Response to Wholesale Market Liquidity: Consultation on a '''Secure and Promote''' licence condition

(I) About GDF Suez Energy International

GDF SUEZ Energy International (formerly known as International Power) is responsible for GDF SUEZ's energy activities in 30 countries across six regions worldwide (Latin America, North America, the Middle East, Turkey & Africa, UK-Europe, Asia, and Australia). Together with power generation, we are also active in closely linked businesses including downstream LNG, gas distribution, desalination and retail. GDF SUEZ Energy International has a strong presence in its markets with 77 GW gross capacity in operation and a significant programme of 10 GW gross capacity of projects under construction as at 30 June 2012.

The UK-Europe region (GDF SUEZ Energy UK-Europe) has 13.9 GW gross capacity in operation, which includes over 7 GW of plant (5.1GW net) in the UK market made up of a mixed portfolio of assets – coal, gas, CHP, wind, a large open cycle diesel plant, and the UK's foremost pumped storage facility. Several of these assets are owned and operated in partnership with Mitsui & Co. Ltd. The company also has a retail supply business and a significant gas supply business in the UK, both serving the Industrial and Commercial sector.

This response is sent on behalf of GDF SUEZ Energy UK-Europe (referred to in this response as GDF SUEZ).

(II) Key points

- **GDF SUEZ supports the general thrust of the ''Secure and Promote'' licence condition and sees it as a significant improvement on the Mandatory Auction proposals that were put forward in May 2102. Requiring obligated parties to offer fair and reasonable terms in trading agreements will set a baseline for trading. Making gross bidding a licensable activity will ensure the continuation of this welcome market development.**

- **GDF SUEZ also believes that market-making is the most appropriate intervention to help create robust reference prices, improve market access and encourage some new market participants that will bring with them new liquidity. Market making is a tried and tested approach in many markets around the world. However, an obligation on all of the big 6 might not be the most efficient solution. We have outlined an alternative approach for a tendered market maker in Appendix 1.**

- **Other options proposed require existing players to trade more. Whilst action to force this may increase overall volumes, GDF SUEZ believes that forcing players to trade more volume than they feel is optimal to hedge their physical positions has the potential to distort the fundamental supply and demand dynamics of the market. It may not lead to the creation of robust reference prices as it creates 'false liquidity'. Rather than forcing existing players to do more, liquidity could be better improved if new players were encouraged into the market, in particular financial players.**

- **The market has taken steps to try to encourage new entrants through the development of the N2Ex Day Ahead Auction and the UK Power Futures products. We see the ongoing industry led project to**

migrate physical power trading from the Electricity Forward Agreement (EFA) calendar to the standard Gregorian calendar as another important step to reduce the barriers for new entrants.

- **We believe that any intervention should focus on ensuring that market reflective prices (i.e. tight bid-offer spreads) are available to as many players as possible as often as is possible. If there is a tight bid-offer spread and no trading takes place, it does not mean the market is broken, it just means that no market participants want to alter their position at these market levels.**

(III) Response to consultation questions

CHAPTER: One

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

1. Whilst we think churn is a rather blunt metric against which to assess liquidity, we agree that there has been no improvement in the extent of churn since the February 2012 assessment. We also agree with Ofgem that wider factors outside of our sphere of influence are contributing to the decline in liquidity (i.e. increased EU regulation, reduction in available risk capital, banks exiting commodity trading activities etc.). We noted in the response to the last consultation that baseload clean spark spreads were around £1-2/MWh. They are now less than this with very little volatility and so churn levels would be expected to remain low.

2. Ofgem highlights that further work is needed to open up the market to independent participants in some specific areas such as credit and collateral. Credit terms must be allowed to cover the risks that parties are taking on and we continue to believe that this is the major obstacle to greater participation by physical players in the market.

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

3. GDF SUEZ believes that the interactions between upcoming European legislation and Ofgem's proposals to enhance liquidity warrant further exploration. Ofgem notes in its bullet point 23 of the consultation that the draft European legislation on MiFID II limits exemptions to firms that are not acting as market makers.

4. It appears that the outcome of the application of MiFID II may not be known until October this year. Ofgem has indicated that it intends to make a decision on the form of intervention ahead of this summer with licence changes by the end of the year. If this timetable is adhered too, it would seem to rule out mandating the big 6 to market make.

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

5. GDF SUEZ continues to believe that the main barrier to improving liquidity is the requirement to post credit and collateral. This requirement has strengthened since the financial crisis. The 'Secure and

Promote' proposals do not directly address this. However, it is important that credit requirements remain robust and companies must be able to determine their own credit policies.

6. Our view is that there are two different tracks that could be taken to try to improve market liquidity. The first approach is to try to encourage existing market participants to trade more. Whilst action to force this may increase overall volumes we feel that forcing players to trade more volume than they feel is optimal to hedge their physical positions may not be to the benefit of the industry overall. This forced market activity will increase the risk associated with holding an asset in the UK market and could therefore discourage investment. In addition, any forced market activity that is entered into out of obligation rather than choice has the potential to distort the real supply and demand dynamics of the market.

7. The second approach, which we believe would be preferable, is to try to encourage more market participants to come and trade UK power and bring in real new liquidity to the market. However, this is a very difficult thing to achieve. Many financial institutions are actually exiting commodity markets due to the scarcity of risk capital and uncertainty over how these markets will be regulated both domestically and by Europe in the future. In addition, the close correlation between the NBP Gas Market and UK Power Market means that many firms trade UK Gas as a proxy for UK Power and so have little incentive to set up a UK Power Trading operation.

8. More focus should be given to trying to remove or reduce the barriers to entry for new market participants. The industry has, through the FOA Power Trading Committee, started the process of migrating physical UK power trades from the EFA Calendar to the standard Gregorian calendar, which removes one of the complexities of UK power. Whilst liquidity in the Nasdaq OMX exchange traded financial products remains low, the industry has developed this product which non-physical players could trade with far lower set up costs than if trading OTC physical forwards contracts.

CHAPTER: Two

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

9. GDF SUEZ believes that the ''Secure and Promote'' model is an improvement on the previous proposal favoured by Ofgem (Mandatory Auctions). We are pleased that Ofgem has adapted its proposals to recognise that the MA has had very little support from industry.

10. Absent detail on each of the proposed actions, it is difficult to say whether or not the model will help meet Ofgem's three objectives. We have listed some issues with the proposed actions in later questions.

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

11. At this stage, we believe that Option A will as indicated by Ofgem at the very least secure existing levels of liquidity and set a minimum standard for trading agreements. GDF SUEZ continues to believe that forcing companies to trade through an intervention (some of the proposals for Option B) will not lead to the creation of robust reference prices – the resulting liquidity will be false liquidity. Rather

than forcing existing players to trade more, new players should be encouraged into the market, in particular financial players.

12. GDF supports the initial proposal to apply any new licence condition to the big 6 vertically integrated companies. Any extension of this group to capture any additional market participants would create a very arbitrary threshold. As the key concern appears to be on how volume associated with domestic customer demand comes to market we believe it is right for the obligations to be on those firms that dominate the domestic supply market. However, we think that other approaches to creating a market maker should be considered. We have outlined one approach in our response to Q11.

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

13. Yes under Option A. It addresses wider issues than just trading along the curve but at the same time preserves continuous trading.

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?

14. It is difficult to give a firm view because it is not clear what is required. To give some examples:

- Would obligated parties be expected to trade on an unsecured basis and if so to what extent?
- Would the 'Fair Pricing' Index be specified by Ofgem or would obligated parties be allowed to specify the reference index?
- How would Ofgem monitor whether or not obligated parties have offered a range of products? Appendix 4 of Ofgem's consultation suggests that obligated parties could demonstrate compliance through providing information on the number of trades that have taken place. This would not cover offers not taken.
- How would Ofgem measure success? Even if this new obligation enhances liquidity, at what point will Ofgem deem that improvements are sufficient?

15. At a more detailed level we have the following comments:

<u>Product Range</u>

16. The suggestion that shaped products must be offered against a defined pricing methodology would add significant risk to the obligated party. Positions created through these trades could not be backed out in the market, forcing providers to hold positions and incur profit and loss on market movements. This would create volatility in earnings and where companies trade purely for hedging purposes, would go against the core purpose of managing and reducing volatility in earnings.

Credit and Collateral

17. Whilst trading does occur over short timescales on an unsecured basis, this is up to a limit and this limit would not extend to large volumes or over seasons. Therefore, prior to agreeing credit terms, counterparties will first have to agree a GTMA (unless trading a cash settled futures contract). This is an onerous task, in the experience of GDF SUEZ, it typically takes 4-6 months to negotiate a GTMA but on some occasions it has taken more than a year. The time taken does not relate to the size of the counterparty.

18. Typically small suppliers prefer to trade with one or two counterparties. Having negotiated a GTMA, there is no guarantee that the work and cost involved will lead to any trading taking place.

19. If credit treatment of these new counterparties was defined by the obligation then this could be outside of the internal credit policy of the obligated firm. In extremis, material counterparty defaults could lead to wider concerns around a company's ability to manage its risks effectively. This, in turn, could affect credit ratings, which could result in the company's liquidity and trading ability being compromised.

Fair Pricing

20. Negotiating a fair pricing mechanism could also be time consuming again with no guarantee of any trade volume being done under this arrangement.

21. There would need to be sufficient liquidity in the market index against which products would be priced.

22. Parties eligible for this offer might be able to 'cherry pick' when they use this facility (for example during periods of low liquidity or volatile pricing) reverting back to the market to trade at other times. Care would be needed to ensure that the obligation does not give parties a 'free option' to trade under a pre agreed mechanism.

Scope

23. If this requirement is to be imposed, it should not be targeted at independent suppliers only. Low levels of liquidity are a market wide issue and the scope should be extended to ensure fair and reasonable terms in trading agreements for the whole market.

Transparency

24. The consultation proposes that obligated parties publicise their approach on for example their public website. This leaves little flexibility to vary the link to the market index if for example prices are volatile or the market is not sufficiently liquid to have confidence in the index. We would not support this requirement, rather it should be left to obligated parties to vary their approach to reflect changing market needs. Whilst parties could update the website as circumstances change this would seem to be an onerous task that could from time to time not be done for quite genuine reasons.

Response to Trading Requests

25. The proposed 20 working days seems reasonable provided a GTMA and credit/collateral are already in place.

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?

26. As Ofgem notes, the six vertically integrated companies are already trading 30% of their output in the day ahead market via Gross Bidding on N2EX. We agree that obligating this would not carry any additional cost. To maintain trust and encourage the big 6 to voluntarily do more than 30% without running the risk that a further voluntary action becomes an obligation, it will be important that this 30% obligation is not increased.

27. We would like to make the observation though that gross bidding does not make any change to net liquidity levels. However, we do support the concept of Gross Bidding as it does allow a more reflective offer stack to be built up in the Day Ahead Auction.

CHAPTER: Four

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

28. There is some potential for trading conditions to improve naturally. Forward clean spark spreads are currently low and if they pick up, or if we see some increase in clean spark spread volatility, parties may be encouraged to trade forward rather than waiting for the near term market.

29. In the absence of any pressure to enhance liquidity, it is unlikely that further trading will develop along the curve naturally if the increased liquidity is required to come from existing market players. If these companies wanted to trade more, they would be doing it already.

30. For any material improvement we would need to see more market participants enter the market and bring new liquidity. Due to external financial and regulatory challenges there are many reasons why this is not occurring. We believe that the industry has and still is taking steps to lower the barriers to entry to trade UK power so that when both regulatory and market conditions are more attractive there is an increased probability that this new liquidity will materialise.

31. Whilst we support the desire to create robust reference prices along the curve, we don't believe that this can be achieved through specifying where and when companies must trade. This is not real liquidity and may cause a distortion in market prices.

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

32. As part of the concept of securing existing levels of liquidity, we think there is merit in preventing liquidity along the curve deteriorating further. We think this could be achieved through a requirement that the big 6 must buy an amount equivalent to their domestic supply volumes in the market.

33. We have outlined an alternative approach to market making in the next question. This could be instead of a trading obligation or could work alongside it. Ensuring that there is a tight bid offer spread will help to establish robust reference prices.

34. Increased liquidity will not create robust reference prices on its own. It will help but there will remain the issue of how to set the reference prices (closing price, average price within window, use of actual deals vs. reported prices etc.). Since reference prices tend to be closing prices on the trading day we believe that any intervention should seek to focus on ensuring market access for all at this time to reduce the scope to any manipulation of closing market levels.

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?

35. Yes. We do believe market-making is the most appropriate intervention and this is a tried and tested approach in many markets around the world. We do not believe that the proposed approach to market-making is the most appropriate intervention if it is an obligation that all the big 6 must take on. It does not seem efficient to have six market makers as taking on this obligation will have cost implications for each firm that does it.

36. An alternative would be for a market maker to be identified through a tender process (this could be one of the obligated parties but doesn't have to be, it could for example be a bank). Ofgem could specify what the market maker must do in terms of products, bid-offer spreads and product availability and potential market makers could tender for the annual cost of meeting these requirements. This cost could then be split amongst the obligated parties. If FSA registration is needed and the requirements of MiFID II do apply, then the voluntary market maker would ensure that this was in place prior to tendering. We have outlined this proposal in much more detail in Appendix 1.

Views on trading obligation

37. GDF SUEZ believes that a trading obligation may have some merit subject to the way it is implemented. We do not believe that the obligation can dictate what products and volumes parties must trade and when they must trade them but it could simply require that they must trade. We do not however believe that parties should be obligated to trade their total output or total supply volumes more than once. Therefore at best, the obligation could be 100% of output/supply.

38. One major benefit of the Trading Obligation compared to the mandatory market maker is that it would avoid being captured by any MiFID II regulations. Despite claims by some of the big 6 that they trade up to 6 times their output and that a trading obligation would therefore have little impact, we believe that this obligation would give the market confidence that there would be a natural obligation to trade in the market.

Views on the evolution of existing platforms

39. The alternative proposal to allow the evolution of existing platforms also has merit. Rather than diving in and imposing an obligation that is not used, it would instead allow product offerings to be

gradually extended if there is interest. There would however need to be a timetable set out of how the end goal (trading up to season +4 for baseload and season +3 for peaks) would be achieved. Without this, it could take several years to get to this point.

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?

40. There is a trade off to be made between the strength of the obligation put on the market maker and the cost of providing the service to the industry. If market makers must provide 10p/MWh bid–offer spreads in all products all of the time then market access would be very high but the costs and risk associated with doing this would be also be very high. If the obligations are to provide tight spreads in certain products for one hour towards the end each trading day the costs would be far lower. GDF SUEZ would support a lighter touch solution that guaranteed a tight market in certain products at certain times but did not result in excessive costs.

41. If there is no cap to the volume of trades then very large positions could be built up by the market makers. Consideration should be given to the market maker obligation falling away on each trading day once a certain volume of agreed trades have been transacted.

42. MiFID II could potentially be a showstopper for the market making obligation. Ofgem should await clarity on the final shape of MiFID II before it progresses this aspect of the licence condition further.

CHAPTER: Five

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

43. A simpler alternative to the MA would be to place an obligation on the big 6 to trade or post orders in the required products at a tight spread at certain points in time – effectively a monthly market place. This would remove the need for buy side rules, which in themselves may distort the auction process and reduce the robustness of the prices that would result. This is also more like continuous trading and could be done on the existing Trayport platform.

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

44. We agree that if the MA were adopted a single auction process would be needed and recognise that if this were to occur on a single platform it could hinder competition from auction providers. Ofgem has outlined some of the complexities with pooling liquidity from various MA platforms to create a single clearing price.

45. Given this complexity and the potential of a significant delay whilst a coupling algorithm is developed, a single platform would seem a better solution.

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Appendix 1 – Third Party Market Makers

GDF SUEZ has below set out a proposal for a Third Party Market Maker. This is presented as an alternative to Ofgem's mandatory market maker proposal set out in the ''Secure and Promote'' licence condition.

Why is a Market Maker obligation preferable to any obligation to trade?

Any obligation to trade may force parties to enter into transactions that they would not want to do for purely commercial reasons. This creates the following issues:

1. Impact on Reference Prices – Forced trading activity moves market prices to false level reducing validity of market reference prices .

2. Increased Costs – Increased credit and transaction costs associated with the market activity when forced to trade outside of desired activity are passed onto the market or reduce attractiveness of investment.

3. Increased Risk – Increased risk associated with market activity when forced to trade outside of desired activity are passed onto the market or reduce attractiveness of the investment .

If a tight bid offer spread is available to all/most counterparties, and this is guaranteed to be the case in future trading periods, then the issue of market access has been addressed. If nobody wants to trade a tight market then it could be argued that all hedging requirements are being met and there is no liquidity issue. Forcing parties to trade may increase liquidity but it is false liquidity and would not necessarily improve market access for all.

A barrier to attracting new participants that bring new liquidity is a concern that they will not be able to close out positions at reasonable transaction costs. A market maker would provide comfort that positions can be closed out when required at a fixed bid-offer spread. An obligation to trade does not necessarily address the issue of transaction costs.

How many market makers do you need?

The current proposals put forward that each of the Big 6 must market make. This has the potential to create six identical bid offer spreads in the market. To enable market access you only really need one bid and one offer. In general markets contract with two or three market makers and to apply the obligation on more than this seems to increase the cost of delivery without any benefits.

Who should be the Market Makers?

Large utilities that focus on hedging of physical assets may not be the organisations that are best placed to act as market makers. Not only may it require a material change to business processes and risk approaches but it could also have a material impact on the business treatment under European Regulations such as EMIR/MiFID II. It may be preferable for the market maker(s) to be non-physical players that are set up to

manage exactly this type of activity. This would minimise the cost to the industry of delivering this service. Alternatively an existing physical player that is FSA registered may wish to offer this service.

How to select the Market Makers?

Ofgem could issue an Invitation to Tender (ITT) on operating as a market maker. The ITT would specify:

- The products that have to be offered
- The maximum spread
- The times when products must be available
- The conditions under which the MM can cease to market make
- The duration of the service
- The clearing rules/trading venue where numbers will be posted
- The required accessibility of the prices posted (i.e. who needs to be able to transact)
- When the market maker must start operating

Interested parties (which could be existing physical participants in the market or financial institutions) would submit an annual fee for delivering against this specified service. Competition should ensure the price charged was reasonable. The lowest priced offer or offers would be contracted to provide the service and would have to take on the risk of trading position resulting from this activity.

This tender process could be a project run by an independent consultant of trade body, such as the FOA. They could the recommend a solution to Ofgem for final approval.

What are the costs of being a Market Maker that firms would seek to cover?

When pricing up a tender to be a market maker we would expect firms to seek to cover the following costs.

1. Transaction Costs – Additional transactions costs (brokerage, clearing fees etc.) associated with the additional trade volume entered into. It is likely that the market provider (i.e. broker house, exchange etc.) would offer a significant fee discount to the market maker to try to encourage the increased liquidity that would be likely to occur to occur on their platform.

2. Credit Costs – The additional trade activity would utilise credit lines and/or collateral. We would expect the opportunity costs associated with this to be priced into any offer.

3. Trading Risk – The additional trade activity brings with it trading risk. If the market maker's offer is lifted then they are short and would need to buy from another market participant to close out the position. This may be done above or below the original trade and so create a trading P&L. The size of the perceived risk would be a function of market volatility (how far could the market move before I close out?) and market liquidity (how easy is it to close out positions at low bid-offer spreads?).

The fee charged to be a market maker will be a function of how onerous the obligation is. If the market maker must post a tight bid-offer spread for half an hour each week then the costs involved are far lower than if requirement is to post numbers for 90% of market opening. This is a trade off that needs to be considered.

How would the cost of this be met?

The cost of the accepted offer(s) to market maker would be spread amongst those parties that would otherwise have been obligated under the ''Secure and Promote'' licence condition.

How do you ensure the numbers are accessible?

For the market maker obligation to work it is vital that the numbers posted are accessible to as many market participants as possible. This could be achieved in a number of ways;

1. Number posted on a regulated cleared exchange – This would ensure that all participants have access to the market maker bids and offers under exactly the same credit terms and transaction costs. However, smaller players tend not to like exchange trading due to high transaction costs and complex business processes. If market making were to be done on a cleared exchange then it may be necessary to ensure that parties offer smaller players physical power contracts at the same/similar prices to those posted on the exchange.

2. Obligation on market maker to set up credit lines – The successful market maker would have an obligation to set up trading relationships and credit lines charged at a reasonable rate with all market participants who needed to access their posted bids and offers. This would make the cost of providing the market maker service significantly higher.

3. Obligation on larger players to sleeve – The market maker could have the obligation to keep open trading lines with the larger players (i.e. Big 6). The larger players would then have an obligation to sleeve trades between the market maker and any other market participants who needed to access their posted bids and offers. This would give all players access to the numbers under bilateral credit terms without the need to negotiate a raft of new GTMAs and credit agreements.