Phil Slarks
Wholesale Markets
Ofgem
9 Millbank
London
SW1P 3GE

15 February 2013

Dear Phil,

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

EDF Energy is one of the UK's largest energy companies with activities throughout the energy chain. Our interests include nuclear, coal and gas-fired electricity generation, renewables, and energy supply to end users. We have over five million electricity and gas customer accounts in the UK, including residential and business users.

EDF Energy has support, and continues to support Ofgem in its drive to enhance liquidity through market led initiatives. We restate our view that there is not a "golden number" with respect to the appropriate level of liquidity in markets. This makes it difficult to assess the appropriateness of liquidity measures, or indeed intervention, and whether their effect on the market in question will meet Ofgem's stated objectives. We agree that benefits might accrue from increasing liquidity in forward markets, and it is for this reason that we support Ofgem in developing market-driven, rather than regulatory, initiatives which might enhance liquidity.

As highlighted in our previous consultation responses, EDF Energy supports the concept of an industry-led extension of the current day-ahead auction to enable participants to take part in week-ahead, month-ahead and season-ahead auctions etc. We remain of the opinion that auction extensions would enhance liquidity but recognise it may take market participants some time to fully exploit the opportunity. However, we are prepared to work with Ofgem and wider industry to evaluate other measures to enhance liquidity.

The consultation document develops proposals for the introduction of a mandatory market maker obligation on the six vertically integrated energy companies (Ch.4). EDF Energy does not support a mandatory market maker solution. However, we would be willing to consider arrangements for an industry-led market making option developed within a commercial and not a regulatory framework. The precise details would reflect existing and trusted market making contracts to ensure that it is credible and fair for all market participants. We believe this should be attractive proposition for Ofgem as it would have the best chance of guaranteeing the most efficient market design at least cost. Such a solution could also be introduced in a timely fashion. Ofgem should specify the products where it would like to see market making services offered as a first step. The industry could then seek to develop agreements and put in place appropriate arrangements. It should be made clear that a measure of success of a voluntary approach

EDF Energy
40 Grosvenor Place, Victoria
London SW1X 7EN
Tel +44 (0) 20 7752 2200

edfenergy.com

*EDF Energy plc.
Registered in England and Wales.
Registered No. 2366852.
Registered office: 40 Grosvenor Place, Victoria, London SW1X 7EN*

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is that market making services are offered by to all generators offering power into the market and not solely to the large vertically integrated companies.
EDF Energy does not support any form of mandatory auction with an unacceptable products requirement or a market making obligation with regulated spreads and volumes. We see the focus on the more detailed design of the proposals as the key to successfully enhancing liquidity. Any poorly designed mandatory arrangements will be costly to implement and will distort the very price signals Ofgem seeks to enhance. We believe that the following issues will artificially distort prices, and that the industry led option 2A presented in the document would solve these problems:

- **Product range -** By mandating products that we do not generate, the market will contain a number of distressed purchasers (if we want to comply) in the market with no real prospect of selling if the buy side rules work against us. Prices will thus reflect the "artificial" supply and demand conditions created by the intervention.
  Solution: We reject the idea that vertically integrated companies are a homogenous group with similar capabilities. Market participants should be incentivised to offer products consistent with their portfolio.

- **Inclusiveness -** By requiring only one part of the market to increase liquidity, only a limited number of generators will be captured. However, there are significant differences between the players in generation and supply. By not including all of them, the prices in the regulated market regime could be distorted as non-obligated generators will have increased market power for certain products that the vertically integrated companies do not generate. We also note that MiFID II captures plant over 100MW as it assumes they have the ability to influence prices.
  Solution: Include all generators over 100MW into the arrangements.

- **Bid offer spreads -** Any intervention which has an impact on bid offer spreads will, by definition, have an impact on prices. As currently drafted, the proposals do not specify a spread but rather leaves it to a comparison between players and other markets. This also creates uncertainty for compliance if energy companies are judged by standards set by other markets with fundamentally different characteristics.
  Solution: Investigative powers under competition and financial regulations should be used instead of attempting to regulate bid offer spreads.

- **Behaviours -** Prices and favourable credit terms offered to new entrants will inevitably be recovered from those obliged to offer them (regardless of their fairness) but paid for by all customers.
  Solution: Use the market mechanism to determine credit.

There are also a smaller number of substantial issues that create regulatory uncertainty and significant compliance issues. The proposed Requirements Document, which is flexible, exists independently of the terms of the licence condition which is fixed. The document can be "refined" (Figure 8, p20) but offers no right of appeal. Instead "regular discussions with stakeholders" (p20) and review after five years are proposed. There are

compliance issues with a number of key terms which need careful legal definition. These include "significant" volumes or "reasonable" credit terms. There are also a number of uncertainties associated with European financial regulation and national legislation which could make this intervention look premature. This is particularly true for the final draft of MiFID II which will have a defining impact on the development of the futures market..

Finally, we believe that it would be useful to take the opportunity presented by the development of a baseload reference price index to underpin the proposed Feed-In Tariff with Contract for Difference (CfD), as per the Government's Electricity Market Reform package. If the index is referenced, as DECC has proposed, to year-ahead power markets, CfD holders will naturally be incentivised to trade in those markets to minimise the basis risk between CfD difference payments and power market revenues. This should in itself contribute liquidity to the forward market. There is significant merit in extending the CfD reference price beyond year-ahead if there is sufficient liquidity to support it: this will help sustain liquidity further out along the curve.

Our detailed responses are set out in the attachment to this letter. Should you wish to discuss any of the issues raised in our response or have any queries, please contact Ravi Baga on 020 7752 2143, or myself.

I confirm that this letter and its attachment may be published on Ofgem's website.

Yours sincerely,

Denis Linford
Corporate Policy and Regulation Director

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Attachment

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

EDF Energy's response to your questions

CHAPTER: One

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

Liquidity has a number of drivers which are cyclical in nature, and these were highlighted in a paper which we submitted to Ofgem in December. The main factors which have had an overriding effect on liquidity are counterparty credit, counterparty risk appetite and Government-driven regulatory intervention. The various effects of these are evident from the commencement of NETA in March 2001 and continue through to today. These factors are significant in driving liquidity in the UK power market, especially further along the curve.

Therefore, the assessment of liquidity has to be benchmarked in the context of the specific characteristics of the industry's position on the liquidity cycle. Comparisons with other fuels or markets might therefore be misleading. For these reasons, EDF Energy does not agree with any blanket assertion that products are not available to support hedging.

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

EDF Energy agrees with the general description of the regulatory landscape but draws different conclusions from it. In a number of respects Ofgem needs to consider regulatory change outside of its direct control. Regulatory arrangements are one of the many drivers of liquidity. There are a number of regulatory initiatives which might positively affect near term trading which we can identify:

- The European target model encourages liquidity on the day-ahead and within-day markets to at least some extent driven by market coupling.
- The balancing review will also have an impact on generators' appetite for risk depending on the review's conclusions with respect to cash out prices. Willingness to commit large volumes in long term contracts are likely to be sensitive to any perceived cash out risk.

Furthermore, the impact of MIFID II, as discussed on page 14 of the consultation document, should be clarified in respect of market making as the final text in Annex I Section C (6) has yet to be confirmed.

In conclusion, there are some significant unresolved regulatory issues which might have an impact on the proposals but have yet to be resolved.

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

EDF Energy restates its view that:

- **credit** is still the major issue for market participants as it is intrinsically linked to trading activity. The lack of credit is therefore a key driver for the current levels of liquidity;
- **the impact of the financial crisis** and the bursting of the commodities bubble, with its subsequent impact on financial institutions' trading, should not be underestimated (but is clearly out of scope of the review);
- **the implications of slow economic** growth in depressing demand.

Taken together, these factors not only dampen the appetite for financial players in the forward market but also create adverse conditions for market entry. Understandably two of the three key drivers of liquidity are not directly tackled by the remedies but nonetheless have a significant impact on the levels of liquidity.

CHAPTER: Two

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

EDF Energy is not certain that Secure and Promote will meet Ofgem's objectives as there are some outstanding design issues that need to be resolved (questions 7 and 12). In terms of our preferences, we prefer proposals to extend the existing auctions into forward products. Once the market has had a demonstration of success (high liquidity, clustered and layered bid/offer strategies, new entry from small/independent suppliers) it can be extended to month-ahead products. We would then apply the previous criteria before extension of auction into seasons.

Table 1 Options and our reactions to them (in high level)

Option	Comment on preference
1. Secure and promote 2A	Our preferred option. It allows for: • Development of what amounts to commercially negotiated contracts is most likely to be at least cost, but the confidence that the regulator has essentially endorsed the proposed solution. • No regulatory compliance risks - contractual only. • Unlikely to distort prices as commercially negotiated. In fact, the developmental process itself could lead to confidence in prices.
2. Mandatory Market Maker	EDF energy supports the development of an industry led market making option.

	There are a number of outstanding issues that at present do not give us confidence in the mandatory aspects of the proposals. • The Mandatory Market Maker proposals need to assess the risks and costs to the market maker. • Enforced bid/offer spreads on a limited number of counterparties may skew prices. • Obligations on a wider number of counterparties that are less onerous would be preferred.
2. Obligation to Trade	The critical issue with this option is the churn rate. We are currently at x2, and it is difficult to see how this option in itself will work, even though it will certainly put prices out there to the market.
3. Mandatory Auctions	Same issues identified in covering letter that is: • Compliance risks associated with key concepts. • Costs associated with implementing the proposals. • Mandated product range which does not fit with portfolio or strategy.

In conclusion, EDF Energy believes that by mandating liquidity that is not naturally present in a market, increases the risk of distorting price signals, or even making them irrelevant in some design options.

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

There are a number of issues which need to be addressed to make the proposed structure acceptable to us.

Obligated parties

Obligated parties must include all generation over 100MW. This is consistent with the REMIT definition which assumes that these counterparties have the ability to move the market price. Exclusion of generation from the obligation will lead to asymmetries in price and poor price discovery.

Legal structure

We accept the logic of the drafting, but we are concerned about compliance risk. It will be difficult to comply with such terms as "significant" volumes or "reasonable" credit terms. Furthermore the Trading Requirements Document is highly discretionary. It can easily be

changed by Ofgem putting us in breach of the licence without the right of appeal. In any event, we could not support a licence condition without seeing the Trading Requirements Document.

Enduring Governance

As stated above, the continuous prospect of change introduces regulatory risk. The proposed consultation process to changes in the Trading Requirements Document outlined in the consultation document does not give us sufficient confidence that the industry will be able to appeal any proposed change. The annual assessment, while useful, does not tackle the fundamental risk. Furthermore, obligated parties will have to develop expensive compliance procedures to demonstrate that they are following the licence condition.

Since Ofgem will be continuously monitoring progress of its objectives, there is no guarantee they could change substantially over time creating considerable regulatory risk. This risk is exacerbated by the fact that participants do not have any visibility of a set of objective criteria (that define an ideal outcome) against which industry participants can assess progress.

Enforcement

We need to solve the design concerns that we have with this proposal, in particular the discretionary elements in the regulatory design. If we do not, compliance will almost be impossible to determine if a particular action taken by the company was a genuine attempt to support the objectives.

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

EDF Energy maintains that a long term solution to improve liquidity would be the presence of a central auction that was developed in consultation with industry from the existing arrangements. These arrangements would develop organically by extending the product range across the curve. This proposal would give the industry the ability to effectively manage risk in order to secure liquidity. However, EDF Energy recognises that Ofgem's previous auction design required review (i.e. products, timings and reverse bidding rules).

Mandated Auctions will probably increase liquidity at the expense of distorting the price signal as:

- The current design will mandate us to offer products we do not generate.
- In terms of regulatory design have concerns about regulatory creep from "Requirements Document".
- The requirement needs to include other generators.
- We need clarification on the calculation of capacity.

CHAPTER: Three

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?

EDF Energy agrees that there are significant design issues with the planned intervention and this is why we support an industry-led initiative.

Credit and collateral

We have argued that access to credit and collateral are crucial to the level of liquidity in the market. The document states that:

"Licensee must offer reasonable credit and collateral arrangements, based on a bespoke calculation in relation to each counterparty – e.g. through an independent assessment of creditworthiness." (Figure 10, p24.)

Ofgem has not presented evidence that credit terms are inherently unfair, but rather has demonstrated that credit is difficult to come by for small players. It may therefore be the case that this aspect of the licence condition will not materially change trading behaviour. In terms of developing a compliance policy, it will be difficult to assess what reasonable credit and collateral requirements are as there will be an inherent disagreement between parties. Finally, developing a new independent and regulated assessment of creditworthiness is likely to be costly, and is likely to come to the same conclusions as the existing checks.

Products

EDF Energy is always willing to discuss bespoke products but we do not see how the licence condition could address the issue as this is dependent on the demand for such products.

Scope

The trading commitments should apply to all generators offering power into the market.

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?

Impact - We believe that gross bidding has had a broadly positive effect but it has not been decisive in the further development of day-ahead auctions consistent with Ofgem's objectives. As we noted in our response to question 2, there are a number of regulatory factors that are exerting positive pressure on day-ahead liquidity. While the day-ahead auction is broadly supported by the large vertically integrated companies, key independent

generators continue to omit their volumes and flexibility from the auction. This omission of available generation has led to price gapping (i.e. a "sudden unpredictable movement in the clearing price"). Price gapping reduces confidence in the auction price, thus stifling membership of the auction and the liquidity of derivatives of the auction clearing price (current futures market). To increase the impact of the auction, Ofgem should consider a voluntary code by which owners of flexible plant commit to offering/bidding all of their output in the auction at cost reflective prices.

Platforms - We note that mandating auctions will provide the opportunity for increased revenues for auction platforms. We would therefore want to keep the competitive pressures on providers as strong as possible.

Volume - We have stated that the calculation of volume itself can be problematic given the risks associated with forecasting production.

In addition, as noted above, volume should not be measured in absolute terms. Instead, the clustering of prices about the clearing price and the efficiency of generators to place cost based bid/offer submissions should be reviewed.

CHAPTER: Four

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

There can be no conclusive evidence to confirm or support a prediction about exactly when and how liquidity will develop. However, we can say with certainty that the drivers for liquidity are not fixed but rather cyclical. Developing liquidity in the UK market will almost certainly be a slow process. In the *medium* term we find:

- The generation mix is set to change as a result of Government policy including Electricity Market Reform, environmental legislation, and European policy including the EU Emissions Trading System.
- Impact of European liberalisation opening up markets through market coupling that will enhance market liquidity
- the prospect of an economic recovery and the reversal of the credit slump that will lead to increased energy demand, and potentially an increase in the number of non-physical players entering the market.

For liquidity in the UK market, we note that markets are highly trust dependent and prefer regulatory certainty. This being the case, increased liquidity will increase incrementally as this is consistent with a prudent risk adverse policy. Intuitively, moving between a weekly to monthly trading horizon for some small players seems more likely than directly moving to season +5, one of the products originally proposed in the mandatory auction proposal (p38).

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

No. EDF Energy can demonstrate that liquidity is cyclical and driven by some important factors not considered in the consultation document and believes that these in time will change (see our response to Question 3). Furthermore, it is difficult to prescribe exactly what level of liquidity constitutes a "liquid" market as this cannot be devoid of contextual factors specific to the industry (see our response to Question 1). This is not to say that there cannot be improvements to the current levels of liquidity but we have not seen any evidence that enables Ofgem to prescribe a particular level of liquidity, especially across the forward curve where it is reasonable to expect different levels of liquidity across different forward products.

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?

Market making will increase the number of prices placed on the trading platforms. This may result in a small increase in the liquidity of the market. Market making services from a number of counterparties will significantly improve the price reporting process on which many market indices are currently based. Auctions would increase actual liquidity but will require significantly more time to implement as they are an obligation to trade.

If Ofgem chooses to proceed with an intervention, EDF Energy can support Market making so long as it is:

- Consistent with existing contracts that create Market making and so are in a form well understood by industry participants
- Is not unduly onerous on the rest of the design issues we have raised in the rest of this document (e.g. our response to Question 12)

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?

The design challenges identified by Ofgem on page 33 of the consultation document are not trivial. They could severely distort price formation, impose very high costs or create unacceptable compliance risks if developed incorrectly.

Bid offer spreads

Our central concern is focused on the potential for these proposals to regulate the bid offer spreads. The regulatory challenge can be demonstrated in the bid proposals presented in figure 12. They create unacceptable compliance risks if the volumes are not prescribed, but if they were stated in terms of target volumes Ofgem would of course distort the market.

Table 2 Bid Offer Spreads Proposals

Element	Comment
Allows significant volumes to be traded over the course of a year	• "Significant" may be very difficult or even impossible to comply with • There is no guidance as to the specification of volumes in particular what would look "acceptable" to the regulator.
Is not significantly larger than spreads posted in existing market making arrangements in GB and in other European energy markets	• It may be dangerous to lock into European spreads. We agree that they can be used as a benchmark but it is difficult to compare the UK market with prices formed, for example in a market with a pool. • We have compliance issues with what would constitute "significantly larger".
Is not significantly wider than spreads posted by other licensees	• Spreads can vary for a number of reasons. They may reflect private information or reflect market participants taking positions as, for example, the market comes under stress.

Costs

We have accurately identified the costs associated with setting up a market. However, they are of course dependent on the details of Ofgem's final decision. The impact of the proposals on participants' market behaviour as a result of the rule change is critical to its assessment but is speculative at this stage. This is inevitable given the lack of precise detail in the consultation document and our own market assessment which has an element of judgement in it.

MiFID

See our response to Question 2. The potential for market makers to fall under MiFID II will mean substantial collateral requirements for participants. While it may be difficult to state the precise amount of collateral required, it would be enough to alter a cost benefit analysis of the proposals. However, we believe that these issues will eventually be resolved. We note that this could happen within the next few months which could be very close to Ofgem's summer deadline.

In conclusion, we are not certain that Ofgem has solved the challenges mentioned in the proposals as identified above.

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CHAPTER: Five

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

We do not currently have a preference on the mandatory auction design. However, by using a simultaneous clock auction approach, success will depend on the number of available rounds and the practical experience of the level of the ascending step changes in prices and volumes. It will therefore be difficult to conduct a conclusive cost benefit analysis before implementation. We would recommend that Ofgem runs a number of simulations for industry participants in a process similar to the one used by ENTSO-G in its development of the European capacity allocation mechanism[1].

Ofgem must also bear in mind that whatever auction design is ultimately chosen, the degree to which the presence of market power is the underlying regulatory issue. If the products and volumes auction are incorrectly mandated then there is a risk that participants are either distressed sellers or buyers. This will lead to inefficient pricing signals and consequently higher end prices.

We do, however, welcome the changes to the mandated products that shorten baseload from season +5 to +4 and peak to from season +4 to season +3. As previously stated, we still have concerns over the requirement to offer peak outside of our ability to generate.

Furthermore we are pleased that Ofgem has recognised the impact of the significant regulatory uncertainty around the EU Emissions Trading Scheme on the market.

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

We support the principle of a single auction process which lends itself to a single provider which can create a concentrated pool of liquidity. In contrast, the multiple platform approach requires a hub, and this is likely to create extra costs associated with co-ordinating exchanges in comparison to a single provider. There is also the risk that by fragmenting the auctions, multiple exchanges will not benefit from economies of scale as a result of concentrating volumes of trades that a single platform can benefit from.

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February 2013

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[1] http://www.entsog.eu/public/uploads/files/publications/CAM%20Network%20Code/2012/Auction%20simulation%203%20days%20combined.pdfhttp://www.entsog.eu/public/uploads/files/publications/CAM%20Network%20Code/2012/Auction%20simulation%203%20days%20combined.pdf Accessed 12 February 2013