



E.ON's response to Ofgem's wholesale power market liquidity: final proposals for a 'Secure and Promote' licence condition and Draft Impact Assessment

E.ON's own business model is based on liquid markets. We want markets where there is a continual improvement in the ability to trade. This means we support Ofgem's aims, but are not sure that the proposed execution is right or, in some areas, goes far enough.

E.ON has to secure large volumes of power from the wholesale market to meet our customers' needs. To achieve this, and help build customers' trust in us, we want to see:

- more transparency in the wholesale market;
- greater availability of all wholesale market products;
- more confidence that there is no economic inefficiency through cross-subsidy between generation and supply within vertically integrated companies; and
- more confidence that there is no economic inefficiency through discrimination in the buying and selling of electricity.

To support this, in addition to Ofgem's proposals for market access rules and reporting requirements, we believe all licensed generators and suppliers should be subject to:

1. a requirement for the trading of minimum volumes with unrelated parties;
2. a prohibition on cross-subsidy between any generation and supply activities within the licensee's group;
3. managerial separation of any generation and supply activities within the licensee's group; and
4. a prohibition on discrimination in the buying and selling of electricity.

We also believe that Ofgem's proposed Schedule A (market access rules) and Schedule C (reporting requirements) should apply to all licensed generators and suppliers that regularly enter into contracts with unrelated companies for the buying and selling of power, or whose affiliates and related undertakings or other third party agents do on their behalf.

We have a number of concerns over how Ofgem is proposing to impose obligated market making. In particular, Ofgem's proposals effectively introduce price regulation of market making, through it setting caps on bid offer spreads, and run a significant risk of unintended consequences. Moreover, the provision of market making should not be a generation or supply licence condition, nor should it be the sole responsibility of six generation licensees.



Overview of Ofgem's wholesale power market liquidity: final proposals for a 'Secure and Promote' licence condition

Ofgem's Market Assessment

Ofgem has not provided a robust or fair assessment of the wholesale and supply markets. Consequently it is difficult to trust the conclusions and proposals Ofgem has brought forward. Also, without a robust and fair assessment, the proposals risk being found discriminatory against certain generation licensees.

More detailed analysis of Ofgem's market assessment is set out in our answers to Ofgem's questions 1 and 2 below.

Ofgem's Proposed Market Access Rules

The introduction of market access rules would help licensees in their trading. However, Ofgem's proposal for market access rules is too focused on a small group of suppliers for it to help increase trading by all licensees. Also, we question whether Ofgem's proposal would be as effective in helping Eligible Suppliers when compared to introducing a volume aggregation service.

To provide maximum benefit to the wholesale market, we believe that Ofgem's proposals should go further than just helping Eligible Suppliers. The rules should be designed to help all licensed generators and suppliers. Also, because trading has to involve two parties, the licence condition should apply to a wide group of licensees. We suggest that the licence condition be extended to cover all licensed generators and suppliers who regularly enter into contracts with unrelated companies for the buying and selling of power, or whose affiliates and related undertakings or other third party agents do on their behalf.

We ask that any licence requirement relating to market access rules allows the licensee to appoint a nominee to discharge these obligations, as is proposed for the market making obligation.

The proposed market access rules do introduce a number of the benefits for some suppliers that a volume aggregation service could provide. However, they do not provide all of the facilities that volume aggregation could offer, namely:

- addressing the needs of small generators;
- a product range that can be targeted at small generators' and suppliers' needs; and
- help in managing small generators' and suppliers' credit and collateral.



A set of market access rules designed to support all licensees in their trading, together with a separate volume aggregation service, would better serve the market and customers than Ofgem's proposed Schedule A.

While supportive of Ofgem's aims for Schedule A, there are a number of issues that need resolving, such as the pricing of quotes, information to be posted on websites and the form of the Trading Agreements. Until these are satisfactorily resolved, E.ON cannot risk being under an obligation to comply with Schedule A.

We provide a more detailed analysis of the market access rules proposal in the answers to Ofgem's Question 5 below.

Ofgem's Proposed Market Making Obligation

With the presence of Trayport publishing the bids and offers being handled by the main brokers for OTC trading, there is already a high level of transparency regarding OTC power market bids and offers, for those contracting to use this service. Against such a background the likely benefit from introducing obligated market making is limited. Further, the proposal effectively introduces price regulation of market making, through Ofgem setting caps on bid offer spreads, and creates a significant risk of unintended consequences. In particular, there is the risk that trading will be taking place outside normal economic forces. This could result in artificial levels of liquidity, measured as churn, creating economic inefficiencies and further distrust in the wholesale market. It also risks creating reference prices that seem more robust than they are, because they are largely based on bids and offers, rather than actual trades, and thus open to manipulation. Consequently, such reference prices would be totally inappropriate for settling contracts between counterparties, including the settling of CFDs.

Ofgem has not provided a robust reason why it believes picking six generation licensees to potentially subsidise the rest of the market, through providing market making services, is not discriminatory. Further, until the requirements of MiFID II are finalised, there are potentially significant financial risks in accepting an obligation to market make. This means that E.ON cannot risk being placed under an obligation to carry out market making (Ofgem's proposed Schedule B) until the requirements of MiFID II are finalised, or unless very robust protection is written into the proposed licence condition.

To ensure the proposed discriminatory approach to the provision of market making is avoided, the market making may have to be provided by independent parties, which are contracted and financed by the industry as a whole. To achieve this, the Transmission System Operator, assisted by the rest of the industry, should appoint the independent market makers and recover the costs through its charges, such as the transmission use of system charge. This is because this service is for the benefit of the market as a whole and should therefore be funded across the whole market. Such an approach, besides being



non discriminatory, would also avoid the problem of the MiFID II requirements not being finalised when this licence condition comes into force.

More detailed analysis of market making is provided in the answers to Ofgem's questions 7, 8 and 9 below.

Ofgem's Proposed Reporting Requirements

Increased levels of reporting will support greater transparency and fairer competition between all generators and all suppliers. Ofgem's proposals are therefore welcome. However, we believe the proposals do not go far enough, particularly in the reporting of Additional Information in the table of the proposed licence condition's Schedule C.

The reporting of Additional Information should cover all corporate groups with generation and supply licensees. A monthly report to Ofgem should cover monthly totals of their total licensed generation volume (disregarding generation for onsite consumption and imports), electricity supply volume and all power trading volume that was for delivery in that month. The current proposals only cover volumes from trading with Eligible Suppliers, market making and day-ahead auctions. To aid transparency this information could then be published by Ofgem.

If the requirement to report "*Total volume bought and sold with Eligible Suppliers*"¹ is to remain, this will mean the reporting of forward looking and thus commercially sensitive information. It is essential that Ofgem requires all parties involved and commits itself to treating this information in strictest confidence, with no publishing of such information.

To secure the reporting is for all corporate groups, Schedule C needs to be in both generation and supply licences.

¹ Wholesale power market liquidity: final proposals for a 'Secure and Promote' licence condition page 59



Additional actions that could support additional trading and help build customers' trust

In addition to Ofgem's proposals for market access rules and reporting requirements, we believe all licensed generators and suppliers should be subject to:

1. a requirement for the trading of minimum volumes with unrelated parties;
2. a prohibition on cross-subsidy between any generation and supply activities within the licensee's group;
3. managerial separation of any generation and supply activities within the licensee's group; and
4. a prohibition on discrimination in the buying and selling of electricity.

A requirement for the trading of minimum volumes with unrelated parties

In 2012 E.ON's Great Britain generation and supply licensees generated 27.4TWh and supplied 49.4TWh² respectively, meaning we supplied 80% more power than we generated. This made E.ON a large net purchaser of power. As a net purchaser of power, we want to see greater volumes of power being made available for trading between unrelated parties. This would provide greater transparency, fairer competition between all generators and all suppliers and secure larger potential volumes for hedging by all generators and suppliers.

A licence requirement on all licensed generators and suppliers to trade, or secure the trade of minimum volumes with unrelated parties in a calendar year would provide such confidence, that power is being brought to the market for trading between unrelated parties.

To achieve this, further consideration should be given to having the licence requirements that:

- 1) all licensed generators must have sold to non related parties, or have secured the sale on their behalf, a volume for delivery in a calendar year that is no less than the volume they generate in the same calendar year, disregarding any generation used for onsite consumption or related to Balancing Service Contracts with the Transmission System Operator, including the UK Balancing Mechanism; and
- 2) all licensed suppliers must have procured from non related parties, or have secured the procurement on their behalf, a volume for delivery in a

² E.ON's UK Consolidated Segmental Report for the year ended 31 December 2012



calendar year that is no less than they supply in the same calendar year.

Placing such a requirement on all licensed generators and licensed suppliers would provide the symmetry for a large number of willing buyers and willing sellers in each of the forums where trading would take place, while not precluding any particular contract arrangements. It would also ensure a diverse mix of buyers and sellers and trading needs.

A prohibition on cross-subsidy between any generation and supply activities within the licensee's group

Cross-subsidy between generation and supply businesses of vertically integrated companies could lead to economic inefficiency in the wholesale market. E.ON's own transfer pricing arrangements are designed to prevent cross-subsidy between its generation and supply activities. However, customers' trust and the general market's trust would increase if it was widely understood that cross-subsidy, between generation and supply activities, was prohibited and that, if it was suspected, Ofgem could investigate and take appropriate action.

To provide trust that cross-subsidy is prohibited, we recommend that further consideration is given to amending and switching on the Generation Licence Condition 17A, *Prohibition of Cross-Subsidies*, and the Electricity Supply and Gas Supply Licence Conditions 19B, *Prohibition of Cross-Subsidies*. This would provide a clear and consistent prohibition of cross-subsidy between the generation and supply activities.

If maximum trust from these licence conditions is to be secured, all vertically integrated groups need to be captured. To achieve this, and recognising the wide diversity of group structures, all licensed generators should be subject to a modified Generation Licence Condition 17A and all licensed suppliers to a modified Electricity Supply and Gas Supply Licence Conditions 19B.

Managerial separation of any generation and supply activities within the licensee's group

Customers and the general markets have to be able to trust that the potential economic inefficiency, through conflicts of interest associated with generation and supply activities being managed as a single business unit, are being avoided. Also, that Ofgem has the power to investigate and take appropriate action if such situations are found.

E.ON has separate management of its generation (E.ON Global Generation) and supply (E.ON Regional Unit UK for the UK) businesses. In the UK, E.ON's CHP activities, because the level of generation is often dependent upon the



customer's heat demand, forms part of the UK supply business. The generation business does not trade power with the supply business. E.ON Global Commodities, which manages all of E.ON's European trading operations, has activities that include purchasing generation from the generation business and providing electricity and gas to the supply business. These arrangements are covered by cross border contracts, which are prepared on an arm's length basis (meaning that although the transactions are between two related or affiliated parties, they are conducted as if the two parties were unrelated) and are subject to examination by the tax authorities in Germany and the UK.

By having this managerial separation, E.ON's generation business can focus on the safe and efficient operation of its plant and the supply business can focus on serving E.ON's customers. The separation of generation, trading and supply also prevents any adverse effect on competition in the wider markets through conflicts of interest, which could arise if these activities were within a single management structure.

To avoid the conflict of interest associated with generation and supply operating as a single management business, we recommend that all generation and supply licences have a licence condition requiring the managerial separation of the generation and supply businesses of vertically integrated groups. With such a licence condition in place, Ofgem would have the powers to investigate and take appropriate action if such managerial separation of generation and supply was found not to be operating within a vertically integrated organisation.

A prohibition on discrimination in the buying and selling of electricity

Customers and the general market must be able to trust that there is no barrier to trading being created through discrimination in trading electricity. E.ON is already prohibited from such discrimination under the existing Generation Licence Condition 17, *Prohibition of Discrimination in Selling Electricity*. If there was suspicion that E.ON was discriminating in the selling of electricity, Ofgem would be able to investigate and take appropriate action.

Licence Condition 17 does not deliver the required level of trust it could. This is because it is active only for a very limited number of licensees. To secure that all licensed generators are offering fair and reasonable terms when negotiating trading agreements, Licence Condition 17 should become active for all generation licensees. If it is believed that it is not appropriate to have Licence Condition 17 active for all generation licensees, then the question has to be asked why does it remain active for E.ON UK plc when that company has a relatively small market share?

To support small generators in particular, the principles of the existing Generation Licence Condition 17 should also be incorporated in all electricity and gas supply licences, in the form of a prohibition of discrimination in purchasing



electricity/gas. Here the licence condition should set out that the licensee and its affiliates must not purchase or offer to purchase electricity/gas from any one provider or person seeking to become a provider on terms as to price that were materially more or less favourable than those on which it purchases or offers to purchase electricity/gas from comparable wholesale providers.



Ofgem's Questions in its final proposals for a 'Secure and Promote' licence condition

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

We question Ofgem's assessment of the Great Britain wholesale power market. The main reasons for this are:

- Ofgem does not seem to fully recognise the level of dependency of the Great Britain generation market on the Great Britain gas market;
- Ofgem does not seem to acknowledge one of the main reasons for low liquidity, namely the lack of interconnection with wider markets;
- Ofgem does not seem to fully recognise the role Trayport now has; and
- Ofgem's apparent assessment of the supply markets.

Dependency of the Great Britain generation market on the Great Britain gas market

The Great Britain wholesale power market has a large proportion of gas fired generation, which is often the wholesale market price setting plant. This has resulted in power market prices having a high correlation to gas market prices, with gas acting as a good proxy for hedging power. This correlation to the gas market and the greater liquidity established in gas means that, for many traders, gas is the more attractive market to operate in, at the resulting expense of power. Consequently, while power prices remain dependent upon gas prices, churn in the wholesale power market should be expected to remain lower than other power markets.

Ofgem is correct *"that speculative firms, who could otherwise provide liquidity to the GB power market, may be attracted to the more liquid GB gas market"*³. We also agree that for physical players, the so-called "dirty hedging"⁴ may not be sufficient. However, while power prices remain dependent upon gas prices, large numbers of speculative firms are not going to be attracted to the Great Britain power market in preference to the gas market.

³ Wholesale power market liquidity: final proposals for a 'Secure and Promote' licence condition - Draft Impact Assessment page 11

⁴ Wholesale power market liquidity: final proposals for a 'Secure and Promote' licence condition - Draft Impact Assessment page 11



Interconnection with wider markets

The Great Britain wholesale gas market acts as an international hub for the purchase and sale of gas. This is partially due to its excellent connections to the continent. The three major pipelines and three major LNG terminals allow around 50% of Great Britain's consumption of gas to enter and exit the market from around the world. By contrast, the connectivity of the Great Britain electricity system with the continent is highly constrained to two links resulting in maximum of less than 10% of the British Isles' electricity being imported and exported.

The German and Nordic wholesale power markets have higher levels of churn compared to the Great Britain wholesale power market. However, they both operate with higher degrees of interconnection to other markets. Indeed, the German market is used for proxy hedging by a number of parties operating in markets outside of Germany. This is to counter poor liquidity in their own markets, in the same way as the so-called "dirty hedging" is used in Great Britain.

These facts suggest that the lack of interconnectivity is a major reason for the relatively low levels of liquidity, as measured by levels of churn, seen in the Great Britain wholesale power market.

Trayport

Trayport is a platform that publishes the bids and offers being handled by the main brokers for OTC power trading. While a subscription fee is required, access to Trayport is available to all interested parties, giving a high level of transparency to the OTC market for power. In publishing all bids and offers, they are presented anonymously, but each user is notified if it is able to trade the posted price. To be able to trade, the counterparties must have a master agreement and both able to manage the credit exposure with the other for the relevant trade being posted. By having bids and offers individually marked as tradable or non tradable, the issue of credit is removed from the published information, while giving users full control over their credit risks. Trayport can handle both physical and financial trades.

Trayport means that bids and offers are being brought to the market in a transparent way. While we are not aware of any active market makers present for Great Britain power, the arrangements are very close to what Ofgem is proposing in respect to market making. Ofgem's assessment of the wholesale market has not considered the role of Trayport or provided analysis as to the marginal benefit market making could introduce over the present arrangements.



Supply Market

In addition to questioning Ofgem's assessment of the Great Britain wholesale power market, we disagree with Ofgem's apparent assessment of the supply markets. In particular:

- In the proposals Ofgem says that, "*the firms subject to the market making obligation control around 98 per cent of the domestic supply market*"⁵. E.ON does not, and is not aware that any of the other five companies do, individually or collectively control 98% of the domestic supply market. The six companies may collectively have a domestic supply market share of 98%.
- Ofgem's press release accompanying the launch of the Wholesale power market liquidity: final proposals for a 'Secure and Promote' licence condition said that, "*Ofgem's proposals will break the stranglehold of the big six in the retail market*". Again, E.ON does not have, and is not aware that any other companies, individually or collectively have a stranglehold of the retail electricity market.

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?

The way Ofgem has presented its assessment of the market brings into question the validity of any conclusions it has made in relation to its proposals for a 'Secure and Promote' licence condition. We therefore have to also question Ofgem's conclusion that it should intervene in the market in the form of the 'Secure and Promote' licence condition set out in the proposal. Before any intervention by Ofgem can be justified, Ofgem needs to first provide evidence that its assessment has been carried out to a much higher level of rigour than it has currently presented.

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

We agree with Ofgem's proposed legal approach to S&P. A robust approach gives the obligated parties much greater protection than would be the case if the obligations were set out in guidance documents. While flexibility within S&P, through the use of guidance documents, may be valuable to some, only by having the robust approach can the obligated parties secure the certainty over obligations covered in the proposed licence condition and its three schedules, which licences provide.

⁵ Wholesale power market liquidity: final proposals for a 'Secure and Promote' licence condition page 16



With guidelines removed from the proposal, we are concerned that the draft impact assessment, when discussing monitoring, says that, "*Where changes are necessary, we will provide clarification by amending guidance, or make changes by modifying licence conditions following the usual statutory process.*"⁶ It is important that all requirements are held within the licence and, where changes are necessary; they are made to the licence using the formal procedures.

The market making obligations on licensees, which may in practice have to be passed to independent third parties, raise a number of issues relating to how the licensees can ensure their nominees will be compliant. The proposed licence condition needs amending so that:

- the problems associated with using an independent third party, as the nominee, can be addressed;
- agreement can be reached as to what Ofgem requires of the licensee in securing compliance by the independent third party nominee; and
- there is appropriate protection for the licensee, if it has complied with Ofgem's requirements and then the independent third party nominee puts, or threatens to put, the licensee in breach of the licence condition.

For example, what contractual requirements does Ofgem consider appropriate for the licensee to secure that the independent third party nominee maintains its bid offer spread within the specified limits? If the independent third party nominee's bid-offer spread then goes outside of the specified limits, the licensee will obviously implement the sanctions set out in the contract, but what assurance has the licensee that Ofgem will not take action against it? Given the licensee has to secure the services of a nominee; it will not be in a strong negotiating position to enforce a contract that has penalties equivalent of those that can be imposed on it by Ofgem.

In securing compliance by an independent third party nominee we would recommend that paragraph 4 of Schedule B is moved into the main body of the licence condition and modified in the following way,

"Subject to paragraph 9 of Schedule B, the Licensee may nominate another person (a "Nominee") to discharge the requirements of schedules A, B and C, as applicable to the Licensee in relation to any period (comprising a whole number of months).

Prior to nominating a Nominee the Licensee may give the Authority a proposed contract between the Relevant Licensee and the Nominee for

⁶ Wholesale power market liquidity: final proposals for a 'Secure and Promote' licence condition - Draft Impact Assessment page 39



securing the Nominee's compliance with this licence condition's requirements in respect of the Licensee's obligations.

Provided the Authority has not objected within 28 calendar days of receiving the proposed contract and the Licensee fully implements the contract with the Nominee, the Licensee shall be treated as satisfying the requirements of schedules A, B and C, even if the requirements are not satisfied by the Nominee."

With the licensee able to nominate a nominee then the rest of the licence condition and the three schedules should not have actions directly on the licensee, but be clear that it is the "licensee or its nominee" or the "licensee shall secure that [a certain action is carried out]".

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

The licence condition should apply to all licensed generators and suppliers who regularly enter into contracts with unrelated companies for the buying and selling of power, or whose affiliates and related undertakings or other third party agents do on their behalf. We therefore disagree that Ofgem's proposed Schedule A and Schedule C should only apply to eight companies.

We also disagree that that Ofgem's proposed Schedule B should apply to only six generation licensees, mainly because:

- We disagree that a generation licence should be used to make the facilitation of market making a requirement to be able to operate generation plant;
- As we explain below, we do not believe Ofgem has provided sufficiently robust evidence as to why other activities within certain generation licensees' corporate groups, make those corporate groups appropriate for being compelled to providing a market making service; and
- Market making is a service to help all generators and suppliers, therefore its facilitation and cost should be shared by all generators and suppliers; to just single out six generation licensees would be discriminatory.

Use of Nominees

Many generation and supply licensees do not trade directly with the wholesale market, but via third parties. We therefore welcome Ofgem's proposal that third parties can be engaged, as a nominee, to carry out market making. We ask that the use of nominees is extended to also cover Schedules A and C.



The use of independent third parties as nominees could help overcome the issues associated with MiFID II and EMIR, which together could make market making by companies within the licensee's group prohibitively expensive. However, as discussed in our answer to Question 3 above, there are a number of issues around securing compliance by an independent third party, which would have to be addressed.

Licensees and Groups

Ofgem's Figure 4 on page 15 of its final proposals document, is an example of Ofgem appearing to mix licensees and groups as if they are the same thing. There must be much greater clarity from Ofgem as to what it actually means by "licensees". As drafted, Ofgem has created a number of impractical requirements on licensees.

Provision of Market Making Services

While suggesting a wide scope for who should face the licence condition, we are concerned with the reasoning Ofgem has provided for its proposed limited number of organisations to face the licence condition. Ofgem has set out three areas where six organisations are present, namely; the domestic supply market, vertical integration and trading capabilities. Because of these factors, Ofgem believes these parties are best suited to carry out market making. We disagree with this logic.

For effective market making, we believe that the market maker needs to base its pricing purely on its belief as to the prices it will be able to buy and sell products. We question whether it would be appropriate that the market maker could price in the knowledge that it can absorb a long position or produce to cover a short position. Even if it is deemed appropriate to have such capabilities, these would only be available if its supply and generation businesses did not hedge until after all market making product timeframes had closed. We therefore question how a presence in the domestic supply market and being vertically integrated can aid a company in making bids and offers for specific products, as has been suggested by Ofgem.

If the market making is being carried out by an independent third party, to overcome the issues associated with MiFID II, then unless an inside trading arrangement is secured with the licensee and an associated supply licensee:

- the obligated organisation's presence in the domestic market becomes irrelevant to the market maker;
- any self supply by the obligated organisation is not relevant as to how the market maker operates; and
- any trading capability the obligated organisation has is lost, due to a it not being in a position to market make.



In summary, once an independent third party has to be used to carry out market making, Ofgem's reasons for particular generation licensees to market make, or procure the services of a third party market maker, are no longer valid. The generation licensee is in the same situation as any other organisation with a generation licensee within its group. To place an obligation on a particular generation licensee to provide market making, or its provision, when it is not practicable for it to provide such a service would be discriminatory.

With the potential need for independent third party providers, the cost of any subsidy needs to be fairly distributed across all suppliers, not six generators. This would avoid discrimination against the obligated licensees. Fair distribution of the costs would also better reflect Ofgem's apparent objective of introducing market making to support all suppliers.

Schedule C

Schedule C covers the reporting associated with Schedule A, Schedule B and Additional Information. The reporting against the requirements of Schedules A and B should therefore apply to all of the licensees that Schedules A and B are applicable. However, participation in the day-ahead auctions goes much wider than just the licensees covered by Schedules A and B. To ensure a complete picture of participation in day-ahead auctions is secured, all licensed generators and suppliers (or their affiliates and related undertakings, or third parties acting on their behalf) who regularly enter into contracts with unrelated companies for the buying and selling of power, should all be subject to reporting on the Additional Information.

As discussed in our answer to Question 3 above, the current drafting of Schedule C does not allow third parties carrying out activities on behalf of the licensee to report to Ofgem on the licensee's behalf. To give flexibility and to retain options as to how independent third party market makers operate, we believe that Schedule C should not require the reporting to be carried out by the licensee, but that the licensee secures that the reporting is carried out.

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'?

As explained in our answer to Question 4 above, ideally the scope of Schedule A should be in support of all licensed generators and all licensed suppliers, and apply to all licensed generators and suppliers regularly entering into contracts with unrelated companies for the buying and selling of power, or whose affiliates and related undertakings, or other third party agents do on their behalf. To only



have eight generation licensees fails to bring trust that the wholesale market does provide good quality market access. It also raises the question of discrimination against eight particular generation licensees.

We believe that there may be times when the market is not trading certain products. The licence needs to recognise this. An example would be if the Government was late announcing the carbon price for season +4. Here the market may have to stop trading the product. Therefore, the licence needs to allow the withdrawal from the market of a particular product. This would be provided the market maker informs Ofgem immediately and gives the reason why it is not offering a particular product.

We would like to see greater consistency between the products being made available under Schedule A and those subject to market making under Schedule B. In particular, why is Quarter+2 required under Schedule A but not under Schedule B?

In relation to credit and collateral, we agree that the suggested approach, for delivering benefits to small suppliers without imposing disproportionate costs and risks on the licensees, is appropriate. However, the actual licence requirement is not consistent with this. The licence seems to require a licensee to always provide a quote once a Trading Agreement is in place. There is no allowance for if the credit exposure would be exceeded. To protect both parties, the requirement to provide a quote has to be subject to the terms of the Trading Agreement.

Consideration should be given to the fact that Schedule A, as currently proposed, could be viewed as forcing Eligible Suppliers to trade with the licensees even when the licensees do not have a credit rating. The use of an independent volume aggregator would remove this risk for the Eligible Suppliers.

In relation to responses to trading requests, we are comfortable with the timetables Ofgem has proposed for negotiations on trading agreements. However, the information requirement needs modifying to accommodate a more practical approach. We recommend that the licence requirement is modified so that:

The Licensee shall secure that on a website controlled and used by the licensee or an Affiliate:

- i. a contact address for the purposes of making a Request for a Trading Agreement that has to be acknowledge within 2 working days after receipt;*
- ii a named contact or contacts for the purposes of making enquires about a Request for a Trading Agreement; and*



- iii. *a list or description of all the information required to enable an offer to be made under paragraph 4(i).*

This revised text accommodates practical issues such as individuals being on holiday. It adopts the approach used in the Generation Licence Condition 16 - Financial Information Reporting.

We fear that the requirement to offer a meeting within 20 working days with the licensee could lead to problems if the meeting has to be with a licensee that does not trade directly with the market. For such licensees the option is needed that the meeting can be with the licensee's nominee.

Ofgem is proposing that *"the price quoted by the licensee to an Eligible Supplier must be the licensee's assessment of the prevailing market price for the Products at the time the licensee provides the quote"*⁷. However, an assessment of market price can become very problematic. Examples of the problems are:

- How is the bid offer spread accounted for?
- 0.5MW clip size can be asked for, but, through Schedule B, the smallest market quote is 5 MW, how is the cost of managing the 4.5MW imbalance factored into the price? and
- The best price may not be available to the licensee or its nominee. The best price will only be available if it is being posted in the wholesale market by a party that is prepared to trade with the licensee or its nominee.

Schedule A must make it clear that the licensee's, or its nominee's, assessment of the prevailing market price for the Product includes allowances for bid offer spread, the cost of managing imbalance and its ability to access products at the prevailing market price.

Ofgem is proposing that *"the quote shall stipulate the period within which it may be accepted, which shall be in accordance with market practice"*⁸. Market practice for the wholesale market is that bids and offers can be withdrawn without notice and at the sole discretion of the trader. Where a quote is to remain open for a period, it becomes an option. Normal market practice for options is to charge an option premium. Schedule A must make it clear that if the quote is for an option, the licensee's assessment of the prevailing market price for the Product will include an option premium.

While Schedule A sets a minimum clip size of 0.5MW, it does not set a maximum, such as given in Schedule B. Given the licensee has to honour all quotes it makes, the licence must be clear that the Trading Agreement can

⁷ Wholesale power market liquidity: final proposals for a 'Secure and Promote' licence condition, page 54.

⁸ Wholesale power market liquidity: final proposals for a 'Secure and Promote' licence condition, page 54.



include maximum volumes and that the requirement to enter into a transaction is always subject to the terms of the Trading Agreement being met.

The Trading Agreement could cover two types of product, physical power (EFET/GTMA) and financial power (ISDA), but it could be that it only covers one type. The licence must reflect that quotes can only be made against those products agreed in the Trading Agreement, i.e. the requirement to provide a quote is always subject to the terms of the Trading Agreement.

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

The proposed licence condition's three schedules should apply to all licensed generators and suppliers who do themselves, or through their affiliates and related undertakings, or third parties that act on their behalf, regularly enter into contracts with unrelated companies for the buying and selling of power.

In addition to Ofgem's proposals for market access rules and reporting requirements, the opportunity should also be taken to better secure customers' needs and help build their trust in the wholesale market. This should be through all licensed generators and suppliers being subject to licence conditions that impose:

1. a requirement for trading minimum volumes with unrelated parties;
2. a prohibition on cross-subsidy between any generation and supply activities within the licensee's group;
3. managerial separation of any generation and supply activities within the licensee's group; and
4. a prohibition on discrimination in the buying and selling of electricity.

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'?

Ofgem says that the market making obligation will enable "*the development of a series of robust prices along the curve, which can inform a range of commercial decisions, including prices offered to customers, investment in new generation and the scheduling of plant maintenance*"⁹.

It is difficult to see how robust prices two years out will help decisions on "investment in new generation" that will be subject to the wholesale market.

⁹ Wholesale power market liquidity: final proposals for a 'Secure and Promote' licence condition, page 29



Usually such investment decisions have to be made more than two years before the plant can be brought into service.

There is no certainty that Ofgem's proposals for market making will deliver the outcomes desired by Ofgem and ourselves. Indeed, there is a significant risk of unintended consequences, such as the risk of creating trades which are not for economic reasons and do not reflect a willing buyer willing seller relationship. This risk could result in artificial levels of liquidity, measured as churn, and misleading reference prices creating economic inefficiencies and further distrust in the wholesale market. Anyone using such a reference price for either settlement purposes or an investment decision, would need to satisfy themselves that the price was fit for purpose, given that both the measured churn rate and the bid offer spread may present a false impression.

As explained in our answer to Question 1 above, Trayport is a platform that publishes bids and offers for Great Britain power that are being handled by the main brokers. Trayport means that bids and offers are being brought to the market in a transparent way. While we believe that there are no active market makers present, the arrangements are very close to what Ofgem is proposing in respect to market making. It is difficult to see how the introduction of full market making is going to provide a significant improvement in market liquidity over and above what Trayport is already delivering.

As explained in our answer to Question 4 above, Ofgem has recognised that the introduction of MiFID II and EMIR could make market making by the obligated licensees and other parts of their organisations prohibitively expensive. To overcome this potential problem, Ofgem has proposed that third parties can be engaged to carry out the market making. This is a helpful proposal. However, while the use of independent third party providers overcomes the issues surrounding MiFID II and EMIR, as discussed in our answer to Question 3 above, there are a number of significant issues surrounding achieving compliance with the obligation when using an independent third party. While still difficult to resolve, the task would be much less onerous if a single industry solution was developed, rather than having six organisations independently trying to resolve the issues. Consequently, delivery should be much quicker through a single industry approach, rather than six companies having to negotiate independently with Ofgem as to what are appropriate contractual compliance requirements, for the third party, and then these companies become distressed purchasers competing with each other to secure the services of third party providers.

Ofgem has suggested that the licence condition should be brought into force at the end of 2013. With this timetable, Ofgem's "*current view is that the licensees could be compliant with S&P before the end of the first quarter of 2014*"¹⁰. If licensees could secure a related third party to carry out the market making for them, then that timetable would be practicable. However, in practice that

¹⁰ Wholesale power market liquidity: final proposals for a 'Secure and Promote' licence condition, page 18



option, because of MiFID II and the potential need to use independent nominees, could be unavailable.

Engaging independent third parties will take time, be dependent on a significant level input from Ofgem and is unlikely to be ready for the first quarter of 2014. However, MiFID II will also take some time to come into force and it may be that market making for the Great Britain power market will be exempt. To allow market making to commence in the first quarter of 2014 and provide time for the requirements of MiFID II to be finalised, a pragmatic approach could be for a modified version of Schedule B to be introduced in 2013, but with robust provisions that those providing the service will have their costs covered by the rest of the industry, if the bid offer spreads prove to be insufficient for financially viable market making, and that the licence condition will cease to have effect on the earliest date of:

- a. a date as the Authority may specify in a direction given to the licensee [or to all Relevant Licensees];
- b. 31 December 2015; or
- c. the entering into force of MiFID II, or equivalent legislation.

Such an arrangement would build on Ofgem's example of "*before MiFID II is implemented, licensees may wish to meet the obligation themselves, but once MiFID II comes into force may decide to nominate a third party*". It would also allow the quick delivery of market making, while providing the licensees protection from incurring the potentially prohibitive costs that could be associated with market making under MiFID II and incurring discriminatory costs in providing the service. The arrangement would also facilitate a subsequent licence condition to reflect the actual requirements of MiFID II, in particular, if independent third party market making was needed or not. Having 31 December 2015 provides a firm date for Ofgem and the industry, together, to deliver market making by independent parties, which are contracted and financed by the industry as a whole. It also provides scope for a post-implementation review, with around twelve months of operating experience, which could feed into any subsequent licence condition.

Ofgem has proposed a requirement that, "*at least 10 persons (other than the licensee and any Nominee of the licensee and their affiliates) who are holders of generation or supply licences have made the necessary arrangements to trade Products on the platform*"¹¹. This would place the market maker in a position that its compliance is dependent upon the actions of parties over which it has no control. With this proposed arrangement, other licensees can leave the platform placing the licensee in breach of its licence. Also, unless 10 suppliers are already present on at least one platform, the obligated licensee will not have a

¹¹ Wholesale power market liquidity: final proposals for a 'Secure and Promote' licence condition, page 56



platform to consider. Further, many licensees do not trade directly with the wholesale market; they use third parties, so there may not be 10 holders of generation or supply licences who trade on platforms. To avoid these problems and give appropriate protection to the market maker, paragraph 5 of Ofgem's proposed Schedule B should be modified so that;

"A Qualifying Platform is a trading platform in relation to which the following three conditions are satisfied at all relevant times:

- (a) the Licensee, or its Nominee, has a reasonable expectation that one or more of the Products may be bought and sold on the platform;*
- (b) the Licensee, or its Nominee, has notified the Authority that it intends to use the platform as a Qualifying Platform for the buying and selling specified Products, together with the product type of each of the specified Products; and*
- (c) that the Authority has not objected within 28 days of receiving the notification."*

The reasons for market makers not being present in the market at a particular time are often the same for all the market makers. It is therefore not clear why an independent third party market maker serving two obligated parties has to be available for 80% of the time, while a market maker only serving one obligated party has to be available for only 50% of the time.

Given the market time is assumed to be from 7am to 4pm (45 hours per week) having an availability requirement of 50% is probably appropriate.

Ofgem is proposing caps on each market maker's bid offer spreads. This is effectively introducing price regulation of market making in the Great Britain wholesale power market. Further, these price regulated caps for each market maker seem to be much tighter than the bid offer spreads typically seen in many other markets.

Besides risking unintended consequences for the market as a whole, by setting tight caps on bid offer spreads for individual market makers, Ofgem will make it more difficult for market makers to cover their costs. With limited potential to cover costs, retaining tight bid offer spreads will require subsidies from the industry, the costs of which will inevitably feed through to customers. It will also make it harder to attract independent third party market makers into the market. However, we would expect that if there is genuine use of the market making by industry participants, rather than just market makers circulating very small volumes to achieve low cost compliance, the market spreads will usually be much tighter than the maximums permitted.

Ofgem has proposed that the cap on bid offer spreads is to be set as a percentage, rather than the usual fixed monetary value. Again market makers



need to be able to cover costs and therefore require a fixed monetary value so as to secure the necessary income at times of low prices. Fixed spreads also simplify the market making process.

Based on E.ON Global Commodities experience in Europe, and their requirements for providing market making services, if market makers are not to require subsidies from licensees, we would recommend any regulatory cap on bid offer spreads for individual market makers is as set out in Table 1 below.

Table 1,

Possible maximum bid offer spreads for individual market makers

	Baseload	Peak
	Index linked	Index Linked
Month+1	£1.20/MWh	£2.40/MWh
Month+2	£1.20/MWh	£2.40/MWh
Quarter+1	60p/MWh	£1.20/MWh
Season+1	30p/MWh	60p/MWh
Season+2	30p/MWh	60p/MWh
Season+3	30p/MWh	60p/MWh
Season+4	30p/MWh	N/A

The structure of the regulated cap on maximum permitted spreads, shown in Table 1 above, reflects that for the market maker:

1. The products covering longer periods can have smaller maximum spreads as there is a larger volume over which costs can be recovered;
2. Baseload can have smaller spreads for the same time period than peak, again because there is a greater volume over which costs can be recovered;
3. The products that cover longer periods can have smaller maximum spreads through term structure of volatility, because the risks of volatility are more predictable for the long period products than the short period products;
4. There is sufficient spread to allow for unforeseen changes in the market after the limits are set; and
5. This is a imposed market making obligation, which cannot be exited, as would be the case for voluntary market making.



We believe that pricing by a market maker can only take place where there is a general perceived certainty. The licence needs to recognise that there could be times when there is clearly uncertainty surrounding a particular product's future price. The example, as given in our answer to Question 5 in relation to Schedule A, would be if the Government was late announcing the carbon price for season +4. Here the market maker would not be able to price that product. Therefore, in addition to having spreads as shown in Table 1 above, the licence needs to allow the market maker to withdraw from a product, provided it informs Ofgem immediately and gives the reason why it is not trading a particular product.

Ofgem has set out a number of product sizes. This is an unnecessary complication. We believe that the product size should be 5MW, regardless of who the market maker is, or the number of licensees it is nominee for. To trade more than 5MW, parties would have to enter into a series of 5MW trades. This is to recognise that the market making is not being carried out on a fully voluntary basis and therefore the market maker has to be protected from the risk of being stranded with non standard product.

Having considered Ofgem's detailed design for the market making obligation, we have developed a model based on using Trayport, which we believe provides a practical route for achieving compliance. We envisage that the market maker would be placing bids and offers with a broker for physical trades. The broker would then publish the bids and offers on Trayport. The market maker's bids and offers would be for all the products required under the licence condition with the allowable spread in 5MW trade blocks. Acceptance of a bid or offer would be on Trayport, with the broker actually managing the OTC trade between the market maker and their counterparty. For the reasons set out above, the trades would be for single blocks of 5MW.

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

Because market making, using financial products on the N2EX Nasdaq platform, does not seem to have proved popular or financially viable, we are concerned that while market makers will be posting bids and offers, there could be little uptake. The result could easily be that the market makers are unable to cover their costs, particularly if bid offer spreads are capped at tight values. So that the market makers can continue to offer the service to licensed generators and suppliers and the proposed licence condition can be complied with, the market makers may need a form of guarantee to cover their costs. The funding of the guarantee should be by all those who are benefiting from the service, all licensed generators and suppliers. To impose the costs on just six generation licences would be discriminatory.

We note that Ofgem is not requiring a minimum credit rating for licensees or their nominees that are to carry out market making. While not having a credit



rating will not prevent compliance with the proposed licence condition, it will be a barrier to actually trading. It is unlikely that a licensee, or a nominee, without a credit rating will be allowed to trade on an exchange. Compliance will thus be achieved by posting bids and offers for an OTC platform where at least 10 persons (other than the licensee and any nominee of the licensee and their affiliates) who are holders of generation or supply licences have made the necessary arrangements to trade Products via the platform. However, while posting such bids and offers would achieve compliance, it is very unlikely any of the persons that have made the necessary arrangements to trade Products via the platform would be prepared to trade with a company with no credit rating. Consequently, it could be that Ofgem delivers six active market makers, but no trading with these market makers. In such a situation the prices of the market makers could have little relevance to the prices the market is actually trading.

Inevitably there are situations, such as a fire at the market makers office, or a failure of the platform it is market making on, which result in it having to suspend market making. A force majeure clause is therefore required in the proposed licence condition.

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?

An industry-run tender process could more successfully deliver a market maker than having just six generation licensees being responsible.

We envisage that for an industry-run tender process the market makers would be appointed by the Transmission System Operator, assisted by other industry parties. The market makers would secure a fee from the Transmission System Operator, who would recover these costs through its charges, such as the use of system charges. Such an arrangement would be of benefit, when compared with generation licensees providing market making, or via independent third parties contracted by them, as it would:

1. provide a simpler contractual relationship, if it is between the Transmission System Operator and the market makers,
2. provide a simpler process for recovering the market makers' costs, through the Transmission System Operator's charges, such as the transmission use of system charge;
3. allow the engagement of organisations that are established in the provision of market making;
4. not divert the attention of generation licensees from the safe and efficient operation of plant;



5. avoid discrimination against certain generation licensees;
6. provide greater confidence that there are no conflicts of interest between a market makers' bids and offers and the needs of the parties contracting them;
7. provide an independent verification process that Ofgem's market making requirements have been met;
8. provide greater transparency to the costs associated with imposed market making; and
9. provide a solution for overcoming the problem of the MiFID II requirements not being finalised when this licence condition comes into force.

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

As set out in our answer to Question 1 above, we question Ofgem's analysis of the present wholesale power market. Consequently we are not in a position to agree with Ofgem's analysis of the costs, risks and benefits of intervening in the near-term market.

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

We are firmly of the view that a case has not been made for intervening in the near-term market. Therefore we do agree that Ofgem should not intervene in near-term markets at this stage.



Ofgem's Wholesale power market liquidity: final proposals for a 'Secure and Promote' licence condition - Draft Impact Assessment

Ofgem has set out five questions asking if we agree with its evaluation of the impacts and risks associated with the Secure and Promote licence condition proposals (the "Proposals") covering;

1. consumers;
2. competition;
3. sustainable development;
4. unintended consequences; and
5. costs.

Ofgem has also asked if there are other factors it should be considering for the first three topics of the above list.

As set out in our answer to Question 1 of Ofgem's wholesale power market liquidity: final proposals for a 'Secure and Promote' licence condition, we question Ofgem's analysis of the present wholesale power market. Without being able to agree the basis for the Proposals we are not in a position to agree or disagree with Ofgem's evaluation of the impact and risks associated with the proposals, as covered by the above list.