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Phil Slarks
Ofgem
9 Millbank
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Dear Phil,

Wholesale power market liquidity: final proposals for a 'Secure and Promote' licence condition

Thank you for the opportunity to respond to the above consultation. Our response focuses on the design of the intervention rather than its principle, albeit we continue to believe that regulatory intervention to improve liquidity is unnecessary.

The effectiveness of the intervention could be greatly enhanced with a few simple changes to its design. In particular, we recommend that market-making is mandated in a short trading window at the end of the day, so as to facilitate the computation of robust price indices and to give market participants more certainty as to the availability of trading counterparties at particular points in time.

We also recommend that generation licences should set out some clear and objective criteria for determining whether a particular licensee is subject to the obligation. This change is critical, not just to meet basic principles of non-discrimination and transparency, but also to ensure that the license condition does not interfere with asset disposals processes.

Annex 1 to this letter summarises our main recommendations, and Annex 2 provides detailed answers to the questions set out in your consultation paper.

I trust that you will find these comments useful. Do not hesitate to contact me if you have any questions.

Yours sincerely,

By e-mail

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Annex 1 – Executive summary

We continue to believe that the current level of liquidity is sufficient to support effective competition. We also maintain that imposing the market-making obligation on the six large, vertically-integrated companies is both arbitrary – because there is no evidence that these companies are responsible for low liquidity – and inefficient – because there is no point in having six companies market-making the same products under the same terms. At a time when new investment is required in the power sector, introducing discriminatory measures on selected large generators sends the wrong signals to investors about the regulatory framework that will underpin those investments.

However, our response focuses on the design of the intervention rather than its rationale. There is scope to make the 'Secure and Promote' model much more cost-effective than it would be under the current proposals, and we suggest a number of changes with a view to reducing the costs of the intervention, maximising its benefits, and mitigating the risks of unintended consequences.

1. **Obligated parties should be required to market-make in a defined trading window at the end of the day**

Ofgem is proposing to allow obligated parties to choose when to market-make provided they are available 50% of market opening time in a given month. Under this approach, market participants would have no certainty as to the availability of market makers at specific points in time, which means that they would not be able to rely on the scheme to manage their positions.

We propose an alternative approach where all obligated parties would be required to market-make in a defined trading window at the end of each day, subject to suitable fast market and reloading rules. This approach would make the operations of the scheme much more predictable and reliable for market participants. It would also make it easier to compute robust price indices by guaranteeing a baseline level of liquidity in a short window every day.

2. **Generation licences should set out clear and objective criteria for determining whether a particular licensee is subject to the obligation**

We understand that Ofgem would implement Secure and Promote by introducing the conditions selectively in one (or potentially several) generation licences held by the energy groups targeted by the intervention. If the intervention is designed in this way there is a high risk that it would interfere with asset disposals processes. For example if an obligated party sells a plant that has the Secure & Promote condition in its licence to a non-obligated party, then it is not clear whether the obligation is transferred to the new owner or not. Unless there are clear rules for dealing with such ownership changes in a mechanistic manner, the licence condition will introduce delay and uncertainty in transactions.

More generally, the proposed approach seems incompatible with basic principles of transparency and non-discrimination. The Electricity Directive provides that Member States shall not discriminate between electricity undertakings as regards their rights and obligations, and that any targeted measures to ensure a level playing field between undertakings must be based on transparent and non-discriminatory criteria. It is not clear that Ofgem's approaches meet these standards.

For these reasons we recommend that generation licences set out some clear and objective criteria for determining whether a particular licensee is subject to the obligation.

3. **Obligated parties should be allowed to discharge the market-making obligation on a platform of their choice**

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Ofgem is proposing that obligated parties should be free to discharge the obligation on any platform that can be ‘accessed’ by at least 10 licensed generators or suppliers (other than the obligated parties). Under the current market conditions, this would effectively force obligated parties to market-make on the OTC market, and more specifically on Trayport. As such, Ofgem’s approach runs the risk of ‘locking in’ the market in its current configuration and stifling competition between trading platforms. Moreover, it would be difficult for obligated parties to assess compliance with this requirement since the membership of trading platforms is not always public information, and the notion of ‘accessibility’ has no generally accepted meaning in the industry. We recommend that Ofgem provides a clear list of ‘eligible platforms’ that can support mandatory market-making.

4. The market-making obligation should be automatically suspended and reviewed when MiFID II is implemented

Ofgem is suggesting that obligated parties might be able to manage their exposure to EU financial regulation by outsourcing the obligation to a third party when MiFID II comes into force. We are not convinced that this approach would work legally: if obligated parties retain ultimate responsibility for discharging the market-making obligation it is difficult to see how they would escape falling within the MiFID definition of market-maker and the consequences that flow from that from a regulatory perspective. Moreover, this approach places an unreasonable level of procurement risk on obligated parties: the implementation of MiFID II will probably be followed by a period of uncertainty and change in market conditions and business models, and in these conditions it would probably be very difficult for the six obligated parties to find a sufficient number of external parties to discharge the obligation on their behalf.

More generally, it is very likely that the extension of EU financial regulation to commodities markets will have profound repercussions on trading arrangements and business models, which might have implications for the design of the market-making obligation. We recommend that Ofgem introduces a reopening clause in the licence condition stating that the market-making obligation would be automatically suspended and reviewed prior to MiFIR/MiFID II being implemented in GB.

On balance, it would be more cost-effective to tender for market-making services on a commercial basis. While there are challenges to implementing this approach in the short run, Ofgem should develop this option as an ‘exit strategy’ for the licence condition. We suggest that the introduction of MiFIDII might be an appropriate time to consider options for transitioning toward a more commercial approach to delivering this service.

5. Obligated parties should have discretion in setting prices under the Market Access obligation

The pricing policy prescribed by Ofgem would not allow obligated parties to recover the cost of the market access service. This would distort competition in the supply market and it would discourage independent aggregators to enter the market. Unless obligated parties are allowed to set cost-reflective prices for the service provided the obligation will amount to a cross-subsidy between market participants, which is not the stated objective of the intervention. Obligated parties should be free to set their prices provided that these are broadly cost-reflective and they do not manifestly frustrate the objectives of the intervention.

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Annex 2 – Consultation questions

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

No. We disagree with the premise that liquidity is insufficient to support effective competition. We have commented extensively on Ofgem's analysis in our previous responses, so we only summarise a few key observations below.

Firstly, the current level of liquidity is consistent with market fundamentals and does not indicate that market participants are unable to hedge their positions. Generators need to adjust their hedge less frequently when spark spreads are less volatile, as is the case at the moment. This means that a low churn rate should be interpreted as a sign that market participants' *need to trade* is limited, rather than an indication that their *ability to trade* is constrained. Similarly, suppliers do not need to trade very long-dated products if they hedge their positions over 18 months. Again, this means that the product mix observed by Ofgem is consistent with market fundamentals.

Secondly, the current level of liquidity is sufficient to support EMR. The day-ahead auction on N2EX provides a robust reference price for intermittent CfDs. Liquidity for Season+1 and Season+2 is sufficient to provide a robust reference price for baseload CfDs.

Thirdly, the most important issues raised by independent suppliers and generators are not truly liquidity issues, and they will not be resolved by the proposed intervention. Small suppliers are frustrated by credit requirements, but this concern is unrelated to the liquidity of wholesale products. Independent generators are frustrated by low demand for long-dated products, but this is a natural outcome of retail competition as suppliers cannot 'lock in' their retail prices for long periods of time.

Overall we think that Ofgem has built unrealistic expectations about the impact of the intervention. It is very unlikely that it will change the economics of new entry or investment in the market, and it is doubtful that it will achieve even the relatively modest reductions in costs or profits required to make the intervention 'break even'.

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

No. We think that Ofgem is overstating the benefits of intervention, and understating the costs. However, we understand that Ofgem is minded to press ahead with 'Secure and Promote', so the remainder of our response focuses on the design of the intervention rather than its rationale. There is scope to make Secure and Promote much more cost-effective than it would be under the current proposals, and we suggest a number of changes with a view to reducing costs, maximising benefits, and mitigating the risks of unintended consequences. This would be in line with Ofgem's duty to consider whether there is any other manner to carry out its functions which would better protect the interests of consumers and to have regard to the principles under which regulatory activities should be transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed (section 3A(1C) and (5A) of the Electricity Act 1989).

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

No. We recognise that the proposed structure is an improvement on that put forward in Ofgem's initial proposals. However, we think that Ofgem should make three key changes to ensure that the legal structure is resilient to changes in market conditions.

1. Ofgem should set out clear and objective criteria for determining which companies are subject to the obligation

We understand that Ofgem is seeking to impose the obligation on a defined group of energy companies, and that this would be achieved by introducing a new condition in one or all the generation licences held by these groups. We have two issues with this approach.

Firstly, as a point of principle, this approach seems incompatible with basic principles of non-discrimination and transparency. Article 3.1 of the Electricity Directive provides that Member States shall not discriminate between electricity undertakings as regards their rights and obligations. Article 43.2 allows for targeted measures to ensure a level playing field between undertakings, but this must be pursuant to proportionate, transparent and non-discriminatory principles and criteria.[1] We are not convinced that Ofgem's approach meets these standards.

More generally, non-discrimination requires that market participants with the same characteristics be treated in the same way, and the proposed approach does not ensure that this is the case if there are changes in corporate structures or business models. For example, if one of the obligated parties were to sell a substantial share of its generation or supply business to a non-obligated party, then two companies with similar characteristics (in terms of market share or vertical integration) could be treated differently.

Secondly, from a practical point of view, there is a risk that this approach might interfere with asset disposals and acquisitions in the market. If the condition is introduced in the generation licences of the plants owned by obligated parties, then this begs the question of what happens if some of these plants are sold to other companies (especially non-obligated parties). Is the obligation transferred to the new owner, or does it remain with the original obligated parties? Ofgem's proposed approach (to review the scope of the obligation on an ad hoc basis) would simply add delay and uncertainty. The process for dealing with such ownership changes must be mechanistic and predictable.

Proposed solution: Ofgem should set out clear and objective criteria for determining whether a generation licensee is subject to the obligation or not. This should take the form of a statement in the licence condition specifying that the condition only applies if the licensee is part of a group that generates more than [xx] TWh and supplies more than [yy] TWh per year.

2. The licence condition should include an automatic reopening clause to deal with expected changes in EU financial regulation

We believe that Ofgem is underestimating the challenges that could be created by the introduction of MiFID II.

[1] Articles 3.2 and 43.2 of Directive 2009/72/EC of the European Parliament and of the Council of 13 July 2009 concerning common rules for the internal market in electricity and repealing Directive 2003/54/EC.

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Firstly, there is a very significant risk that the market-making obligation might trigger exposure to EU financial regulation for obligated parties. This would impose very costly requirements on obligated parties, such as mandatory central clearing for OTC trades, additional capital requirements, and more onerous specifications for back-office processes (eg in terms of trade confirmations, portfolio reconciliation, and mark-to-market valuation). Moreover, it might precipitate profound changes in trading arrangements that might actually defeat some of Ofgem's objectives. For example obligated partied might be required to move a large share of their trading activity onto regulated platforms (such as exchanges or multilateral trading facilities). Regulated platforms tend to require more onerous forms of credit protection for trading, which means that they can be more difficult to access for small players.

Ofgem's proposed approach for dealing with this issue - allowing obligated parties to 'outsource' the obligation to a third party - is unlikely to work in practice. The implementation of MiFID II is likely to be followed by a period of uncertainty and potentially significant changes in trading arrangements and business models. This means that the six obligated parties are likely to find it difficult to find third parties willing to perform the market-making function on their behalf at the time when MiFID II comes into force, or they might be charged a very high price for doing so. It is not reasonable to place that level of procurement risk on obligated parties. Legally, if obligated parties retain ultimate responsibility for discharging the market-making obligation it is difficult to see how they would escape falling within the MiFID definition of a market-maker and the consequences that flow from that from a regulatory perspective.

Secondly, the introduction of MiFID II might have broader implications for the GB power market. For example, it may introduce some restrictions on OTC trading for certain types of products. It also proposes the creation of a new category of trading venue within the regulatory framework in the form of an Organised Trading Facilities (OTF), which is a trading platform that is not currently regulated. An OTF will include all forms of organised execution and arranging of trading that do not match existing categories of trading facility such as hybrid electronic and voice broking facilities. These changes might have implications for key requirements of the market-making obligation, for example the platform eligibility criteria or the list of products.

Proposed solution: include a sunset clause in the licence condition to suspend and review the market-making obligation automatically when MiFID II comes into force.

3. Obligated parties should have a suitable grace period to implement the obligations

The implementation of the market-making obligation will require significant changes in systems and processes for obligated parties, including: introducing a new trading book to record market-making transactions (with associated risk limits and risk-management rules); hiring new staff (unless the obligation applies to a trading window); and agreeing system changes with platform operators to support the market-making function (eg recording of bids/offers, automatic linkage with other commodities, etc). Implementing these changes will take time, and we suggest that the licence condition allows for a grace period between its introduction and the obligations becoming effective.

Proposed solution: allow for a grace period of at least four months between the introduction of the licence condition and the obligation becoming effective.

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

No. We disagree with the arguments put forward by Ofgem to justify imposing the market-making obligation on the 6 large, vertically-integrated companies, and we consider that Ofgem has not made the case for departing from the prohibition on discrimination in Article 3.1 of the Electricity Directive.

The arguments stated by Ofgem broadly fall into two categories:

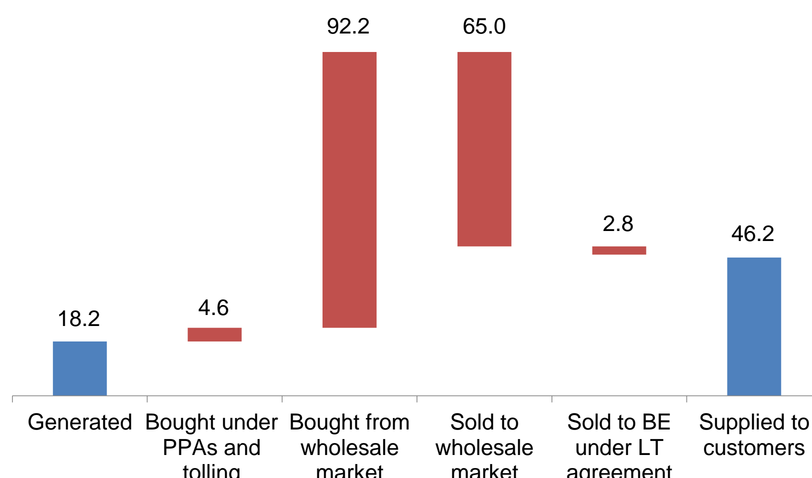
– the first two arguments seek to demonstrate that these companies are somehow responsible for low liquidity in the GB market (due to the characteristics of the supply market and the effects of vertical integration);

– the other two arguments (based on the trading capabilities of these companies and the 'optimal' number of market-makers) imply that placing the obligation on these companies is the most efficient way of delivering the intended outcome.

We summarise the main issues with this thinking below.

– **The domestic supply market.** Ofgem argues that low switching rates in the domestic supply market reduce incentives to trade for large suppliers (insofar as these suppliers do not need to adjust their hedge in response to changes in consumer numbers). However, Ofgem provides no evidence to support this argument. If this argument was true, then one would expect suppliers with significant market shares in this segment to trade *less* than the market average. In reality, Centrica, who has the *largest* market share in this segment, churns its supply position 3.4 times, which is *more* than the market average (see Figure 1). We also think that the logic behind this argument is flawed: it rests on an implicit assumption that, if switching rates were higher, suppliers would trade more to accommodate changes in consumer numbers. However, it is just as likely that suppliers would respond to higher switching rate by reducing their hedging timescales (for example by hedging over 12 months instead of 18 months), which would actually *reduce* liquidity on the back end of the curve by reducing demand for long-dated products.

Figure 1 Centrica power balance (TWh, 2012)



– **Vertical integration.** Ofgem argues that because the six large vertically-integrated companies have the *option* of internalising their trades, the market-making obligation is

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needed to *guarantee* that these companies remain present in the market on a relatively continuous basis. However, there is no evidence that these companies are actually internalising a substantial share of their trades, and that this is indeed causing liquidity to dry up at times. For example, British Gas purchases less than 10% of its power from Centrica Energy, and these trades are fairly evenly spread over time. Moreover, if this was indeed the justification for targeting vertically-integrated companies, then Ofgem should differentiate between companies and place the obligation only on those vertically-integrated companies who internalise a substantial share of their trades. Ofgem's broad-brush approach fails to recognise that the 'Big 6' have actually very different business profiles and asset portfolios. This approach thus treats different participants in the same manner, without using clear and objective criteria to do so.

– **Trading capabilities.** Ofgem argues that the trading capabilities of the large, vertically-integrated companies would enable them to meet the obligation more effectively than other market participants, notably because 'they regularly take both long and short positions' and 'they have the capabilities to take a sophisticated view of market prices'. These two observations are unfounded. The primary purpose of Centrica's trading functions is to provide a route to market for the group's generation and supply businesses and allow these businesses to hedge their positions. The trading function tends not to take material long or short positions. Ofgem seems to assume that the market-making obligation could easily be 'bolted on' the trading activities of these companies, while it is in fact a radical departure from their existing business models. Finally, other market participants, such as banks or independent generators owned by large energy groups, also have sophisticated capabilities, and therefore would be equally well placed to perform this function.

– **Effectiveness of the intervention.** Ofgem argues that imposing the obligation on the six largest vertically-integrated companies provides the best balance of costs and benefits to consumers. However Ofgem has not considered precisely how costs and benefits would vary with a smaller number of market-makers. It is very unusual for commodities markets to have more than one or two market-makers, and it is hard to see how the GB power market would benefit from having six companies market making the same products under the same conditions. It is more likely that this approach will simply replicate the overhead costs of market-making six times for no obvious benefit.

In conclusion, we maintain that imposing the market-making obligation on the 6 large vertically-integrated companies is both arbitrary and inefficient. It is arbitrary because there is no evidence that these companies are responsible for low liquidity. It is inefficient because there is no point in having six companies market-making the same products under the same terms. Moreover it is not evident that the large, vertically-integrated companies are particularly well placed to perform this function in the market (financial intermediaries might be equally or better equipped to manage the risks associated with market-making).

Proposed solution: the logical approach would be to tender for market-making services on a commercial basis. This would allow the industry to have the optimal number of market makers (probably no more than one or two), and it would reveal which companies are best placed to perform the function. For these reasons it would be a more cost-effective approach to delivering this service. (See our response to question 9 for more details).

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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'?

Yes. We think that a number of changes are required to reduce the risk of distortions in the market and ensure that the obligation does not interfere with legitimate due diligence checks and counterparty onboarding processes.

1. Obligated parties should be allowed to reflect the costs of trading in their pricing

Obligated parties will essentially act as intermediaries between the wholesale market and eligible suppliers, ie they will buy products in the wholesale market and resell those products in small clip sizes to eligible suppliers. They will incur significant costs to provide this service: Ofgem's draft impact assessment recognises that these costs would amount to c. £250k initially and £470k on an enduring basis. These costs will include: the cost of 'onboarding' the counterparties in the company's trading systems; the cost of processing and executing the orders; the credit exposures incurred in trading with eligible small suppliers; and the cost of managing the exposures incurred in trading small clip sizes (eg if a small supplier buys 0.5MW of season+1, the obligated party cannot retrade this position in the open market until it has aggregated orders amounting to 5MW).

Under Ofgem's proposals, obligated parties would only be allowed to recharge the *external* costs incurred for individual transactions. This means that obligated parties will not be able to recover the full costs incurred to meet their obligation, and the service will essentially be provided for free. We believe that this approach would introduce a number of distortions in the market.

Firstly, this approach would fail to create a level playing field between small and large suppliers, which is the very purpose of the intervention. Large suppliers *do* incur costs to access the wholesale market (eg British Gas is charged a cost-reflective price per transaction by the trading function of Centrica). All suppliers should face these costs if the intervention is to create a level playing field. Otherwise this intervention risks distorting competition between suppliers, a risk that has not been evaluated in Ofgem's impact assessment.

Secondly, this approach might 'crowd out' potential offers from commercial aggregators. One objective of the liquidity review has been to attract financial intermediaries and independent aggregators to create a more vibrant market and stimulate the emergence of more sophisticated services for small players. If Ofgem forces obligated parties to provide a standardised service for free, market entry will be less attractive, if not impossible, for independent aggregators.

Thirdly, if obligated parties are forced to provide the service for free they will naturally be incentivised to do only what is strictly necessary to meet the requirements. They will have no incentive to improve the service provided, for example by creating a web interface, responding to requests more quickly, or offering additional risk-management services.

Ofgem seems to believe that obligated parties will be able to 'tie in' the obligation with their normal trading activities, and that this will allow them to derive some value from the transactions. This is completely unfounded. The obligation will force obligated parties to enter into transactions for mandated products upon request, ie irrespective of their own trading needs. It is very unlikely that the needs of small suppliers will match the needs of obligated parties. In most cases, obligated parties will need to retrade the positions in the market and will incur the associated costs.

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Proposed solution: obligated parties should have discretion in setting prices for mandated products to recover the legitimate costs of providing the service.

2. Additional changes are required to ensure that the obligation does not interfere with counterparty due diligence and onboarding processes

We also recommend a number of changes to make the obligation workable in legal terms.

– **Licensees should have at least 20 working days (not 15) to respond to a request for a trading agreement.** This is because obligated parties will need to complete a series of processes (including Counterparty Due Diligence) before being in the position to start negotiations. The Counterparty Due Diligence process, in particular, must accommodate the ability to critically review and assess the required documentation provided by the counterparty. Obligated parties might need to ask for clarifications on the documents provided by applicants. In addition, the counterparty's responses may give rise to further questions because of their content or because, when independently verified or checked, the content suggests some higher risk factors that need to be considered. In most cases we would expect to be able to complete the process within the 15-day limit proposed by Ofgem. However, there might be some more difficult cases that require more attention, and it would be inappropriate to compromise the integrity of the checks to comply with the licence condition.

– **The licence condition should specify a suitable period between the conclusion of the agreements and their coming into force.** This is because obligated parties will need to complete a counterparty onboarding process before they are able to trade with the new counterparties. This process covers the registration of the counterparty in internal systems and industry protocols (BSC, ECVN). We suggest a period of 10 working days for this purpose.

– **The requirements surrounding credit terms should be more objective.** Ofgem is currently proposing that credit terms would be considered 'proportionate' if they are 'a reasonable reflection of the risks of trading with the counterparty'. The criterion of reasonableness could be subject to interpretation. We propose that the assessment be based on the concept of non-discrimination instead, ie obligated parties should propose similar terms to counterparties presenting a similar degree of risk.

3. Ofgem should leave some scope for 'unregulated' trading agreements

The scheme proposed by Ofgem focuses on trading agreements for standardised wholesale products. In our experience, certain small suppliers are interested in more complex and innovative services, for example services that bundle power procurement and risk management. These services are complex to design and they cannot be developed under the conditions and timescales prescribed in the Secure & Promote condition.

Proposed solution: to avoid confusion, we suggest that eligible suppliers be required to state clearly in their initial request whether they are requesting a 'Secure & Promote' agreement (which would only cover the products specified in the requirement) or a more customised form of agreement (which could cover different products and/or additional services). If the request is for a customised agreement then it should be clear that the licence condition does not apply.

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

No.

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'?

Yes. We suggest three key changes to make the scheme more cost-effective and prevent possible distortions in trading arrangements.

1. **Ofgem should mandate market-making in a trading window, subject to suitable fast market rules, reloading rules, and exposure cap rules**

Ofgem should consider an alternative to the proposed availability requirement (50% of market opening time) where obligated parties would be required to market-make during a specific time window every day. We suggest that this trading window should be 4.00 to 4.30pm, to encompass the pricing window used in the gas market (4.00 to 4.15pm).

This approach would have significant benefits for the market:

- the concentration of liquidity in a specific time window would facilitate the calculation of robust price indexes;
- market participants would be more confident to take positions during the day in the knowledge that they can close these positions at the end of the afternoon (so this approach would not necessarily dry up liquidity during the day);
- having simultaneous windows in the power and gas markets would facilitate trading in spark spreads, which will generate a useful price signal for gas generation.

This approach would also reduce the costs and risks placed on obligated parties. If the obligation was designed in this way then obligated parties could probably meet the requirements without having to hire new staff or make significant system changes.

To maximise effectiveness and mitigate risks for obligated parties, this approach would need to include the following rules:

- **fast market rule**: the obligation is suspended if the market moves by more than 2% with the first trade in that window;
- **reloading rule**: an obligated party is required to repost a bid/offer for a product no later than five minutes after it has been hit/lifted;
- **exposure cap rule**: the obligation is suspended if a counterparty trades five clips of the same direction in the window (eg sell five clips).

We see two key advantages in having a single, relatively short window at the end of the day. Firstly, it makes it easier to derive meaningful price signals from the transactions executed in the window. This is because it is reasonable to assume that the trades executed in that window reflect different views of the same market fundamentals (whereas if the window is longer then there is a greater chance that market fundamentals will change during the window). In other words, lengthening the window dilutes the effectiveness of the concept. Secondly, if there is a single window at the end of the day then there is a lower risk that liquidity will dry up outside the mandated windows.

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While the details of this concept are open for discussion, we are confident that it represents a more cost-effective approach to delivering the obligation then the rules currently proposed.

Proposed solution: Ofgem should only mandate market-making in a trading window, subject to suitable reloading rules, fast market rules, and exposure cap rules.

2. Obligated parties should have more discretion over the choice of trading platform

Ofgem is proposing that obligated parties be free to discharge the obligation on any platform that can be accessed by at least 10 licensed generators or suppliers (other than the obligated parties). We have two issues with this requirement.

Firstly, it would effectively force obligated parties to discharge the obligation on the OTC market, and more specifically on Trayport. To our knowledge, none of the other platforms that currently trade energy products in GB (Nasdaq OMX, ICE, Griffin, etc) would meet Ofgem's requirement. As such Ofgem's approach runs the risk of 'locking in' the market in its current configuration and stifling competition between trading platforms. Ofgem has not provided any evidence that the benefits of focusing the intervention on Trayport outweigh this risk.

Secondly, it would be difficult for obligated parties to verify compliance with this requirement. This is because market participants do not always have transparency over the membership of trading platforms. Some members of exchanges prefer to remain anonymous. Others trade via clearing banks, and therefore do not appear in membership lists. The situation is even less clear when it comes to the OTC market, as there is typically no definitive list of active parties.

Proposed solution: One solution would be for Ofgem to remove this requirement, allowing obligated parties to discharge the obligation on any platform of their choice. An alternative approach would be for Ofgem to publish a list of eligible platforms. Ofgem would be free to alter this list depending on changes in market circumstances.

3. Bid-offer spread should be wider and the obligation should be phased in progressively

The bid-offer spreads prescribed by Ofgem would be challenging to deliver under certain market conditions. If Ofgem insists on the '50% availability rule' then it would be necessary to widen the prescribed bid-offer spreads, and it would be preferable to phase in the obligation progressively, for example by introducing long-dated peak products only six months after the obligation comes into force. We support the recommendations made by Energy UK in this respect. However, if the trading window concept as described above is adopted, then it might be possible to deliver the obligation to the specifications currently proposed by Ofgem.

Proposed solution: if the trading window concept is not adopted, then Ofgem should widen bid-offer spreads and phase in the obligation more progressively.

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Question 8: Do the detailed elements of the proposed market making obligation appropriately balance costs and risk for the licensees?

No. As currently designed the obligation places an excessive level of risk on licensees on which it is imposed. It would be much more cost-effective to design the obligation around the trading window concept as described above.

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?

Yes. A tender process would be a much more cost-effective approach to delivering the market-making function. This would allow the industry to have the optimal number of market makers (probably no more than one or two), and it would reveal which companies are best placed to perform the function.

The most logical approach would be for Ofgem to tender for the service directly and recover the costs from licensed suppliers through the license fee. Liquidity can be seen as a form of 'public good' which can be under-delivered if there are coordination issues: collectively all market participants have an interest in improved liquidity, but individually companies have an incentive to 'free-ride' on the effort of others. The obvious solution to this problem is for the regulator to arrange for the provision of the service centrally and then recover the cost from all market participants through a regulated levy. Ofgem has little experience of procuring this type of service but this problem is not insurmountable: Ofgem could consult extensively on the specifications of the service and/or require assistance from a trade association (eg the FOA).

An alternative approach would be for an exchange to procure the service. This is a tried and tested approach to market-making, and it has the obvious advantage that the exchange has all the necessary information to specify the service and monitor the performance of the market-maker. It would be an interesting option if and when exchange-based trading develops in the GB power market.

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

Yes, we agree with Ofgem's analysis of the costs and benefits of intervention in the near-term market.

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

Yes, we agree that Ofgem should not intervene in the near-term market at this stage.

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