Also we are not convinced that there would be a strong demand for this product if we assume an 18-month hedging horizon for suppliers.

– **Scope—The obligation should only cover trading agreements with small suppliers.** The intervention should be targeted at the problem that has been identified, namely the difficulties faced by small suppliers in finding adequate routes to market. There is no evidence that other market participants face undue difficulties in accessing the market. Making this regulated service available to all independent players would effectively create a two-tier market where only the Big6 would trade in the 'real' wholesale market while independent generators and suppliers would trade in a segregated market facilitated by the Big6. This would simply entrench the position of the Big6 and the need for regulatory intervention.

  More concretely, it would make more sense to design this obligation to meet the needs of the parties that actually need it instead of trying to come up with a one-size-fits-all approach to trading arrangements. There is a risk that a generic obligation to offer terms would overlap with existing commercial practices (GTMAs), without the consequences being properly understood.

Question 8: Do you have any views on our proposed approach to securing existing developments in relation to day-ahead auctions – in particular those points listed under "outstanding design challenges" on page 28?

We believe that gross-bidding agreements have been a positive step forward for liquidity in the market. Improved liquidity in the N2EX auction has made it easier for market participants to buy and sell individual blocks of power at the day-ahead stage, and it has provided the market with a robust reference price for financial futures, but also for PPAs and CfDs. Should Ofgem want to crystallise these developments in a licence condition, then the requirements should essentially mirror existing practices.

It is critical that Ofgem refrains from putting any restrictions on gross-bidding arrangements. The purpose of gross-bidding is to enable generators to meet their commitments to support the day-ahead auction without interfering with their incentives to hedge positions in the forward market. For example, if a generator has sold 90% of its generation in the forward market for a given day, it can still meet its commitment by offering 30% of its capacity in the auction and 'bidding back' 20%. If this generator was prevented from placing a matching bid of 20%, then in effect it would be forced to keep 30% of its position unhedged until the day-ahead stage. This would lead to reduced liquidity in the forward market and increased risk exposure for generators.

Gross-bidding will remain necessary as long as forward trading is based on physical contracts instead of financial futures. Physical contracts are settled by the physical delivery of electricity during the contract period. This essentially means that a MWh cannot be 'sold twice': if it has been sold in the forward market, it cannot be sold again at the day ahead stage (at least not without being simultaneously bought back using gross bidding). In contrast, financial futures are settled by a financial payment corresponding to the difference between the contract price and the spot price during the contract period. Using financial futures means that a MWh *can* be 'sold twice': before delivery, generators sell financial futures to hedge their exposure; and at the day-ahead stage they sell their physical output in the auction (or the OTC market). If financial futures were used more commonly in GB, it would be possible to require market participants to trade larger volumes in the day-ahead auction without gross-bidding arrangements. As long as forward trading is based on physical contracts, gross-bidding arrangements remain necessary.

In this context, we do not see any benefits in increasing the volume obligation beyond 30% of generation. This would simply lead to increased gross-bidding in the auction without any

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additional benefits in terms of price discovery. More importantly, the auction is already sufficiently liquid to support market participants' needs. The implementation of market coupling and the development of CfDs will further improve liquidity in the spot market. We would also note that the existing 30% commitment can be challenging for marginal generators who normally sell a large share of their output *after* the day-ahead stage (ie in the intraday market or in the balancing mechanism).

However, we would encourage Ofgem to define the volume obligation more precisely. For example, it would be necessary to specify whether 'generation' includes volumes bought under PPAs or tolling agreements, and whether it includes volumes sold in the balancing mechanism or the intra-day market.

Question 9: Will trading along the curve naturally develop from the near-term market?

Yes, to some extent. We think that two changes in trading arrangements might provide the foundations for increased trading along the curve.

– **Futures trading**—We recognise that the uptake in futures trading has been limited so far. In our opinion this is partly due to the current lack of engagement of financial counterparties (see our answer to question 1). However, we continue to believe that having the near term market in place reduces barriers to entry for certain counterparties, and that they could lead to a significant improvement in liquidity when the market environment becomes more supportive.

  From the point of view of stimulating liquidity, the key advantage of financial futures over physical forwards is that they are easier to trade for European counterparties: there is no need to enter into separate trading agreements with GB counterparties (GTMAs), and no need to trade different products based on the GB calendar (the Electricity Forward Agreement, or EFA calendar). These products are also easier to trade for purely financial players because they are easier to execute operationally; for example, the counterparties trading these products do not need a 24h trading desk to manage delivery and settlement. In other words, the development of this market is reducing barriers to entry for EU trading houses and financial intermediaries wishing to trade GB power.

– **Trading calendars**—The GB physical market currently trades contracts based on the EFA calendar, while other EU markets trade contracts based on the normal (ie Gregorian) calendar. The EFA calendar has been cited as one of barriers to entry into GB by European trading houses (because of system issues and the difficulty to arbitrage between both types of contracts). Having recognised this issue, the Futures and Options Association (FOA) is now working to align GB trading arrangements with EU rules over the coming months (the market is planning to trade Summer 2014 under the normal calendar). Again, this will facilitate participation by EU counterparties in the GB market.

These changes will ultimately enable increased participation by European and financial counterparties in the GB market, which should improve liquidity along the curve. However, as explained in our answer to question 1 financial counterparties are currently facing difficulties and this means that any improvements in forward liquidity will be gradual.

Question 10: Should Ofgem intervene to ensure that robust reference prices along the curve develop?

No. Ofgem should refrain from trying to direct the trading activity of market participants. We believe that such an intervention would be unnecessary given that the current level of liquidity is sufficient to support effective competition, and trading might develop naturally along the curve.

Instead of trying to direct the behaviour of market participants, Ofgem should seek to structure their market environment so that they face the full costs and benefits of forward trading. This would ensure that market participants face natural incentives to exhaust all efficient trading opportunities in the market, and that liquidity naturally reaches its optimal level.

For example, we suspect that the current methodology for computing cashout prices may disincentivise forward trading for peak products by dampening scarcity prices. There is a possibility that suppliers may feel relatively relaxed about leaving forward peak positions unhedged because they know that if they are short during delivery, part of the cost of balancing the system will be socialised over all system users through the cashout/BSUoS rules. We would encourage Ofgem to explore this type of effects as part of the cash out review. If such distortions exist, it would seem very awkward to leave them in place while developing an additional intervention to mitigate their effects on liquidity.

The potential obligation to use central clearing under EMIR is another possible distortion that threatens to reduce forward liquidity under its optimal level. The industry has developed a set of commercial practices to deal with credit risk in the most efficient way possible. Typically, market participants agree trading lines with each other, and they only exchange collateral when trading positions exceed these limits. This effectively means that credit risk sits with market counterparties up to a certain level, and is transferred to banks and other financial institutions beyond that level (as market counterparties typically open credit lines with banks to finance margin calls). This is an efficient allocation of credit risk: financial institutions are better placed than energy companies to bear credit risk (due to a larger size, a higher level of diversification, and a better ability to manage this risk through derivatives), but their involvement is costly and therefore only make sense when credit risk exceeds a certain level. An obligation to use central clearing would force energy companies to transfer all credit risk to banks, even when it would be more efficient for them to bear this risk. This would increase the cost of trading which would, in turn, reduce liquidity.

Question 11: Is market-making the most appropriate intervention option to promote robust reference prices along the curve? What is your view on the trading obligation option that is outlined on page 34?

No. We have strong reservations about a market-making obligation.

– **Interaction with MiFID/EMIR/CRD**—our main concern is that mandatory market-making would probably trigger an obligation to clear trades under EU financial legislation, which would lead to increased costs for trading activities, and reduced liquidity in the wholesale market. The rules determining exposure to the clearing obligation broadly work as follows: companies can be exempted from the clearing obligation under EMIR if their 'speculative' trading positions (ie, the trading positions that are not entered into for hedging purposes) exceed €3bn; however, to be eligible for this exemption, companies must be considered non-financial institutions under EU law, which involves securing an exemption from MiFID.

Against that backdrop, there are at least two ways in which mandatory market-making could trigger exposure to the clearing obligation. Firstly, any trading positions developed through market-making would count towards the clearing threshold in EMIR (insofar as these positions could not be treated as a hedge for a physical position). Secondly, entering into a market-making arrangement would make it extremely difficult, if not impossible, to secure an exemption from MiFID II. The key exemption clause in MiFID II is only available to companies who can demonstrate that their trading activity is 'ancillary' to their main business, with this condition being defined in fairly restrictive terms (notably by reference to the extent to which trading is used to reduce the risk of the main business). The EU Parliament is currently proposing an amendment to this clause that would explicitly prevent market makers from using this exemption.

Moreover, exposure to MiFID would entail additional requirements (in terms of reporting and mandatory exchange trading) and exposure to the Capital Requirements Directive (CRD), which would further increase costs.

– **Risk exposure for obligated parties**—the cost of mandatory market-making would be substantial for obligated parties. These costs would fall into three categories: the cost of developing the systems needed to support the market-making function (for example, system changes might be needed to enable automatic adjustments of bid and offers in response to market developments); the costs incurred in executing trades (including brokerage fees and the cost of covering credit exposures); and the cost of managing the market risk generated by the obligation. This last item goes beyond the risk of accidental mispricing mentioned by Ofgem, and involves all actions taken to hedge and optimise the positions taken under the scheme.

  Suppose for example that there are two market-makers selling a product for £51.0/MWh and £51.5/MWh, respectively. If a buyer takes up the cheapest offer at £51.0/MWh, the seller has an open position that creates market risk. This seller may choose to hedge this position immediately by taking up the offer of the second market-maker, in which case it incurs a bid-offer spread of £0.5/MWh on the position. Alternatively, if this second offer is not available, or not sufficiently attractive, the seller might choose to leave the position open until market conditions change, in which case this increases the risk exposure of the business. So the risks created by this obligation are much more significant than the risk of accidental mispricing highlighted by Ofgem.

– **Practicalities of applying the obligation to multiple parties**—We do not understand how the obligation could be operationalised if 6 obligated parties are required to market-make the same products. This is bound to introduce complexity and cost duplications in the market.

– **Effect on liquidity**—Finally, the overall impact on liquidity remains uncertain. The obligation would use up a share of the obligated parties' credit lines and Value at Risk (VaR) limits to meet the obligation. If obligated parties cannot expand these credit lines and VaR limits, they might respond to the obligation by reducing trading volumes elsewhere. In other word, if credit and risk capital are finite resources, then the market making obligation would only displace liquidity in the market.

We would not support the **Trading Obligation** option proposed by Ofgem. We believe that trades should reflect the commercial preferences of market participants rather than regulatory requirements.

We are aware that a number of stakeholders have proposed a **Self Supply Restriction** (SSR) as an alternative approach to improving liquidity in the market. We think there might be merit in considering this option provided that:

– the requirement is imposed on all market participants (not just the Big6);

– the implementation costs are reasonable (in particular, obligated parties should not be required to have separate trading facilities for their different businesses);

– companies retain total discretion over their hedging policies (companies should not be obliged to trade a defined proportion of their volumes on certain sections of the curve).

In our opinion, a SSR would only make sense as a substitute to the Secure and Promote model. Developing a SSR in addition to the various obligations considered by Ofgem would only add costs and complexity to current trading arrangements.

Question 12: Do you have any views on the design of the market making intervention outlined in this document – in particular those points listed under "outstanding design challenges" on page 33?

We do not support the market-making obligation, but we think that the draft specifications proposed by Ofgem are broadly appropriate. From our point of view the main requirement is that companies should be free to set their bid-offer spreads as long as they are not *manifestly* trying to evade the obligation. The maximum bid-offer spread that a market-maker can apply depends on the volatility of market prices, which in turn depends on the volatility of the underlying demand and supply. This means that the external benchmarks suggested by Ofgem (eg the bid-offer spreads observed in the GB gas market or in other European markets) are essentially irrelevant.

Question 13: Do you have any views on the MA design issues discussed in this chapter?

The responses to Ofgem's public consultation indicated very limited support for the MA proposals. Out of 31 companies who responded to the consultation, only 6 supported the MA (and only 3 of the companies that did support the MA specified the MA as their first choice - the other preferred a SSR or a MMM). Importantly, the majority of independent suppliers and generators who responded to the consultation (that is, the very companies that this initiative was supposed to help) did *not* support the MA. We think that it would not make sense for Ofgem to pursue the MA option in the light of this feedback.

Question 14: Do you believe that a hub approach to pool liquidity across multiple MA platforms is a viable option?

No. We think that this approach would create additional complexity and costs.