Phil Slarks
Wholesale Markets
Ofgem
9 Millbank
London
SW1P 3GE

Alan McAdam
Economic Regulation Manager
RWE npower PLC

15 February 2013

gb.markets@ofgem.gov.uk

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

Dear Phil,

We welcome the opportunity to respond to the above consultation, this response is provided on behalf of RWE npower, RWE Generation SE, RWE Supply and Trading GmbH and the UK subsidiary of RWE Innogy GmbH, RWE npower renewables.

RWE is of the view that Ofgem should engage collectively and work with market participants including the obligated parties to develop proposals that are acceptable and achieve Ofgem's objectives. However, recent consultations and workshops, while useful, highlight some of the more extreme and polarised views between those obliged to meet the proposed obligations and those who will benefit from the proposed interventions. This makes it difficult to find acceptable compromise solutions.

Below we provide our high level response to the proposed Secure and Promote licence condition:

- Ofgem does not clearly define "liquidity" but instead phrases like, "*robust reference prices*" and "*availability of products which support hedging*" appear in the Consultation Document without a definition of what these terms mean;

- We support increased liquidity in the GB power market but do not beli*eve* that non-market solutions will deliver this and liquidity cannot be "regulated" into the GB electricity market. Liquidity is a market outcome. However, the GB electricity market is presently characterised as one which is undergoing unprecedented levels of policy reform which, coupled with a global financial crisis, all impact on levels of liquidity in the GB electricity market;

- We do not agree that the proposed intervention based on a "Secure and Promote" licence condition on certain "obligated parties" will improve liquidity. Liquidity obligations should not be differentially imposed in the GB electricity market. We note that small suppliers already benefit from certain regulatory advantages such as under the ECO and Warm Home Discount arrangements (with up to £100 of benefit for each dual fuel customer supplied by a small supplier against economies at most of £23);

- Applying a specific licence condition to mandate the provision of certain products by "obligated parties" is discriminatory and disproportionate given that not all obligated parties are the same and indeed some do not have direct access to the products described. There

are many non-obligated parties who are significantly better placed to provide the products described, thus increasing the cost of this intervention unnecessarily; and

- The absence of clear governance surrounding the proposed “Technical Requirements Document” and specifically the absence of any right of appeal against changes in that document prevents RWE accepting a licence condition in the form proposed.

Appendix one provides detailed responses to the Consultation questions.

Please contact me if you have any questions.

Yours sincerely

Alan McAdam
Economic Regulation Manager

Appendix 1 – Detailed responses to consultation questions

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

Ofgem carry out an assessment of market developments against their stated objectives, which are;

- Availability of products which support hedging;
- Robust reference prices along the curve; and
- An effective near-term market.

In this consultation and in previous liquidity market assessments Ofgem has concluded that;

- Churn ratios are low relative to GB gas and other European electricity markets
- Depth of trading along the curve remains limited
- Bid-offer spreads remain wide compared to gas
- Trading in financial products has increased – but volumes remain low and volatile
- There has been continued growth in trading on day-ahead auction platforms.

In the Consultation Document Ofgem state that, "*in recent years, poor liquidity in the electricity wholesale market has been identified as a barrier to competition, preventing the entry and growth of new players and imposing costs on consumers*". However, Ofgem gives no definition of what is meant by "*availability of products which support hedging*" or how it is to be measured or assessed. Ofgem appears to assume that the volume of trades provides a direct measure of availability, when conceptually they are very different. There are a number of factors which influence demand and the actual volumes traded. Ofgem also fails to provide any objective benchmark for how much availability would be adequate. Without such a benchmark there is no way to judge whether the objective is or is not being met.

Ofgem gives no definition of what it means by "*robust reference prices*", or how "*robustness*" is to be measured or assessed. Ofgem assumes the bid-offer spreads and the proportion of trades that take place on exchanges are good indicators of "*robustness*", but it is unclear how these measures relate to the concept of "*robust reference prices*".

Ofgem's objective of ensuring the availability of products for hedging and robust reference prices is not clearly defined. Ofgem has not provided any objective benchmarks that could be used to assess whether they have been met. In practice, it is hard to avoid the conclusion that Ofgem's real objective is to provide assistance to ensure that small independents can grow their businesses at the expense of the so-called "Big 6" suppliers. In the context of Europe's most successful and competitive retail market, with effective competition between six large and several already successful independent suppliers, Ofgem may breach its statutory duty to protect the interests of consumers by promoting *effective* competition wherever possible. While independents, especially small independents, may have trouble competing because of lack of economies of scale or because the market is already highly competitive, Ofgem has singularly failed to provide any evidence that the current arrangements are failing to deliver effective competition nor any evidence that the proposed intervention will promote effective competition rather than distort and undermine competition by introducing costly and ineffective restrictions.

Overall, Ofgem has not provided a satisfactory (any) cost/benefit analysis of its proposed intervention and as such is failing in its statutory duties to consumers.

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

Ofgem gives a comprehensive list of factors currently impacting the electricity wholesale market, namely;

- Electricity market reform
- The Energy Bill, particularly the backstop powers on liquidity
- The Regulation on Energy Market Integrity and Transparency (REMIT)
- The Markets in Financial Instruments Directive (MiFID 11)
- The European Target Model
- Electricity Balancing Significant Code Review
- Liquidity

To this list could be added the continuing effects of the global financial crisis, uncertainty surrounding the EU emissions trading scheme and the distorting impact of the carbon floor price. These regulatory factors point to a very uncertain future and a wholesale electricity market that is likely to look very different to the market that has been operation for the last ten years.

Some of these policy reforms have been on the table for a number of years which also adds to the uncertainty. These conditions are hardly supportive of initiatives to improve liquidity and the combined effect of them is to drive the market to operating in relatively near time-scales where there is less uncertainty.

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

Ofgem defines liquidity as "*the ability to quickly buy or sell a desired commodity or financial instrument without causing a significant change in its price and without incurring significant transaction costs*". Ofgem also notes that a key feature of a liquid market is that it has "*a large number of buyers and sellers willing to transact at all times*". Ofgem does not spell out what counts as a "*significant change in price*" or "*significant transaction costs*", or a "*large number of buyers and sellers*". It is therefore difficult to understand what Ofgem precisely has in mind when it is looking for improvements in liquidity. In our own continuous interaction with the market we find many counterparties willing to transact in sufficient volume to avoid moving prices and for relatively small transactions costs.

According to Ofgem's data, GB power churn has fallen from 6-7 in 2003 to 3-4 today, but over the same period GB gas churn has risen from 6 to 9-10. The very strong correlation between GB power and GB gas means that the GB gas trades provide a close substitute for GB power trades and is often used as a proxy for UK power for risk hedging purposes. The relevant metric for assessing liquidity in GB is therefore aggregate churn in the two markets and, if churn is a recognised indicator of liquidity, then overall the performance of the GB power and gas markets is very good in comparison to churn in European markets. We are not convinced, therefore, that direct comparisons can be made between the GB power market and European power markets.

Ofgem observes that trading of longer dated products is low relative to shorter dated products. This is true of all commodity markets for good reasons. There is less demand for hedging long-term due to volume risk and since the volatility of long-term prices is lower there is less need to trade in response to changing prices. Longer-term trades also involve greater potential credit exposures

and require more collateralisation. The GB electricity market is no different to any other commodity market in that respect.

While RWE absolutely shares Ofgem's desire to see even more liquidity, liquidity cannot be artificially manufactured into existence in the absence of underlying market demand to manage and transfer price and volume risk. Ofgem suggests that supplier's need to hedge up to season plus 4 when its own analysis of the retail margins earned by the six largest players appears to be based on evidence that the larger suppliers hedge no more than 18 months into the future. Ofgem appears to be seeking to create a market in products for which there is no natural demand. The result of such an approach can only lead to unnecessary cost to the industry, and therefore ultimately to the consumer which is not aligned with Ofgem's objectives.

We do not believe that liquidity represents a barrier to new entry into the GB retail market. The problems articulated by small independent suppliers generally relate to the collateral costs or the pricing of shaped and long-term products. Ofgem has not presented any evidence that the terms offered in the market now are overly restrictive or fail to reflect the underlying credit risks counter-parties face with small independents. The difficulties encountered by small independents may reflect their limited financial capacity and relatively high financing costs, a comparative disadvantage faced by small firms across the economy, rather than inefficiencies in the market. Measures aimed at helping small independent suppliers would not be conducive to promoting economic efficiency and protecting the interests of consumers. Ofgem has also failed to demonstrate that the pricing of bespoke shaped and long-term products is something that small independents would ever reasonably expect to find in highly standardised wholesale markets, particularly when larger retail businesses also don't have access to these products currently and therefore also have to internalise the associated risks within their retail offering.

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

No. Liquidity cannot be regulated into a market; liquidity is an output driven by market fundamentals. Ofgem's proposals will therefore fail to meet its objectives for the intervention with an unknown and likely material cost to the consumer.

As we have stated in previous responses, we too would like to see higher levels of liquidity in the GB wholesale electricity market: it is as much in our interests as that of smaller players for this to happen. However, as we have already stated in response to earlier questions there are a number of reasons why liquidity is at current levels, not least the uncertain future because of the many policy initiatives. Having said that, we believe the current levels of liquidity are nevertheless still adequate for all participants to trade their requirements.

Ofgem seems to believe that if we "fix" how the market operates at a point in time, then this will secure the existing market developments for the benefit of all. Markets simply do not work like this; they expand, contract and mutate in response to the constantly changing demands from market participants. Market participants will therefore factor in any restriction into future activity and "trade around" the restriction to get back to the position that they originally wanted or needed to achieve. Moreover, intervening once creates expectations of future interventions which in themselves undermine the credibility and effectiveness of any intervention.

Ofgem proposes that the licence condition would apply to the six large, vertically integrated suppliers on the basis that "*the purpose of the intervention would be to remove barriers to more effective competition in the generation and supply – particularly domestic supply – markets*". We agree that a competitive market is the best way to produce efficient market outcomes, and thus protect the interests of consumers. Any structural intervention in the GB power market with the aim to increase liquidity should first be justified on the basis that low liquidity is preventing effective

competition in generation or retail. However, all relevant metrics firmly illustrate that we have effective competition in both generation and retail, and therefore intervention cannot be justified on those grounds.

Competition authorities use a number of structural indicators to assess the competitiveness of a market, such as, market shares. However, based on their market shares, none of the six largest players is individually dominant compared with the usual 50% threshold[1] for dominance and no pair of companies is collectively dominant in either generation or supply.

The three-firm concentration ratio measures the total market share of the top three players in a market and is widely used by regulators across Europe. The three firm concentration ratios in the UK are 62%, which is substantially below that of the Netherlands, Belgium, Italy and Spain. Competition authorities also use a measure of market concentration called the Hirschman Herfindahl Index (HHI). The HHIs in the GB power market are 1,238 for generation by volume generated and 1,768 for electricity sold to domestic consumers. These HHIs are below the threshold of 2,000 for a "highly concentrated" industry used by European authorities. This is also well below that of Spain, Belgium and Italy.

In addition, even if the six largest players provided all of their output exclusively to their affiliated supply businesses, something they do not do in practice, that would still leave the 30% of GB generation output produced by independent generators available for sale through other means. We therefore see no reason why small independent suppliers cannot get fair access to the range of products required to support expansion.

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

No, we do not feel that it is appropriate in any regard. Further, we believe that if such a licence condition is introduced then it should be a standard licence condition, switched on in all generation licences, to avoid discrimination and distortion of the generation market.

We have major concerns that only a high-level structure would be set out in the licence with the detail contained in separate "Trading Requirements Document". As we understand how this would work, Ofgem would consult on changes to this document but there would be no formal route to appeal. It would therefore appear that Ofgem could change this document whenever it – or indeed the Government - saw fit to do so. Indeed Ofgem state, "*S&P is intended to be flexible, with the Requirements Document adapting over time to reflect the needs of the market*". Unfortunately, that very flexibility and adaptability could also lead to negative or potentially serious or terminal outcomes to the obligated parties without any scope for appeal. This concern is particularly acute given the contrast between the absence of any independent, objective and reasoned economic case for the proposed intervention versus the highly emotive and politically charged narrative that Ofgem and Government have sought to adopt surrounding the role of the six largest players in what, factually and economically, remains the most competitive and successful retail electricity market in the world. The argument that Ofgem will use any flexibility cautiously and proportionally is further undermined by the widespread acknowledgement that one of the key drivers for the intervention at this stage is Government's political imperatives under EMR.

We do not consider this to be best regulatory practice; if such a licence condition were to be introduced we would expect to see detailed and objective impact assessment, detailed requirements set out in the licence and a means of challenging both the initial and any changing requirements.

---

[1] Office of Fair Trading – Abuse of a Dominant Position, Case C62/86, *AKZO Chemie BV v Commission* [1993] 5 CMLR 215.

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

While the Secure and Promote proposals may appear more attractive than the Mandatory Auction at a high level, the detail (or lack or it) of how and what is proposed, suffers from essentially the same issues as the Mandatory Auction proposals. Both are discriminatory and will do nothing to improve liquidity, in fact they are likely to have a negative impact on liquidity and will introduce further distortions into the market. The end result will be more and more regulation layered on previous poorly thought out regulation that will only lead to further escalation in prices to consumers without any attendant benefit.

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?

At first glance "*the licensee must offer fair and reasonable terms when negotiating trading agreements*" may seem reasonable. However, when considered against the detail being contained in a "Technical Requirements Document" which may be subject to periodic change and lack of definition of, "*fair and reasonable*" (and from whose perspective is it "*fair and reasonable*"), it causes significant concern.

Ofgem set out illustrative requirements within figure 10 of the consultation; we have the following comments to make.

Clip sizes – Clip sizes of 0.1 MW are not trading in the market: if we are forced to trade clips at this resolution we would be forced to carry unhedged risk until we have accumulated sufficient volume to trade out of the risk. The expected cost of bearing this unhedged risk will therefore naturally need to be reflected in wider bid-offer spreads or transaction costs for these products.

Product Range – We need to understand the volumes in this proposal. The market tends to trade base-load further along the curve and peak only as you get closer to prompt. Forcing the market to trade products that it does not naturally need to trade nor naturally have will therefore create a distortion. We are naturally "short" of shape since we are predominately a CCGT-only company. We only have "shape" when coal is deeply in-the-money and gas is at the margin. Going forward, given the increase in carbon tax, this will reverse and coal stations will become the marginal plants more often and therefore the generation business will have to buy this from the market to meet the obligation to sell these products. In addition, our supply business (which is approximately twice as large as our generation business) already buys its shape from the market to meet its requirements. Given that our business is able to do this, and is significantly larger than any other independent supply business, we do not understand why others cannot or should not do the same. Forcing us, or indeed any company, to sell a product that they don't own or manufacture is a manifest and costly distortion to the market and only serves to add unnecessary transaction costs rather than achieving any beneficial transfer of risk between those wanting to buy and sell. The proposal is even more distorting and discriminatory given that many of the natural shape providers in the market are not even caught by this proposed licence condition.

Fair Pricing – We would like to understand what is meant by "*recognised market index*", by "*fair*" pricing and by "*pricing methodology*". There is no index that covers the period out to Season +4 and all standard products are clearly traded at prevailing market prices. We assume that Ofgem is not seeking to dictate the price at which transactions can or cannot take place in a free and competitive market and therefore cannot see what if anything this provision is designed to cover.

Credit and Collateral – We do not understand the requirements set out here. Credit and collateral risks are a commercial judgement (not a science) based on an assessment of counterparty's credit

worthiness and based on the risks that we are prepared to take. There is no objective measure for this risk nor could we or should we be forced to trade with a counterparty irrespective of our judgement on the risks involved in doing so. We also fail to see how we could be expected to accept a counterparty solely on the basis of an independent (and usually extremely limited) assessment of credit worthiness. For many small companies, independent credit assessments are extremely limited, based on accounting ratios only. Given the volatility of commodity markets we do not believe that these assessments are expansive enough to make proper commercial credit decisions. We would also note that our counterparty approval process also includes compliance checks into the history and background of a company which again involve a degree of judgement on the reputational and commercial risks associated with specific counterparties. These latter checks have been particularly important in recent years given approaches from counterparties engaged in financial crime in the emissions and power markets. Again we fail to see how we could be forced to trade with a counterparty in the face of a negative credit and compliance finding.

Response to trading requests – We would like to understand what the timescales here mean. If it means having a trading agreement in place in 20 days, this would be difficult to guarantee as these are negotiated contracts. We would endeavour to respond if the requirement is taken literally.

Transparency – Aside from the above comments this should not be an issue.

Scope – The scope suggested is not the issue, the points above are.

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?

Our main concern regarding this again is that the detailed requirements are set out in a Technical Requirements Document which is subject to unknown governance arrangements.

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

Ofgem set out some of the issues facing the market which we believe are having an impact. Page 8 – "*we note the downward trend in churn in some other markets in this period, highlighting that wider factors may be affecting trading in energy markets and contributing to the decline in liquidity in recent years. For example, risk capital available to financial firms has fallen due to the financial crisis. Some stakeholders have also suggested that widening capacity margins due to the fall in economic activity may be dampening incentives to trade forward.*"

Pages 13 and 14 of the consultation also refer to electricity market reform, the Energy Bill and its "backstop power", European legislation including the European Target Model and Ofgem's Electricity Balancing Significant Code Review. Liquidity has also been under review since 2008.

All these uncertainties impact on the development of the market including the development of liquidity.

Once we get clarity on at least some of these major policy initiatives and the financial position improves, the market will be better able to respond to the needs of the participants and we would expect to see an increase in liquidity along the curve.

We would note here that Ofgem's ongoing proposals to impose measures to improve liquidity also threaten to impede liquidity development in discouraging and delaying potential sources of risk capital from participating in the market because of perceived regulatory risk. Ofgem has also allowed potential market participants to believe that it will meet their commercial requirements and tilt the playing field in their favour, which in itself discourages them from engaging in the market

now on a non-discriminatory basis. In particular, we have seen very limited engagement from any of the potential beneficiaries from Ofgem's intervention in any of the market initiatives that many of the larger players have tried to encourage.

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

No. We believe that the market will develop outwards from the day ahead auction but this will take time as there is much uncertainty as we have outlined in our answer to question 8. It will require government and the regulator to have confidence in the market and allow this to happen.

Neither the regulator nor government can ensure that robust reference prices will be created by an intervention, any such prices will be a function of the intervention, not as a result of the market, and therefore they will not be robust.

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?

We believe that the market should be allowed to develop to deliver the products that market participants require. We do not believe that an intervention will produce robust reference prices, they will be prices based on the form of intervention not the market.

With regard to an alternative approach to promoting objective two based on an obligation to trade we believe that this is not a market based intervention. Rather, it is directing how obligated parties buy and sell products. This is likely to result in the party failing to meet its obligation if there is no one on the other side of the market or being distressed sellers, this is not the way to run a market.

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

We are concerned that the detail of the proposals would be set out in a technical requirements document which is subject to change by Ofgem following consultation. We consider this not to be best regulatory practice as there is no recognised route of appeal.

We have already signed a market making agreement with NASDAQ OMX, we continue to market make and would be happy to market make on the same terms and conditions as this.

We are concerned as to how the "*Illustrative requirements for a market maker*" would work. Under availability "*the licensee must be willing to post prices for more than 50% of the market opening time in any given calendar month*." Under "*Maximum trade size*" the requirement is, "*at any particular quoted bid or offer price, licensee must be willing to trade up to 10MW*." So it appears as though obligated parties would be expected to trade any number of 10MW clip sizes for 50% of the market opening time, this could be a huge volume.

Furthermore, it is proposed that obligated parties would be required to "*maintain a spread between the bid and offer price for each product which:*

- *Allows significant volumes to be traded over the course of a year*
- *Is not significantly larger that spreads posted in existing market making arrangements in GB and in other European energy markets*
- *Is not significantly wider than spreads posted by other licensees*"

This is similar to the obligation to trade as outlined on page 34 of the consultation document. We have serious concerns regarding obligations to trade as we have outlined in our response to question 11. We also think that it is unrealistic to attempt to anchor spreads in the UK market to other markets with completely different underlying economic conditions and liquidity. This serves to emphasise the point that liquidity must ultimately stem from the market and a stable regulatory framework rather than something that can artificially be brought into being.

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

We do not believe that the MA is the appropriate mechanism to meet Ofgem's immediate objectives. Indeed we are concerned that the introduction of a MA will divert liquidity away from existing platforms, has the potential to increase costs for customers as obligated parties will be forced to adopt inefficient trading practices and may create further barriers to entry. As a result the intervention will fail to ensure additional products that will "*support hedging*" by diverting activity away from innovation in financial products (Objective 1) and has the potential to undermine the development of robust reference prices (Objective 2) by diverting liquidity from existing platforms.

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

No – this would create a vey inefficient process, increase complexity and increase the barriers to trade.