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Dear Mr Slarks,

**Ofgem Secure and Promote Final Proposals - Consultation Response**

Please find below First Utility's response to the Secure and Promote Final Proposals consultation. We provide a general answer and then we answer the specific questions raised in the consultation. We would welcome follow up discussions.

Yours sincerely,

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**General Response**

First Utility continues to be extremely concerned about the low levels of liquidity in the UK wholesale electricity forward market and believes urgent action is necessary to develop a fairer market and more level playing field for all market participants. The UK electricity market is characterised by low levels of liquidity and high levels of vertical integration. In such a market it is natural for incumbent participants to focus on defending existing market share than fighting vigorously for new market share, and we believe such stagnation is not in the interest of the energy consumer.

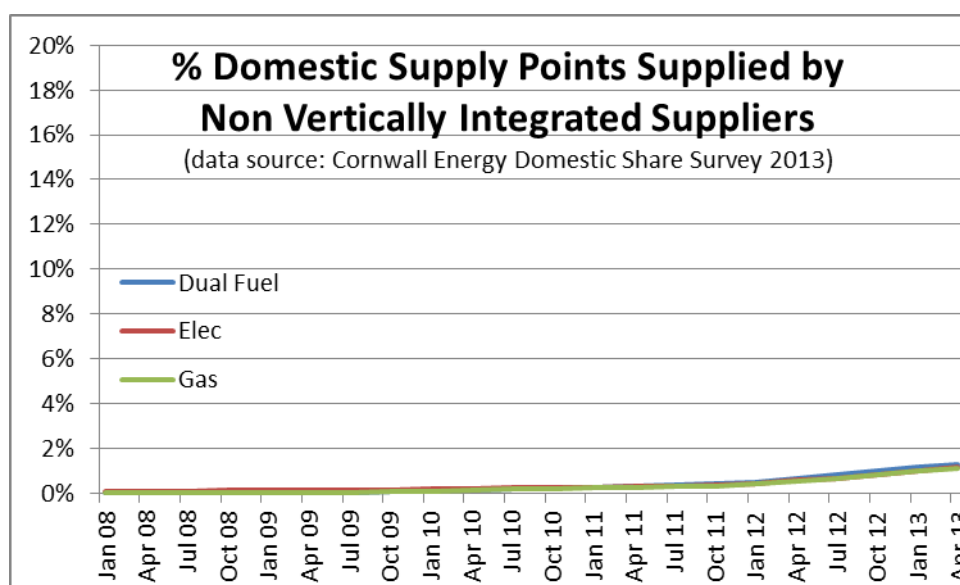


Figure 1 illustrates the level of UK domestic supply market share not held by the vertically integrated suppliers over recent years. The level of market penetration by new entrants into the UK domestic electricity and gas supply sector is very low despite the energy retail market being opened to competition more than 15 years ago. The scale on the vertical axis is adjusted to 20% as the lines depicting non-vertically-integrated market share would not be clear to see if this was scaled to the entire market. In 2013 only slightly over 1% of all domestic energy supply points are supplied by non-vertically-integrated market participants. There has been a modest increase in market share outside incumbents in recent years, but we note this is a very small effect. This contrasts markedly with the change in market share in other retail markets reliant on networks that have been opened up to competition, where progress has been far faster and effective, to the benefit of consumers. The telecommunications industry is a good example of this where in Q4 2012 the incumbent integrated supplier BT held a 45.7% share of fixed telephony retail revenues<sup>1</sup> rather than the >98% share held by the incumbent big 6 suppliers in energy.

We believe the stagnant energy retail market with low volumes of market share outside the big 6 is a reflection of the huge barriers to new entry and new entrant growth in the energy retail market. Lack of liquidity is the key barrier, due to the vertical consolidation that has occurred in the industry driven by the structural design of punitive dual-priced cashout under NETA. Urgent steps need to be taken to remedy these steep barriers to competition. We recognise that moves to single priced cashout are being considered under the cashout SCR and we welcome these steps, but we believe that a liquidity intervention is also urgently required.

In the recent sessions of the Energy and Climate Change Committee on “Energy Prices, Profits and Poverty”, many questions were asked by the committee to understand liquidity in the context of the nature of trading activity in the vertically integrated market players. Some of those players claimed to trade 90% of their generation into the wholesale market and source similar proportions from the market for their retail businesses<sup>2</sup>. If this is the case, it would be expected that a far wider range of products should be trading in the forward electricity market as each side of the business independently sought to discover prices for a range of products that support hedging. However, for peakload forward products there are very few bids and offers, while for forward ‘blocks’ and more granular forward products there is almost never a bid or offer. We believe this is inconsistent with the statements made on forward hedging activities, which suggests that more needs to be done to understand how much electricity is truly sold from integrated generation businesses into the market, how much is bought from the market by the integrated retail businesses, and how much electricity is transferred internally between those entities. We believe that the best way to understand this is to gather information on all ECVN and MVRN activity between the consumption and production accounts across all the BSC entities under each Big 6 parent company. This is data that Exelon hold. We note that it is insufficient for the market that such products only trade very close to delivery: liquidity is required in all forward products for all forward tenors in order to facilitate fair access for all players and true competition.

First Utility believes that high levels of wholesale liquidity are fundamental to creating a vigorously competitive wholesale hub. Intervention at the wholesale level will drive down barriers to new market entry and growth, both upstream and downstream of this hub, delivering vigorous competition that will benefit consumers in terms of price, service and innovation. First Utility faces on a daily basis the significant structural barriers to driving enduring retail competition, all of which stem from the issues at the wholesale level. We intend to remain at the forefront of these issues, championing improvements for all energy consumers across the UK. We view illiquidity and its root causes as the key barrier to competition across the generation, wholesale and retail markets in the UK.

First Utility analysis suggests that lack of liquidity has a significant detrimental impact on consumer prices in the domestic energy retail market. Independent suppliers are disadvantaged by the illiquid market due to the combination of (i) higher shaping costs relative to vertically integrated suppliers and (ii) exposure to higher volumes of imbalance (hence higher costs of imbalance) in the punitive dual priced cashout regime, due to lack of access to flexible generation close to delivery. We estimate that the sum of these two effects increases the wholesale cost of supplying Profile Class 01 (domestic) customers by up to £50 per year at average consumption levels. If wholesale market liquidity was remedied to create a level playing field for all suppliers, this could benefit the 26 million UK domestic energy consumers by in aggregate £1.3 billion per year. Lack of liquidity represents the most significant obstacle to creating a level playing field. A remedy for liquidity will drive down barriers to competition and deliver direct financial benefits to consumers.

We welcome the desire under Electricity Market Reform to increase wholesale liquidity and we would support significant intervention that is urgently required if this issue is to be successfully addressed without the need to call on backstop powers under the Energy Bill.

**A: The reasons why a Self-Supply Restriction is the best and most enduring solution**

First Utility believe that the enduring solution (and the one likely to drive the most immediate impact in solving the liquidity problem) in the UK electricity market is a Self-Supply Restriction (SSR). We believe this because a SSR would specify the one activity that a mandated participant could not undertake: the transfer of wholesale electricity from its generation arm(s) to its retail arm(s). This would leave all participants needing to contract their generation sales into the wider market and contract all their retail purchases from the wider market which would drive:

- **An immediate step change upwards in liquidity** – as any remaining internal transfers would be replaced by sales into the market and purchases from the market, at market prices, leading to more access to product (in particular products that leverage plant flexibility including shaped product) for all players
- **Step change improvements in the robustness of price discovery** as it would be now be based on vigorous supply and demand fundamentals rather than trading around the edges of a portfolio – this is important to ensure that the several billions of pounds of annual CFD payments under EMR are not gameable due to the illiquid market against which they are set. There will be clear CFD FIT gaming opportunities in the absence of a liquid and robust market price.
- **Product discovery** – particularly for forward peakload, block and other forward shaped products, as all the mandated suppliers would suddenly need to go to market to source all their forward shaped power requirements
- **Confidence** for consumers, regulators, auditors and other interested parties that transfer prices between generation and supply arms in vertically integrated businesses are trustworthy – as those prices would now be market prices based on executed trades rather than large internal volume transfers at a market price linked to lower volumes of trading in an illiquid market. Transfer pricing has been identified as a significant issue in large companies in other contexts such as its potential links to management of corporation tax liabilities. Market-based mechanisms are a clear way of removing lack of transparency.

Most importantly the above improvements would level the playing field by removing the wholesale market cost disadvantages of being an independent supplier. Natural competitive forces would remain in place – as this kind of intervention would leave companies free to choose who they sell to or buy from, when they time their sales and purchases, at what price, and would only describe the one activity that cannot be done. These features of an SSR would drive up competition at the wholesale market level and both upstream and downstream, which would be hugely beneficial to energy consumers.

Up to £110 billion of investment is required in the UK electricity industry, which will ultimately drive up consumer bills, so it is more important than ever to ensure vigorous competition at the wholesale level keeps the size of these retail increases for consumers to the minimum possible. In this complex market we find the simplicity of a SSR and its clear beneficial consequences compelling.

## **B: How can a 'Secure and Promote' approach drive some benefits?**

In the absence of Ofgem progressing SSR, First Utility believe that there could be a version of the Mandatory Market Maker (MMM) that could deliver some of the benefits to liquidity we describe, though we do not think the final proposals achieve this. We describe below some changes that will improve the likelihood of driving some benefit to liquidity from the S&P approach, though we note that even with this approach the benefits will be far lower than those from a SSR.

### **Supplier Market Access Rules**

While First Utility do see the potential for some benefit from the MMM elements of the Secure and Promote (S&P) proposals (if some of the proposals are modified) we do not see as much benefit in the Supplier Market Access Rules (SMAR) under S&P. The three main trading terms that drive stalled commercial negotiations between incumbents and independents are price, product and credit. We recognise that more risk-averse market participants who are more concerned with defence of existing market shares than of building new commercial relationships will be more conservative and less innovative in commercial offerings. We see little scope for SMAR to drive improvements in these areas. We welcome the aims of Ofgem to deliver improvements in the likely terms for trading between mandated players and small suppliers, but we continue to believe that higher liquidity in itself will be the driver of improved and more scalable trading terms once more (and more innovative) participants enter the wholesale market.

### **Mandatory Market Maker**

We believe that, if S&P is to have a meaningful impact on liquidity in the UK electricity forward wholesale market, the MMM rules will need to be far tighter than those in the S&P final proposals.

### **Wider Product Range**

There needs to be a much wider set of products mandated to be available in the forward market., in particular mandated trading of four hourly 'Blocks' of Weekday and Weekend day seasonal forward products, and the mandated trading of products with monthly as well as seasonal tenors. Non Half Hourly customers are settled against a half hourly intra-day profile, which differs significantly from the intra-day profile of baseload and peakload products. Please see the confidential Appendix for further details. If a vertically integrated supplier leaves those differences to be managed at delivery and the cost of 'true up' trades at delivery increases sharply, this drives an uplift in generation profits and a drop in retail profits, but the integrated business sees limited impact on the combined profit. It is therefore less important for a vertically integrated supplier whether more granular products appear for trading on a forward basis or only appear in the spot market. This illustrates one of the key benefits vertical integration offers in the current market design. The key difference for independent suppliers is that they do not have the offsetting upstream business to mitigate the risk of spot market price spikes – in the same scenario described above an independent supplier would only see the drop in profits, which illustrates the increased risk exposure to lack of liquidity in shaped products faced by independent suppliers. In a liquid and fully competitive energy market there would be liquidity in the form of bids, offers and executed trades for standard 'shaped' products (such as blocks) on a forward basis as well as on a spot basis. This is because suppliers of all types should need to make the value judgement of when is best to lock in electricity 'shaping costs' on behalf of their customers. Lack of such products having forward liquidity is a key indicator of lack of wholesale competition.

If the MMM is to assist smaller/independent suppliers, it needs to stimulate liquidity in some of these more granular forward products, that they often cannot easily or cost effectively access, in order that it provides suppliers with the option of locking in their shaping costs ahead of time. It is not possible for a market to facilitate enduring retail competition if it does not support access to the wholesale products reasonably required in order for all participants to manage their risks appropriately. These products would help form a more 'complete' forward market so that the playing field becomes more level. **As a bare minimum, the market needs to see weekday and weekend blocks 5 and 6 for the front two seasons available under the MMM scheme.**

The block products we propose to be mandated under the MMM will drive price discovery for plant flexibility (as a generator needs flexibility to ramp up and down output to shape a block) along the forward curve. In so doing, this will provide a more complete set of risk management products for energy retailers. We have supported the SSR approach because it would drive these products instantly into the forward market - because all participants would suddenly need to trade these products – so we would need to see such products come into the forward market under the MMM if S&P is to have a chance of being successful. We note that without these products there is not a 'complete' forward wholesale market in which a supplier can forward hedge their retail demand without leaving significant risks in their business. The key financial benefit of more granular product availability than that proposed would be to reduce shaping risk and cost disadvantages (as described above) that independent suppliers face relative to integrated suppliers. Availability of these more granular products on a forward basis will drive confidence that retailers can manage market risks appropriately and cost-effectively and in so doing it will drive down barriers to entry. Transparent pricing of these products will also drive price discovery for the value of plant flexibility, which is an important price signal to restore confidence for upstream generation investment.

### **Tighter and Aligned Bid – Offer Spreads**

First Utility do not believe that the emergence of bids and offers is in itself sufficient – there needs to be a significant increase in the volume of trading activity in forward products driven by any intervention if it is to be successful.

First Utility note that by mandating upper limits on spreads there is implicit risk that trade bids and offers collapse onto the exact upper percentages proposed. A mandated counterparty can arrange their bid - offer pair so that the market mid-price is not in the middle of the range. In so doing a mandated counterparty drives the probability of executing trades via the MMM towards the natural direction they currently want to trade anyway, which will make trades executed under the MMM likely to be part of normal trading activity in the market. This is a method by which the mandated counterparty may tag 'normal' activity as MMM activity, ticking a regulatory box but adding limited extra liquidity.

First Utility believe that to guard against this the bid-offer spreads mandated need to be tighter than those proposed in particular for peakload and other shaped products. This is important in order to increase the likelihood and number of transactions occurring under the MMM. Lower spreads will reduce the ability of mandated players to effectively employ the above strategy.



We note that an added benefit of tighter bid-offer spreads is that transaction costs are lowered for all participants, increasing market efficiency and increasing the appeal of the market to a more diverse range of participants.

### **Higher MMM Availability**

We believe that MMM obligations need to be in force for at least 80% and not 50% of the time and we believe there should be rules to minimise the ability of mandated players from performing MMM activity at the points in the day of lowest trading interest in the market. This strikes a better balance between granting the ability of mandated parties to manage market risk in volatile periods and ensuring the intervention delivers consistent improvements to liquidity.

An alternative that has been discussed is to use 'trading windows' and oblige the MMM to continuously trade within those windows. We note there has been discussion around narrow windows and we are concerned that this will concentrate liquidity within too narrow time periods, which is likely to create unintended consequences, for example in the correlated gas and carbon markets. We would also be concerned that a narrow window is more gameable than a wide window under the assumption that the volume weighted average trade price of executed trades in the window is used to set the CFD indices, against which several billion pounds under CFD contracts will be settled. This is clearly not in consumers best interests. We would support the alternative of a trading window if it was a wide window from 10am to 3pm, or at the very least 50% of the traded day to ensure that the MMM availability is consistent with the initial 50% proposal from Ofgem. This would ensure that liquidity is there when participants need to trade.

We note that there are concerns around 'fast market' conditions, and understand the need to mitigate those risks. We would support this as long as the rules are consistent with such conditions in other markets where they have been successfully employed.

We note that volume caps have been discussed under availability. First Utility does not believe volume caps are appropriate as they would significantly undermine the purpose of the intervention: to drive up the volume of executed trades in the market. We believe that the availability of bids and offers is necessary but not sufficient to demonstrate a liquid market; the churn multiple is the clearest leading indicator of market activity and is also the leading indicator of a market price that is more robust. Volume caps would undermine the ability of the intervention to significantly improve churn multiples.

### **MMM on Vertically Integrated Participants**

We understand the concerns regarding market making in the context of emerging European financial legislation. We agree that if MMM activity brings participants within the scope of that scheme, such suppliers could nominate a 3<sup>rd</sup> party to fulfil the obligation, but the costs of so doing should be payable by that third party, and the obligation (and risk of enforcement for non-compliance) should lie with the mandated participants. We note that a SSR avoids this issue completely.

While it is possible that a wider industry-tendered approach to market making could be possible, we do not believe that the case has been made that this would deliver more benefits or deliver at a lower cost to the industry. We believe that action on liquidity should be taken immediately and we have concerns that an industry-tendered approach would take more time and for uncertain cost or benefit to competition.

The current lack of liquidity is due to the structure of the main players in the market, which has evolved in a vertically integrated manner to mitigate market and credit risks. We note that this is a rational economic decision in a market design that has a punitive dual-priced cashout regime, but it has come at the cost of disadvantage to independents, high barriers to entry, wholesale and retail stagnation. Given that integrated players own approximately 80% of the UK generation fleet it makes sense that these players are the ones mandated to release more of their generated volumes into the traded forward market if the liquidity problem is to be solved. We thus believe that the MMM requirement must be placed on the vertically integrated utilities. If the MMM obligation was industry tendered, the costs and risks of the liquidity intervention should fall on the integrated utilities too.

### **Ring Fencing of MMM Trading**

We believe that the MMM activity needs to occur independently from other trading activities, in order to minimise the risk that existing trading activity gets tagged as extra MMM trading activity. The liquidity intervention must drive new liquidity into the market and not be a means to 'tag' existing liquidity, otherwise this intervention would risk becoming a 'box ticking' exercise of little benefit.

These key modifications are required to ensure that Ofgem minimise the opportunity for mandated players to employ timing, product and bid-offer spread strategies to reduce the number of MMM transactions they must execute, which would frustrate the intentions of the MMM and increase the likelihood of reserve powers needing to be called on under EMR to drive up liquidity.

### **Importance of an Enduring Liquidity Solution**

We believe that a successful forward market liquidity intervention must deliver improvements on a number of key performance indicators:

- Higher level of overall churn in the forward market
- Higher level of churn in each forward product
- More peakload and shaped forward products traded
- More reliable (robust) and transparent forward prices
- Increase in depth of the market (more bids and offers on each product)
- Entry of new intermediaries and increased participation of existing intermediaries
- No evidence of gaming of the CFD FITs
- More independent participants entering both upstream and downstream of the wholesale market
- Increased retail competition and innovation

We would support Ofgem in designing wholesale market key performance indicators around these metrics so that they can monitor the evolution of the market and intervene further if progress is not made in all areas.

We welcome the opportunity to discuss our concerns and ideas further as we see liquidity as the key barrier to entry and barrier to competition in the UK wholesale, generation and retail markets. Given that this is a time of significant investment in UK electricity infrastructure, which will drive energy retail prices significantly higher, it is crucially important that this issue is addressed in order that energy retail price increases over the coming decade are minimised via vigorous retail competition.



## **Answers to Response Questions**

### **Question 1:**

#### **Do you agree with our updated assessment of the wholesale market?**

We believe that liquidity along the forward curve in the UK wholesale electricity market continues to remain extremely poor, which damages competition upstream and downstream of the market. We are particularly concerned by the lack of peakload product trading and the almost complete absence of any more granular products forward trading. A successful liquidity intervention needs to address the lack of liquidity in the most basic forward products (baseload and peakload in the front few seasons) but it also needs to address this lack of a 'complete market' for forward traded products that match the intra-day consumption patterns of retail consumers. Without this, the intervention cannot serve the needs of independent suppliers.

We believe that forward 'block trading' should be mandated under any liquidity intervention in order to facilitate the development of a more complete forward market, and to establish a forward price for products that leverage plant flexibility (the ability to ramp up and down output from flexible generation units). Such a forward price signal would aid volume and price risk management for investors in flexible generation units and for electricity retailers selling energy to customers who consume in a very different pattern to the simple baseload and peakload products. We note that domestic customers do not consume electricity in a profile that matches baseload and peakload products – there are some very significant differences between this profile and the standard Profile Classes that non-half-hourly electricity MPANs are settled against. Please refer to the confidential Appendix for further details.

### **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?**

We agree that intervention is urgently required, but we believe the intervention proposed needs to be modified if it is to deliver liquidity benefits.

First Utility believe that a significant liquidity intervention is urgently required in the UK wholesale electricity forward market if it is to truly open up and drive the vigorous generation and retail competition which would ultimately benefit UK retail energy consumers in the form of innovation, lower prices and better service. A significant intervention is also required to ensure that the CfD FIT indices under Electricity Market Reform are not gameable. These indices will be used to settle contracts for a significant amount of the monies available under the Levy Control Framework (£7.5 billion pounds annually by 2020), which will be collected via a CFD FIT Supplier Obligation, ultimately borne by UK retail consumers.

While we clearly agree that intervention is urgently required, First Utility continue to believe that the Self Supply Restriction (and not the S&P proposals) is the most effective route to driving the required step-change in liquidity for standard forward electricity products. It would also immediately drive 'product discovery' on non-standard products that would facilitate more accurate forward hedging of both Half Hourly customers and Non Half Hourly Profile Classes. Lack of ability to accurately hedge forward consumption patterns is of particular concern for independent suppliers who do not have the ability to hold back from the forward market the flexibility in their generation plant in order to retain it as an imbalance risk mitigant for their own retail customers – as such suppliers do not own generation plant. We believe that if the market is intended to enable new retailer entry and drive downstream competition, it can only be successful if the hub of the market – the wholesale market – is a complete market that allows such pure downstream participants to access all the product they require, in the volumes they require, at prices that do not disadvantage them relative to participants that are vertically integrated.

If Ofgem do proceed with the Secure & Promote approach set out in the final proposals, we believe that in order to drive an increase in liquidity these proposals need to be modified in a number of ways.

- An wider set of mandated products with higher granularity to support hedging of retail supply positions and to drive price discovery for plant flexibility into the traded forward market
- A higher mandated proportion of the time to Market Make
- A narrower maximum bid-offer spread in particular for peak and shaped products
- MMM activity ring-fenced behind a Chinese wall from other trading activity, and
- A rigorous monitoring and enforcement regime

This kind of approach could drive some liquidity and product discovery benefits. Such changes would be of assistance to independent downstream participants in hedging demand and would increase the ability of market intermediaries to offer innovative risk management solutions to upstream and downstream participants that would facilitate more vigorous competition.

Without this we have serious concerns that the intervention will not make meaningful improvements for independent suppliers, attract new market participants, or drive the step change in liquidity required to make prices robust to support CFD FITs under EMR.

### **Question 3:**

#### **Do you agree with our proposed legal approach to S&P?**

We agree. A significant driver of low liquidity and the lack of a 'complete' set of products in the UK electricity forward market is the withholding of products related to plant flexibility at the forward trading stage. These products are more often released at delivery for internal supplier needs.

Mandation via generation licences seems to be the appropriate way to drive the release of more products for sale into the forward market.

**Question 4:**

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

We believe that the driver of low liquidity in the UK wholesale electricity market is vertical integration. Therefore it seems sensible that an intervention on liquidity is in the form of a mandate on vertically integrated participants.

**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’?**

While we welcome steps to ease supplier access to the wholesale forward electricity market, we believe that vertically integrated utilities are not the most natural innovators in facilitating market access or in the design of credit risk and price risk solutions for independent suppliers. A vertically integrated business model is designed specifically to minimise volumes exposed to these market risks and credit risks. Managing and minimising third party credit exposures is naturally something that a prudent credit department in such a utility would seek to do first and foremost. We also note that there is a natural conflict of interest because if such a vertically integrated participant was to design such solutions, they would be building the ability of a rival new supplier to take away market share from them. The forward liquidity issue needs to be solved in a way that manages such conflicts of interest.

Given this, we are concerned that Supplier Market Access rules will not drive significant benefits for independent suppliers; the liquidity intervention itself is several orders of magnitude more important than the proposed Supplier Market Access approach. We continue to believe market access can be best improved for independent suppliers via a step change increase in liquidity for baseload, peakload and forward shaped products. This will provide a price and liquidity signal for more intermediaries to enter the market with confidence that they can effectively manage and warehouse these risks - and in doing so innovate on these very issues for the independent suppliers.

While the enduring solution to Supplier Market Access can only come via increased wholesale liquidity, we see some benefit to having a framework for discussions between generation owners and new independent suppliers. This will provide confidence, particularly to the smallest new entrants, that they can hold timely, open and fair discussions with the established upstream players who own in aggregate more than 90% of the total market for the products such new entrants require.

Some specific comments on the elements of SMA rules:

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## **A2 – Scope**

We welcome the increase in the threshold for suppliers to fall into this category up to 5TWh/year. We note that if eight named counterparties are each obliged to only offer terms for supply guided by these rules for 0.5TWh, a 5TWh company would have to negotiate an agreement with all 8 mandated counterparties up to the full capacity and still fall 1TWh/year short of the total volume they require. We therefore believe that the 0.5TWh commitment should be increased to at least 1TWh/year per mandated counterparty.

We realise there could be fair and reasonable commercial reasons why a trading line might be removed at a particular point in time (e.g. material deterioration in the balance sheet or credit rating of the counterparty). However, we believe there should be a grandfathering provision to protect any supplier that grows beyond the 5TWh threshold. This provision should ensure that any counterparty who grows beyond the 5TWh threshold cannot have their existing market access removed just as a result of no longer falling within the mandated regime. Cliff edge effects like this create significant barriers to growth and competition elsewhere in the UK electricity market policy design, for example in the design of CERT, CESP, ECO and the Warm Homes Discount. The SSR approach avoids cliff edge risks.

## **A3 – Response to trading requests**

We note that this is a very narrow and highly structured process that leaves little room for the realities of a negotiation.

We seek to understand Ofgem's view of what constitutes good faith negotiation, or what a 'vexatious' request would be, as these terms are not necessarily easy to define. We note that if a supplier seeks to add to or change its trading counterparties, initial discussions would need to be at quite a general level, probably with several counterparties at the same time, with no commitment yet on either side to progress. Given the commitment to trade could only be for up to 0.5TWh out of an up to 5TWh annual requirement, up to 10 such negotiations would have to lead to successful execution of trading documents for a supplier at the upper end of the scale to procure their requirements. The processes described above should all constitute good faith negotiation and non-vexatious requests for trading agreements.

We note that in a volatile market a commitment to respond to a trading request within 3 hours is of no benefit at all to a supplier. For standard market products a trade request should be executable within minutes of it being made and all credible counterparties should be able to commit to tighter timelines like this.

## **A4 – Credit and Collateral**

We note that the SMA rules do not solve the credit issues in the market. An independent supplier with a low or no credit rating could be shown some quite punitive but objectively justifiable credit

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terms. This, alongside trade pricing and lack of wholesale forward product range, will be the reason why such a negotiation often fails – it will not be because there is not a structured and mandated set of rules of engagement between mandated participants and independent suppliers.

#### **A6 – Product Range**

We note that the set of products under the SMA rules do not in aggregate form a ‘complete’ set of products in order that an independent supplier can hedge their customer demand profile. Suppliers are settled on a half hourly basis, yet these products have:

- at best 12 hour intra-day granularity
- no ability to track monthly variations in demand across the forward curve more than 2 months forward
- no ability to purchase weekend peak products (as the market peak product only covers weekdays)

For these reasons the set of products will create some quite serious hedging exposures for counterparties not holding access to the higher granularity products not on this list. Please refer to the confidential Appendix for further analysis of these differences.

We believe that the higher granularity products defined above do not constitute ‘bespoke products’ – they are traded closer to delivery in the brokered wholesale market, but with extremely poor liquidity further forward. While we understand that a fully shaped product with half hourly granularity is a bespoke product, Weekday and Weekend blocks should be standard traded forward products with good levels of liquidity, so we disagree with Ofgem’s view in 3.23 of the consultation document. We note that the view in 3.23 essentially dictates a hedging strategy for suppliers in which they must hold shape risk to delivery – and we have described the risks this uniquely poses for independent suppliers relative to integrated supplier in our general response. We believe mandating a set of higher granularity forward products under the MMM would leave the market to decide if it wanted to mitigate some of this risk further forward or not – but it does not have this choice if those products are not bid or offered forward.

**As a very basic starting point the product list should include Weekday and Weekend Blocks 5 and 6 for the front two seasons forward, and standard products should also be offered with monthly granularity for the first 12 forward months.**

We strongly believe that any successful liquidity intervention must create a mandate that drives higher granularity shaped products into the forward markets than just those specified. We note that this would be an extremely positive development for forward shape price discovery and as an added benefit would put a forward price on flexibility that investors could factor into investment decisions on new generation plant.

## **A7 – Fair and Transparent Pricing**

We believe that counterparties should be able to quote prices on whatever basis they mutually agree. This rule looks too proscribed. We believe that it should simply be a requirement for a Licensee to justify any deviation from the market price in their quotes, with recourse to enforcement action under the licence conditions if such prices are not reasonable and justifiable by an objective 'market expert'.

### **Key Outstanding Design Issues**

We reiterate that the credit and collateral discussion formalisation might deliver marginal benefits to small suppliers – as it will require mandated counterparties to look closely at the credit risks of small suppliers and ensure they are being proportionate in their assessments and can justify their decisions. However, we believe that there are punitive credit terms that could still be justifiable. The way we expect such issues to be solved is via liquidity. Improved liquidity should drive a more competitive market with more robust prices – that encourages more market intermediaries into the market. It is often intermediaries who are able to innovate around credit and market risks on behalf of suppliers. We therefore believe that one metric to measure the success of a liquidity intervention should be an increase in the volume of power traded by market intermediaries and an increase in the number of market intermediaries.

### **Question 6:**

#### **Are there any further areas that these rules should cover?**

We believe the main area that needs to be worked on is the Product Range – which needs to include Weekday Blocks and Weekend Blocks, as well as monthly granularity products for the first 12 months forward on all products.

Finally we think that mandated counterparties should also be required to offer market access to other market participants too (upstream, midstream and downstream participants), not just to independent suppliers. This would be a good way to ensure that, if credit risk was an issue for the mandated parties when offering market access to independent suppliers, they may instead be required to trade with other market players with better credit ratings who might take a different view on the credit risk of independent suppliers if only they had fair access to these products.

### **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'?**

We strongly believe that if the MMM is to drive meaningful immediate benefits it needs to be modified up in the following ways:



### **B1 – Nominating a third party**

We have no issue with mandated counterparties using a third party as this would be a way to ring-fence MMM activity from normal trading activity. We strongly believe that the MMM function needs to be ring-fenced from 'normal' trading activity in each mandated counterparty, perhaps via a 'Chinese wall' to restrict information flow and ensure that MMM bids and offers are not positioned around that participants' current net hedge position in that product. Without such a separation of function there is a strong risk that the mandated counterparty will position their MMM bids and offers around a 'biased mid' - biased towards the direction of trading that participant wanted to execute anyway. This kind of behaviour would enable a counterparty to tag 'normal' trading activity as MMM trading activity. This would 'tick the regulatory box' without contributing extra liquidity to the market.

We believe there is a requirement for a rigorous monitoring, reporting and enforcement regime around this requirement if the MMM is to have a chance of success.

### **B2 – Platform**

We note that by allowing MMM activity on any platform it will push up the cost of monitoring compliance with MMM activity up. We would propose that MMM activity should be focused on the main market place for UK power forward trading activity – the brokered wholesale forward market. There are software trade aggregation services that could be used to provide a single collated view of all brokered UK wholesale market activity. We believe Ofgem should require mandated counterparties to tag bids and offers as MMM related or not at the point of publishing those bids or offers (not after the event) and the timestamps of these actions (when they were published, executed and withdrawn) will enable the mandated counterparties to monitor compliance with the Availability requirements.

### **B3 – Products**

The suite of forward products needs to be widened so that more shaped products than simple peakload is mandated. We propose that the following products changes are made:

- Weekday Blocks and Weekend Blocks should also be mandated
- The front 12 months of forward products should all be tradable with monthly as well as quarterly and seasonal granularity

As an absolute minimum requirement, seasonal weekday and weekend blocks 5 and 6 should be also mandated under the MMM.

### **B4 – Availability**

We believe the percentage of time that each mandated counterparty must act in a MMM capacity needs to increase substantially – we propose that this should be at least 80% of the time, tested

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daily, or 100% of the time between 10am and 3pm when the market is more active. We are concerned that if the percentage is set at the far lower 50%, it would be natural for the MMM activity to be scattered throughout the trading days at times when other market participants are far less likely to want to execute at trade.

We believe Ofgem can monitor this risk by comparing the points in time when MMM actions were carried out relative to times when the general market trade executions occurred. Ofgem should set requirements on the MMM activity that ensure MMM actions are not purposely carried out mainly at times with the lowest likelihood of trade execution occurring.

### **B5 – Bid – Offer Spreads**

Bid offer spread needs to be tighter. We note that wider bid-offer spreads lower the probability of trade execution at those bid or offers. Thus by mandating a wider peakload bid-offer spread (than that for baseload) Ofgem will be giving regulatory consent for lower liquidity in peakload. We would prefer to see a single low bid-offer spread for all products and would propose that Ofgem sets the maximum bid-offer spread for all MMM products nearer the baseload level of 0.3%.

We note that there will be rounding questions to address with a percentage bid – offer spread limit. We propose that this is managed by MMM prices being rounded down to the nearest tick size on offers, and rounded up to the nearest tick size on bids in the event that the bids and offers are at the upper limit of the requirement. This would ensure that rounding is not a way to increase bid-offer spreads and decrease the probability of trade execution.

### **B6 - Obligation to trade**

We agree with this fundamental requirement – otherwise it would not be a mandatory process and would have no benefit.

### **B7 – Trade Size**

We believe that the minimum trade size should be 1MW not 5MW, with a requirement to trade any size in 1MW increments up to 10MW at the price posted.

## **Key Outstanding Design Issues**

### **Balance of Costs and Benefits**

We strongly believe that the balance has been tipped towards the Low Cost/Low Benefit region in the diagram of Figure 10 in the consultation document. We are very concerned by this as we believe this is insufficient for the following reasons:

- The products are not granular enough or a broad enough set to allow independent suppliers to hedge their forward price risks on their demand profile appropriately. This reinforces the lack of liquidity and lack of product discovery in the current wholesale forward electricity
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market. We note that a Self-Supply Restriction would have instantaneously driven a huge market demand for granular forward shaped products – as the big 6 suppliers would suddenly need to source all their forward shape requirements from the wholesale forward market and not via an internal transfer within the vertically integrated utility. If the MMM is to have a chance of success it needs to drive up activity in shape products that are more granular than peakload alone – which is why we propose forward block trading requirements too under the MMM.

- Mandation for a low percentage of market open time (such as 50%) provides more ability for the mandated counterparties to choose the ‘low activity’ times to post their bids and offers in order to minimise the chance of MMM bids and offers being executed as trades. This undermines the likelihood for the required step-change increase in liquidity, which is hugely important in order to establish the robust reference prices required for CFD FITs under EMR.
- Wide bid-offer spreads, particularly for peakload, reduce the likelihood of trades being executed under the MMM. This undermines the likelihood that the MMM can drive a step change increase in liquidity.
- Maximum volumes should be aligned with the maximum volumes in standard traded products elsewhere in the UK electricity forward market, which is typically 10MW. We believe trades should be executable for any volume from 1MW upwards, in 1MW increments up to the maximum.

#### **Alternative delivery mechanism for market making**

We strongly believe the industry tender approach outlined in 4.24 would be the wrong approach. The main driver of low liquidity is vertical integration. It therefore stands to reason that the solution can only come from a mandate on vertically integrated parties to make a market for products that are currently illiquid or even not traded on a forward basis at present. Market intermediaries will come back into the market if liquidity returns and could drive a positively reinforcing cycle rather than the current situation (where low liquidity drives vertical consolidation that drives further reductions in liquidity in a negatively reinforcing cycle).

#### **Question 8:**

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

We believe that the costs of a well-designed intervention will be tiny in comparison to the benefits to competition that would drive down prices for end consumers. First Utility estimates that a liquid wholesale market could benefit domestic energy consumers by up to £50 per household per year, or approximately £1.3 billion per year in aggregate. Please see our confidential Appendix for further details.

While we believe the costs might not be fully justified versus the benefits given the detailed design in the final proposals consultation document, we believe our proposed enhancements to the MMM

(as outlined in the answers to previous questions) would tip the balance and drive more of the benefits (although not all of the benefits of a SSR) we would expect to see from such an intervention.

We believe Ofgem should state clearly the measurable key performance Indicators of success, and publish these frequently, with a clear timeline for further refinements if such an intervention is not delivering the benefits Ofgem require them to.

**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?**

We do not believe an industry-run tender process can be successful. Please see our answer to question 7 for our detailed reasoning.

**Question 10:**

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

First Utility believes that the main issue in the UK electricity market is lack of liquidity in the forward electricity market and not the spot market. Suppliers typically only make a small proportion of their trades in the spot markets and most market participants are far less concerned about the spot market. It is the lack of a liquid wholesale forward market and lack of forward shaped products that drives the risks to independent suppliers as it is these products that are required in order for suppliers to lock in a hedge to remove wholesale risk in their business and operate competitively. We believe that a liquid forward market can unlock competition and can only be a good thing for spot market liquidity too. We would therefore recommend that Ofgem focus on solutions to the far bigger issue of illiquidity in the forward wholesale market.

**Question 11:**

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

Yes we agree as this would distract from the main issue of the forward market illiquidity which is of far greater concern. We believe that spot market activity will naturally increase if an intervention to increase forward market liquidity is successful, so Ofgem should focus efforts on the forward market liquidity problem.

## References

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