

E.ON's response to Ofgem's December 2012 Wholesale power market liquidity: consultation on a "Secure and Promote" licence condition

Ofgem's proposal for a Secure and Promote licence Condition, together with the two roundtable meetings, have provided helpful steps towards resolving the "liquidity issue". We trust that this response likewise provides another forward step.

In summary, a secure and promote licence condition offers a framework for a number of proposed actions, which together could secure market developments and support interventions for further goals. However, some of the actions proposed, in particular the market making obligations, could have very negative effects on affected licensees. These actions need further consideration. Also, there are other actions that potentially provide better support for Ofgem's goals, which should also be given further consideration.

Against such a background, this response is split into four sections setting out:

1. our thoughts on the aims and issues behind a Secure and Promote licence condition;
2. our thoughts on Ofgem's actual proposals;
3. additional actions, which we believe could help deliver a more effective approach; and
4. our responses to Ofgem's specific questions.

Aims and issues behind a Secure and Promote licence condition

We believe that Ofgem's overall aims behind Secure and Promote are to support the development of CfDs and small suppliers secure easier access to the wholesale market.

DECC's plans for CfDs will provide a guaranteed price for electricity generated by low carbon energy including renewables, nuclear and CCS. This should help to give confidence for new investment. We do, however, believe that the most robust reference price for settling CfDs will be the one that is set closest to the actual time of generation, i.e. the current day-ahead auctions. Other reference prices, regardless of how they are calculated, are unlikely to be as robust. We strongly urge that plans to use forward reference prices for settling CfDs are reconsidered.

Wholesale markets are generally based on the trading of large volumes. This often makes them unsuitable for players, such as small suppliers, wishing to trade small volumes. In recognition of this, Ofgem seems to be trying to develop a solution that would provide easier access to the wholesale market for small suppliers. Here six of the vertically integrated companies would be required to provide services exclusively for small suppliers. We have concerns with such an approach and believe that there are better alternatives available for supporting small generators and small suppliers, in particular through the use of a volume aggregator service.

Notwithstanding who provides the solution, Ofgem's approach to helping small suppliers seems to have two independent aspects. First, availability of clip sizes which are sufficiently small to support purchase of volumes that match supply commitments. The second surrounds overcoming limitations of capital strength, so as to permit hedging along the forward curve. The two issues are quite different and to deliver positive outcomes they need considering independently of each other.

Considering Ofgem's three objectives:

- "Availability of products that support hedging" – the present standard products do support hedging, but there is an apparent lack of demand from suppliers further out on the curve. To increase the availability of products, greater demand on behalf of suppliers is first needed.
- "Robust reference prices generated along the curve" – as explained above, there is already an appropriate and robust reference price, in the form of day-ahead auction prices, which can be used for settling all CfDs. Further, there are other market reference prices already available. Against such a background, we believe that continuation of this objective is not warranted.
- "Effective near-term market"– this objective has been achieved, there is already an effective near-term market, supported by the day-ahead auctions, although there will always be scope for ongoing improvement.

This suggests that the only objective that should be taken forward is the "availability of products that support hedging". From this, the basis of any interventions should be:

1. support for overall market trading (liquidity), which we believe should be implemented through licence obligations placed on all licensed generators and suppliers; and
2. specific support for small suppliers, which we believe should be through an industry supported volume aggregation service that is focused on meeting the specific needs of small suppliers and small generators.

These two interventions should support an improvement in liquidity, i.e. that market participants will be able to more quickly and easily buy or sell power at a price that reflects supply and demand fundamentals.

With the possible exception of market making, all of Ofgem's and our additional proposals are unlikely to have any significant positive impact on churn, or on the robustness of reference prices. This is despite the proposals helping to make products more accessible for hedging.

When considering what would be the measure of success for an introduction of a Secure and Promote licence condition, it must be related to the end customer and how they have benefited. Such a measure could be, how have levels of competition in supply to customers, relative to comparable markets, changed?

Ofgem should not be using churn in the wholesale power market as the measure of success.

Ofgem's actual proposals

A Secure and Promote licence Condition

While supporting the concept of a Secure and Promote licence condition, we have concerns with the proposed structure of the licence condition. All the obligations on the licensee should be contained within the licence, not split between the licence and a separate Trading Requirements Document.

To have maximum effect, a Secure and Promote licence condition should be in both the generation and supply licences, with the licence conditions applicable to all generation and supply licensees.

A licence requirement that the licensee must offer fair and reasonable terms when negotiating trading agreements

We support a licence obligation that prohibits discrimination in trading electricity. Such a prohibition helps to secure that all market participants offer fair and reasonable terms when negotiating trading agreements. A licence condition that required the offering of fair and reasonable terms would be too subjective.

The existing Generation Licence Condition 17, *Prohibition of Discrimination in Selling Electricity*, sets out that the licensee and its affiliates shall not sell or offer to sell electricity to any one purchaser or person seeking to become a purchaser on terms as to price, which are materially more or less favourable than those on which it sells or offers to sell electricity to comparable wholesale purchasers. This is very similar to a "requirement that the licensee must offer fair and reasonable terms when negotiating trading agreements". However, the current licence condition avoids the subjectivity of what is "fair and reasonable". Rather than introducing a subjective licence condition, consideration should be given to better use of the current Licence Condition 17.

The benefit of the current Licence Condition 17 may not be having the full effect on the market it could have. This is because it is active only for a very limited number of licensees. To secure that all licensed generators are offering fair and reasonable terms when negotiating trading agreements, Licence Condition 17 should become active for all generation licensees.

To support small generators in particular, the principles of the existing Generation Licence Condition 17 should also be incorporated in all electricity and gas supply licences, in the form of a prohibition of discrimination in purchasing electricity/gas. Here the licence condition should set out that the licensee and its affiliates must not purchase or offer to purchase electricity/gas from any one provider or person seeking to become a provider on terms as to price which

were materially more or less favourable than those on which it purchases or offers to purchase electricity/gas from comparable wholesale providers.

By having a prohibition of discrimination in trading electricity applicable to all, it could also:

- help in addressing any concerns there are that large licensees discriminate against independent generators and suppliers;
- be implemented much more quickly and at lower cost than a set of mandatory auctions; and
- introduce less risk to participants, in particular avoiding distressed trading to meet compliance obligations, than an introduction of mandatory auctions would create.

Many of the goals as to what Ofgem believes constitute fair and reasonable terms for small generators and suppliers would be better delivered through the introduction of services focused on supporting their needs, such as a volume aggregation service.

A market maker licence obligation

We have very serious concerns around the financial implications of introducing a market making obligation. Unless these concerns can be fully addressed, the financial risks are so large that a market maker licence obligation could prevent the affected licensees from continuing their business. We discuss these concerns in detail in our answer to Ofgem's Question 12.

We do, however, believe that having voluntary market making would benefit the market. There are market makers trying to establish themselves in the Great Britain power market, but are apparently not delivering what is envisaged by Ofgem. These market makers and other potential providers of this service should be approached to establish what support is needed to enable them to offer a voluntary service closer to what Ofgem envisages.

To show that a supported voluntary service was providing value to the consumer, we suggest that it would be initially set up for 3 years. It should then be reviewed to confirm that it was providing best value to the consumer and what continued support, if any, would be required for a further fixed period.

A licence condition that the licensee must buy and sell at least 30% of its generation on a day-ahead auction platform

Provided suitable arrangements with the day-ahead auction providers can be protected, we are comfortable with licensees having to buy and sell at least 30% of their generation on a day-ahead auction platform.

Through the licence obligation, the use of the platforms would be changing from the current voluntary arrangement to an obligated arrangement. This would remove the licensees' current option of not using the platforms if the terms become unacceptable. The effect would be to place the licensees in a vulnerable contractual position. To address this, the licence condition would have to provide suitable protection to licensees, should the terms of the service offered by the providers of the platforms change.

A requirement to trade a net volume (either buy or sell) on day-ahead platforms would not be appropriate. Such a requirement would either force uneconomic generation selling; or purchasing out of line with customer desires for price stability. This would risk adding additional cost to customers.

As with the other proposals, a requirement for trading minimum volumes on day-ahead auctions would be more effective if it applied to all licensed generators and suppliers.

Mandatory Auctions

We support an obligation aimed at encouraging trading along the curve, which seems to be the aim of mandatory auctions. However, there are inherent problems with mandatory auctions. Trading along the curve would be better supported through generation and supply licences having a requirement for trading, as presented in the additional actions discussed below.

In the case of small generators and suppliers, their specific needs for trading along the curve would be better served by the presence of a bespoke service, such as a volume aggregation service, rather than through a series of auctions.

Additional actions that could help in creating a more effective approach

Volume aggregation services for small generators and suppliers

We continue to believe that many of the problems faced by small generators and suppliers would be best addressed through introducing a form of volume aggregation service. Volume aggregation services for small generators and small suppliers are a proven means of securing access to the wholesale market.

The scope of volume aggregation services could be set so as to primarily help small generators and suppliers:

- better access small clip sizes;
- better access a product range targeted at their needs;
- secure products through agreed fair pricing;
- better manage the use of their credit and collateral;
- secure better responses to their trading requests; and
- secure products through an agreed level of transparency.

In both the German and Nordic markets procurement of small volumes has been addressed through the development of volume aggregating arrangements (known as "Client Clearing" in Nordpool). The actual detailed arrangements for volume aggregation vary between the two markets, and between the various arrangements within each one. However, the common model is that groups of players working with small volumes (small volume suppliers, small volume generators, small volume vertically integrated players and large consumers) coming together to aggregate their demand requirements into volume sizes that allow their aggregated needs to be met through trading in the wholesale market using standard products of standard sizes.

We understand that, although there are some players offering the services, e.g. Smartest Energy, volume aggregation services for the Great Britain power market have not developed because of a number of factors, including the higher costs associated with trying to provide such a service commercially (compared to other countries), the current lower levels of liquidity and the relatively small number of potential initial users. However, if these obstacles can be overcome, an efficient mechanism for assisting small generators and suppliers hedge will have been delivered.

We suggest that Ofgem works with potential volume aggregators to explore how the additional costs and risks surrounding the provision of volume aggregation services in Great Britain can be lowered. This should include considering levels of support (financial and trading) that the industry as a whole would have to provide to make the service economic for the provider.

Because of the current small total volumes of the small players in Great Britain, it may be that there would be initially insufficient volume to aggregate into clip sizes that could be then traded in the wholesale market, using standard products of standard sizes. Potentially this could be addressed by developing a combined volume aggregating and voluntary market making service. Here the combined operation could provide the services of a volume aggregator through a market maker prepared to tailor their offering to help small generators and suppliers. Again, this would need support (financial and trading) from the industry as a whole.

In order to show that such a service was providing value to the consumer, we suggest that it would be initially set up for 3 years. It should then be reviewed to confirm that it was providing best value to the consumer and what continued support, if any, would be required for a further fixed period.

A generation and supply licence requirement for trading

To secure larger potential volumes for hedging by independent generators and suppliers, a licence requirement could be placed on all generators and suppliers to trade minimum volumes in a calendar year.

This would not be a ban on the transfer of power between the generation and supply arms of vertically integrated firms. A complete ban could be expensive, both for the licensees, as they introduced and managed arrangements to

achieve compliance, and Ofgem, as it established and maintained teams to deliver effective enforcement.

We would therefore suggest that for any intervention, consideration is given to having the requirements that:

- 1) all licensed generators must have sold to non related parties, or have secured the sale on their behalf, a volume for delivery in a calendar year that is no less than the volume they generate in the same calendar year, disregarding any generation used for onsite consumption; and
- 2) all licensed suppliers must have procured from non related parties, or have secured the procurement on their behalf, a volume for delivery in a calendar year that is no less than they supply in the same calendar year.

Placing such a requirement on all licensed generators and licensed suppliers would provide the symmetry for a large number of willing buyers and willing sellers in each of the forums where trading would take place, while not precluding any particular contract arrangements. It would also ensure a diverse mix of buyers and sellers and trading needs.

A generation and supply licence requirement for forward trading

To support trading along the curve, all generators and suppliers could be required to have traded minimum volumes by set dates for delivery within set future periods.

We understand that some independent generators and suppliers, while wishing to see more opportunities to trade, do not want to participate in auctions. This seems to be mainly because of the costs associated with auctions; particularly for generators who already have large amounts of capital invested in their plant.

Recognising the concern, we recommend that Ofgem introduces a generation and supply licence obligation that all licensed generators and licensed electricity suppliers are required at all times to have traded, or secured such trades on their behalf, with unrelated parties an equivalent, in total, of no less than 25% of their generation (disregarding generation for onsite consumption) or 25% of supply, whichever is the greater, in the previous calendar year. The trades would be for delivery in defined periods over the forward curve. Such a licence condition should not be a requirement on different types of product, as generators have different plant portfolios and suppliers different customer profiles. We discuss this in more detail in our answer to Ofgem's Question 13.

This requirement for forward trading is similar to the alternative approach presented on page 34 of the consultation. However, it does not carry some of the risks that are within the alternative proposal.

A modification of licence conditions prohibiting cross-subsidy.

Market confidence would be strengthened if there was greater certainty that no cross-subsidy was taking place between the generation and supply businesses of vertically integrated groups.

The Electricity Generation Licence Condition 16, *Financial Information Reporting*, and the Electricity Supply, and Gas Supply Licence Conditions 19A, *Financial Information Reporting*, set out the revenues and costs of the generation and supply activities of certain licensees. With these licence conditions now becoming more established, they should be built on. This could be achieved by giving other generators and suppliers greater certainty that the generation and supply businesses of vertically integrated groups are not receiving a cross-subsidy from other parts of their organisations.

Amending the Electricity Generation Licence Condition 17A, *Prohibition of Cross-Subsidies*, and the Electricity Supply and Gas Supply Licence Conditions 19B, *Prohibition of Cross-Subsidies*, so that there is a clear and consistent prohibition of cross-subsidy between the generation and supply activities, which are within the same group, would help to deliver this.

To secure maximum benefit from these licence conditions, all vertically integrated groups need to be captured. To achieve this, and recognising the wide diversity of group structures, all licensed generators should be subject to a modified Generation Licence Condition 17A and all licensed suppliers to a modified Electricity Supply and Gas Supply Licence Conditions 19B.

A generation and supply licence reporting obligation

Market confidence and the general appetite for trading would benefit from greater transparency through corporate groups being required to report recent trading volumes in relation to their volumes of generation and supply using a standard format.

This could be achieved by generation and supply licence obligations requiring all corporate groups with generation and supply licensees to publish, on a monthly basis, monthly totals of their total generation volume (disregarding generation for onsite consumption), electricity supply volume and power trading volume.

The trading volume would be all trades with parties unrelated to the corporate group that had been entered into within the applicable month, regardless of delivery date. To preserve commercial confidentiality, the trading should only be reported as a single total of the combined buys and sells. Also, there would need to be no requirement to give details of products traded or delivery dates.

To secure the reporting was for all corporate groups, the licence obligation would have to be for both generation and supply.

Ofgem's Specific Questions

CHAPTER: One

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

We broadly agree with Ofgem's descriptions of market developments, although we disagree with the assessments.

The market already offers availability of products that support hedging. However, there is insufficient supplier demand to support effective generator hedging. Our experience in the market is that generators generally seek to hedge long-term, but are restricted by the reluctance of suppliers to hedge long-term. Suppliers' reluctance reflects customers' general reluctance to enter into long-term fixed price contracts and that domestic customers need give only 28 days notice of termination. If the intention is to support competition in supply, there should be no presumption that all suppliers wish to purchase product a long way in advance of delivery, as suppliers generally seek to mirror their customers' desire for price stability, which generally does not go beyond two years.

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

We disagree with the reasons put forward by Ofgem for the relatively low levels of liquidity in the Great Britain wholesale power market. We also disagree that the claimed benefits would transpire if higher levels of liquidity were achieved.

We believe that competitive energy supply markets have and will continue to deliver real benefits for consumers through lower bills, better service and greater choice. To underpin competition, energy wholesale markets must be fair, transparent and effective. However, we disagree with Ofgem's assertion that poor liquidity in itself can be a barrier to entry. Liquidity is an indicator of a market's ability to support efficient trading. A low level of liquidity does not form a barrier to entry, but rather acts as an indicator that barriers to entry may be present. Also, using churn as a measure, which as recognised by Ofgem is only a high level indicator of liquidity, may not be giving a true picture of how market participants are able quickly and easily to buy or sell electricity at a price that reflects supply and demand fundamentals.

The assertion that high levels of liquidity in a wholesale market will translate to higher levels of competition within supply markets is not supported by data for the Great Britain domestic gas market. As Ofgem has previously found, churn in the Great Britain wholesale power market is low in comparison to the Great Britain wholesale gas market. However, the level of competitiveness, as measured by the Herfindahl index (see Table 1 below), shows that the domestic gas supply market is far less competitive than the domestic electricity supply market. The picture is similar for non domestic supply markets. This suggests that simply forcing the wholesale power market to be more liquid, as measured

by the level of churn, will not necessarily filter through to make the supply market more competitive.

Table 1 Herfindahl index for Great Britain electricity and gas supply

	Electricity	Gas
Domestic supply by customer numbers	1728	2304
Domestic supply by volume	1791	2422
Non domestic supply by contract numbers	1706	3029
Non domestic supply by volume	1338	1038

Values derived by E.ON using Q4 2012 market shares provided by Cornwall Energy

The low level of churn in the Great Britain wholesale power market, as compared to the Great Britain wholesale gas market, may be due in part to two particular aspects. These are the relative lack of interconnection of the Great Britain power market and the dependency of the Great Britain generation market on the Great Britain gas market. It also has to be recognised that the Great Britain wholesale gas market's NBP is the hub for European gas trading and so inherently has a high liquidity level, whereas in electricity it is the German power market that is the hub for Europe's electricity trading, not the Great Britain wholesale power market. We would suggest that there can only be one hub for electricity and one hub for gas in Europe.

Interconnection with wider markets

As explained above, the Great Britain wholesale gas market acts as an international hub for the purchase and sale of gas. This is partially due to its excellent connections to the continent. The three major pipelines and three major LNG terminals allow around 50% of Great Britain's consumption of gas to enter and exit the market from around the world. By contrast, the connectivity of the Great Britain electricity system with the continent is highly constrained to two links resulting in maximum of less than 10% of the British Isles' electricity being imported and exported.

The German and Nordic wholesale power markets also have higher levels of churn compared to the Great Britain wholesale power market. However, they both operate with higher degrees of interconnection with other markets.

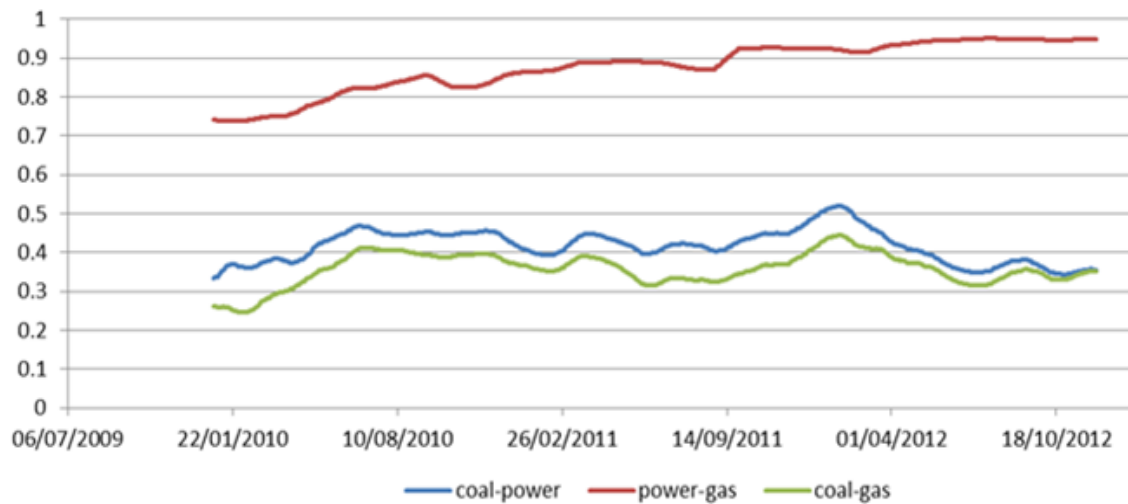
These facts suggest that the lack of interconnectivity is a major reason for the relatively low levels of liquidity, as measured by levels of churn, seen in the Great Britain wholesale power market.

Dependency of the Great Britain generation market on the Great Britain gas market

The large proportion of gas fired generation competing in the Great Britain wholesale power market has resulted in a very close correlation between

wholesale gas prices and wholesale power prices, as shown in Figure 1 below. The correlation is much closer than with coal or between coal and gas.

Figure 1 Price correlations between energy sources



Source E.ON using the front quarter prices

With electricity's dependency on the gas market and the greater liquidity established in gas, for many traders gas is the more attractive market to operate in, at the consequential expense of power. Consequently, while power prices remain dependent upon gas prices, churn in the wholesale power market should be expected to remain lower than other power markets. This includes those also having limited levels of interconnection, but who are not as dependent upon an associated gas market.

Other barriers to entry

Because of the large financial commitments being entered into in both the power and gas wholesale markets, they each require participants to have established financial strength and scale. These two factors are probably the largest barriers to entry for potential new supply entrants in both markets, not the factors causing relatively low levels of churn in the wholesale power market.

A further restriction, which is probably having a more adverse effect on the general willingness to trade forward products, than would normally be seen, is the current uncertainty surrounding future legislation and industry developments surrounding the wholesale power market.

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

There are other factors that Ofgem has not identified, which are probably posing a barrier to improvements in liquidity.

As explained in our answer to Question 2, the physical characteristics of generation, transmission and interconnection impact on the wholesale power market. The nature of these characteristics means that liquidity, as measured by levels of churn, in the Great Britain power market will often be lower than in the Great Britain gas market and the highly interconnected power markets, such as Germany.

When compared to the German and Nordic power markets, the Great Britain power market does not have established volume aggregation services. Removal of this difference, through support for volume aggregation, or similar services, could remove one of the smaller barriers to improving liquidity.

CHAPTER: Two

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

A modified form of the Secure and Promote model presented by Ofgem could help in addressing concerns over the procurement of power by suppliers and, probably more importantly, help generators in their hedging.

Extending the model to address generators' concerns over the selling of power should provide an improvement in liquidity, when measured by how market participants are able quickly and easily to buy or sell electricity at a price that reflects supply and demand fundamentals. Also, to have maximum effect, the licence obligation should apply to all generation and supply licensees.

As discussed in our answer to Question 2, the proposal offers little to support market churn and so is unlikely to have any noticeable positive effect on the robustness of reference prices.

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

The proposed structure for Secure and Promote is not appropriate.

Our main concern with the proposed structure is that the actual obligations would appear to sit in a Trading Requirements Document, which could change at any time with no protection for the licensee. Such an arrangement is tantamount to requiring the licensee to sign a set of blank cheques to the Authority for it then to complete as and when it so desires.

The Trading Requirements Document would not be setting reporting requirements, but potentially fundamental changes to the way licensees can conduct their business and their ability to continue as a generator. Such potentially fundamental changes to how licensed generators operate in Great Britain must be in the actual licence.

To have maximum effect, the licence obligation should apply to all generation and supply licensees. However, if the licence obligation were only to apply to certain licensed generators, then the criteria for when it applies, and when it does not apply, must be clearly set out in the licence condition. To simply pick on six organisations, regardless of their current size, would seem to be discriminatory.

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

A modified form of the proposed Secure and Promote model could be a more effective intervention than the Mandatory Auction. However, as currently proposed, both interventions have flaws that would prevent them from becoming effective.

Both the proposed Secure and Promote and Mandatory Auction models, as currently drafted, appear to be offering similar solutions to support overall market trading (liquidity) and the specific needs of small generators and suppliers. They both place certain licensees under a mandatory obligation to provide specified products in specified ways to the market, and in particular to small suppliers. The current drafting of both proposals carry significant risks and costs for the parties having to provide these services.

We have a number of concerns with the current drafting of Secure and Promote, in particular market making obligations for certain generators. This obligation could make it too expensive for these licensees to continue their operations, which would prevent the licence condition from ever becoming effective. However, the Secure and Promote model has the potential that in a modified form it could provide an effective intervention for supporting overall market trading (liquidity) and the specific needs of small generators and suppliers.

Mandatory Auctions, while not carrying the very high risks that the Secure and Promote licence condition currently carries, does still carry significant risks for those obligated to provide services under it and contravenes the basic principle for successful auctions, namely the need for willing buyers and willing sellers. Unlike Secure and Promote, it does not offer the scope for development to the point where it could become an effective intervention model for supporting overall market trading (liquidity) and the specific needs of small generators and suppliers.

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?*

Ofgem lists three design challenges on page 25; credit and collateral, products and scope.

Credit and Collateral

Credit and collateral arrangements are a key issue for any organisation seeking to trade, whatever the market. This is a complex area where, in a competitive market, organisations must be able to pursue the particular approach, which is best for their risk management.

While we support any requirement that a licensee must offer reasonable credit and collateral arrangements, based on a bespoke calculation for each of the counterparties, the requirements must not compromise an organisation's ability to manage its financial risk. In a competitive market, licensees must not be placed under an obligation to pass assessment of counterparties' credit worthiness over to a third party, or be placed in a position where they cannot maintain their own credit risk appetite. This is against a background that the electricity market has seen many credit failures of both small (e.g. Biz Energy and E4B) and large (e.g. Enron and TXU) companies. Consequently, there is a natural focus on credit risk. It would be inappropriate to now oblige companies to accept credit risks they do not believe to be acceptable, irrespective of the company size.

Ofgem does give an example of independent assessment of the creditworthiness of participants without a credit rating being used by electricity distribution companies. However, a distribution company is a regulated monopoly business that can guarantee its long-term income if a customer defaults. A distribution company is not a generation licensee with a small market share operating in a competitive market with no recompense if a direct trading party defaults. Consequently, such assessments cannot be given any role in determining creditworthiness for the sale of wholesale power in a competitive market.

Volume aggregation services and similar services could help address credit and collateral issues. They would help small players to more efficiently use their limited financial resources, by allowing them to concentrate their credit capital risk with a single counterparty, their service provider. Also, such services, if supported by the rest of the industry, would be better placed than generators and suppliers to offer reasonable credit and collateral arrangements, based on a bespoke calculation for counterparties through an independent assessment.

Products

Current forward hedging is predominantly based on baseload, with some peak. A licence obligation to offer a range of standard products in baseload from week-ahead to Season+4 and peak from week-ahead to Season+3 would be logical for a Secure and Promote licence condition, provided the minimum clip sizes were of sufficient size to support economic trading.

If the requirement is for products to be tailored for the needs of small generators and suppliers, then such offerings should be through a volume aggregation service, or similar arrangement.

Scope

Trading commitments should generally apply to all dealings in the wholesale market and be applicable to all generation and supply licensees. Targeting support just at independent suppliers would be discriminatory, particularly against small independent generators.

Considering the elements in Ofgem's Figure 10: *Illustrative requirements for ensuring fair and responsible terms for trading*; (clip sizes, product range, fair pricing, credit and collateral, response to trading requests and transparency) these are all activities that could benefit all market participants. As these elements could benefit all market participants they should apply to all dealings in the wholesale market.

If the purpose is to provide specific support for small generators and suppliers, then this would be better delivered through a specific service such as a volume aggregation service. Having a number of licensees each providing special services for small generators and suppliers would be an inefficient use of resources.

Vertically integrated companies are no better placed to provide the requirements listed in Ofgem's Figure 10 than any other large generator or large supplier and significantly less well placed compared with volume aggregators.

Considering the specifics for three of the elements in Ofgem's Figure 10:

Clip Size – while we can accommodate clip sizes as small as 0.1MW in an auction, for an OTC trade to be economic we would be looking for at least 10MW. A supported volume aggregator specialising in small clip sizes would be much better placed for offering to trade a range of 0.1MW clip sizes.

Fair Pricing- we would only be able to trade at market price if we had plant with costs below market price. If we did not have such plant, then we would have to purchase from the market. The price we would then need to offer would be the market price plus a charge to cover our administrative costs and a fair margin. Further, it is difficult to see how quotes can be based on a recognised market index, or reported against it, as suggested in Ofgem's appendix 4. The index is an historical record of prices, not the current price. At best, prices have to be the price paid on the market plus the commission.

Response to trading requests - our trading systems are designed for efficient trading of large volumes in a wholesale market, not relatively small retail volumes. If there was a dedicated volume aggregation service, it could be set up to focus on responding to requests for small volumes.

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 generally support Ofgem’s approach to securing existing developments in relation to day-ahead auctions. However there are a couple of concerns that would need addressing; namely the licensee’s vulnerability to its compliance being dependent upon third parties and the ongoing uncertainty of required minimum volumes for day-ahead trading.

Through the licence obligation, the use of the day-ahead platforms would be changing from the current voluntary arrangement to an obligated arrangement. This would remove the licensees’ current option of not using the platforms if the terms become unacceptable. The effect would be to place the licensees in a vulnerable contractual position. To address this change, the licence condition would have to provide suitable protection to licensees, should the terms of the service offered by the providers of the day-ahead auctions change.

The percentage to be traded on the day-ahead platforms set by this obligation could be subject to ongoing review. To protect the licensees from excessive volume obligations, the percentage must be set out in the licence, not a Trading Requirements Document, with the licence clearly setting how any changes to this requirement would be managed.

In addition, any obligation to trade net rather than gross volumes would risk distorting the market. An obligation needs to support generation being sold on the basis of economic dispatch and supply purchasing to back customer needs. Obligations to trade volumes at given points, including day-ahead, risk diluting this. Therefore, the minimum volumes set for the day-ahead auction need to be limited.

Extending this trading requirement to all generators and suppliers would help to increase the total volume traded day-ahead and so further increase the robustness of the day-ahead reference price, without adversely affecting trading on the forward curve.

CHAPTER: Four

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

Trading along the curve should naturally develop from the near-term market out to Season+3. Beyond Season+3 trading is unlikely to develop above current levels.

As we explained in our response to Ofgem’s February 2012 consultation, “*Retail Market Review, intervention to enhance liquidity in the GB power market*”, the developments over the last few years mean that towards the end of this year Ofgem’s objectives covering the period out to Season+3 will have been delivered. This should set the foundations for trading along the curve to

naturally develop from the near-term market. Nevertheless, given all of the factors present, in particular the restriction on physical interconnection to other competitive power markets, the dependency on gas, regulatory uncertainty and suppliers' customers generally being reluctant to sign long-term fixed price contracts, it is difficult to see many suppliers wishing to procure large volumes of product beyond Season+3. Without a realistic supplier demand, trading beyond Season+3, as with many other European power markets, is likely to remain thin, or even become thinner.

It should also be recognised that, in most wholesale markets, trading gets thinner along the curve. Also, with the forecast increase in the use of long-term CfDs, trading along the curve is likely to reduce from current levels.

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

We do not believe there is a need for more robust reference prices. The current day-ahead auction provides a robust reference price, which can be used for the settlement of all CfDs. With the need for robust reference prices addressed, Ofgem should not be intervening in an attempt to secure that more robust reference prices along the curve develop.

There is the view that, in order to participate effectively in the wholesale market, market participants need confidence that prices in the market reflect underlying supply and demand conditions. To achieve this there is a need for forward reference prices. This has been recognised with the market already providing such information; for example, Trayport shows live prices that can actually be traded. With this requirement addressed it is questionable if an intervention to create another set of reference prices along the curve can be justified.

As explained in our answer to Question 9, it is difficult to see suppliers wishing to procure large volumes of product beyond Season+3. In this situation, while an intervention could produce a reference price, it is very doubtful if it could ensure more robust reference prices further along the curve than currently exist. Interventions that went beyond what the industry has already established and did not reflect market sentiment would be counter to Ofgem's stated aim of locking in the positive industry-led initiatives it has seen. Also, the lack of supplier demand for long-term contracts would not form a robust basis for potentially pushing for further progress in this area.

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?*

While we do not believe there is a need for more robust reference prices along the curve, voluntary market-making may be one of the most appropriate ways of supporting small generators' and suppliers' hedging activities. However, unless a very robust exemption for licensees can be secured from Financial

Regulation, an intervention that imposes a market-making obligation on licensees is totally unacceptable.

We believe that, for most generation licensees, the regulations make market making possible only if the activity is carried out on a small scale. Also, going forward, with MiFID II and related European financial regulations, the cost implications could be prohibitive for most generation licensees to undertake market making. This is discussed further in our answer to Question 12 below.

Notwithstanding our concerns about the cost of a market making obligation; Ofgem's proposals in Figure 12: *Illustrative requirements for a market maker* of the consultation, do address a number of the concerns we raised in response to Ofgem's February 2012 consultation. Removing the requirement to trade specified volumes is particularly welcome. However, further refinement, particularly in relation to bid-offer spreads, would be needed before implementation.

The concept of the alternative approach, as outlined on page 34 of the consultation, is very similar to the generation and supply licence requirement for trading, which we discuss in more detail in our answer to Question 13 below. In a modified form the alternative approach offers an attractive alternative to Mandatory Auction. However, as currently presented, it seems to be requiring a large number of small trading windows, each with relatively high obligated volumes. Ofgem correctly identified that this risks creating distressed buyers and sellers. The approach would also result in generators having to procure products, which they were not able to generate themselves, to achieve compliance.

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?*

Unless a very robust exemption for licensees can be secured from Financial Regulation, an intervention that imposes a market making obligation is totally unacceptable.

Market making, as noted on page 33 of the consultation paper, raises the potential risks associated with financial regulation (MiFID, MiFID II, EMIR and CRD IV). We believe that the potential cost and risk posed by being captured under these financial regulations would be prohibitively large for physical asset based companies, such as electricity generators.

To explain our concerns, in its Figure 12 Ofgem describes its proposal for mandatory market making as:

"The licensee is required to market make on any standard, commonly used GB power trading platform"

"The licensee must post bids and offer prices in the following products (either financial or physical)"

"The licensee must post prices for more than 50% of the market opening time in any given calendar month."

"If requested, the licensee must be willing to trade at quoted prices."

"At any particular quoted bid or offer price, licensee must be willing to trade up to 10MW."

It should also be noted that one of the reasons given for introducing mandatory market making is to support market liquidity.

The FSA defines market making activities¹ as being;

"Under Article 2(1)(k) the definition of 'market-making activities' are the activities of an investment firm, a credit institution, a third-country entity, or a firm as referred to in point (l) of Article 2(1) of Directive 2004/39/EC2 (MiFID), which is a member of a trading venue or of a market in a third country, the legal and supervisory framework of which has been declared equivalent by the Commission pursuant to Article 17(2) where it deals as principal in a financial instrument, whether traded on or outside a trading venue, in any of the following capacities:

- i. by posting firm, simultaneous two-way quotes of comparable size and at competitive prices, with the result of providing liquidity on a regular and ongoing basis to the market;*
- ii. as part of its usual business, by fulfilling orders initiated by clients or in response to clients' requests to trade; or*
- iii. by hedging positions arising from the fulfilment of tasks under points (i) and (ii)."*

This definition appears to be a near perfect match with Ofgem's proposal.

We also note that the FSA has also previously stated that trades in physical power products could, under certain circumstance, be considered to be a 'Financial product', namely;

*"We think that GTMA bilateral forward trades can amount to futures within the RAO, if they are entered into for investment purposes. This view applies an interpretation of the threshold requirement in article 84 of the RAO for a contract for the sale of a commodity or other property that is based on the economic effect of these trades."*²

This leads us to conclude that a licensee or affiliate undertaking market making, as currently envisaged by Ofgem, will need to hold an FSA Authorisation (or local equivalent).

Holding an FSA Authorisation (or local equivalent) and undertaking market making activity would probably mean that the licensee or affiliate would be subject to the Capital Adequacy Directive (CAD) and the Capital Requirements Directive (CRD). These two directives require authorised entities to hold

¹ FSA Document "The UK notification process for market-making activities and primary market operations" September 2012

² FSA Regulatory Regime for Energy Market Participants Oct 2001

sufficient capital (normally in the form of cash) to cover some or all of their trading activities. We assume that the margin requirement would be as per other markets, the difference between actual transacted values of a company's traded position and the value of its traded position at the relevant margin index price (e.g. the day ahead auctions). A very simplified example of potential costs would be:

A licensee or affiliate has established a 'traded' position of 1TWh, which equates to having sold around 40MW baseload for the next three years. The average price of the transactions has been £45/MWh, giving a net position of £45m. Depending upon the margin calculation used by the exchange, this will result in an 'initial margin' requirement, the posting of capital by the licensee, to mainly reflect the level of risk if it goes into default before delivery of the contracts.

While 'initial margin' requirement is a known cost, the 'variation margin' is not. Considering the very simplified example further:

If the margin index price moves from the average transaction price of £45/MWh to £50/MWh, then the additional 'variation margin' requirement has to be met. If the licensee's average position valuation was 10% then its additional 'variation margin' requirement for that day would be 10% of £5 x 1 million MWh = £500,000. If on the next day the margin index price increases to £55/MWh, the additional margin requirement for that day would rise to 10% of £10 x 1 million MWh = £1million.

In this simplified example, on day one the company would have had to post an additional £500,000 of its capital, with a further £500,000 on the second day. As the relevant margin index price is a function of the market and has no upper limit, the licensee is exposed to an unknown capital requirement, over which it has little control, other than limiting the level of its traded position. This capital, which is being used to meet margin requirements, cannot be used elsewhere. Such changes in the use of capital carry a potentially large negative impact on the Capex and Opex position of the licensee, its affiliates and its parent company.

Holding an FSA Authorisation (or local equivalent) may also expose the licensee, affiliate and parent company to full impact of the EMIR regulations. If it does; the licensee, its affiliates and parent company will be required to mandatorily clear and then margin all OTC transactions in the EU, in all relevant commodities (electricity, gas, emissions, coal, oil, currency/foreign exchange, etc.). For large organisations, such as E.ON, much greater daily margin requirements than the simplified example above would be expected. This would have profound implications for the operation of such organisations.

We believe that the difficulty of securing a robust exemption is reflected in the financial legislation coming into force, which does not appear to currently provide a basis under which Ofgem, as an energy regulator, can give exemptions. There is possibly some limited scope for the Financial Service Authority (FSA) to give an exemption. If correct, then Ofgem would need to

work with the FSA to secure the exemptions before introducing the licence condition.

Even if all the financial implications can be addressed, if a market making obligation became part of the generation licence, then maintenance of a generation licence would become dependent on the licensee securing a FSA authorisation. We are not aware that FSA authorisation has ever been seen as a prerequisite for being fit to operate a power station.

While we do have significant concerns over obligated market making, we do recognise the benefits that market making can bring. There are market makers apparently trying to establish themselves in the power market, but it seems that they are currently unable to deliver what is envisaged by Ofgem. These market makers and other potential providers of this service should be approached to establish what support is required for them to offer a service closer to what Ofgem envisages. These parties may also be interested in combining market making with volume aggregation, which could reduce the overall cost to the industry and its customers of supporting the two services.

CHAPTER: Five

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

A series of mandatory auctions along the curve is unlikely to be the best solution for promoting forward trading.

We understand that some independent generators and suppliers, while wishing to see more opportunities to trade, do not wish to participate in auctions. This is mainly due to costs associated with auctions; particularly for generators who already have large amounts of capital invested in their plant. If these market participants do not want to use auctions designed to help them, then the purpose of mandatory auctions becomes questionable. Unless the auctions can be made suitable for all to participate, then mandatory auctions should not be introduced and an alternative sought. Also, by removing product from the voluntary market mechanisms, the introduction of mandatory auctions could have a detrimental effect on market liquidity.

We believe that the objectives behind mandatory auctions along the curve (to support access to products for hedging by small generators and suppliers) would be better served through Ofgem introducing a generation and supply licence requirement that all licensed generators and licensed electricity suppliers have to trade with unrelated parties, or secure such trades on their behalf, an equivalent in total of no less than 25% of their generation or supply, whichever is the greater, over the forward curve. There should not be a requirement on different types of product, as generators have different plant portfolios and suppliers different customer profiles. Table 3 below provides a suggested obligation level for trading along the curve.

Table 3 Possible product list for a forward trading obligation

Product	Obligation to have traded a cumulative minimum total volume by the end of the product period
Month +1	25% of the greater of actual generation & supply in Month minus 11
Month +2	22% of the greater of actual generation and supply in Month minus 10
Quarter+1	20% of the greater of actual generation and supply in Quarter minus 3
Season+1	14% of the greater of actual generation and supply in Season minus 1
Season+2	9% of the greater of actual generation and supply in Season minus 2
Season+3	4% of the greater of actual generation and supply in Season minus 1

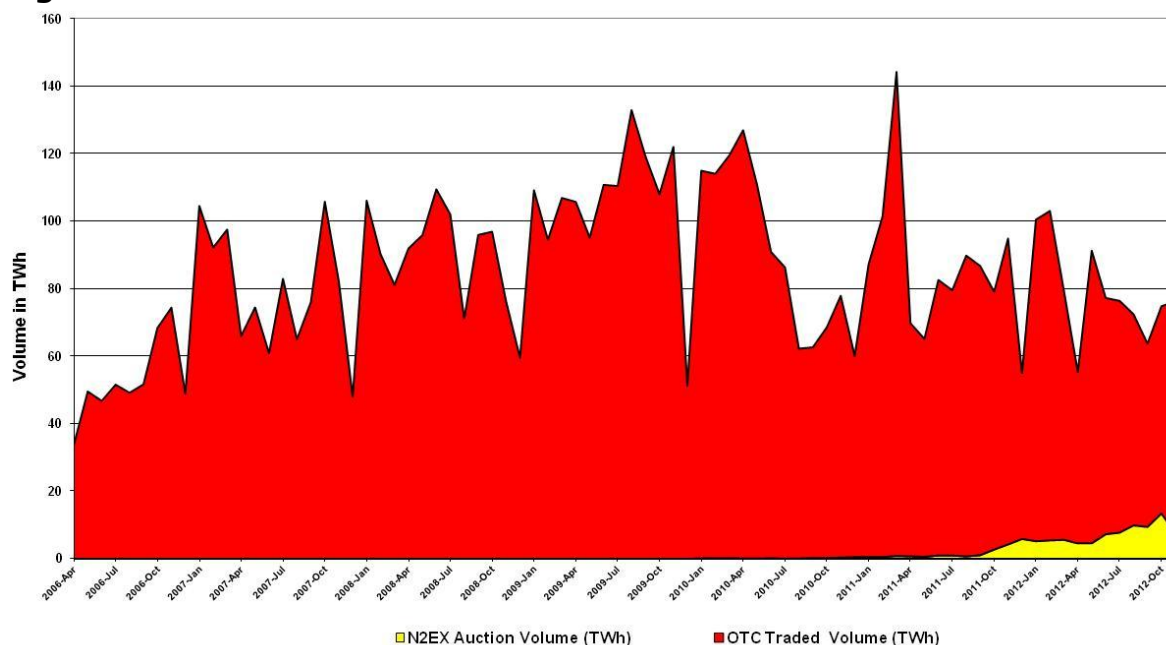
Recognising that forecast supply and generation volumes could be lower relative to the reference season, licensees would need to be able to change their targets after first informing Ofgem of the reason. Reasons for notifying Ofgem that the targets were to be amended from those in the Table 3 could be, but are not limited to:

- Generation: maintenance; asset closure/opening; changes in generation economics;
- Supply: extreme seasonality impacting demand; a significant change in portfolio size due to customer churn; a change in customer behaviour in seeking long-term fixed prices; and
- Uncertainty over future regulation: an example is the Carbon Floor Price beyond March 2015, currently Season +5, where the commitment to purchase for this period and beyond would have to be suspended until greater clarity is available.

Obviously such adjustments would have to be subject to an audit trail.

By having such an obligation it would not limit the route to market. Also, it would not have small trading windows and, consequently, the risk of distressed buying and selling just to meet compliance requirements, which would be the case with the alternative approach presented on page 34 of the consultation. It would provide a clear incentive to trade further out on the curve than the obligations required, so as to avoid distressed end of product period trading. It would also allow licensees, or the parties acting on their behalf, the freedom to better use the most economic route to market for them and their load shape, when compared with mandatory auctions. This would then help to overcome the problem that auctions do not appear to improve the overall level of trading and thus liquidity, as measured by the level of churn. The introduction of the N2EX day-ahead auction, as shown in Figure 2 below, is an example of where auctions have not increased overall levels of churn.

Figure 2 Great Britain Power Market Traded Volumes OTC and N2EX



Source E.ON

Such a requirement for trading should be much quicker to implement than a requirement for mandatory auctions. Also, the development costs and ongoing running costs should also be much lower and the licensees are not dependent on third parties, such as the platform providers, that are not subject to the same licence obligations.

For small generators and suppliers the availability of volume aggregation, or similar services may be more appropriate than mandatory auctions and provide an efficient means of complying with a general generation and supply licence requirement for trading.

If there are to be mandatory auctions, then all licensed generators and suppliers should have an obligation to participate. This would help to address the problem that generators struggle to trade forward, because suppliers do not have the need to trade forward. Thus, for the auctions to succeed, all suppliers need to be obligated to participate.

Notwithstanding our concerns with mandatory auctions, any participation in a mandatory auction should be based on posting a given volume of bids and offers for the auctions' different products. It should not be an obligation to secure the sale or purchase of products equivalent to a given volume. Having to secure a minimum volume of sales and purchases could result in distressed buying and selling just to meet compliance requirements.

The detail presented in Ofgem's *Appendix 3 – MA further design work: buy-side rules and auction mechanism*, does largely address the concerns we expressed in 2012 with regard to the buy-side rules. Also, the amended proposals for product better reflect the market's needs than before.

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

If mandatory auctions have to be introduced, then they should be on a single platform.

The concept of developing several mandatory auction platforms to feed a single mandatory auction platform hub seems to be overly complex and wasteful. We therefore remain of the opinion that if mandatory auctions have to be introduced, then they should be on a single platform.