Phil Slarks
Wholesale Markets
Ofgem
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Dear Phil,

<u>Wholesale power market liquidity: consultation on a 'Secure and Promote' licence condition</u>

Statoil UK Limited ('STUK') welcomes the opportunity to respond to the proposals outlined in the consultation document and appreciates the opportunity for direct stakeholder engagement through the two workshops held in January and February 2013.

In principle STUK is supportive of efforts to enhance liquidity in the power market; however we would urge that any regulatory intervention be as light-touch as possible to allow the market to develop in response to any such intervention. To this end, STUK continues to believe there is value in giving further consideration to the large-scale or longer-dated Mandatory Market Maker (MMM) option discussed in the February 2012 consultation document, since this would better fulfil Ofgem's liquidity objectives whilst also following its 'lighter touch' regulatory approach. We do not believe sufficient explanation has been provided as to why MMM is not being developed further while the Mandatory Auction (MA) is. We believe MMM has the benefits of introducing depth, through the entry of additional parties such as financial institutions, and work with the grain of the market as these entities would be responding to price signals.

STUK still believes that the reluctance of traders to trade further out on the forward curve may be due to a range of factors in addition to concerns about liquidity. Although the Energy Bill has now been published, the final shape of the legislation, including whether and how the proposed capacity market will operate, will only be finalised by the end of the year at the earliest. This along with the concerns about the potential impact of REMIT and MIFID II and the rolling 2-year projection of the carbon price floor are together impacting on the extent of power trading activities. Therefore the danger remains that the market may not show significant improvements until the Energy Bill and secondary legislation are passed. Consequently, we support Ofgem's conclusion that it would be inappropriate to make a final assessment now on whether there is a need to intervene to support liquidity, and the form that intervention should take.

In the meantime STUK would urge Ofgem to continue to formulate, in consultation with industry parties, appropriate and transparent critical success criteria so that all parties are aware of the extent to which the market is performing in terms of liquidity. The metrics used in the S&P consultation could form the basis of such success criteria.

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

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

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

STUK agrees that the recent developments in the near-term market are encouraging, but with two caveats: first, the growth in gross-bidding may belie the depth of actual net volumes available to the wider market, so STUK would be keen to understand better how net volumes are developing; second, OTC / N2EX Cleared OTC liquidity seems to have declined significantly, a development that is not reported. Therefore there may not be a case to intervene in the day ahead market.

In terms of robust reference prices being generated along the curve, we agree that there has been little improvement, and we believe the same is the case for the availability of hedging products.

At a high-level, STUK agrees that the decline in annual churn reflects the impact of the wider factors Ofgem has suggested – lower risk capital available to financial firms and falls in economic activity. As discussed above, we also believe that the changing policy landscape, along with the details of the capacity market still to be finalised , is having an inevitable impact on power trading activities.

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

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

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

STUK understands Ofgem's rationale for proposing a Secure and Promote (S&P) licence condition as an alternative methodology to the MA, but believes there are a number of issues in pursuing such an approach. First, in setting a precedent for S&P licensees to undertake actions in support of liquidity, there is a risk that these requirements evolve over time so as to reduce the focus of the licence condition solely on liquidity. Second, the criteria by which S&P licensees are determined may also change, expanding the number of participants covered. Both are outcomes Ofgem should guard against.

Another concern is that in the process of "locking in" progress made to date, the conditions in the S&P licence may instead result in unintended consequences that undo this progress.

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Furthermore, if Ofgem is to require S&P licensees to report on their efforts to meet their obligations as set out in the Trading Requirements Document then there must be a set methodology in place to objectively and systematically assess all the items that are reported, in light of both the wider market conditions and each licensee's market position – and this methodology should be consulted upon and widely understood in the market.

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 commitments" on page 25?

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?

On the requirements set out on trading agreements (page 25) STUK believes a number of them are already being met voluntarily by most market participants (for example the proposals on transparency and scope), and therefore they should not necessarily be enforced through a license condition which may have unintended consequences.

Moreover some of the intended benefits may not materialise. For example, on product range, we believe smaller suppliers may not actually be interested in this full suite of standard products being suggested and so would not derive much benefit from them. On fair pricing, the proposal for licensees to share their pricing methodology with counterparties is likely to result in high-level summaries to be provided so as to not to divulge commercial information which may also affect competition.

Some of the conditions may also negatively impact on licensees' ability to undertake proportionate action to manage risk with counterparties. For example, the question of what are 'reasonable' credit and collateral arrangements is likely to vary from licensee to licensee, depending on their approach to trading and risk, and so an independent assessment of creditworthiness may not be appropriate. Also, the requirement for licensees to respond to requests within the deadlines proposed are not likely to be sufficient to undertake a full due diligence. Moreover the effect of these conditions could result in disproportionately higher costs for licensees since they will require additional capacity to deal consistently with a likely increased number of trading requests.

On the requirements to secure existing developments in the day-ahead auctions (page 28), STUK has similar concerns on potential unintended consequences of a requirement on licensees to buy and sell a minimum proportion of their generation through day-ahead auctions. S&P licensees may already be meeting this requirement of their own volition but, depending on market conditions and their own position, the extent to which each licensee will trade in the day-ahead market could fluctuate from all to nothing. Therefore setting it as a requirement runs the risk of severely impacting on their commercial interests and also creating market distortions. The key priority of any intervention must be to facilitate normal market behaviour and raise the number of market participants. It is also unclear what effect this proposal would have along the curve.

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

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

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?

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?

STUK believes it is possible that liquidity may develop along the curve without further intervention. It is worth pointing out that lower volume traded along the curve during recent times is not a feature unique to UK power markets, and moreover that this could be a symptom of market participants simply being unwilling to trade, in which case tight bid-offer spreads may be sufficient.

If an intervention is needed to promote robust reference prices along the curve then, in accordance with the points made above, of the two measures proposed STUK would support the use of a market-making option, since in principle it is a less interventionist measure than the alternative, the obligation to trade, which would place an overly restrictive condition on licensees. The illustrative requirements proposed in the consultation seem appropriate, however implementation and monitoring will be key - we would like to better understand how Ofgem intends to assess the performance of each licensee against them, for example on the appropriateness of bid-offer spreads.

There are a number of considerations on the market-making obligation which we believe should be addressed. One relates to the entity tasked with the market making – there may be greater incentives for a third party to undertake this role more effectively than if this was done by each S&P licensee. Another relates to the timing of when the market making is carried out – it may be more effective a measure if there were specified times during the trading day, providing greater certainty to market participants, rather than leaving it to each entity's discretion which could lead to market making being undertaken when it was not needed in the market.

On the illustrative requirements proposed (page 32), we believe the maximum trade size should be increased from 10MW to 15MW since this would bring power in line with gas, while the requirement on bid-offer spreads should be removed as it is too prescriptive – it is better to leave this to the market.

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

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

As said above, STUK remains of the view that MA is not the option that best meets Ofgem's objectives for increasing market liquidity; rather the MMM proposal would be a more effective intervention since it would support

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trading volumes taking place on an on-going basis rather than in concentrated bursts around the time of each auction, as evidenced by the VPP markets in the US and France. Traders in the market need the facility to buy or sell volumes at any specific moment and cannot wait for a scheduled auction. Moreover the MMM is a ‘lighter touch’ approach and would allow the Big Six increased flexibility to decide when to post bids and offers. As long as they fulfilled the volume obligation over an agreed period, for example on an annual basis, then the companies in question would meet their regulatory obligations in this area. Such an approach better facilitates continuous trading rather than a one off monthly volume auction.

Therefore we believe that there is value in re-examining the MMM option, or construct a hybrid of the MMM and MA options. An obligation on the relevant parties to post bids and offers for a range of longer dated products adhering to the volume thresholds proposed by Ofgem would in our view, provide a significantly greater probability of improving depth and liquidity in the market than a MA.

STUK believes that regulatory complexity effectively provides a barrier to entry for new participants and hinders market liquidity and therefore the platform for, and mechanism of, auctions should be as simple as possible. Hence STUK prefers a single platform for auctions; and on the auction mechanism, STUK would argue that this should mirror what is used in other auction mechanisms, such as the capacity mechanism (which is proposed to be ‘pay as clear’) rather than using an entirely different approach which would add to market complexity and possibly create distortions.

Yours sincerely,

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