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Dear Phil,

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

Thank you for providing SSE with the opportunity to respond to the consultation on the proposed 'Secure and Promote' licence condition to enhance liquidity in the GB power market.

SSE broadly welcomes the change of emphasis in Ofgem's proposals – particularly the acknowledgement of the various market led changes and Ofgem's move away from the Mandatory Auction (MA) as the preferred option. Despite the additional work that has gone into the MA, SSE believes that this remains an inappropriate and ineffective intervention, which would impose increased risks on obligated parties with little material benefit for the market participants whom Ofgem is seeking to assist.

SSE has been instrumental in bringing about the marked improvement in prompt liquidity and has taken further steps to improve the access of smaller market participants to the products and clip sizes they need. SSE believes that improved liquidity would be to the benefit of all market participants and continues to support the aspiration to see increased volumes traded further forward.

This summary provides a high-level overview of SSE's position on the different elements of 'Secure and Promote', with detailed answers to specific questions provided in the Appendix.

Premise for intervention

In response to the previous consultation on wholesale liquidity[1], SSE questioned whether Ofgem had successfully made the case that improved wholesale liquidity is a prerequisite for increased competition in electricity retail, particularly in the domestic market. Ofgem repeats this assertion in the current consultation document[2]. Whilst Ofgem has provided no further evidence in support of this view, there is sufficient evidence to suggest that liquidity levels are not adversely impacting competition in energy supply:

- Stephen Fitzpatrick (CEO of Ovo Energy) has gone on record as saying, "We've never had any problems buying power. It surprises me when other independents, even smaller than us, say they can't buy enough electricity"[3];
- Co-Operative Energy entered the domestic supply market in May 2011 and in less than two years has established a customer base in excess of 100,000, most notably grabbing headlines by out-competing established large suppliers in a collective switching auction[4];

[1] SSE response dated 11 May 2012
[2] Consultation document: Executive Summary, p. 4 and Chapter 2, para. 2.7
[3] Utility Week, 9 Nov 2011
[4] Co-operative Energy website, 22 Jan 2013

- Whereas large-scale generators such as Drax (with 4GW capacity) and GdF Suez Energy International (with an interest in more than 6GW capacity in GB) have chosen *not* to expand their existing supply interests by entering the domestic market.

These observations undermine Ofgem's assertion that liquidity is a barrier to entry or growth in the domestic supply market.

Policy context and the impact of uncertainty

Ofgem has correctly identified the most important elements of the current policy landscape which combine to inhibit the natural development of improved liquidity in the forward market. UK policies such as the Carbon Price Floor and the EMR are the most obvious factors influencing the market at present. However, the profound changes to the market driven by EU legislation could also have a significant impact on liquidity in the GB power market in the medium term.

The European legislative process to develop the Markets in Financial Instruments Directive (MiFID II) still has a long way to go; it is likely to take several more months for the Council of Ministers to finalise their position and only after that has happened can the trialogue discussions begin. It could therefore take until the end of 2013 before there is any certainty on the impact of MiFID II and the European Markets Infrastructure Regulation (EMIR).

There are various scenarios for the final definitions which are of particular interest in the context of Ofgem's proposals: forward gas and power transactions may or may not be classified as "Financial Instruments"; market making may or may not be given an exemption from MiFID II. Clearly, an obligation to provide market making services could, under certain circumstances, be the only criterion under which a company is caught by MiFID II and consequently brought into the scope of mandatory exchange clearing. Similarly, should all forward trades be treated as financial instruments, the measures discussed in the current consultation relating to bilateral trading arrangements would become irrelevant.

With such scenarios in mind, SSE agrees with Ofgem when it states that it does "not believe that now is the best time to make a final assessment of the need to intervene to support liquidity – and what that intervention should be"[5].

However, as stated above, SSE would like to see improved forward liquidity and recognises that the backstop powers introduced in the Energy Bill increase the likelihood of some kind of intervention in the market. With that in mind, SSE regards Ofgem's process of consultation and market engagement as the most appropriate and effective route to balance the needs of different market participants.

Secure and promote

SSE is concerned that the framework for the 'Secure and Promote' licence condition calls for potentially obligated parties to agree the licence condition before the Requirements Document is finalised. Ofgem rightly intends to consult widely on the specific requirements but it is likely that this process will become quite polarised. This approach to introducing new obligations places an undue regulatory risk on the potentially obligated parties. One means of mitigating this risk is to broaden the range of obligated parties to cover a wider spectrum of business models. For instance, in the case of the trading commitment, there is no reason why *all* parties with a significant volume of generation capacity should not be obliged to offer fair and reasonable terms to smaller players.

<u>Trading commitments</u>

This element of 'Secure and Promote' has similarities with SSE's small supplier trading commitment. However there are some elements of this proposal of concern to SSE:

- The obligation should apply to large generators as well as to large suppliers – Ofgem's rationale for excluding such market participants is based on a misrepresentation of the sophistication of the trading operations of such parties

[5] Consultation document, Chapter 1, para. 1.35

- Effective credit risk management is a key commercial activity - it is imperative that the setting of appropriate credit and collateral arrangements remains the prerogative of the obligated party
- Ofgem should not consider incorporating a shaped product as this is unduly complicated and does not align with what currently works in the market
- Baseload and peak are sufficient for hedging purposes, as fine tuning of positions can be done nearer delivery in the more liquid prompt market (at which point more accurate demand forecasts are available)
- SSE remains concerned that the basis on which small suppliers are defined needs to be reviewed but recognises that the detailed elements of the proposed requirements are most appropriately targeted at smaller market participants – the proposed threshold of 1TWh per year would be an appropriate upper limit

<u>Day-ahead auctions</u>

SSE welcomes the proposal not to restrict the platform on which the volume must be traded as it is important to allow for competition between auction providers. SSE currently submits 100% of generation and demand volumes into the day-ahead auction on N2EX, and intends to continue to do so regardless of whether or not this becomes a licence obligation. Since October 2011 the volume of power traded through the day-ahead auction on N2EX has increased from around 40GWh per day to nearly 400GWh per day. This transformation has been built upon large vertically integrated companies voluntarily entering into gross-bidding contracts for 30% of annual generation volume.

SSE believes that there is merit in applying the same obligation to all flexible generators and that the obligation should be for more than 30% of volume. If the majority of the generation stack was in the auction it would provide the market with greater confidence that the auction process yields a true economic price. This would consolidate the work that has already been done to establish the N2EX day-ahead auction as the most robust and reliable reference price for the GB power market.

Promoting further developments

<u>Market maker obligation</u>

SSE has previously argued that market making is a more proportionate intervention than the mandatory auction. SSE continues to believe that market making would provide the best means of targeting the specific issue of improving forward liquidity in the GB power market. However, the ongoing development of MiFID II raises significant concerns about the possible implications of a requirement to market make. There is potential for an obligation on large players to provide market making services to lead to increased cost of capital, as working capital requirements increase. This risk would be particularly significant if Ofgem did not place some sort of volume cap on the obligation to market make.

There is an alternative solution which would ensure that intervention was robust and future-proofed against adverse consequences arising from European legislation: Ofgem should consider the possibility of tendering for two or three parties to market make on a voluntary basis. Financial firms may be better placed to offer this service which should be funded by all market participants in proportion to portfolio size. This option would ensure that energy firms are better able to manage the size of forward positions taken, and the consequent cash-flow challenges that large margin calls could present.

<u>An obligation to trade</u>

This proposal shares similar design challenges to market making – particularly in the specification of products and volumes to be traded. However, it may be much easier and less costly to implement and would also be relatively easy to amend or remove should it become apparent that the obligation is unduly onerous. Equally, this obligation may serve as a suitable catalyst that would promote the accelerated evolution of improved forward liquidity but which would become superfluous once the market develops sufficient momentum.

It is worth noting that market makers would in all probability enter into agreements with exchanges to secure advantageous rates and would therefore have a contractual commitment that could not easily be unwound. This consideration means that market making cannot be introduced with any confidence at this stage, whereas the much simpler obligation to trade would target the same problem at lower risk to obligated parties.

SSE believes that it is absolutely critical to the success of any intervention that large generators are required to meet the same obligation as vertically integrated companies. This would ensure the depth and flexibility which the market requires. Capturing a wider range of generation assets bases and cost drivers (reflecting the greater range of plant dynamics and efficiencies) would provide the best means to mitigate the real risk of creating "distressed buyers or sellers as licensees try to meet their obligation"[6].

In order to work effectively, this obligation would need to be based on parties' total generation *or* supply volumes (rather than "generation and supply volumes"[7]). A clear definition of the terms under which this obligation applies is necessary to ensure that the licence condition is future-proofed and remains fit for purpose in an evolving market.

<u>Self-supply restriction (SSR)</u>

At the two roundtable events organised by Ofgem, a number of stakeholders once again suggested that forward liquidity could be addressed through the introduction of a restriction on self-supply. This discussion has been repeated in meetings of Energy UK members seeking a consensus view on the best way forward. Whilst an SSR could come in a variety of flavours, it seems apparent that even advocates of a restriction on self-supply recognise that additional measures would be required in order to meet Ofgem's second objective.

Indeed, focusing on an SSR as an intervention allows certain market participants to deflect attention from their own potential role in improving forward liquidity. SSE strongly advocates that any obligation intended to improve forward liquidity should apply to all large generators, and as such the SSR is an unnecessary distraction.

SSE agrees with Ofgem's previously published assessment that an SSR in itself would not guarantee increased trading of particular products, would be hard to enforce and would not necessarily lead to increased volumes being brought to market. SSE does not support calls for Ofgem to consider this option again and would encourage all stakeholders to focus on measures which directly impact forward liquidity.

<u>Mandatory auctions</u>

SSE does not believe that the MA has a role to play under 'Secure and Promote'. Ofgem has described further work on the MA, including the proposal that obligated parties "must bid a single price throughout the interval where its net position is within 20% of its mandatory sale quantity"[8]. A more succinct phrasing of which would be that Ofgem intends to impose a bid-offer spread of zero on obligated companies. This requirement is not consistent with the approach and care taken in the consideration of a market making obligation, where Ofgem "aimed to limit the bid-offer spread to ensure the mechanism would be effective, while stopping short of placing explicit regulatory limits on them, which could distort prices"[9]. Periodic auctions still suffer in comparison to other proposals which could offer liquidity on a more continuous basis.

Conclusion

Ofgem's current proposals reflect the rapid and significant improvements witnessed in the wholesale market and with minor changes could help to meet policy objective one and three. Some further work is required to ensure that progress can be made towards meeting objective two without placing a disproportionately onerous obligation on some market participants. SSE would like to see further work towards a workable version of the obligation

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[6] Consultation document, Chapter 4, para. 4.15.
[7] Consultation document, Chapter 4, para. 4.13.
[8] Consultation document, Appendix 3, para. 3.7.
[9] Consultation document, Chapter 4, para. 4.12.

to trade, critically incorporating a wider range of players to minimise the risk of creating distressed buyers or sellers.

Ofgem have correctly identified the various sources of market uncertainty but SSE believes that further work is required to fully understand the range of consequences of European legislation – in particular the capital requirements and the possibility that providing market making services will change the classification of a company under MiFID II. A fuller understanding of these consequences is necessary before further consideration is given to the mandatory market making proposal.

SSE would be very happy to discuss the issues raised in this response and will continue to contribute to ongoing work to identify the best means of building on the market led improvements in wholesale liquidity.

Yours sincerely,

(by email)

Roger Hutcheon
Regulation, Markets

Appendix 1 – Answers to specific consultation questions

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

SSE broadly agrees with Ofgem's market assessment.

The prompt market continues to work well. The increase in volume cleared through the N2Ex day-ahead auction has been sustained, with current auctions clearing volumes of 350-400GWh. This is a tenfold increase since Oct 2011.

There are signs of improved volumes trading through January 2013 - Heren has reported provisional volumes which seem to have picked up in the weeks and months contracts particularly. SSE has previously argued that liquidity develops naturally in markets, building forwards from the prompt out through the curve.

An important point which is sometimes lost in discussion of the GB power market is that this market is intrinsically linked to the gas market, which is one of the most liquid commodity markets in Europe. The spark spread market which provides this link is typified by tight bid-offer spreads and, given the tight spreads seen in the liquidly traded gas market side of this spread, there is 'hidden liquidity' in the power market. The fact that spark spreads are often quoted with narrow bid-offer spreads but not traded suggests that there is not an underlying problem with liquidity in the GB market. At least one broker is looking at a solution which would link the markets automatically – effectively making the power prices implied by the spark spread market more visible to market participants. Perhaps this is an area which Ofgem should look into as there is scope to encourage market participants to support this project, which is clearly intended to build on what already is already available in the market.

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

Ofgem has correctly identified the most important elements of the current policy landscape which combine to inhibit the natural development of improved liquidity in the forward market. UK policies such as the Carbon Price Floor and the EMR are the most obvious factors influencing the GB market at present. However, there are others, including ongoing work on European network codes being conducted by ENTSOE.

It is important to note that all of the ongoing work (either at European or GB level) which affects cash-out prices will have a direct impact on how generation assets are traded and hedged. These policies will therefore have a bearing on the development of liquidity in the GB power market.

Added to this risk is the uncertain impact of European legislation which may have a profound effect on trading of power and gas. MiFID II and EMIR could effectively move all forward liquidity onto exchanges – so any intervention to secure fair bilateral trading terms would be rendered irrelevant.

SSE therefore agrees with Ofgem when it states that it does "not believe that now is the best time to make a final assessment of the need to intervene to support liquidity – and what that intervention should be"[10].

However, SSE would like to see improved forward liquidity and recognises that the backstop powers introduced in the Energy Bill increase the likelihood of some kind of intervention in the market. SSE regards Ofgem's process of consultation and market engagement as the most appropriate and effective route to balance the needs of different market participants.

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

[10] Consultation document, Chapter 1, para. 1.35

SSE would like to see a clear statement from Ofgem as to whether cost of market participation or access to markets (and products) is seen as the higher priority. This is relevant in connection with day-ahead markets in particular and cleared markets in general (particularly given possible future scenarios under EMIR).

Discussions at Ofgem's roundtables and other industry events suggest that different parties are working towards different ends and in the continued absence of a stronger line from Ofgem on cost versus access there is a danger that the current consultation process will not address the appropriate element.

SSE would argue that access to markets is already provided, either by GTMA's or by exchanges, and is available subject to meeting the credit and collateral requirements of the relevant counterparty. Many of the roundtable discussions have suggested that access is available but the cost is not seen as acceptable. There needs to be greater recognition that credit and collateral costs, whilst significant, merely represent the economic cost of adequate credit risk management. Others have criticised the limited visibility of forward prices (particularly OTC trades), yet several price reporting agencies exist which provide such information for a fee – this is another cost of participation in the wholesale power market. Discussion should focus on whether it is reasonable to impose further costs on some market participants in order to facilitate the preference of some others to avoid the reasonable costs of participation.

CHAPTER: Two

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

Yes.

Ofgem's current proposals reflect the rapid and significant improvements witnessed in the wholesale market and with minor changes could help to meet policy objective one and three. Some further work is required to ensure that progress can be made towards meeting objective two without placing a disproportionately onerous obligation on some market participants. SSE would like to see further work towards introducing voluntary market making, which could be funded by all market participants in proportion to portfolio size. Further work should also look at a workable version of the obligation to trade, which critically incorporates a wider range of players to minimise the risk of creating distressed buyers or sellers.

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

SSE is concerned that the framework for the Secure and Promote Licence Condition calls for potentially obligated parties to agree the licence condition before the Requirements Document is finalised. Ofgem rightly intends to consult widely on the specific requirements but it is likely that this process will become quite polarised. This approach to introducing new obligations places an undue regulatory risk on the potentially obligated parties. One means of mitigating this risk is to broaden the range of obligated parties to cover a wider spectrum of business models. For instance, in the case of the trading commitment, there is no reason why *all* parties with a significant volume of generation capacity should not be obliged to offer fair and reasonable bilateral trading terms to smaller players.

Similarly, obliging a wider range of licensees to participate in both the DA auction and any obligation to trade would result in a wider range of plant dynamic and efficiencies being brought to market. For instance, Drax Group operate the UK's largest and most efficient coal-fired power station – if the unique plant economics of Drax were included in the DA auction it would provide market participants greater certainty that the auction price represents the true economic cost of power in GB.

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

Yes.

SSE does not believe that the MA has a role to play under 'Secure and Promote'. Ofgem has described further work on the MA, including the proposal that obligated parties "must bid a single price throughout the interval where its net position is within 20% of its mandatory sale quantity"[11]. A more succinct phrasing of which would be that Ofgem intends to impose a bid-offer spread of zero on obligated companies. This requirement is not consistent with the approach and care taken in the consideration of a market making obligation, where Ofgem "aimed to limit the bid-offer spread to ensure the mechanism would be effective, while stopping short of placing explicit regulatory limits on them, which could distort prices"[12]. Periodic auctions still suffer in comparison to other proposals which could offer liquidity on a more continuous basis.

Whilst further work is required to refine the proposals – particularly to meet Objective Two – the 'Secure and Promote' model aims to build on what already exists in the market or is seen to work well in other markets (e.g. market making). As such there is a greater chance of success through 'Secure and Promote' than there ever was through the MA.

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?*

SSE has been supportive of this type of measure through our small supplier trading commitment. Ofgem's proposal has many similarities with SSE's voluntary commitment, but there are some elements of this proposal of concern to SSE:

- The obligation should apply to large generators as well as to large suppliers – Ofgem's rationale for excluding such market participants is based on a misrepresentation of the sophistication of the trading operations of such parties
- Effective credit risk management is a key commercial activity - it is imperative that the setting of appropriate credit and collateral arrangements remains the prerogative of the obligated party
- Ofgem should not consider incorporating a shaped product as this is unduly complicated and does not align with what currently works in the market
- Baseload and peak are sufficient for hedging purposes, as fine tuning of positions can be done nearer delivery in the more liquid prompt market (at which point more accurate demand forecasts are available)
- SSE remains concerned that the basis on which small suppliers are defined needs to be reviewed but recognises that the detailed elements of the proposed requirements are most appropriately targeted at smaller market participants – the proposed threshold of 1TWh per year would be an appropriate upper limit

There is a certain degree of circularity in Ofgem's proposed approach to 'fair pricing' – if quotes are to be based on a recognised market index then surely no further intervention is required to promote forward liquidity. However, SSE welcomes the proposal that reasonable administrative costs should be recovered provided they are clearly itemised. This approach presents the opportunity for obliged parties to compete for the business of smaller parties based on efficient costs, whilst minimising the risk that additional administration costs are subsidised.

[11] Consultation document, Appendix 3, para. 3.7.
[12] Consultation document, Chapter 4, para. 4.12.

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?*

Given SSE's support for gross-bidding on N2EX, we welcome Ofgem's clear statement that this initiative has had a net positive impact in the GB power market. SSE believes that liquidity levels in the DA auction are now sufficient to properly support the healthy development of the futures market indexed against the auction price.

SSE welcomes the proposal not to restrict the platform on which the volume must be traded as it is important to allow for competition between auction providers. SSE currently submits 100% of generation and demand volumes into the day-ahead auction on N2EX, and intends to continue to do so regardless of whether or not this becomes a licence obligation. Since October 2011 the volume of power traded through the day-ahead auction on N2EX has increased from around 40GWh per day to nearly 400GWh per day. This transformation has been built upon large vertically integrated companies voluntarily entering into gross-bidding contracts for 30% of annual generation volume.

SSE believes that there is merit in applying the same obligation to all flexible generators and that the obligation should be for more than 30% of volume. If the majority of the generation stack was in the auction it would provide the market with greater confidence that the auction process yields a true economic price. This would consolidate the work that has already been done to establish the N2EX day-ahead auction as the most robust and reliable reference price for the GB power market.

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

SSE has always argued that liquidity naturally develops from the prompt market forwards through the curve. All external factors being equal, this process happens naturally in well functioning markets. We would agree that the pace of development has been slower than might have been hoped, and would put this down to a combination of factors, principally the uncertain policy landscape. The degree to which the liquid gas market attracts any speculative investors wishing to take a position in the GB energy market is an important factor.

See Questions 1) and 8) for observations on the natural development of forward liquidity.

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

SSE agrees with Ofgem when it states that it does "not believe that now is the best time to make a final assessment of the need to intervene to support liquidity – and what that intervention should be"[13].

However, as stated above, SSE would like to see improved forward liquidity and recognises that the backstop powers introduced in the Energy Bill increase the likelihood of some kind of intervention in the market. With that in mind, SSE regards Ofgem's process of consultation and market engagement as the most appropriate and effective route to balance the needs of different market participants.

Question 11: *Is market-making the most appropriate intervention option to promote robust reference prices along the curve? What is your view on the trading obligation option that is outlined on page 34?*

Market maker obligation

[13] Consultation document, Chapter 1, para. 1.35

SSE has previously argued that market making is a more proportionate intervention than the mandatory auction. SSE continues to believe that market making would provide the best means of targeting the specific issue of improving forward liquidity in the GB power market. However, the ongoing development of MiFID II raises significant concerns about the possible implications of a requirement to market make. There is potential for an obligation on large players to provide market making services to lead to increased cost of capital, as working capital requirements increase. This risk would be particularly significant if Ofgem did not place some sort of volume cap on the obligation to market make.

There is an alternative solution which would ensure that intervention was robust and future-proofed against adverse consequences arising from European legislation: Ofgem should consider the possibility of tendering for two or three parties to market make on a voluntary basis. Financial firms may be better placed to offer this service which should be funded by all market participants in proportion to portfolio size. This option would ensure that energy firms are better able to manage the size of forward positions taken, and the consequent cash-flow challenges that large margin calls could present.

An obligation to trade

This proposal shares similar design challenges to market making – particularly in the specification of products and volumes to be traded. However, it may be much easier and less costly to implement and would also be relatively easy to amend or remove should it become apparent that the obligation is unduly onerous. Equally, this obligation may serve as a suitable catalyst that would promote the accelerated evolution of improved forward liquidity but which would become superfluous once the market develops sufficient momentum.

It is worth noting that market makers would in all probability enter into agreements with exchanges to secure advantageous rates and would therefore have a contractual commitment that could not easily be unwound. This consideration means that market making cannot be introduced with any confidence at this stage, whereas the much simpler obligation to trade would target the same problem at lower risk to obligated parties.

SSE believes that it is absolutely critical to the success of any intervention that large generators are required to meet the same obligation as vertically integrated companies. This would ensure the depth and flexibility which the market requires. Capturing a wider range of generation assets bases and cost drivers (reflecting the greater range of plant dynamics and efficiencies) would provide the best means to mitigate the real risk of creating "distressed buyers or sellers as licensees try to meet their obligation"[14].

In order to work effectively, this obligation would need to be based on parties' total generation *or* supply volumes (rather than "generation and supply volumes"[15]). A clear definition of the terms under which this obligation applies is necessary to ensure that the licence condition is future-proofed and remains fit for purpose in an evolving 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?*

Bid-offer spreads

The regulation of bid-offer spreads in other markets (e.g. Nordpool) provides a useful reference for how these may be set. Ofgem has identified the correct parameters for consideration, particularly the tension between an effective mechanism and price distortion. If under normal market conditions (as opposed to fast markets which would require more flexible conditions) a spread of 80p/MWh for instance would be more than sufficient to allow obligated parties to manage the size of their position (and to control which side of a trade they are likely to be on). Such a spread would highlight the need for market making to presented through a single platform or hub to avoid the risk that an obligated party is picked off by a counterparty able to arbitrage prices. In addition to the bid-offer spread, a volume cap on the

[14] Consultation document, Chapter 4, para. 4.15.
[15] Consultation document, Chapter 4, para. 4.13.

total position that an obligated party could develop may be appropriate in addition to the protection offered by the bid-offer spread.

Cost
Limiting the size of individual trades does not limit the cost of market making. In addition to the 10MW clip size, a limit on the total position developed would provide a better control on costs. It is also worth highlighting that in order to find a voluntary market maker it will probably be necessary to provide additional remuneration above the profit available from the bid-offer spread (the cost of which SSE suggests is funded by all market participants in proportion to the size of their portfolio). It would therefore be unreasonable for Ofgem to consider imposing an obligation on some market participants which may expose them to costs above those which could be recovered through the spread (critically costs which could represent more than that party's share of the costs should Ofgem pursue a voluntary market making alternative).

MiFID II
There are various scenarios for the final definitions which are of particular interest in the context of Ofgem's proposals: forward gas and power transactions may or may not be classified as "Financial Instruments"; market making may or may not be given an exemption from MiFID II. Clearly, an obligation to provide market making services could, under certain circumstances, be the only criterion under which a company is caught by MiFID II and consequently brought into the scope of mandatory exchange clearing.

SSE believes that this consideration makes it difficult for Ofgem to proceed with the proposed mandatory market making until there is further clarity on the likely outcome of MiFID II, which may take as long as the end of 2013.

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

SSE does not believe that the MA has a role to play either under 'Secure and Promote' or under any other intervention intended to address Objective Two.

In particular the proposal that obligated parties "must bid a single price throughout the interval where its net position is within 20% of its mandatory sale quantity"[16]. A more succinct phrasing of which would be that Ofgem intends to impose a bid-offer spread of zero on obligated companies. If regulation of the bid-offer spread is a concern under market making then setting it at zero under the MA is completely unacceptable.

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

Given the above answer, SSE does not believe that this factor is significant.

[16] Consultation document, Appendix 3, para. 3.7.