Phil Slarks
Wholesale Markets
Ofgem
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Dear Phil,

<u>Wholesale power market liquidity: final proposals for a 'Secure and Promote' licence condition</u>

Statoil UK Limited ('STUK') welcomes the opportunity to respond to the final proposals outlined in the consultation document and appreciates the opportunity for direct stakeholder engagement through the workshop held on 23rd July 2013.

As an independent market participant, STUK supports measures to enhance wholesale power market liquidity provided they allow for proper market-functioning and hence allow the market to develop in response to such measures. In our previous consultation responses we have stated our support for a Market Making Obligation (MMO), as was first discussed in the February 2012 consultation document, as we believe this better meets Ofgem's objectives for market liquidity through a 'lighter touch' approach compared to the Mandatory Auction (MA) which was also proposed. Therefore we welcome the inclusion of a MMO in the Secure and Promote (S&P) licence condition and the general thrust of the proposals to improve the liquidity of the forward market. We believe a MMO has the benefits of introducing depth, through the entry of additional parties such as financial institutions that work with the grain of the market as these entities would be responding to price signals.

We believe there is progress in the liquidity in the day-ahead and prompt markets and so a monitoring and reporting requirement is more appropriate, particularly given other regulatory and non-regulatory developments. However implementation and monitoring will be key in ensuring S&P achieves the significant increase in liquidity and potential benefits to consumers that Ofgem is seeking, while keeping to a minimum the cost on market participants.

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

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

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

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

At a high-level, STUK agrees that developments in liquidity in prompt and day-ahead markets are encouraging, but for products beyond this the picture remains far less promising. There has been little improvement in liquidity along the curve so this should be addressed as a priority. On the level of churn in the GB power market, the comparison of Q1 2013 to Q1 2012 (2.9 to 3.2) suggests it is more likely than not that the annual figure for 2013 will be lower than that of 2012 – which would mean a fall for four years running.

The very recent tightening of bid-offer spreads is, as you suggest in your consultation, perhaps more likely due to seasonality in trading volumes and the falls in the gas spread over the same period. We do also believe that the effect of the upcoming policy transition to Electricity Market Reform on power trading is significant.

Therefore in order to meet Ofgem's liquidity objectives we believe an intervention in the market is necessary but, as mentioned above, such an intervention should be as 'light touch' as possible so as to work with the market and not lead to unintended consequences. In general, we believe the revised proposal for an S&P licence condition as set out in your June consultation document strikes this balance and is in line with previous Government statements on the need to improve liquidity.

Small suppliers face considerable barriers to entry, and so it is appropriate to introduce conditions on the largest generators in the market in order to improve their access. Similarly it makes sense to set a condition on the current largest suppliers, whose firms are also the largest players in the generation and supply market when considered as a whole, to market make as they are best placed to be able to do so. Hence the proposed set of S&P licensees seems sensible, as to expand the set further would mean diminishing beneficial market liquidity returns on additional costs to industry. However this set should be reviewed to take into account changes in market share or changes in activity of each licensee.

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'?

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

STUK supports Ofgem's recognition that a number of participants have already made efforts to improve their approach to trading with independent suppliers. We appreciate the rationale for these measures, to improve liquidity of products for the use of retail market suppliers, but believe that once the wider issue of market liquidity has been addressed sufficiently they may no longer be needed. We also believe Ofgem has to be consistent on how it will evaluate the success of this proposal.

A particular issue is the question of the "fairness and transparency" of credit and collateral terms – we believe the revised proposal, whereby the S&P licensees are required to offer proportionate credit and collateral terms that follow a clear process is important, in that it allows licensees to undertake proportionate action to manage counterparty risk. While suppliers will benefit from qualification to the SMA list for 12 months, it is important that S&P licensees have the opportunity to revise their decisions on credit should there be a change in credit status.

Small suppliers should get greater feedback on the rationale behind the terms they receive in the Credit Transparency Form (CTF) but there is a risk that this only results in high-level summaries being provided so as to not to divulge commercial information which may affect competition, thus providing little useful information. Hence Ofgem's design of the CTF pro forma will be key.

On fair and transparent pricing, it is highly likely there will be diverging views between S&P licensees and the small suppliers on whether the quotes provided are "reflective of the market price", therefore Ofgem must be clearer on what it means by this.

Another question is the timetable set out to respond to trading requests, where there is a balance to be struck between speed and usefulness of requests for trading agreements, and between the licensee's costs (in having the capacity to respond meaningfully and undertaking appropriate due diligence) and those of the small supplier (in the opportunity cost in making the request and waiting for the response).

On product range, we remain of the view that there may actually be very low interest at first from the smaller suppliers in the full set of standard products proposed, so there may be some merit in a phased rollout.

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'?

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

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?

STUK welcomes Ofgem's confirmation of the MMO as its preferred intervention to improve liquidity along the curve. The success of this proposal should be a more liquid forward market as evidenced by higher rates of churn and greater reference price visibility.

From the stakeholder event we know there has been much discussion around the question of whether market making should be undertaken on a "continuous" basis or via trading windows. While there are risks associated in the latter (e.g. creating market distortions), we believe an approach that stipulates two windows per day of 90 minutes each is preferable since it will provide smaller players greater certainty on when they will have the best opportunity to trade into and out of a particular position in response to changing market conditions. The alternative, a continuous requirement will leave it to each licensee's discretion which could lead to market making being undertaken when it was not needed in the market – and would lead to potential monitoring issues in ensuring that each player has bid or offered for the right amount of time at the mandated bid-offer spreads.

This requirement should be accompanied by a fast market rule to allow licensees to remove bid-offer spreads from the market in response to high levels of volatility, although these should be designed so as to be used only very rarely.

On products, we remain of the view that the maximum obligated trade size should be increased from 10MW to 15MW since this would bring power in line with gas clip sizes. The obligation to trade on posted prices and the maximum bid-offer spreads should mean that the S&P licensees trade a significant proportion of their volumes in these windows.

STUK is aware of the potential impact of MiFID II on S&P licensees and that becoming a market maker could result in their losing their hedging exemption and lead to large additional costs, and that some support licensees may opt to instead nominate a third party to undertake their obligation. There may be greater incentives for a third party to undertake this role more effectively than if this was done by each S&P licensee. But we believe this should not impact on the wider timetable for implementation, nor on the range of products offered. If a prioritised roll-out is taken forward, we would prefer to see all baseload products offered first, followed by peak products.

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

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

STUK believes it is possible that liquidity may further develop in the prompt without further intervention, and hence the case for an active intervention has more downsides than a reporting requirement on the S&P licensees. We do retain concerns that a significant proportion of reported N2EX auction volumes are as a result of Gross Bidding by the larger utilities and hence it might be useful to understand what the actual net traded volumes in this market are. One factor in this is the non-regulatory developments in the market, such as the NWE market coupling project and the introduction of Contracts for Difference under EMR, while another is the Electricity Balancing SCR. Any intervention here must have the aim to facilitate normal market behaviour and raise the number of participants.

Yours sincerely,

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