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22 February 2013

Dear Phil,

WHOLESALE POWER MARKET LIQUIDITY: CONSULTATION ON A 'SECURE AND PROMOTE' LICENCE CONDITION

Thank you for the opportunity to provide views on behalf of ScottishPower on Ofgem's proposals for a 'Secure and Promote' licence condition to secure the industry-led market developments to date which have improved liquidity and also push for further improvements.

We agree with Ofgem's Secure and Promote objectives on availability of products that support hedging, robust reference prices along the curve and an effective near-term market. Our responses to the detailed questions in the consultation are provided in Annex 1, but our main points are as follows:

- **Availability of products that support hedging**: Initiatives by ScottishPower and some other major generators have recently improved access to the market for independent market participants. Our trading with independent suppliers has significantly increased following the commitments we have given on bi-lateral trading terms. Bi-lateral arrangements can involve less onerous collateral requirements than exchange trading and thus can be more attractive to small independent suppliers.

- **Robust reference prices along the curve**: We agree that all market participants need confidence that prices in the market reflect underlying supply and demand conditions. We believe that larger players already have robust reference prices along the curve sufficient to meet their trading needs, mainly through OTC trading, and that the key issue is to ensure that these prices are visible and available to smaller players.

    - **Information sharing:** This could be achieved by major players agreeing to provide information to the market on the volumes and prices of all the trades they enter into. This information is already available to major players and provided it can be made available to all market participants in the same timescale, smaller players will have the same visibility as larger players. If smaller players then find they are being unfairly excluded from trading at the same prices as the larger players, they will have evidence to put to Ofgem to judge if intervention is required.

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- **Trading undertakings:** Trading along the curve could also be encouraged by restricting self-supply through seeking an undertaking from large generators that they will trade at least their generation volume on an annual basis with external parties, with a specified proportion of this in the forward market. We believe an undertaking to trade 25% of generation output in forward market products, without specifying how much should be traded in each individual product or on which platform, would be unlikely to lead to distortion of market prices.

- **An effective near-term market:** Ofgem have noted strong growth in day-ahead auction trading on the N2EX and APX platforms and recognise that this could increase the robustness of the reference price on which financial products are based giving market participants greater confidence. Trading on these platforms is continuing to increase and we are now trading a minimum of 30% of our daily GB power generation day-ahead. This is helping to increase liquidity in the day-ahead market leading to more robust reference prices and greater transparency which in turn is helping the development of liquidity along the forward curve.

- **Voluntary commitments rather than licence conditions:** We agree that all market participants need confidence that market led developments improving liquidity and access will continue and can be relied on. However we believe this can be achieved through voluntary commitments made by licence holders to Ofgem and publicised to the market. We have progressively increased our voluntary commitments in this area over the last few years and other major market participants have done the same. We are not aware of any major withdrawal of commitments over the last few years which has had an adverse impact on market liquidity and access but, if this were to happen, Ofgem could then propose licence conditions locking in these beneficial commitments.

Under the options set out above, which are built on what works well in the market, independent suppliers would be confident that they are able to trade on the same basis as the larger players and the six largest suppliers would be committed to trade a minimum of 30% of their generation day-ahead, a further minimum of 25% in forward products and 100% overall. This should ensure liquidity along the curve without the risks associated with market making or other options requiring greater change to the operation of the wholesale market.

We believe that all of Ofgem's Secure and Promote objectives can be met through existing and further voluntary commitments from market participants and that these are best identified by the market with their impact assessed by Ofgem. Improvements that prove to be beneficial to the market could be sustained through seeking ongoing voluntary commitments from market participants and if these were not forthcoming or were being discontinued then Ofgem could propose licence conditions to lock them in.

I hope you find these comments useful. Should you wish to discuss any of these points further then please do not hesitate to contact me.

Yours sincerely,

Rupert Steele
Director of Regulation

Annex 1

WHOLESALE POWER MARKET LIQUIDITY: CONSULTATION ON A 'SECURE AND PROMOTE' LICENCE CONDITION

SCOTTISHPOWER RESPONSE

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

We agree that availability of products that support hedging, robust reference prices along the curve and an effective near-term market are key objectives for ensuring that the GB wholesale power market supports competitive supply and generation markets through reliable trading in key products and provision of robust signals.

While churn is a broad indicator that does not measure whether the specific key objectives are met, we agree that it is a useful indicator to monitor. Although the GB annual churn rate reduced in 2012 from the 2011 level, it is still over three times generation volume, which we believe is sufficient for the market to operate successfully. We would however like to see additional liquidity in the forward market and more robust futures prices, and therefore we support industry-led measures to achieve this.

In relation to availability of products that support hedging we believe that initiatives by ScottishPower and some other major generators have recently improved access to the market for independent market participants. Our trading with independent suppliers has significantly increased following the commitments we have given to expedite and simplify master trading agreements, provide trade notification services free of charge, provide initial lines of credit, streamline financial regulatory compliance, trade small clip sizes and transfer qualifying over-the counter (OTC) sales to exchanges for clearing where the supplier is a member of the exchange. Bi-lateral arrangements can involve less onerous collateral requirements than exchange trading and thus can be more attractive to small independent suppliers.

Ofgem's analysis shows that OTC trading over 12 months out in peak and off-peak products continues to be low. We do not think that this is a major concern since we and the other large suppliers trade baseload over 12 months out and shape our requirements through shorter term trading. This is partly a consequence of recent market conditions which have led to a relatively stable price difference between baseload and peak, and little incentive to trade shape further out; were market conditions to change, we might expect such trades to increase accordingly. We are able to meet our own hedging requirements through OTC trading and hence, provided the same products at the same prices are transparently available to all other market participants, we believe Ofgem's objective in this area can be met.

In relation to robust reference prices along the curve we agree that all market participants need confidence that prices in the market reflect underlying supply and demand conditions and that smaller players have the same pricing visibility as larger players. While a tight bid-offer spread is preferable to a wider spread, the key issue facing smaller players is that they can be confident that they are facing the same bid-offer spread as larger players. Ofgem's latest analysis shows that bid-offer spreads for longer-dated baseload products have not changed significantly over the last 5 years although there has been an increase in bid-offer spreads for longer-dated peak products over this period. As above, we do not think this is a major concern as baseload can be used for longer term trading with shape being introduced through shorter term trading.

We agree that trading in financial products has increased in 2012 but that it still makes up only a small proportion of volumes traded in the wholesale market. While we would like to see more trading in financial products we believe it is unlikely that financial products alone will enable Ofgem's objective of robust reference prices along the curve to be realised. We believe that more transparency in OTC physical trading prices is key.

In relation to an effective near-term market, Ofgem have noted strong growth in day-ahead auction trading on the N2EX and APX platforms and recognise that this could increase the robustness of the reference price on which financial products are based giving market participants greater confidence. Trading on these platforms is continuing to increase and we are now trading a minimum of 30% of our daily GB power generation day-ahead. This is helping to increase liquidity in the day-ahead market leading to more robust reference prices and greater transparency which in turn is helping the development of liquidity along the forward curve.

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

The consultation has highlighted various potentially changing aspects of the policy landscape which could impact on or be impacted by GB wholesale power market liquidity.

Electricity Market Reform (EMR) as currently proposed will rely on liquidity for reference prices and could itself increase liquidity by encouraging trade in the wholesale market. The increased liquidity in the day-ahead market is already delivering a robust reference price which can be used as the intermittent CfD reference price under EMR. Improvements in robustness, transparency and liquidity along the forward curve could deliver the baseload CfD reference price required under the current EMR proposals.

Changes to European legislation could have an impact on wholesale market liquidity and are likely to impact the economics of alternative options. The consultation has correctly identified REMIT, MiFID II and EMIR as the major impacting legislation. Changes to European financial regulations may require additional risk capital from market participants along with increased operational costs. Some of the options for increasing liquidity may be incompatible with certain regulatory exemptions, particularly under MiFID II, with consequent significant cost increases.

Market coupling through a "GB hub" driven by implementation of the European Target Model could provide a single reference price by pooling the liquidity on the GB day-ahead auctions. However, we believe the market has sufficient day-ahead liquidity already and thus there is no need to rely on the European Target Model to deliver the required intermittent CfD reference price for EMR.

In relation to Ofgem's Electricity Balancing Significant Code Review (SCR), we agree that the potential impacts on liquidity of the SCR, if any, are uncertain. We believe that any reform of electricity balancing will have a strong interaction with both the EMR capacity mechanism and the implementation of the European Target Model and thus should not be rushed into.

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

In our view the consultation has identified the major factors that may be posing a barrier to improvements in liquidity.

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

As a general principle, we agree with the regulatory model in which companies are encouraged to meet a requirement on a voluntary basis, followed up, if necessary, by a formal obligation. This has the advantage that companies are able to find the most efficient way of meeting the objective, subject to normal competitive pressures - as opposed to a model in which the regulator imposes his own solution on the market from the outset. Any decision to formalise a voluntary solution into licence conditions must be taken on a case by case basis, weighing the benefits of continued forbearance (continued flexibility and innovation) against the benefits of regulation (e.g. achieving a level playing field where not all participants are participating).

We agree that it is important that all market participants can have the confidence that market-led developments that have improved wholesale market liquidity and access will continue and can be relied on. However this can be achieved through voluntary commitments made by licence holders to Ofgem and publicised to the market. We have progressively increased our voluntary commitments in this area over the last few years and other major market participants have also done so. We are not aware of any major withdrawal of commitments over the last few years which has had an adverse impact on market liquidity and access but if this were to happen, Ofgem could then implement licence conditions locking in these beneficial commitments.

The roll out of emerging best practice across the wholesale market can also we believe be best achieved through voluntary means rather than through licence conditions. Licence conditions can stifle innovation in market developments.

We recognise that there are areas where further improvement is necessary in order to meet Ofgem's objectives. We believe that all of Ofgem's objectives can be met through further voluntary commitments from market participants and that these are best identified by the market with their impact assessed by Ofgem. Improvements that prove to be beneficial to the market could be sustained through seeking ongoing voluntary commitments from market participants and if these were not forthcoming or were being discontinued then Ofgem could propose licence conditions to lock them in.

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

We agree with Ofgem's three liquidity objectives as the basis for Secure and Promote:

1. Availability of products which support hedging
2. Robust reference prices generated along the curve
3. Effective near term market

Achievement of these objectives is key to ensuring that the GB wholesale power market supports competitive supply and generation markets through reliable trading in key products and provision of robust signals.

Whether or not Secure and Promote is achieved through a licence obligation, a trading code or through voluntary commitments it will be necessary to recognise the different requirements from different market participants in relation to each of the objectives. Under the 'Effective near term market' objective it would not be appropriate to extend the requirement to buy and sell at least 30% of generation on a day-ahead platform to generators who do not have a significant presence in the supply market, which would be likely to limit this requirement to the large suppliers. However under the 'Availability of products that support hedging' objective, the requirement to offer fair and reasonable terms when negotiating trading agreements should not be limited to the large suppliers but should include large independent generators and perhaps be extended to include all generators and suppliers.

The proposed structure envisages a Trading Requirements Document setting out the detailed requirements that parties would face and it is recognised that it would be necessary for this Requirements Document to adapt over time to reflect the needs of the market. The Requirements Document will be the key to the success of the intervention rather than the proposed licence condition itself. It is essential that the Requirements Document reflects the needs of the market before there is an obligation to comply with the requirements set out in it. This could best be achieved by developing these requirements through voluntary commitments from market participants before bringing any licence condition into force. If sufficient commitments can be obtained from the market on a voluntary basis then there may be no need for the licence condition.

In relation to how Secure and Promote meets Ofgem's key principles for the design of any liquidity intervention we agree that it aims to align with what currently works well in the market and to allow GB to evolve towards becoming an integrated part of a wider European market. Whether or not Secure and Promote imposes unreasonable costs will be dependent on the option chosen, with some options (such as six market makers) likely to impose significant costs. Ofgem have recognised that uncertainty remains as to the impact that developments in EU legislation will have on the Secure and Promote proposals.

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

We believe that Secure and Promote would be more effective than a Mandatory Auction as it builds on what currently works well in the market rather than risking market distortion through the imposition of a previously untried market intervention.

We believe that a Mandatory Auction with buy-side rules carries a significant risk of settling at artificially discounted prices. The revised buy-side rules set out in Appendix 3 of the condoc appear to be an improvement on Ofgem's previous proposals, but it remains the case that any constraint on market participants' bidding behaviour is likely to lead to a distortion of normal market outcomes – which could have serious adverse consequences. We have had direct experience of this in the Spanish market where major players were obligated to sell but not allowed to buy. These auctions did not attract new entrants into the retail market but instead attracted speculators who resold the energy at market prices. Such an outcome would create significant inefficiencies and be harmful to investor confidence.

A Mandatory Auction is likely to require market participants to put up more working capital to cover both initial margin and regulatory capital requirements and the periodic nature of such an auction will result in increased volatility with parties preparing their market positions in advance and correcting their positions after the event. Hedging, which is vital to wholesale market participants, would become more difficult as a result of a Mandatory Auction and other associated markets such as fuel and carbon could also be distorted by the process.

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

We already meet the Secure and Promote requirements for ensuring fair and reasonable terms in trading arrangements with independent suppliers. We originally made voluntary commitments to all independent suppliers in December 2010 and in January 2012 wrote to all 56 supply licence holders with whom we had no existing bilateral trading relationship making them aware of our commitments and inviting them to establish a trading relationship with us. We are actively engaged in discussions with 20 independent suppliers, having established trading relationships with 6.

We agree that credit and collateral arrangements are a key issue for independent suppliers seeking to trade, particularly for those who do not have investment grade ratings or parent company guarantees. We have a transparent methodology for assessing the creditworthiness of potential counterparties which does not discriminate between counterparties based on size or status as new-entrant or incumbent market participant. Our methodology allows for an unsecured credit line to be granted to any legal entity provided they can provide sufficient financial and key qualitative information to enable us to perform a full and satisfactory credit review of that entity. It is necessary to take into account the potential cost of default by a counterparty which can be a significant risk for parties who do not have investment grade ratings or parent company guarantees. Whilst recognising this, our methodology has still enabled us to grant bilateral credit lines worth an aggregated value of over £14m to the independent suppliers with whom we have established trading relationships, including suppliers who do not have investment grade ratings or parent company guarantees.

In relation to the range of products which should be offered we already offer a range of standard products in baseload from week-ahead to Season+4 and peak from week-ahead to Season+3. We also offer to buy and sell further more bespoke products as requested of non-standard shape, duration and size as well as giving suppliers visibility of market prices to compare with our prices. The cost of managing the risk of buying and selling shape is variable depending on market conditions and the pricing of bespoke products must take this into account.

In terms of the threshold that determines the independent suppliers eligible to receive the offer, the most significant factor for including larger independent suppliers would be the credit that could be awarded to any large supplier without an investment grade credit rating. The probability of default of a party without an investment grade credit rating can be over 5% and this must be taken into account when agreeing a credit limit. If credit exposures exceed a credit limit, then the counterparty must provide credit support in order to continue trading.

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?

In February 2012 we signed a gross bidding agreement with the N2EX exchange to trade a minimum of 30% of our GB power generation volume through its day-ahead auction and we agree with the advantages identified by Ofgem as a result of the significantly increased volumes in the day-ahead market. The day-ahead market is now very liquid enabling firms to better shape their positions at the day-ahead stage, providing a robust settlement price for financial products which helps liquidity to develop along the curve, providing a liquid reference price for the intermittent CfD under the Government's EMR proposals and also providing price signals for the efficient allocation of interconnector capacity under market coupling as part of the European Target Model.

Ofgem notes that some parties are sceptical about whether the increased volumes on day ahead auctions are actually available to a range of market participants or whether they are bought and sold by the same players without meaningfully adding to liquidity[1]. This reflects a widely held misunderstanding about the nature of gross bidding. Gross bidding can take two forms, with bids submitted on a price-independent or price-dependent basis. The criticisms cited by Ofgem may have some validity in respect of price-independent bids, but they are not relevant to price-dependent bidding, which is the approach currently adopted by ScottishPower.

We agree that securing day-ahead volumes can be accomplished through any day-ahead auction connected to the GB hub and that maintaining competition between auction providers would help to ensure that fees remain at competitive levels.

Trading 30% of our generation volume in the day-ahead market enables us to operate on both sides of the market without incurring significant costs of balancing our position. If we were required to trade above this level we could incur significant additional costs in order to balance our position and also our ability to offer competitive generation to National Grid in the ancillary services market could be constrained. At a volume of 30% the market is able to deliver the advantages set out above without risking additional costs.

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

We believe there is evidence that the increased volumes in the day-ahead market are enabling parties to better shape their requirements at the day-ahead stage giving them greater confidence to trade along the curve, particularly in baseload products. We do not think it is a major concern that trading over 12 months out in peak and off-peak products is low, since the larger players use baseload to trade further along the curve with initial shaping through short term products and final shaping day-ahead. If there were a greater need to trade shape further along the curve, e.g. because the price difference between baseload and shape became less predictable, we would expect such trading to develop naturally.

We would like to see more trading in both physical and financial products along the curve. While Ofgem have noted an increase in the number of firms registered to trade financial products we believe it is also important to encourage more trading in physical

[1] Condoc para 1.21

products along the curve. Ofgem have noted that most independent players are largely indifferent between hedging through physical or financial products and we believe that more transparency in OTC physical trading prices combined with increased day-ahead liquidity could encourage increased trading along the curve.

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

We believe that larger players already have robust reference prices along the curve sufficient to meet their trading needs and that the key issue is to ensure that these prices are visible and available to smaller players. We and other large suppliers trade baseload over 12 months out and meet our shape requirements through shorter term trading. Improved day-ahead liquidity now gives small suppliers the confidence that they only need to trade in the forward market if they choose to do so.   We are able to meet our hedging requirements, mainly through OTC trading, and thus, provided the same products at the same prices are transparently available to all other market participants, we believe Ofgem's objective for robust reference prices along the curve can be met without the need for intervention.

We believe this could be achieved by major players agreeing to provide information to the market on the volumes and prices of all the trades they enter into. This information is already available to major market players and provided this information can be made available to all market participants in the same timescale then smaller players will have the same visibility as larger players. We believe there is a good prospect that this will go a long way to addressing the problems faced by small suppliers, and would be consistent with the principle of proportionate regulation (no more than is necessary to solve the problem). However, if small suppliers or generators find they are still being unfairly excluded from trading at the same prices as the larger players, they will then have strong evidence to put to Ofgem for Ofgem to judge if intervention is required.

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 an obligation or indeed an undertaking to trade would be a more efficient means of achieving Ofgem's objective of robust reference prices along the curve than a market making option, particularly the option outlined by Ofgem where all the six largest suppliers would be required to market make in forward market products. (See our response to Question 12 for further discussion of the disadvantages of mandatory market making.)

An undertaking to trade a reasonable volume (say 25% of generation output) between month ahead and Season +4, without specifying how much should be traded in each individual product or on what platform, would we believe be unlikely to lead to distortion of market prices. The larger the obligated volume and the more prescriptive any obligation is in terms of specifying particular forward market products then the greater the risk of market distortion.

This could be combined with a self-supply restriction where an undertaking is sought from large generators to trade at least their generation volume on an annual basis with external parties. When this is combined with the day-ahead undertakings already given by the six largest suppliers then these companies would be committed to trade a minimum of 30% of their generation day-ahead, a further minimum of 25% in forward products and 100% overall. This should ensure liquidity along the curve without the risks associated with market making or other options requiring greater change to the operation of the wholesale market.

Companies who have given undertakings to Ofgem to trade particular volumes could also undertake to provide information to Ofgem on their trading levels on a periodic basis. Ofgem would then be able to assess each company's performance against its undertakings and if these are not being met then Ofgem could introduce a licence obligation.

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?

As a large supplier who does not currently market make we would be concerned about having an obligation to do so. There are likely to be other companies, perhaps including other large suppliers, who would express an interest in becoming market makers and if this is the option chosen then Ofgem should seek interest from suitably qualified parties who can provide this service on an independent basis. Ofgem suggest that the presence of several market makers would provide arbitrage opportunities enabling a consensus view of the market price to develop and could allow the bid-offer spread to be narrower than the bid-offer spread posted by an individual market maker. However, while more than one market maker may be beneficial, no evidence has been provided indicating that six market makers would be appropriate for the GB wholesale market. Indeed, in other areas, the "natural" number of market makers is often no more than two or three. If all the six large suppliers are required to market make then inefficient costs could be incurred and there may even be an adverse impact on overall market making efficiency.

The proposed obligation requires the licensee to maintain bid-offer spreads which encourage trading and are comparable to other licensees and other similar markets. We believe that the alternative where Ofgem sets maximum bid-offer spreads would both be very difficult for Ofgem to administer and may impose very significant costs on obligated parties. Bid-offer spreads will be affected by volatility, the cost of offering the service and the need to manage out any position imbalances. The energy market is relatively poorly characterised, making it difficult to compare with other markets and therefore increasing the risk that any constraints set by Ofgem may be inappropriately tight and impose disproportionate costs on market makers. In our view it would be very difficult to set appropriate levels administratively while still allowing obligated parties the necessary flexibility to react to market events.

Ofgem has sought to limit the costs and risks imposed on the market maker by limiting the maximum trade size to 10MW and limiting to 50% the proportion of market opening time in any given calendar month that the licensee is required to post prices. Should Ofgem proceed with this option, we believe it is important that these limits are not increased, as they are needed to allow parties a reasonable period to seek balancing trades to restore their position after accepting bids or offers and thus avoid an open-ended obligation which could result in market distortion and potentially in parties holding large net positions.

Ofgem have recognised that market making may be incompatible with certain regulatory exemptions under MiFID II. If parties are unable to make use of these exemptions as a result of market making this could lead to very high consequential costs on businesses as a result of the additional compliance obligations this would trigger.

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

In our view a Mandatory Auction is the most risky of the options under consideration and is unlikely to improve wholesale market access for independent suppliers.

A Mandatory Auction is likely to require market participants to put up more working capital to cover both initial margin and regulatory capital requirements and the periodic nature of such an auction will result in increased volatility with parties preparing their market positions in advance and correcting their positions after the event. Hedging, which is vital to wholesale market participants, would become more difficult as a result of a Mandatory Auction and other associated markets such as fuel and carbon could also be distorted by the process.

In relation to buy-side rules we welcome Ofgem's continued recognition that in order to ensure that the auction does not settle at below-market prices it is necessary to permit all market participants to participate on the buy-side as well as on the sell-side. However, Ofgem's latest design still includes buy-side rules limiting bid prices and bid volumes for obligated parties. There is a danger that these buy-side rules could still result in the auction settling at artificial prices and if this option were chosen then it would be essential that the impact of any such rules was clearly understood by all market participants before an auction of any significant volume took place.

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

We believe that implementing a Mandatory Auction on a single platform would be a risky option and that seeking to implement a single auction process across multiple platforms through a hub approach would significantly exacerbate this risk. Ofgem have recognised the challenges that a hub would bring, including the need for collateral arrangements to underpin trading between platforms across the hub, which we believe would be likely to make this option very unattractive for independent suppliers.

ScottishPower
February 2013