Phil Slarks
Wholesale Markets
Ofgem
9 Millbank
London

9 August 2013

Dear Phil,

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

EDF Energy is one of the UK's largest energy companies with activities throughout the energy chain. Our interests include nuclear, coal and gas-fired electricity generation, renewables, and energy supply to end users. We have over five million electricity and gas customer accounts in the UK, including residential and business users.

EDF Energy is supportive of enhancing liquidity and committed to finding a solution that works for all industry parties. We are keen for the industry to develop a robust set of proposals which will genuinely enhance liquidity and meet Ofgem's requirements. This will have the best chance of success as there will be strong commercial incentives to resolve market design issues at least cost.

Ofgem has not focussed on the real issues behind the current levels of liquidity in this consultation. We maintain our view that access to credit is a primary driver of liquidity and this is the most important problem faced by new entrants which prevents them from trading.

There are aspects of Ofgem's final proposals which we can support. In particular, the option for an industry led market making solution and the supplier market access rules.

However, the three concerns we have had with Ofgem's original proposals continue in this consultation are:

1. The inclusiveness of the proposals. All licence holders must be included to make the proposals work.

2. The products specified by Ofgem would obliged us to sell products we could not generate.

3. The prospect of a regulated bid offer spread.

Of these three issues in the proposals, the regulation of Bid offer spreads (BO) is the most concerning for EDF Energy. Bid offer spread regulation is unprecedented, added to this the spreads suggested would be costly for utilities to manage and as a minimum we need limited volume embedded in any proposed Mandatory Market Maker (MMM) agreement.

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Our detailed response outlines how this can be achieved through an industry led voluntary market making arrangement (VMM). We suggest that VMM is accompanied by a qualitative ex-post scrutiny of bid offer spreads and volume commitments. This would be a more appropriate regulatory mechanism to help enhance liquidity. A market expert group would need to be setup to propose any qualitative/quantitative bid offer spread rules and volume commitments. This should be chaired by Ofgem. We also highlight that removing the two peaks seasons and a baseload season would be a lower risk option and give Ofgem the right to add these if liquidity is improved by Market Maker (MM) on the shorter dated products. By implementing the VMM in two phases it would allow time for the market to settle in and give the regulator time to make any adjustments if necessary.

We remain concerned that Ofgem has not fully appreciated the potential impact of its proposals on firms in terms of European financial regulation. Until the final text of MiFID II is agreed, the possibility remains that market making could result in affected licensees becoming MiFID investment firms and therefore automatically subject to the requirements of EMIR. We believe Ofgem's 'solution' that affected licensees can nominate a third party to meet their market making obligation cannot be relied on, as it presumes that such third parties will come forward to provide services at an acceptable cost. This cannot be guaranteed, particularly when viewed against the restrictions, imposed in the licence condition if a licensee chooses to discharge its obligations in this way.

Our detailed responses are set out in the attachment to this letter. Should you wish to discuss any of the issues raised in our response or have any queries, please contact Ravi Baga on 020 7752 2143, or myself.

I confirm that this letter and its attachment may be published on Ofgem's website.

Yours sincerely,

Angela Piearce
Corporate Policy and Regulation Director

Attachment

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

EDF Energy's response to your questions

Chapter one

Q1. Do you agree with our updated assessment of the wholesale market?

We maintain our view that access to credit is a primary driver of liquidity and this is the underlying issue for new entrants not tackled by these proposals. EDF Energy is always open to discussing selling forward products to all market participants and has made some supplier commitments that aid the process[1].

Liquidity is driven by a number of factors we have identified in table 1 and set in the context of the market's reaction to them (figure 1). These factors can have a high or a low impact on liquidity levels and are more or less transitory. We have no reason to believe that levels of liquidity will remain static and/or decline as stated in the Impact Assessment p4. We remain convinced that counter party credit and low risk appetites have been depressing liquidity levels.

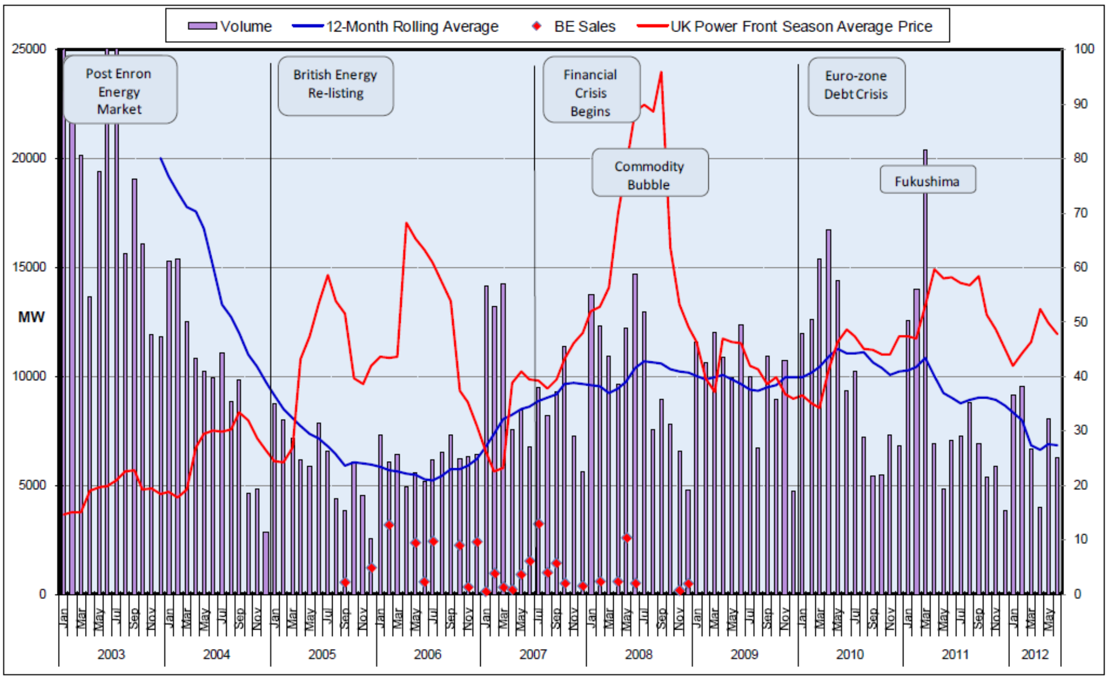
Table 1 Historical Drivers of liquidity

Factor	How it Impacts Liquidity	High or Low Impact
Counterparty Credit	Cost of credit and credit restrictions	High – Long term trends require longer timelines to reverse
Counterparty Risk Appetite	Availability of risk capital for trading UK power	High – Reduced appetite for trading along the curve tends to be a longer term trend
Government driven Regulatory Intervention	Regulatory uncertainty affects risk appetite and reduces liquidity in any market	High – Creates additional non-fundamental market risk.
Spark Spread Evolution	Low spreads = reduced trading appetite = reduced liquidity in power market	Low- Transitory impact, recovery of spark spread value will eventually encourage hedging activity to increase
Commodity Bubble in 2008	Price bubbles can increase liquidity as both speculation and risk management may increase during commodity bubbles	Low – Transitory affect as price bubbles are usually short lived
British Energy Long Term Trades 2005- 2008	Significant changes to any counterparty's hedging strategy may affect liquidity	Low – Transitory affect as BE market share was not significant

[1] See: http://www.edfenergy.com/about-us/energy-generation/PDF-Documents/liquiditycommitMarch11.pdf

Factor	How it Impacts Liquidity	High or Low Impact
Fukushima	Market "shocks" associated with significant emergent issues	Low – Transitory impact but the effects of the "shock" might endure in the medium term
Structural Change in the UK & European Gas Markets	Increasing liquidity in Gas markets may reduce availability of risk capital for UK power market	Low – Application of risk capital to these markets may have a negative impact on availability for UK power market activity
Volatility	Periods of low volatility reduce speculative market activity	Low – Transitory impact, the return of volatility will result in the return of hedging activity

Figure 1 Liquidity Drivers 2003-2012



Note – The left hand x-axis has been set at a maximum of 25,000MW as this better illustrates the liquidity in the period. This only truncates two months in 2003, June and July, where the volume traded was around 30,000-35,000MW.

Q2. 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?

EDF Energy agrees with Ofgem that liquidity is important and could be improved and we support this objective. We do not however, agree with Ofgem's conclusion that the S&P licence condition as drafted in the consultation should form the basis of a market intervention. We have argued in question 1 that liquidity is driven by a number of drivers not tackled by the response. It follows that the proposed intervention is likely to be less effective than it could have been.

We are seriously concerned about the regulation of bid offer spreads. It is unprecedented and will have an impact on wholesale market price formation. In particular:

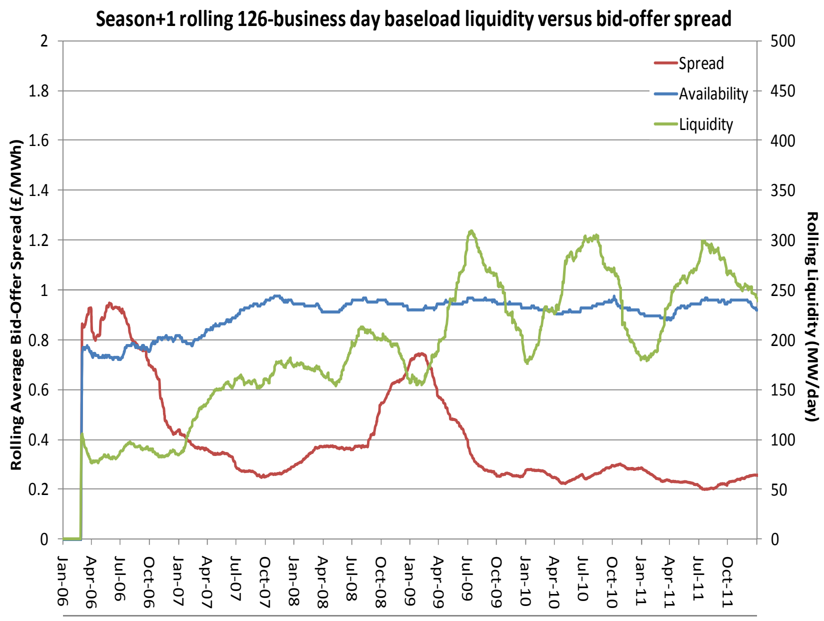
- The market will not be able to reflect those occasions when different views will be taken about future availability of plant or levels of demand that naturally create wide bid offer spreads especially in the context of a non physical market.

- There is no provision for fast markets and *force majeure* in the licence as it stands. This would expose EDF Energy to unacceptable levels of risk in cases of where the normal market process is disrupted such as major plant failure.

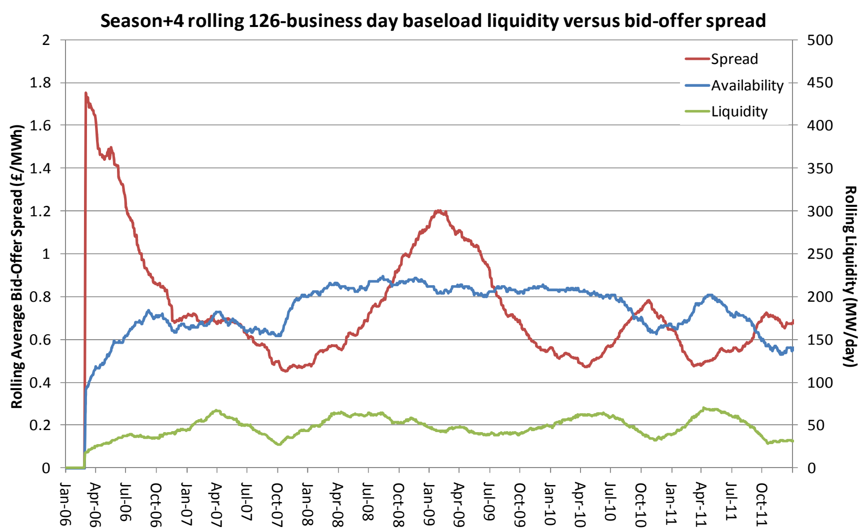
- The licence condition does not have a volumetric cap. We are not in a position to provide infinite depth over the time period required in the licence.
- The costs of creating regulated bid offer spreads are unknown until a tender has been completed, but generally speaking the lower the spread the higher the costs.

- The assumption that wide bid offer spreads necessarily represent an inefficient market is questionable. They may simply represent differences in opinion about the value of the products. This is because market participants will react differently to the same information.

In setting bid offer spreads, it is important to consider the existing levels of liquidity and how liquidity changes with different traded products over time before designing an intervention is considered. Figure 2 below demonstrates that liquidity displays some seasonality within years as Quarter 1 experiences higher levels of liquidity than Quarter 4. It has also varied over time. Industry structures do not remain fixed in time and could change as plant is retired or new plant commissioned. Churn rates vary across the vertically integrated companies as a result of their different customer and generation portfolios. Finally, we note that for any individual player, a churn rate above three times its volume would require the energy company to start trading like a bank.



Further out to season +4 we observe liquidity flattening out and in some years widening spreads.



We can make two key observations from the existing patterns of liquidity. Product availability is higher for nearer dated products that correspond to higher liquidity. Liquidity certainly appears to have a seasonal nature which needs to be taken into account in the design of the obligations.

The industry has not had sight of the methodology by which Ofgem set the proposed bid offer spreads. While this will inevitably involve judgement, we can make some observations on the existing patterns of spreads. There is a wide difference between what Ofgem has proposed and what has been experienced in the market. While Ofgem has argued these are challenging targets to improve efficiency, the spreads for four of the seven base load products observed in the market are double Ofgem's mandated spreads. We note that there are wide variations between the contracts which are not reflected in Ofgem's flat requirements. This intervention will distort the products' natural trading patterns. For peak products there is an even bigger variation between the pattern of bid offer spreads and Ofgem's prescribed limits particularly for peak load season +2 and +3.

Table 2 Bid Offer spreads compared with Ofgem's targets

Baseload	**Ofgem**	**EDF Energy**[2] **(observed spreads)**	**Difference**
Month+1	0.30%	0.37%	0.07
Month+2	0.30%	0.68%	0.38
Quarter+1	0.30%	0.79%	0.49
Season+1	0.30%	0.44%	0.14
Season+2	0.30%	0.62%	0.32
Season+3	0.50%	0.84%	0.34
Season+4	0.50%	1.07%	0.57
Peak	**Ofgem**	**EDF Energy (observed spreads)**	**Difference**
Month+1	0.70%	1.44%	0.74
Month+2	0.70%	2.19%	1.49
Quarter+1	0.70%	2.01%	1.31
Season+1	0.70%	1.50%	0.80
Season+2	0.70%	2.53%	1.83
Season+3	1.00%	3.90%	2.90

It should be noted that through the voluntary commitments made by some of the major suppliers there has been significant progress in relation to the small supplier access issue. We know that these voluntary measures have allowed two new suppliers to enter the domestic retail market in the last 18 months satisfying Ofgem's desire to increase competition in that sector and consequently through the actions of some there is no need for intervention in relation to SMA.

[2] Taken at 10am for calendar year 2011 our last complete data set

Chapter two

Q3. Do you agree with our proposed legal approach to S&P?

Ofgem will have to consider carefully the balance between the degree of detail put into the licence obligation and that which is better placed in accompanying guidance, in order for it to retain the ability to act quickly should the outcome be less than optimal at the start or as the market develops. We therefore do not agree with the S&P licence condition's structure and content as illustrated in Appendix 3 of the document. The table below presents our comments against each of the licence conditions.

LIQUIDITY LICENCE CONDITION SCHEDULE B	**EDF Energy Comment**
Availability of prices 6. Bids and offers for each Product must be posted on a qualifying platform for at least: a. fifty percent (50%), or b. where the licensee has nominated a Nominee which at the relevant time is also nominated by another Relevant Licensee, eighty percent (80%), of the time during which the market is assumed to be open in each month. The market is assumed to be open from 8 am to 5 pm Monday to Friday excluding bank holidays in England.	• EDF Energy believes that a fixed liquidity indexing period in the afternoon (based on the gas market model) and/or morning would provide a suitable meeting point for participants. • A liquidity window reduces the requirement on participants to watch the market all day (i.e. associated operational cost). • Concentrating liquidity at this time in particular should support robust reference prices along the curve, and regularly lead to price discovery. • Indexing periods not only concentrate liquidity within their window, they promote liquidity outside of the window. Counterparties wishing to trade during the indexing period may wish to open there positions "off-index". This behaviour became apparent when LEBA introduced their morning indexing Day Ahead product. • The complexity associated with reporting and monitoring of compliance under a % of market open time obligation should not be underestimated

Limits on difference between bid and offer prices 7. The difference between the bid and offer prices at any time for each Product, expressed as a percentage of the [bid] price, may not exceed the percentage in the table below: Baseload/Peak Month+1 0.3% 0.7% Month+2 0.3% 0.7% Quarter+1 0.3% 0.7% Season+1 0.3% 0.7% Season+2 0.3% 0.7% Season+3 0.5% 1% Season+4 0.5% N/A	• EDF Energy has a fundamental issue with bid offer spread regulation. It is an unprecedented intervention, falling only marginally short of price control. For this reason EDF Energy believes a commercial solution is the only solution which will attract third parties to the market as well as providing value for end use customers. • If a licence condition was forced on the industry, EDF Energy would strongly campaign for the removal of an ex-ante bid offer spread requirement, replacing this with an ex-post bid.offer spread reporting obligation (in support of price liquidity). To this we would add a voluntary volume commitment, reported ex-post, to support liquidity (see suggested licence text bellow). • Clearly the introduction of any bid.offer spread over so many products creates a significant compliance risk, which should not be underestimated by Ofgem.
Trade volumes 8. The volumes of each Product for which bid and offer prices must be posted are: (a) subject to paragraph (b), 5MW and 10MW; (b) if the licensee has nominated a Nominee, 5M, 10MW, 15MW and 20MW. 9. The licensee may not nominate a person as Nominee in relation to a month if that person is also nominated as Nominee in relation to that month: (a) by two other Relevant Licensees, or (b) if the Nominee is itself a Relevant Licensee or an affiliate of a Relevant Licensee, by one other Relevant Licensee. For the purposes of this Schedule B: "**Product**" means each of the products in the table below (where product means a traded electricity product for delivery in Great Britain, including a product settled financially) Baseload Month +1 Month +2 Quarter +1 Season +1 Season +2 Season +3 Season +4 Peak Month +1 Month +2 Quarter +1 Season +1 Season +2 Season +3	**Volume cap** • We would support reload for a window and a volume cap for both continuous trading and for each window. We would also require a portfolio limit for credit exposure • Mandated bid offer spreads and availability of those spreads on screen without a volume cap would expose market participants to potentially unpalatable financial risks. • A *force-majeure* or fast trading gateway to prevent liability would be strongly recommended **Products** • In designing the solution all participants and stakeholders need to understand the constraints that the various drivers of liquidity can cause so that the solution is robust and has the flexibility to deal with significant extraneous events. For instance, the current constraints of credit and counterparty appetite would make introducing a solution along the curve (as detailed in the Final Proposal) a high risk solution and in fact an approach that builds out the solution from the near end of the curve would appear the most practical strategy. • EDF Energy recommends a phased approach with shorter dated baseload products being market made and with Ofgem introducing impartial success criteria on these products before transitioning to longer dated products. • EDF Energy recommends a product list containing baseload products up to and including Season +2, and peak products up to and including Front Season. • If peak products are retained in the MM

	solution, EDF Energy believes that significant inefficiencies are introduced by not included the owners of peaking plant in the obligation. During August 2013 GDF Suez and Intergen have significantly more peaking plant that EDF Energy and Eggborough Power and Drax have a similar portfolio of flexible assets.

Additionally, we would add a review clause. At present there is no mechanism for participants to respond to extreme changes in the market or their portfolios. The licence as drafted is the mechanical application of the table to real life market conditions. We have demonstrated that the market has faced a series of exogenous events that have driven prices (figure 1, question 1). Under these conditions market participants will have to react quickly and will very probably be in breach of the licence precisely because extreme events can lead to wide spreads as the market may take more extreme views on the resolution of the issue. Restricting this vital function of the market impedes the natural process of competition yet the regulator wants to maintain narrow spreads during the normal course of the market. Our solution would be for a process similar to the transmission constraint licence condition where parties' have to provide an objective justification for the obligated parties behaviour if they deviate from the spreads outlined in the schedule B. We recommend the following drafting:

"The regulator will review the Market Making activity of each obligated party to ensure that appropriate spreads are posted for an acceptable duration. The regulator will reference historic market spreads with reference to the table above. If Ofgem are unable to rationalize the observed differences between the expected MM activity and the ex-post observed MM activity or there are unexplained differences between the obligated counterparty and other market makers, the regulator may ask the obligated party to justify objectively its Market Making activity. The obligated party would be expected to reference (but not limited to) the following exceptional market conditions: unacceptably net open positions, movements in underlying commodity prices, significant change to physical asset performance, revised assessment of transmission system health, counterparty credit and collateral."

We have also included some detailed comments on the draft legal text.

Special Condition X X3 –Ofgem could only subsequently direct that Schedule B is to apply to a licensee (who was not subject to it from the outset) if the licensee provides consent. X5 – "product" – both paragraph reference are wrong – should be "X.4(a)" and "X.4(b)"
Schedule A Para 1 – incorrect paragraph reference – should be "X.4(a)" Para 2 – what constitutes "acknowledge"? Para 6 – this leaves it potentially open ended – also is it possible that after a lengthy period the offered terms may need to be amended/updated? Para 7 – "retain all information" surely that wording on its own would cover "data, correspondence…" Para 8 – delete one of the "must include"

Para 11 (ii) – this wording implies a supplier would always make an offer – yet para 4(ii) allows a supplier to provide reasons not to make an offer. Para 12 – both Schedule A and B use a defined term "Products" with the definition different in each – not good regulatory practice to have a term used twice with different definitions. I would recommend changing the terms to "Schedule A Products" and "Schedule B Products" Para 12 – are we comfortable with the use of "in accordance with market practice" – if it is a standard period why isn't simply inserted in to the licence condition? Para 14&15 – Amend term "Product" to "Schedule A Product" Para 16 – "Product" – amend to be "Schedule A Product" Para 16 - "Trading Agreement" – is this a sufficiently clear definition?
Schedule B All – Amend any reference to "Product" to "Schedule B Product" Para 1 – "X.3(b)" should read "X.4(b)" Para 2 – reference to "paragraph 4" should be "paragraph 5". Para 3 – does this in practice constrain your ability to post prices for Products outside of the volume requirements under para 8? From a compliance perspective some controls will be needed if we intend to use a "nominee" – not just on the impact on timings and volumes but also the monitoring of who else uses that nominee.
Schedule C Not clear on the timings – when does the quarter/annual period start?

Q4. Do you agree with our proposals for who should face the obligations under S&P?

We believe that the obligation should apply to all market participants trading within their credit or risk limits, the cost of which we have demonstrated in our response to the impact assessment. This will maximise the opportunity to trade. Anything less will ultimately limit the scope for enhancing liquidity.

Chapter three

Q5. Do you have any views on our final proposals for the Supplier Market Access rules, particularly those aspects listed under 'key outstanding design questions'?

EDF Energy supports the general approach to the SMA. However, under the current draft S&P rules if we are on the "Eligible Supplier" list we could potentially be required to offer terms for a supplier despite non credit related concerns such as reputational risk. We believe it would make sense to have a provision which allows licensees to take other factors into consideration during the decision making process.

We have included some comments in the table below on how the text could be improved:

LC	Comment
Schedule A **A2. Request for acknowledgement**	• Would prefer five working days to avoid exposure to illness, leave otherwise would increase costs substantially for no real benefit.
A3. Response to trading requests	• Two day window is very tight but has no material impact on the timing of the decision or costs
A4 Credit and Collateral b Quantative assessment **b. The quantitative and qualitative factors and information taken into account in making this assessment** **c. Any steps the counterparty could take which could result in a material improvement in the credit terms offered.** **The licensee must share the Credit Transparency Form with the counterparty and be prepared to discuss it.** **These credit forms should be held on file for Ofgem audit for three years.**	• We will identify the key factors that have been taken into account when coming to our decision but we are not giving up our commercially confidential internal rating methodology. • We agree with the objective but EDF Energy cannot and will not provide what could be deemed as financial advice. We would like the drafting to be amended not to give that impression. We could of course give information on upfront payments, parent company guarantees etc. • EDF Energy would need to agree the content of the form regarding our comments above.
A7. Fair and Transparent Pricing – Acceptable	• **Reporting obligations –** The fundamental problem with the reporting requirements is that Ofgem have not made it clear anywhere as to what is the measure of compliance with this proposed new licence condition. Without an understanding of what constitutes compliance we obligated parties will be subject to regulatory risk. • For example if obligated parties receive no requests from counterparties to provide trading agreements, which is a possibility (given that all existing suppliers appear to have access to market and potential new entrants may only require one or two trading relationships at their outset) then we could be deemed to be in breach of the condition as the draft stands through no fault of our own.

	• EDF Energy fundamentally disagrees with any prescriptive form of pricing for smaller customers. The obligated party must be free to re coupe both internal and external costs associated with a transaction in a non-standard bilateral deal. • Further, the frequency of reporting is too onerous, and EDF Energy suggests that we propose a 6 monthly reporting cycle.

Q6. Are there any further areas that these rules should cover?

EDF Energy is concerned that the costs associated with setting up a new small supplier counterparty will not be recouped unless the new counterparty executes a sufficient number of contracts with the obligated party. EDF Energy believes that obligated parties should be able to recoup fix costs from a small supplier if costs of setting up trading arrangements cannot be recouped through deals executed.

Chapter four

Q7. Do you have any comments on our proposed detailed design for the market making obligation, particularly those listed under 'key outstanding design questions'?

We suggest that the following draft principles would address the issues associated with developing a market liquidity provider:

The draft outline of a market making contract

1. A Liquidity Provider must consider on which and on how many trading platforms it provides a liquidity service.
2. The Liquidity Provider must consider for which products at a minimum it commits to provide liquidity services.
3. The Liquidity Provider must consider the bid-offer spread it commits to within a commercial agreement.
4. Liquidity provision means posting orders within the spread agreed for volumes which meet or exceed the minimum agreed volume.
5. The Liquidity Provider must consider the parameters governing its actions whenever a transaction is made based on the liquidity provision order (i.e within how long must the Liquidity Provider replace the matched order with a new liquidity provision order, and at what level?).

6. The Liquidity Provider must consider within which hours it will commit to providing a service.

7. The Liquidity Provider must consider circumstances under which it is temporarily released from placing liquidity provision orders, for example:

   - for an aggregate period of up to [30] minutes on each trading day provided the Liquidity Provider fulfils its service in the period during which daily closing prices or final closing prices are set for the specified products;

   - for an aggregate period of [10] trading days per calendar year provided the Liquidity Provider notifies the trading platform in advance to the applicable trading day;

   - where the Liquidity Provider is prohibited from placing orders or entering transactions on the trading platform under the respective market conduct rules of the trading platform;

   - where the Liquidity Provider has transacted above a specified threshold in a product over a specified time period;

   - where the relevant product is suspended from trading by the trading platform;

   - where the Liquidity Provider is subject to technical failure or similar incident which materially affects its ability to post orders;

   - where the market experiences movements outside of a pre-defined range ("Fast Market").

8. The Liquidity Provider must consider from when it will commence provision of a liquidity service, and for what duration.

9. The Liquidity Provider must consider the duration of and obligations under any termination agreement, including market communications.

10. The Liquidity Provider must consider the risks / liabilities it would seek to cover in its fee versus pass contractually to the counterparty (ies) to the agreement

11. The Liquidity Provider must consider the conditions under which it would seek to re-open or terminate an agreement, e.g. if it impacts on its ability to retain an exemption from MiFID.

Q8. Do the detailed elements of the proposed market making obligation appropriately balance costs and risk for the licensees?

We accept the trade off between costs and benefits identified in figure 10 (p34). The issue we have identified is that this balance will inevitably change during the continuing development of the market. EDF Energy would argue that striking the right balance between wide bid offer spreads needs to consider the possibility that there will be an event which places place extreme pressure on the market. In these cases the benefit of narrow bid offer spreads could easily be unwound without some flexibility in their application.

Q9. 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?

EDF Energy believes that a tendered commercial market maker solution is likely to be the most acceptable solution to all parties. This solution will be easier to design, implement and monitor than an SLC. This is because it will be the most robust solution regarding compliance risk associated with EU Financial regulations as well participant financial risk management. A commercial tender is an essential stepping stone to make clear the costs of market making for all parties.

We believe that the tender process can deliver an acceptable outcome. We have drawn up a proposal to provide the necessary detail for such a tender outlined bellow:

Which parties should be involved in running the tender process?

- Falling liquidity is an industry problem; therefore, an industry solution should be led by industry. The timeframes required to develop an acceptable solution to meet the requirement for a tender to be run transparently for the industry, requires an experienced team from within industry to run the mechanics of the tender process, on behalf of the industry. We believe that the experience exists within our industry, however, not necessarily solely within one organisation.

- We believe that it would be possible to find an organisation such as Gemserv with the capability to run the overall tender process; that the FOA, with its wide experience of traded markets, and a membership including experienced market makers, should work with the tender provider, supporting it in the tender document creation and assessment elements of the tender process; and that the PTC, as a representation of market participants, should steer the tender process.

- Ofgem would be kept informed through all steps of the tender process by industry (the Power Trading Committee). Moreover, in order to ensure its suitability in meeting Ofgem's liquidity intervention objectives, Ofgem would be expected to engage with the PTC through the tender process, raising any concerns or significant issues which it identifies may risk suitability against their objectives, on a timely basis.

- In order to provide all Market Participants with visibility of the process, the PTC would provide updates in copy to Energy UK for distribution to all relevant interested parties.

How would this process be governed?

- The tender document would specify a full set of requirements for the market making role. The document would be based upon the initial licence condition proposals drawn up by Ofgem, with the initial tender document to be agreed between Ofgem and the PTC. Within that document, it is recognised that there are four key components of the tender where cost to benefit could be explored through varying the underlying assumptions in these areas, these being:

    - products included;
    - time on market;
    - size of spread; and
    - volume commitment.

- Alternative assumptions with regards to each of these components (to be varied independently) would therefore be drawn up to also be tested as part of the tender process.

- Third parties would be invited to provide a compliant bid in line with the agreed tender document; to separately specify the impact on their compliant bid of each of the independent changes to the four key components; and then also to submit a non-compliant bid, describing the basis upon which, in the bidder's view, they could offer the most effective market-making service at the most reasonable cost (the "preferred service" bid) if not already covered by the compliant bid or by one of the specific variations to the compliant bid as listed above.

- Third parties will be asked to confirm the platform on which they would market make. In order to satisfy the needs of the developing energy market the industry and Ofgem should be polled to determine the nature of the MM solution. While a cleared solution would clearly provide credit benefits for the active participants and the MM, credit costs currently higher than those offered through the OTC market. In addition financial products would allow a multitude of financial players to enter the market increasing liquidity. Arbitrage opportunities would ensure than physical and financially cleared markets remained aligned. As a minimum we would expect any MM solution to begin by building on existing liquidity and avoiding fragmentation of the market. A Trayport hosted solution would be recommended as the obvious platform of choice, and bidders would need to explain in detail the basis for an alternative choice.

- Tenders would be assessed by a suitable tender provider team, with the support of experts provided by market participants and through the FOA. When bids come back, no company who has bid or is related to a company who has bid for the service will be permitted to take part in any of the assessment process. Ofgem will be invited to review the findings of the assessment process and help to determine the selected parties in line with the cost/benefit principles.

What would Ofgem's role be?

- Ofgem should comment on the tender document and should advise on a timely basis on any significant concerns.

- Ofgem should contribute to the tender process and assist the selection process against cost/benefit principles.

- Ofgem should agree and confirm the suitability of the solution.

- Ofgem should agree the apportionment of the costs of tender and solution to industry. See Collection of Fees below.

Procurement risk

- *How many firms would bid to become market makers?*

- FOA have noted that prospective MMs have indicated a preference for a financial product that is cleared.

- By asking for a compliant bid, variations to the key components in the compliant bid and inviting parties to offer a non-compliant bid if required, the number of potential bidders is maximised.

- The term of the contract, break clauses and re-openers could also be considered to reduce procurement risk.

- This approach also opens the potential for one or more than one market makers to be selected, dependent on a transparent cost/benefit analysis.

- The FOA would be invited to identify potential bidders, however, any company interested in bidding should be encouraged to submit their proposals. Firms could be identified by their current or previous presence in the UK power market, in other UK energy markets such as gas or their presence in other similar traded markets, either outside of energy or outside of the UK.

- An early communication from the FOA, pre-empting the issue of a tender proposal, should also maximise the number of bids received.

Timetable

- *Could the tender process be completed to a reasonable timetable?*

- The minimum duration for a commercial tender should be approximately six months from start to finish, followed by a period of set-up if required for the market maker(s). Late Quarter 2 2014 is therefore a realistic estimate of market-making activity commencing.

- The complexity of the solution selected is related to the time required for implementation including physical set up and commercial agreements.

- Time taken to implement should feed into the selection process.

Counterparty to the contract

- *Who would be the counterparty to the contract with the market makers?*

- By principle this is an industry problem which requires an industry solution. Industry (including Ofgem) should work together to enshrine an appropriate counterparty acting on the behalf of and with the backing of industry. If possible, the requirement to set up a new body to act as counterparty should be avoided.

- Depending on Ofgem's decision on the apportionment of the costs of the arrangement, new commercial contracts may be required between the market maker, the counterparty and those market participants obligated to fund the arrangement.

- Any contracts would need to consider the pass through of liabilities through the counterparty to obligated market participants. If industry was obligated to fund the arrangement, the legal framework would be simpler as liability could be passed through to industry in a proportional manner (in line with other industry charges).

Collection of fees

- *Who would pay any fees charged by the market makers? Through what process would these fees be collected?*

- Ofgem's final proposal for a licence condition suggests placing an obligation on obligated parties to participate in market making.

- Any party not subject to this potential obligation would therefore naturally consider that the charges associated with a VMM should be recovered from the obligated parties alone.

- An alternative view is that liquidity is an industry problem and requires an industry solution. This means industry involvement in the design of the solution and industry contribution to the costs of the solution in a proportional manner – as well as the benefits of a functioning and liquid market.

- A mechanism under the BSC could be set up to divide equitably the costs of the agreement across industry, if an industry solution was agreed.

- Ofgem must decide who will be obligated to fund the contract/solution.

Chapter five

Q10. Do you agree with our analysis of the costs, risks and benefits of intervening in the near-term market?

We agree.

Q11. Do you agree that we should not intervene in near-term markets at this stage?

We agree. Ofgem should not intervene in the near term market.

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