

Ofgem
Attention: Phil Starks
9 Millbank
London
United Kingdom

09 August 2013

Dear Phil

APX response to Ofgem consultation on Secure and Promote: Final Proposals

On the 1 March 2013 APX-ENDEX split into a power spot and clearing entity (APX) and a derivatives and spot gas entity (ICE-ENDEX). APX operates prompt, auction and intraday markets (near to real time) in the United Kingdom, Netherlands and GB. The split has allowed a renewed focus of APX on the operation and development of efficient and interconnected close to real time power markets.

APX focused on developing near term markets

As part of this renewed focus we held our first APX Market Development Advisory Board (MDAB) meeting for the United Kingdom on the 27 June. We took the decision to establish both a UK and continental MDAB, instead of a single MDAB for all markets, to better reflect the specific challenges that APX and our members face.

We welcome Ofgem's attendance the UK MDAB and hope that the feedback that you received on your liquidity proposals was useful. Our members encouraged us to look for opportunities to leverage our wide member base to facilitate industry led solutions to improve liquidity. You will be aware that APX currently has 67 members in the UK, the highest number of members of any UK energy exchange. Exchange membership is an important liquidity metric as it is a good measure of contestability and accessibility of a market.

We would like to highlight that we have recently been successful at attracting a number of independent generators and suppliers to our market. We believe that smaller independents have a preference for APX because our credit terms are more attractive and our UK markets, particularly intraday, provide the flexibility and depth that independent companies need. APX's direct clearing model removes the need for parties to enter into a relationship with a clearing bank, which acts as a significant barrier to entry to smaller players. We hope that Ofgem recognises APX's effort to encourage and facilitate new market entry.

We agree with Ofgem's assessment that the effectiveness of near term markets in GB has improved and that there is no need for direct regulatory intervention in the form of license conditions. However, we would encourage Ofgem to adopt a more nuanced and balanced approach to assess and report on developments in near term markets. This relates to Ofgem's choice of success metrics for near term markets.

We will continue to proactively engage with our members, Ofgem and DECC, building on our expertise in making markets work, to ensure that near term markets remain effective, efficient and contestable. This is a particular concern given the considerable challenge faced by the industry to

efficiently integrate low carbon generation and implement the anticipated European network codes and financial legislation.

Participants in the wholesale market face considerable policy uncertainty, which may impact price expectations, and discourage them from contracting ahead (Electricity balancing significant code review, Electricity market reform, and EU network codes and financial legislation). Liquidity may improve when the current regulatory uncertainty is addressed. We note that historical periods of increased liquidity also coincide with periods of regulatory stability.

The APX intraday market

We appreciate that Ofgem has (indirectly at least) recognised our efforts to develop an efficient, transparent and accessible intraday market. The APX intraday market accounts for over 95% of exchange based intraday trading in the UK. You note in your December consultation that “intraday liquidity is not currently a widely held concern”. However, we remain concerned that Ofgem’s approach to assess and report on the development of near term liquidity is unbalanced.

For example, it is surprising that Ofgem does not mention intraday markets in its final proposals consultation. It is widely recognised that the development of efficient and integrated intraday markets will be particularly important for the UK, as we seek to efficiently integrate significant volumes of less predictable and intermittent generation in the market.

We will continue to work with all of our members, and policy makers, to ensure that the APX intraday market evolves to meet these new challenges. While we understand the pressure on Ofgem to be seen to act, we consider it important to recognise industry led initiatives to build liquid and contestable markets.

We recommend that Ofgem continues to monitor and report on progress in intraday markets as well as day-ahead.

The APX day-ahead market

We agree with Ofgem’s assessment that volumes in the GB day-ahead auctions have increased. For the month of June, volumes in the APX day-ahead auction experienced a 160% year on year increase.

However, we do not believe that day-ahead volumes matched are the only success metric Ofgem should use to assess near term liquidity. For example, in the UK we make public our aggregated bid and offer curves and report on market concentration through HHI calculations. These metrics, along with membership numbers, provide valuable information on the competitiveness, reliability and depth of our market.

In the Netherlands and Belgium we also provide resilience analysis for the regulators. The resilience analysis shows the impact on price of an additional 50MW, 250MW and 500MW of supply and demand. We would be happy to explore whether there are any benefits from providing similar information in the UK.

We also note the concern Ofgem raised in its December consultation that some specific industry arrangements may mean that significant volumes are bought and sold in the GB day-ahead auctions by the same players without meaningfully adding to liquidity. We would be happy if Ofgem could explain these concerns so that we can work constructively with our members to address them.

Ofgem should note that APX is currently devoting significant resources to developing its UK day-

ahead auction market. In particular, APX is a leading party in the Price Coupling of Regions (PCR) and North West European (NWE) projects to integrate European power markets. The successful inclusion of GB in European market coupling arrangements will improve market depth, increased price resilience, promote cross border competition and potentially lower market concentration.

GB regulatory arrangements

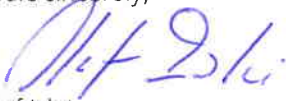
We agree with Ofgem's assessment that there is no need to intervene in near term markets. We would not welcome any licence condition that requires our members to post volumes on our, or any other, near term market. In general we believe that such mandatory measures are not effective at promoting liquidity.

However, we see increased pressure coming from anticipated policy developments which may warrant better oversight of near to real time markets. These include the choice of the GB day-ahead auction price as the reference price for EMR contracts for difference, day-ahead and intraday market coupling, NEMO designation and the implementation of European financial regulation.

We would be happy to lead a dialogue with our members, DECC and Ofgem on the oversight of near to real time markets.

If you would like to discuss any of the issues raised in this consultation response please contact me.

Yours sincerely,



Olaf Islei
Public and Regulatory Affairs

Chapter one

Question 1: Do you agree with our updated assessment of the wholesale market?

Ofgem's "health assessment" for wholesale markets is split between near term and forward markets. We agree with Ofgem's assessment that poor liquidity in electricity wholesale markets acts as a barrier to competition, preventing the entry and growth of new players and imposing costs on consumers.

Forward markets (derivatives)

Ofgem's assessment of forward markets shows that, following a sharp decline in trading volumes and churn in 2002, the market experienced an increase in traded volumes and churn between 2005 and 2009, and a decrease in traded volumes and churn between 2009 and 2013 (Figure 12). This indicates a shift from a positive path to a negative path in 2009.

Ofgem explains the shift to a negative path as resulting from a decline in risk capital available to financial firms since the financial crisis and widening capacity margins due to the fall in economic activity. The message of widening capacity margins does not sit comfortably next to Ofgem's recent assessment of capacity margins. However, we do acknowledge that it is difficult, and to an extent speculative, to pinpoint specific causes for the reverse in trend since 2009.

It is not clear that the market is locked into a low equilibrium as, according to Ofgem's metrics, the level of liquidity is not below that experienced in 2005 and 2006, which was a sufficiently high equilibrium to set liquidity on a upwards path.

Participants in the wholesale market face considerable policy uncertainty, which may impact price expectations, and discourage them from contracting ahead (Electricity balancing significant code review, Electricity market reform, and EU financial and market integration legislation). Liquidity may improve when the current regulatory uncertainty is addressed. We note that historical periods of increased liquidity also coincide with periods of regulatory stability.

Near term (physical market)

We agree that volumes in the day-ahead market have increased. However, as expressed in our previous consultation response we remain concerned that the metric that Ofgem uses to assess and report on near term liquidity is too narrow.

In particular it focusses too much on day-ahead volumes and not enough on the quality and robustness of the price formation, it fails to mention other industry led initiatives to develop liquidity in near term markets and, related to that, omits any mention of intraday markets.

There is a risk that, in adopting a single metric to assess and report on success in near term liquidity, Ofgem will fail to recognise genuine industry led efforts to promote liquidity and contestability of near term markets. This raises a question whether the approach adopted by Ofgem will result in an outcome that is in the public interest.

APX is currently devoting significant resources to developing our UK markets. We note there is little recognition of these initiatives in Ofgem's liquidity report.

Question 2: Do you agree with our conclusion that we should intervene in the market in the form of the 'Secure and Promote' license condition set out in this document?

We understand that there is significant pressure on Ofgem to be seen to act and that Ofgem's

priority will inevitably be the process to put in place the proposed license conditions. However, we see a strong risk that, in focusing its attention on implementing the secure and promote license conditions, Ofgem will fail to recognise genuine industry led efforts to promote liquid and contestable markets.

Chapter two

Question 3: Do you agree with our proposed legal approach to S&P?

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Question 4: Do you agree with our proposals for who should face the obligations under S&P?

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Chapter three

Question 5: Do you have any views on our final proposals for the Supplier Market Access rules, particularly those aspects listed under 'key outstanding design questions'?

At the Ofgem roundtable discussion we noted that Ofgem's key objective with the Supplier Market Access rules was to improve transparency around the handling of small suppliers' requests. We highlighted a legal risk that Ofgem may expose itself to, if it provided a list of approved small suppliers, without any checks of their creditworthiness, and at the same time exposed Licensees to a risk of breach of license on the price and credit terms offered to an approved small supplier. We see two options which may help manage this risk:

1. Undertake some form of assessment of the suppliers creditworthiness in developing the approved list
2. Amend the proposed license condition to focus on promoting transparency and remove the requirement on Ofgem to take a view on the appropriateness of credit terms or prices

To assist, we would be happy to explain the checks and balances we use at APX when new members join our market.

In addition, we would like draw your attention to two new services we have been developing for our UK members. We believe that these services improve the liquidity and contestability of near term markets and are linked to your Supplier Market Access rules.

The first is APXs new bilateral trade functionality on our EuroLight platform that went live in March 2013. This allows APX participants to conclude a bilateral trade, notify APX of that bilateral trade, which we subsequently clear and nominate. This means that our members can execute bilateral trades without having to establish a GTMA. While existing market participants already have GTMAs, the requirement to negotiate one with each potential counterparty, acts as a barrier to new entrants.

The second is a new service that APX is currently exploring to enable APX to clear and nominate trades that our existing members conclude via GB brokers. Given our wide membership base this new service could significantly improve the liquidity and contestability of near term markets.

Question 6: Are there any further areas that these rules should cover?

Chapter four

Question 7: Do you have any comments on our proposed detailed design for the market making obligation, particularly those listed under 'key outstanding design questions'?

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Question 8: Do the detailed elements of the proposed market making obligation

appropriately balance costs and risk for the licensees?

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Question 9: Do you believe that an industry-run tender process could more successfully deliver our proposals for a market maker? If so, do you have views on how we can solve the practical challenges we have identified?

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Chapter five

Question 10: Do you agree with our analysis of the costs, risks and benefits of intervening in the near-term market?

We agree with Ofgem's assessment that the effectiveness of near term markets in GB has improved and that there is no need for direct regulatory intervention in the form of license conditions. However, as expressed in our previous consultation response we remain concerned that the metric that Ofgem uses to assess and report on near term liquidity is too narrow.

In particular it focusses too much on day-ahead volumes and not enough on the quality and robustness of the price formation, it fails to mention other industry led initiatives to develop liquidity in near term markets and, related to that, omits any mention of intraday markets.

There is a risk that, in adopting a single metric to assess and report on success in near term liquidity, Ofgem will fail to recognise genuine industry led efforts to promote liquidity and contestability of near term markets. This raises a question whether the approach adopted by Ofgem will result in an outcome that is in the public interest.

APX has been devoting significant resources to develop our UK markets. The availability of new products and services has resulted in growth in new members and traded volumes. We note that there is little recognition of these efforts in Ofgem's liquidity report.

Day-ahead market coupling

We agree that implementing day-ahead market coupling in GB, as part of the North West Europe Market Coupling Project, will enhance the robustness of the day-ahead market. APX's day-ahead auction is currently the only GB day-ahead auction which is coupled to the continent via the BritNed interconnector. Market coupling brings several benefits, including better market depth, increased price resilience, promotion of competition across borders and potentially lower market concentration.

NWE market coupling, as a result of the algorithm design, will also allow APX to develop and offer new products in our GB day-ahead auction. These include simple and profile block products as well as smart products that will provide members with enhanced functionality. The availability of new products should encourage greater participation in our GB day-ahead auction.

We also agree that if DECC use the GB day-ahead auction price as Electricity Market Reform CfD reference price, this may increase volumes traded in the day-ahead auction. However we would like to note that it is not the "GB Hub" that will provide the reference price. In this aspect Ofgem's assessment should be more factual.

There will be three legs to GB market coupling post NWE go-live:

1. **GB – Netherlands:** market coupling between the APX GB day-ahead auction and the APX day-ahead auction in the Netherlands via the BritNed interconnector.

2. **GB – France:** market coupling between the NPS GB day-ahead auction and the EPEX Spot Day-ahead auction in France via the IFA interconnector
3. **GB – GB:** a special purpose vehicle (SPV) will be established to act as a virtual interconnector and couple the APX GB day-ahead auction and the NPS day-ahead auction

These arrangements mean that it will be the APX GB day-ahead auction and the NPS day-ahead auction that provide the day-ahead reference price for EMR CfDs – not the “GB Hub”. The prices in the APX and NPS day-ahead auctions will be determined by the European market coupling algorithm “Euphemia” which is currently being developed by European power exchanges under the Price Coupling of Regions initiative.

Question 11: Do you agree that we should not intervene in near-term markets at this stage?

We agree with Ofgem’s assessment that it is not necessary to introduce a new licence condition to require our members to post volumes on our, or any other, day-ahead auction. In general we believe that such mandatory measures are not effective at promoting liquidity.

However, we see increased pressure coming from anticipated policy developments which may warrant better oversight of near to real time markets. We would be happy to lead a dialogue with our members, DECC and Ofgem on how best to respond to these issues:

1. **Liquidity proposals:** Ofgem propose to introduce some form of reporting requirement for near to real term markets. We would be happy to discuss the type and format of information that Ofgem is seeking to request.
2. **EMR reference price:** we understand that DECC intend to use the GB day-ahead auction price as the reference price for the EMR contracts for difference. We believe that the reference price should be set against a physically settled contract and that day-ahead or intraday prices provide the best option given the nature of the exposure it is trying to negate. We believe that policy makers will require certainty that the chosen reference price is transparent, robust, accessible and not open to abuse.
3. **Day-ahead and intraday market coupling:** the arrangements for GB market coupling, which accommodate two power exchanges and multiple TSOs, are complex and require an appropriate GB contractual framework to ensure that the arrangements are robust, transparent and non-discriminatory. Project parties are currently in the process of developing the GB contractual framework which we expect to finalise in September, before NWE go-live in November.

It is also important to note that the GB contractual framework for market coupling will impact on the quality of GB price formation, and therefore the EMR reference price. There are also options in the detailed design of the market coupling algorithm and its implementation in GB that will impact price formation.

Concerns were raised at our recent MDAB regarding the transparency and oversight of these arrangements in GB may be appropriate.

4. **NEMO designation:** The anticipated CACM Network Code and Governance Guideline require Member States to establish a process to designate Nominated Electricity Market Operators. We understand that NEMOs, together with TSOs, will be responsible for the implementation of day-ahead and intraday market coupling.

5. **European financial regulations:** at our recent MDAB our members requested that we explore the possibility for APX to facilitate transaction reporting. We will seek to work with our members and Ofgem to understand how best to provide this service.

It should also be noted that the GB Hub arrangement will impact on our ability to monitor market participants behaviour.

6. **Demand side participation:** we have been working to develop a mechanism to lower barriers for Industrial and Commercial Customers to actively participate in our near term markets. We would be happy to discuss our proposal to enable demand side participation with Ofgem.