NASDAQ OMX Response to OFGEM consultation

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

August 8, 2013

Question 1: Do you agree with our updated assessment of the wholesale market (set out in this chapter and appendix two)?

NOMX largely agree with Ofgem's assessment of the current UK Curve Market particularly in terms of liquidity and price availability. However, NOMX would place more weight upon the low number of active participants than bottom line liquidity levels.

At the July 23rd Secure and Promote Roundtable it was widely accepted that the number of regular curve participants is significantly below 20. Similarly, the trend reflects an ongoing decrease in participation and the block exit of all but a small handful of financial participants. NOMX argue that the limited and homogenous participant list hampers the development of UK Power as an attractive tradable commodity. As financial players do contribute greatly to overall market liquidity, NOMX would advise to focus on including more financial, and fundamental, participants in UK Power market to boost liquidity.

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

Ofgem's belief is that 'particularly independent market participants' struggle with price availability and liquidity in the Curve Market. NOMX would go one step further and hold that the existing market structures also serve to discourage new entrants from participating in the UK Power Market and that this is of equal importance.

NOMX believe that Secure and Promote will go some way to improving price availability for those Physical participants already trading the curve. Such participants should also gain some confidence that a set group of contracts will have reasonable spread availability during a significant part of the trading day.

However, we are skeptical as to the wider benefits of the intervention and believe that general liquidity levels, participation and the availability of robust reference prices will remain largely unchanged. So long as new entrants are discouraged from entering the marketplace liquidity and trading activity will not grow to desired levels. Current activity levels reflect the limited appetite for trading amongst the similarly limited participant group. The general complaint from existing traders is that prices are not available on a wide range of contracts and that spreads are too wide. NOMX argue that the most significant contributing factor to this state of affairs is the absence of pure trading participants acting as liquidity providers.

We argue that a critical reason for this is the current bilateral and physical nature of the UK market requiring all participants to complete a laborious and financially demanding set up process before trading can begin:

i) The reliance of the market upon Bilateral Credit Arrangements entails that GTMA agreements must be drafted between all active participants before a new entrant can begin trading. The drafting of GTMA's is estimated to cost on average 40k GBP per participant per side requiring an initial investment of 800k GBP to any new entrant
ii) The physical nature of the existing marketplace requires mandatory BSC accreditation along with the associated Elexon collateral and notification staffing costs (est. annual cost of 1M GBP)

In conclusion, NOMX support the intentions of Secure and Promote and hope that it produces more competitive and reliable prices. At the same time, we argue that the intervention does not address the fundamental barriers to entry that have hampered the development of the UK Curve Market over the past decade.

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

No Comment

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

No Comment

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'?

NOMX support the objectives of the SMA rules to improve market access to smaller participants. However, we question the operation of the credit and collateral arrangements. Under the proposal credit negotiations will continue on a bilateral basis and will vary from counterparty to counterparty. We question the possibility to effectively oversee these arrangements in a fair manner and predict significant increases to administrative work for both licensee and counterparty.

Similarly, we doubt that this process can be standardized across the licensees and would expect to see wide differences in terms of Risk appetite and calculation of collaterals.

Finally, we are quite skeptical to the method of monitoring the licensees' compliance with SMA rules as proposed in S&P. In the coming EU Wholesale market regulations (REMIT)market participants are required to report from 2014 all bilateral energy transactions to relevant EU Authorities . To comply with REMIT obligations S&P licensees will need to report their orders and trades with only a few days delay. A similar reporting scheme could be used for monitoring SMA rules. We believe more frequent reporting will contribute to:

1) Incentivizing licensees to comply with the rules
2) Providing a more reliable update if the intervention works according to the objectives

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

No Comment

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'?

There is a need to further assess the relationship between market making under S&P will operate in relation to EMIR, REMIT as well as the proposed MIFID II. In particular the proposed exemptions from MiFID II that refer to non-financial participants and physically delivered contracts needs to be given proper consideration. We believe that the impact of S&P design on participation of financial participants in light of abovementioned regulations requires further analysis. Otherwise the successful delivery of the initiative will be threatened and/or create uncertainty for participants.

The S&P proposals tend towards a business as usual attitude when it comes to platform and contract choice. Ofgem have recognized that the existing UK Curve market is 99% Bilateral and 85% Physical and have reflected this bias in their draft market design being unwilling to force drastic market change at the same time as introducing enforced market making.

NOMX fear that by permitting S&P Market Making to take place within existing market conventions (ie Bilateral Credit and Physical Delivery) that Financial Counterparties, due to other legislation such as EMIR or MiFID II, will be effectively barred from using the very liquidity pool that Ofgem seek to develop through S&P. In our understanding existing UK Curve participants seek to continue to act under the exemptions provided under MIFID and it should be further considered how this would be affected by the implementation of EMIR and the clearing obligation for Non-Financial Counterparties and for physically settled contracts. NOMX recognize that this may appear to be a more cost efficient option to firms with existing bilateral credit arrangements in place. For this reason NOMX understand the rationale behind Ofgem's intention to permit S&P Market Making through existing channels in the hope that the contracts retain a Physical Contract exemption from the definition of financial instruments under MIFID II for the benefit of Non-Financial Counterparties.

However, such a solution will serve to enshrine the current modus of the curve market and could when EMIR and MIFID II is implemented practically exclude Financial Counterparties from access to the S&P Market Making prices. Furthermore, this solution could exclude Financial Counterparties from acting as a 3rd Party Market Maker as envisaged by the S&P documentation. And potentially, even preclude the Big 6 themselves from acting as Market Makers if they are unable to find exemptions from clearing under EMIR as NFC+ entities.

Given the above, we consider it fundamental to the design process that a full analysis be carried out on the regulatory implications to the market making initiative under Secure and Promote. And to ensure that the improved price availability targeted by S&P be available to all potential participants both Physical and Financial.

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

No Comment

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?

NOMX do not believe that the industry will be able to attract a Financial Counterparty, as defined in EMIR, to tender for market making services under S&P in its current form. We refer to our answer above under Question 7 for the reasons lying behind this view. We again draw attention to the current narrow makeup of the UK Curve trading community and the general lack of interest amongst Financial Counterparties to participate in the Ofgem consultation on Secure and Promote. The roundtable event on July 23rd being a case in point at which there were no representatives from Financial Counterparties in attendance at potentially the most significant meeting for determining the future path of UK Curve market development.

NOMX believe that one or two of the existing Big 6 currently acting as quasi Market Makers on the UK Curve might be willing to extend their current activities to become a formalized UK Power Market Maker on behalf of the whole industry but that this would need to be under a commercial agreement acceptable to all. We also repeat our concerns that such an entity would need to consider and most likely seek exemption from MIFID II and EMIR in order to fulfill such a role.

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

No comment

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

NOMX share Ofgem's assessment that the short dated market is much improved since the launch of N2EX in 2010 and the associated growth in the day-ahead auction. As such we accept Ofgem's current strategy of ongoing monitoring as opposed to intervention.